A PROGRESSIVE SYSTEM OF MARK-TO-MARKET TAXATION

By David S. Miller

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On November 1, the President’s Advisory Panel on Federal Tax Reform released its recommendations. As expected, the panel recommended a repeal of the alternative minimum tax. However, to offset the lost revenue, the panel proposed to eliminate the deduction for state and local taxes, and limit the deductions for home mortgage interest and charitable contributions.

Already, Democrats and Republicans alike have declared the panel’s proposed offsets unenactable. Rep. Charles Rangel, D-N.Y., has promised to “fight to the death” the panel’s proposal to deny the deduction for state and local taxes, House Minority Leader Nancy Pelosi, D-Calif., declared the home mortgage interest deduction “untouchable,” and even Senate Finance Committee Chair Chuck Grassley, R-Iowa, said that the panel’s proposal “just doesn’t meet the common sense test.”

This article offers an alternative that would repeal the AMT, better achieve the president’s objectives, and preserve the deductions for state and local taxes, home mortgage interest, and charitable contributions. It proposes “progressive” mark-to-market taxation as a component of fundamental tax reform.

Under the proposal, all public companies, all private companies with $50 million or more of net assets, and all individuals and married couples with $1.6 million of adjusted gross income or $5 million of publicly traded property — representing the top 0.1 percent of highest-earning and wealthiest individuals — would be required to mark to market their publicly traded property and derivatives.

Mark-to-market gains of corporations would be subject to tax at the current marginal rate of 35 percent. Mark-to-market losses of corporations would be fully deductible against ordinary income or capital gain.

Mark-to-market gains (and qualified dividends) of individuals would be subject to tax at the long-term capital gains rate of 15 percent, and their interest and other ordinary income would remain subject to tax at the ordinary income rate of 35 percent.

Individuals’ mark-to-market losses would be fully deductible to the extent of prior mark-to-market gains, could then be used to offset capital gains, and then mark-to-market losses could offset 43 percent (15 percent/35 percent) of ordinary income or could be carried forward indefinitely.

By a conservative (but back-of-the-envelope) estimate, Miller concludes that the proposal would generate between $490 billion and $750 billion of new revenue over a 10-year horizon. The revenue generated by the proposal would be applied to repeal the AMT.

A progressive system of mark-to-market taxation, he says, would achieve all of the president’s objectives for fundamental tax reform. It would help repeal the AMT but would adversely affect fewer than 400,000 households.

It would not increase rates, deny deductions, or impose new taxes. Therefore, Miller says, it would not violate the president’s “no new taxes” pledge.

Also, he explains, it would help achieve the president’s goal of progressivity, it would allow significant simplification, and it would prevent nearly all tax shelters for mark-to-market property.

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I. Introduction

In his first press conference after winning the 2004 presidential election, President Bush established tax reform as a priority for his second term.\(^1\) In January 2005 the president appointed an advisory panel on tax reform to make recommendations,\(^2\) and on November 1 it issued its report. This coming January, in his State of the Union Address, Bush is expected to introduce his own proposals for fundamental tax reform.

Bush's call for tax reform is not unexpected. Ever since the last major tax reform in 1986, government officials and politicians have periodically called for a fundamental revision of the Internal Revenue Code\(^3\) and several recent developments have again elevated the issue:

- the dramatic increase in taxpayers that will be subject to the alternative minimum tax beginning in 2010 (from 1.3 million in 2000 to 3 million in 2005 to 30 million in 2010, representing 94 percent of all married filers with children that make between $75,000 and $100,000);\(^4\)
- the exposure of a number of prominent corporate and individual tax shelters;\(^5\)


Some commentators attribute the significant decline in the proportion of federal taxes paid by corporations (from approximately 27.5 percent between 1950 and 1959 to 15 percent in 1970-79 to a projected figure of 9.6 percent in 2000-09) to corporate tax shelters. Mihir Desai, "The Corporate Base, Tax Sheltering Activity, and the Changing Nature of Employee Compensation," NBER Working Paper 8866 (April 2002). Those conclusions are controversial. George K. Yin, "The Problem of (Footnote continued on next page.)
Corporate Tax Shelters: Uncertain Dimensions, Unwise Approaches," 55 Tax L. Rev. 405 (2002) ("The measures of a book tax disparity used . . . may both be too crude to capture the book-tax effects of certain corporate tax shelters. Thus, even if shelters are proliferating and causing ever greater discrepancies between financial and tax reporting, existing methods of analysis may not permit us to perceive the existence of such trends.").

See David H. Hasen, "A Realization-Based Approach to the Taxation of Financial Instruments," 398 Tax L. Rev. 397, 398 (2004) ("In recent years, a consensus has emerged among practitioners, policymakers, and tax scholars that financial contract innovation poses significant challenges to the federal tax system.""); Dale S. Collinson (IRS special counsel to the associate chief counsel (financial institutions and products)), "Grumpy Observations on Reality in Financial Instruments," Tax Notes, June 20, 2005, p. 1587 at 1588 ("I believe that current efforts to achieve effective taxation of a great many financial transactions result in an application of scarce IRS resources that is excessive in relation to the results received and that this adverse input/output ratio is destined to worsen rather than to improve. Consequently, a radical change in approach may be required."); see generally David M. Schizer, "Balance in the Taxation of Derivative Securities: An Agenda for Reform," 104 Colum. L. Rev. 1886, 1888 (2004) (hereinafter Balance) ("It is well understood that aggressive tax planning among high-income individuals and corporations represents a threat to the U.S. tax system, and that derivatives are staples of this planning. . . . Even when the use of derivatives is not tax-motivated, moreover, the relevant tax rules are complicated but still fail to provide answers to basic questions — obviously, a frustrating combination."). (citations omitted).

Under the new law, the IRS may require that practitioners, practitioners, and tax scholars that financial contract innovation poses significant challenges to the federal tax system. Any reform, he said, would not be "simpler" and "faster," but not for a flat tax, a national sales tax or abolishing the Internal Revenue Service, people familiar with the report said.


3David D. Kirkpatrick, "Talk of Taxes, Social Security and Blows at G.O.P. Retreat," The New York Times, Jan. 30, 2005, section 1 at 5 (hereinafter Talk of Taxes) ("House Republicans heard a report on Saturday from the National Republican Congressional Committee on the potential politics of changing the tax system, saying that there was broad support for ‘simplification’, but not for a flat tax, a national sales tax or abolishing the Internal Revenue Service, people familiar with the report said.").

4Scott Hodge, "Polls Show We're Ready for Tax Reform" (Apr. 14, 2005), available at http://www.taxfoundation.org/news/show/346.html (81 percent are concerned with complexity; the public believes that the rich with help from their lawyers and accountants get away with not paying their fair share of taxes); Adam Nagourney and Janet Elder, "Americans Are Concerned About Bush Agenda, Poll Shows," The New York Times, Nov. 22, 2004, at A1 ("In the poll, more than 6 in 10 of the respondents said people with higher incomes should pay a greater proportion of their income in taxes"); "Federal Budget and Taxes," available at http://www.pollingreport.com/budget.htm (out of 1,010 people surveyed, 84 percent felt the rich did not pay their fair share) (last visited June 6, 2005); "Americans' View on Taxes" (April 2003), available at http://www.npr.org/news/specials/polls/taxes2003/ (46 percent concerned that the wealthy do not pay their fair share; and 31 percent concerned with complexity).


competitive. Those goals were repeated in the executive order establishing the tax reform panel.16

Those are lofty but potentially achievable objectives. However, the administration has added three additional conditions for fundamental tax reform that together significantly dim its prospects.

First, tax reform must "fix" the AMT (at an estimated cost of $1.2 trillion);17 second, tax reform must retain deductions for home mortgage interest and charitable contributions (or at least recognize "the importance of homeownership and charity in American society");18 and, finally, because President Bush and congressional Republicans have signed a "no new taxes" pledge, although tax reform should be revenue neutral, it must not raise rates or, as the pledge is widely understood, impose any new taxes.19

In short, the president has demanded that tax reform forgo $1.2 trillion of tax revenue generated by the AMT but remain revenue neutral without raising rates or new taxes, and without sacrificing home mortgage interest or charitable contribution deductions.

And even if the administration’s goal of revenue neutrality is abandoned, any proposal must significantly broaden the tax base or otherwise tap a new source of revenue because the president has pledged to reduce the $319 billion federal deficit to $260 billion,20 and the federal government faces significant additional costs: Nearly $1.8 trillion over the next 10 years to make Bush’s tax cuts permanent;21 $105 billion in 2005 alone and as much as $458 billion over the next 10 years for the wars in Iraq and Afghanistan;22 $500 billion for the new Medicare prescription program;23 more than $100 billion and as much as $200 billion for the recovery costs for hurricanes Katrina and Rita,24 and a long-term Social Security shortfall of $10.4 trillion.25

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16See "Executive Order Establishing Advisory Panel on Tax Reform," available at http://www.whitehouse.gov/news/releases/2005/01/20050107-1.html ("The purpose of the Advisory Panel shall be to submit to the Secretary of the Treasury in accordance with this order a report with revenue neutral policy options for reforming the Federal Internal Revenue Code. These options should: (a) simplify federal tax laws to reduce the cost and administrative burdens of compliance with such laws; (b) share the burdens and benefits of the federal tax structure in an appropriately progressive manner while recognizing the importance of homeownership and charity in American society; and (c) promote long-run economic growth and job creation, and better encourage work effort, saving, and investment, so as to strengthen the competitiveness of the United States in the global marketplace.").


19Confessore, "Breaking the Code," supra note 8, at 35 (222 members of the House, 46 senators, and President Bush himself have pledged never to raise tax rates); Wesley Elmore, "Tax Reform Will Take Back Seat to Deficit Reduction, Analysts Predict," Highlights and Documents, Nov. 30, 2004, p. 2145 (Brookings Senior Fellow William G. Gale "agreed that a VAT would be a viable solution to the country’s revenue needs, but warned that Bush and most congressional Republicans have signed a ‘no new taxes pledge’ so it is ‘extraordinarily unlikely’ that they will raise taxes. Republicans have ‘systematically ruled out most of the solutions to deficit problems because of that stance.’").


21Edmund L. Andrews, "Trim Deficit? Only if Bush Uses Magic," The New York Times, Feb. 6, 2005, at 1 ("Mr. Bush wants to permanently extend his tax cuts rather than allow them to expire in 2011. That would cost about $1.8 trillion over the next decade, and most would occur after 2009."). In testimony before the Senate Finance Committee, Robert J. Carroll, the deputy assistant Treasury secretary for tax analysis, stressed the importance of making these cuts permanent: "Permanent extension of these tax cuts is a key component of the President’s economic agenda to ensure that taxes do not increase for millions of Americans." Testimony of Robert J. Carroll Before the Senate Finance Committee (Mar. 15, 2005), available at http://www.finance.senate.gov/hearings/testimony/2005test/rctes031605.pdf.


24David E. Sanger and Edmund L. Andrews, "Bush Rules Out A Tax Increase For Gulf Relief," The New York Times, Sept. 17, 2005, at A1 ("others have said that the federal government will quickly run through the $62.3 billion already approved in relief aid by Congress, and could wind up spending as much as $200 billion."); Edmund L. Andrews and Carl Hulse, "Cost of Recovery Surges, as Do Bids to Join in Effort," The New York Times, Sept. 9, 2005, at A1 ("White House officials and Congressional budget experts now are sure that federal costs for the hurricane will shoot past $100 billion, which itself is more than twice the entire annual federal budget for domestic security.").

Fundamental tax reform faces other hurdles. First, any proposal must appeal to public opinion. According to polls, there is broad support for “simplification” but not for more radical changes.

Second, as former Treasury Secretary James Baker urged the advisory panel when he testified in March, any fundamental tax reform proposal must be politically acceptable and likely will need some bipartisan support.

Initially, President Bush’s advisers offered two competing models for tax reform. One, championed by Vice President Dick Cheney, would scrap the entire income tax and replace it with a national sales tax or single-rate flat tax on wages. The second, supported by Chief of Staff Andrew Card and Treasury Secretary John Snow, would retain the income tax but substantially simplify and improve it by broadening the base and lowering rates, along the lines of the Tax Reform Act of 1986.

Preliminary feedback suggested that a national sales tax or VAT would fail to clear two of the three conditions for enactment. Broad support exists to “simplify” the federal tax system but not for a flat tax or national sales tax. And because Bush and most congressional Republicans have signed a “no new taxes” pledge, they are unlikely to agree to a VAT or national sales tax “supplement” to the income tax.

Republican leaders then retreated from the VAT and national sales tax proposals. Instead, administration officials suggested a piecemeal evolution, widely referred to as the “five easy pieces,” toward a consumption tax: (i) marginal income tax rates would be reduced, (ii) the estate tax would be repealed, (iii) the tax rates on stock dividends and capital gains would be reduced, (iv) tax-free health and “lifetime” savings accounts would be expanded, and (v) the cost of new buildings and equipment would be immediately written off. Those tax costs would be offset by a denial of deductions for state and local taxes and corporate interest expense.

Over a two-day period in May, the tax reform panel heard testimony on a number of comprehensive reforms to the federal tax system, including a retail sales tax, Prof. Graetz’s hybrid income tax/VAT system, David Bradford’s X-Tax, and the flat tax. Later that month, four former assistant Treasury secretaries for tax policy strongly urged the panel to recommend piecemeal improvements to the tax code rather than wholesale change.

On November 1, the tax reform panel issued its report, which offers two alternative plans. The Simplified Income Tax Plan would repeal the AMT, reduce the maximum individual tax rate from 35 percent to 33 percent, condense the number of tax brackets from six to four (15 percent, 25 percent, 30 percent, and 33 percent), eliminate all taxes on dividends paid by U.S. corporations, and reduce the maximum long-term capital gains tax rate on the sale of stock of a U.S. corporation from 15 percent to 8.25 percent (but apply ordinary marginal rates to all other capital gains). Section 401(k) plans and other saving incentives would be simplified into three accounts; the “marriage penalty” would be reduced; the standard deduction, personal exclusion, child care credit, and head of household filing status would be streamlined into a new family tax credit; and the earned income

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26David D. Kirkpatrick, “Talk of Taxes,” supra note 10
27Id.
29See Martin A. Sullivan, “The Rise and Fall of the National Sales Tax,” Tax Notes, Nov. 15, 2004, p. 916 at 918; Daniel Altman, “Taxes and Consequences: The Second Term Begins,” The New York Times, Nov. 7, 2004, section 3 at 4 (“Simplification could take several forms, from closing loopholes and streamlining rates (as in the 1986 restructuring), to a complete overhaul resulting in a flat tax. So which is it?”). Some commentators have suggested other paths. See Michael J. Graetz, “To the Point of No Returns,” The New York Times, Nov. 15, 2004, at A21 (14 percent national sales tax, tax exemption for families that earn less than $100,000, and a 25 percent reduced rate of income tax for all other individuals); see also Gene Sperling, “No Pain, No Savings,” The New York Times, Jan. 5, 2005, at A23 (“universal 401(k)s” supplemented by governmental contributions and funded by a 3 percent surcharge on all incomes exceeding $200,000).
31Nicholas Confessore, Breaking the Code, supra note 8, at 35 (222 members of the House, 46 Senators and President Bush himself have pledged never to raise tax rates); Wesley Elmore, “Tax Reform Will Take Back Seat to Deficit Reduction, Analysts Predict,” Highlights and Documents, Nov. 30, 2004, p. 2145, supra note 19.
American society.” The panel also failed to enhance progressivity, as President Bush instructed. The denial of deductions for state and local taxes, the reduction in home mortgage interest and charitable contribution deductions, and the imposition of a tax on employer-provided health insurance will hit the middle and lower classes, but the reductions in individual and corporate tax rates, the exemption of tax on dividend income received from U.S. corporations, and the reduction in the capital gains rate for sales of U.S. corporate stock under the Simplified Income Tax Plan will primarily benefit high-income individuals.

The tax reform panel also ignored the sage advice of former Treasury Secretary James Baker to offer suggestions that can gain broad bipartisan support and survive the legislative process. Already, Democrats and Republicans alike have declared the tax panel’s proposed offsets unenactable. House and Ways Committee ranking minority member Charles Rangel, D-N.Y., has promised to “fight this to the death” against any proposed denial of the deduction for state and local taxes.

This article offers an alternative to the tax reform panel’s recommendations that would better achieve the president’s objectives; preserve deductions for state and local taxes, home mortgage interest, and charitable contributions; and maintain the current exemption for

41 Letter from Robert R. Davis, executive vice president and managing director, government relations, America’s Community Bankers, to Connie Mack, Chairman of the President’s Advisory Panel on Federal Tax Reform (Oct. 14, 2005) (“Changes to the interest deduction would be a disguised tax increase”).
employer-provided health insurance and long-term capital gains rates for all property. It proposes mark-to-market taxation as a component of fundamental tax reform.

Mark-to-market taxation is not a new idea. For more than 30 years, academics have suggested two forms of mark-to-market taxation. The first — a comprehensive system — would impose mark-to-market on all taxpayers and all assets. Critics of that approach agree that a mark-to-market (or accrual) system of taxation best measures Haig-Simons accrual to wealth and therefore is the optimal method to tax income, but identify three "insurmountable" obstacles to the implementation of a comprehensive regime. First, annual valuation is administratively unfeasible (the "valuation" concern); second, without realization, taxpayers will not have the cash to pay their tax (the "liquidity" concern); and third, taxing "paper gains" is psychologically unacceptable (the "psychological" concern) and therefore politically unsaleable.

Those valuation and liquidity concerns were addressed in a second generation of proposals that restricted mark-to-market taxation to publicly traded securities only and suggested other measures of taxation for nontraded assets. Critics, in turn, charged that this "partial" system of mark-to-market taxation would create new inefficiencies by providing an artificial incentive for taxpayers to purchase non-mark-to-market assets; it would not adequately solve the valuation issues; and it would not at all address the most difficult issue of all: the psychological concern of taxing paper gains. As a result,
those commentators unanimously concluded that even a partial mark-to-market system of taxation is not saleable. 50

This article makes a third attempt. It proposes a “progressive” system of mark-to-market taxation. Under the proposal, all public companies, all private companies with $50 million or more of net assets, and all individuals and married couples with $1.6 million of adjusted gross income or $5 million of publicly traded property would be required to mark to market their publicly traded property, derivatives with respect to publicly traded property, and certain publicly traded debt and other liabilities (described below).

Married individuals with annual taxable income of $29,050 (unmarried individuals with annual taxable income of $29,050) and investment assets of $50,000 or less (excluding assets held in tax-exempt retirement accounts) would be exempt from tax on all capital gains, dividends, and interest. 50 (Alternatively, rather than exempt investment income for low-income taxpayers, tax-free retirement accounts could be expanded more generally.)

All other taxpayers would remain on the realization system. Realization taxpayers would be permitted to elect mark-to-market treatment for any publicly traded property they hold.

Mark-to-market gains of corporations would be subject to tax at the current marginal rate of 35 percent. Mark-to-market losses of corporations would be fully deductible against ordinary income or capital gain.

Mark-to-market gains (and qualified dividends) of individuals would be subject to tax at the long-term capital gains rate of 15 percent, and the interest and other ordinary income of individuals would remain subject to tax at the ordinary income rate of 35 percent. Individuals who are securities dealers, or who receive allocations of gains for performing investment services, would not benefit from the reduced rates of tax.

Individuals’ mark-to-market losses would be fully deductible to the extent of prior mark-to-market gains, could then be used to offset capital gains, and then mark-to-market losses could offset 43 percent (15 percent/35 percent) of ordinary income or could be carried forward indefinitely.

The proposal would generally bifurcate financial instruments into a debt component and a nondebt mark-to-market component and, for corporations, isolate any section 1032 component. The proposal would also generally accelerate the recognition of deferred compensation that is measured by reference to publicly traded property.

How much revenue could be generated by the proposal? If it had been in place in 2004, the proposal would have generated more than $2.2 billion from the founders of Google alone. 51 Although no direct data exists on the long-term revenue potential of the proposal, an indirect back-of-the-envelope conservative estimate suggests that it could raise between $490 billion and $750 billion over a 10-year horizon. 52

50 On Dec. 31, 2004, the founders of Google, Larry E. Page and Sergey Brin, had between them more than $14.5 billion of unsold Google stock. Global Securities Information Inc., Google Inc. Insider Trading 18, 101 (Feb. 18, 2005) (on file with author). Assuming that they had purchased their stock for $20 million (which is probably a very low estimate), even at reduced long-term capital gains rates, a mark-to-market tax system would have generated $2.2 billion of tax in 2004 from those two individuals alone.


52 Over the 10-year period from 1995 through 2005, the wealth of the Forbes 400 grew from just over $500 billion to $1.13 trillion, an increase of 226 percent. See United For a Fair Economy, Born on Third Base: The Sources of Wealth of the 1996 Forbes 400, available at http://www.faireconomy.org/press/ archive/Pre-1999/Forbes 400_study.html (the net worth of the Forbes 400 was just over $500 billion in 1995); Forbes.com, The 400 Richest Americans, available at http://www.forbes.com/home/lists/2005/09/19/400-richest-americans-2005-list_05rich400_land.html. If the assets of the Forbes 400 increase at this rate over the next 10 years, they will be worth $2.55 trillion in 2015, representing an increase of $1.76 trillion.

Economists estimate that the Forbes 400 hold 3.5 percent of all the individual wealth in the country, and the 0.1 percent wealthiest individuals hold 9 percent. Wojciech Kopczuk and Emmanuel Saez, “Top Wealth Shares in the United States, 1916-2000: Evidence from Estate Tax Returns,” 47 National Tax Journal 445-487 (June 2004) (hereinafter Top Wealth Shares) (9 percent of wealth concentrated in wealthiest 0.1 percent). Those numbers suggest that the wealth of the top 0.1 percent wealthiest individuals is $2.91 trillion and, if their wealth increases at the same rate as the wealth of the Forbes 400 has increased over the past 10 years, the value of their assets will increase by $5.44 trillion. However, 13.6 percent of the wealth of Forbes’s top 25 individuals is represented by two privately held companies — Mars and Fidelity Investments — and real estate investments, which would not be affected by the proposal. If one assumes that 13.6 percent also represents the percentage of private equity and real estate held by the 0.1 percent highest-income and wealthiest taxpayers, and the prior numbers are reduced by (Footnote continued on next page.)
The revenue generated by the proposal would be applied to repeal or modify the AMT and either eliminate tax on the investment earnings of low-income taxpayers or expand tax-free retirement accounts more generally.\textsuperscript{54}

How much revenue could be generated by the proposal? If it had been in place in 2004, the proposal would have generated more than $2.2 billion from the two founders of Google alone.

The proposal is designed to attain the president’s objectives for fundamental tax reform in a politically achievable manner. First, by repealing or substantially modifying the AMT, the proposal would offer significant simplification for the 30 million taxpayers that would otherwise be subject to it in 2010 and, by eliminating the ability of high-income and high-net-worth taxpayers to time their gains and losses, the proposal would eliminate the need for the straddle rules, the wash sale rules, the constructive ownership and constructive sale provisions, and the capital loss limitations for mark-to-market property. More importantly, mark-to-market taxation would prevent nearly all abuse and eliminate virtually all loopholes for mark-to-market positions, and would help to create a “fair” tax system under the president’s definition.

By imposing mark-to-market taxation on high-income and high-net-worth taxpayers only, exempting low-income taxpayers from tax on investment income or expanding tax-free retirement plans, and retaining the realization system for all other taxpayers, the proposal would use the incidence of tax on investment assets to achieve progressivity: no tax for low-income taxpayers, mark-to-market for high-net-worth and high-income individuals, and realization for everyone else. In short, the proposal would expressly use realization as a subsidy for those who need it and deny it to those who do not.\textsuperscript{55}

By eliminating tax on the investment income of low-income taxpayers or expanding tax-free retirement plans, the proposal also would encourage savings for the most important segment of the population, and would complement the administration’s “progressive indexing” proposal for Social Security.\textsuperscript{56} By eliminating deferral, lock-in/lock-out, and strategic trading for mark-to-market taxpayers, the proposal would enhance the efficiency of the tax system and the capital markets.

And, by conforming the tax and GAAP treatment of most publicly traded securities and derivatives, the United States would join the United Kingdom in what is likely to become a global trend toward increased book tax conformity.\textsuperscript{57}

Finally, the proposal paves the way toward a fair consumption tax. One of the most serious issues in transitioning to a consumption tax is the potential exemption of untaxed appreciation in the investment assets of wealthy taxpayers. By taxing the appreciation in

\begin{itemize}
  \item \textsuperscript{54}The revenue generated by the proposal may not be sufficient to eliminate the alternative minimum tax and eliminate taxable income for low-income taxpayers or expand tax-free retirement plans. Recent estimates place the cost of repeal of the alternative minimum tax at between $600 million and $1.2 trillion over the next decade, or $385 billion to continue the temporary fixes for the next 10 years. Andrews, “Repeal of Alternative Tax Gains a Top G.O.P. Backer,” \textit{The New York Times}, May 24, 2005, at C3; Edmund L. Andrews, “Trim Deficit? Only if Bush Uses Magic,” \textit{The New York Times}, Feb. 6, 2005, at 1 (“Mr. Bush wants to permanently extend his tax cuts rather than allow them to expire in 2011. That would cost about $1.8 trillion over the next decade, and most would occur after 2009.”).
  \item \textsuperscript{55}In this respect, the proposal borrows from David Schizer’s observation that realization is a subsidy. \textit{See generally} Schizer, Realization, supra note 46, at 1549.
  \item \textsuperscript{56}President Bush endorses Robert C. Pozen’s “progressive indexing” proposal for social security under which workers averaging $25,000 a year or less (in today’s dollars) — representing the lowest 30 percent of workers — and retiring after 2012, would receive their full benefits determined under the current formula, but workers with incomes averaging $113,000 or more (in today’s dollars) would receive benefits that increase only enough to compensate for the rising cost of living rather than, under the current formula, increases in wages. \textit{See generally} Pozen, Social Security Plan, supra note 50.
  \item \textsuperscript{57}Beginning in section 42 of the Finance Act 1998, the United Kingdom has generally followed book profits in computing taxable income, with specific adjustments. Under U.K. GAAP Financial Reporting Standard 26 and International Accounting Standard 39, all assets and liabilities held for trading (and certain other assets and liabilities), all derivative financial instruments, and any part of a hedged asset or liability in which the hedging instrument is marked-to-market must be marked-to-market for book purposes. Although those mark-to-market gains and losses are booked to “reserves” rather than earnings, under U.K. legislation enacted in 2004, the marked-to-market gains and losses are generally required to be recognized for tax purposes, subject to specific exceptions. \textit{See} Finance Act 2004 Schedule 10 (paragraphs 3 and 49); \textit{See} Finance Act 1996; Schedule 26 Finance Act 2002 (paragraph 16).
\end{itemize}
publicly traded property held by high-net-worth individuals, the proposal would halt future untaxed appreciation and ease transition toward a fair consumption tax. Moreover, once high-income and wealthy shareholders are taxable on the untaxed appreciation in their public equities securities, the cost of integrating the corporate and individual tax systems may be manageable.

**In short, the proposal would expressly use realization as a subsidy for those who need it and deny it to those who do not.**

Significantly, the proposal does not increase rates, deny deductions, or impose new taxes, and therefore (in contrast to the tax reform panel’s recommendations) does not violate the president’s “no new taxes” pledge. It would reduce or eliminate taxes for tens of millions of taxpayers, adversely affect fewer than 400,000 households, and therefore would be expected to win strong public support. (However, the proposal would directly affect the ultrawealthy taxpayers that form a core political constituency of the Republican party and so it would remain to be seen whether their opposition is stronger than the opposition facing other proposals.)

The proposal also attempts to address the most serious concerns of other mark-to-market proposals. By subjecting only high-net-worth and high-income individuals and large corporations to mark-to-market taxation, the proposal underruns the primary psychological hurdle faced by other partial mark-to-market proposals. Those taxpayers are fully capable of accessing their paper gains; for them, paper gains are actual cash. And only those taxpayers have access to financial products that defer or eliminate tax. Similar concerns were raised and cleared in section 1259 — when it was convincingly demonstrated that the proposal would affect only the ultrawealthy taxpayers that form a core political constituency of the Republican party and so it would remain to be seen whether their opposition is stronger than the opposition facing other proposals.

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Liquidity concerns also should be manageable for superrich individuals and large corporations subject to mark-to-market tax on gains on their publicly traded securities and derivatives. Those positions are (or may be structured to be) entirely liquid. And the proposal offers the backstop of government-sponsored collateralized loans to pay the taxes of those taxpayers that hold restricted and other illiquid publicly traded property.

Two other charges cannot be as easily dismissed, but are addressed. First, some derivatives and debt are inherently difficult to value; critics will charge that requiring taxpayers to value them will lead to endless litigation. However, the force of this argument is diminished now that securities and derivatives valuation is required under GAAP. Under the proposal, taxpayers that maintain “relatable financials” could generally elect to use their financial reporting values for tax purposes.

And for other taxpayers, the proposal addresses the concern directly by adopting a “process-based” approach. As discussed in greater detail in Part II.K., below, the proposal assigns valuation responsibility in the first instance to financial institutions and other designated “mark providers.” If a taxpayer relies on a mark provider’s valuation in good faith, underreported gain in prior years would be subject only to an interest charge at market rates of interest. Penalties would be imposed on mark providers only if their valuations are unreasonable or conducted in bad faith. Some taxpayers would be permitted to value their own positions; those taxpayers would not benefit from the safe harbor.

Second, by subjecting only some assets to mark-to-market treatment, the proposal is open to the legitimate concern that mark-to-market taxpayers would shift their investments into real estate, private companies, and other “nontraded assets.” That consequence is inevitable at the margins, but should not be overstated. The strategy would carry a significant cost: illiquidity. Our current tax system, by imposing a corporate-level tax only on publicly traded active businesses, already imposes a significant cost on liquidity, which has not deterred public offerings, even of highly profitable partnerships. In most cases, the benefits of liquidity would outweigh the loss of deferral.

Part II of this article describes the proposal in greater detail and discusses the choices and issues it raises. Part III addresses the anticipated criticisms of the proposal. Finally, Part IV catalogues its benefits and argues, ultimately, that it offers a model that is at least as politically plausible as the tax reform panel’s recommendations and other reform proposals. The article concludes with Part V.

**II. Progressive’ Mark-to-Market Taxation**

**A. Mandatory Mark-To-Market Taxpayers**

Under the proposal, only public companies, private companies with $50 million or more of reported shareholder equity or $75 million or more of net assets, and individuals and married couples with $1.6 million of adjusted gross income (including tax-exempt income) or $5 million of publicly traded property would be subject to mandatory mark-to-market taxation. Those limitations are designed to enhance progressivity, address the liquidity and psychological concerns of other mark-to-market proposals, and increase the likelihood of the proposal’s political acceptance.

1. Public corporations. Under the proposal, publicly traded corporations would be subject to mark-to-market...
taxation on their publicly traded securities and derivatives. Publicly traded companies are required under GAAP to annually mark to market their marketable equity securities, debt securities, and some of their derivatives, and use those valuations to report their earnings or other comprehensive income.62 The ability of those companies to report shareholder equity of $50 million or more on audited financials, or have net assets (that is, assets less liabilities) with a fair market value of $75 million or more.

Those thresholds correspond roughly to the requirements for listing on the NASDAQ and Amex stock exchanges.65 The $50 million shareholder equity test is simple to apply, and a shareholder equity test is justified by the incentive of companies to maximize their asset value and minimize their liabilities for financial reporting purposes. However, it is possible that a company will eschew audited financials to avoid the lower $50 million threshold. That “avoidance” of mark-to-market taxation would not be considered abusive. However, it is more likely that the benefits of audited financials — such as access to the Rule 144A debt market — will outweigh the loss of deferral.

Although private companies do not have the same access to the capital markets as public companies, those valuation thresholds are set high enough so that “small” private companies would not be affected, and any private company of that size would normally have sufficient liquidity to pay annual appreciation on its appreciated securities, thereby mitigating the liquidity and psychological concerns. And any company maintaining audited financials would be required to value its publicly traded securities for GAAP purposes, thereby mooting the valuation concern.

Valuation issues would exist for companies that do not report $50 million of shareholder equity on audited financials. However, for those companies the threshold is 50 percent higher (at $75 million) and, to prevent a windfall lawsuit settlement or other extraordinary events from triggering mark-to-market treatment, the test would require that the threshold be met during 30 days of the tax year.66 Antiabuse rules would prevent corporations from avoiding the asset threshold through tax-motivated transfers or related-party borrowings.67

62See Financial Accounting Standards Board, Statement of Financial Accounting Standards (FAS) 115, paragraph 7 (investments in debt securities for which the investor has a positive intent and the ability to hold until maturity are accounted for as held-to-maturity securities and are not marked-to-market); FAS 115, paragraphs 12.a and 13 (marketable equity securities and all debt securities that are bought and held principally for the purpose of selling them in the near-term (thus held for only a short period of time) [trading securities] are carried at fair value and changes in fair value are recognized in earnings on the income statement); FAS 115, paragraphs 12.b and 13 (marketable equity securities and all debt securities that are not held-to-maturity or trading securities are classified as available for sale securities; in this case the mark-to-market gains and losses are reflected in “other comprehensive income,” which is reflected as equity on the balance sheet); FAS 133 (requiring derivatives to be marked to market); FAS 149 (modifying FAS 133); FAS 150 (establishing standards for classifying and measuring instruments that may be both liabilities and equity). See generally Alvin D. Knott and Jacob D. Rosenfield, “Book and Tax (Part One): A Selective Exploration of Two Parallel Universes,” Tax Notes, May 12, 2003, p. 865; Yoram Keinan, “Book Tax Conformity for Financial Instruments,” 6 Florida T. Rev. 676 (2004) [hereinafter Book Tax Conformity].

63The Emerging Issues Task Force of the Financial Accounting Standards Board issued guidance in 2003 for valuing energy derivatives. This guidance is commonly used to value listed derivatives. It provides, in general, that gain can be reported as earnings only if objective evidence of the gain exists. See EITF, Issue No. 02-3 (“issues involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved In Energy Trading and Risk Management Activities.”). See generally Alan B. Munro and Yoram Keinan, “The Case for Book-Tax Conformity for Mark-to-Market Valuations,” 16 J. of Taxation of Financial Institutions 5, n.11 (July/August 2003).

64See Finance Act 2004 Schedule 10 (paras. 3 and 49); 84A Finance Act 1996 Schedule 26 Finance Act 2002 (para. 16).
Insurance companies are likely to be hit hardest by the proposal because they typically maintain their reserves in publicly traded securities, and the insurance lobby may imperil the proposal. Nevertheless, subjecting insurance companies to mark-to-market treatment on their publicly held property is appropriate. If insurance companies were exempt from mark-to-market treatment, they would become tax shelters for wealthy taxpayers seeking deferral.

3. Mark-to-market thresholds for individual taxpayers and trusts. The proposal would impose mandatory mark-to-market treatment on any individual, married couple, or trust with annual adjusted gross income (including tax-exempt income) in excess of $1.6 million, and on any individual, married couple, or trust with $5 million or more of publicly traded property, cash, or cash-equivalent investment assets.

The $1.6 million threshold roughly corresponds to the highest 0.1 percent income-earning individual taxpayers and married couples (roughly 290,000 households), and would be adjusted annually in sizable increments (for example, $500,000) to track the taxable income of the 0.1 percent highest-income individual and married couples.

Wealth is highly concentrated in that group. By some estimates, as much as 9 percent of all wealth is held by the 0.1 percent wealthiest individuals. Thus, the $1.6 million threshold subjects a relatively high amount of wealth, but a relatively small number of taxpayers, to mandatory mark-to-market taxation.

Moreover, because the wealth of that group is heavily weighted in corporate stocks and bonds, it disproportionately benefits from the deferral that is possible in a realization system.

An income test alone is insufficient to identify the taxpayers that should appropriately be subject to mark-to-market treatment for their publicly traded property. If the threshold for mark-to-market treatment were based on income alone, an extremely wealthy individual with equity securities could avoid $1.6 million of adjusted gross income simply by avoiding dividend-paying stock, hedging his risk with derivatives, and either borrowing against the appreciated securities or entering into prepaid forward contracts or other derivatives that produce cash but no immediate taxable income. For that reason, an asset test is necessary.

Therefore, mandatory mark-to-market treatment would also be imposed for any tax year that an individual, married couple, or trust holds $5 million or more of publicly traded positions, cash, or cash equivalents that are investment assets.

The $5 million threshold roughly corresponds to the wealthiest 0.1 percent of taxpayers and also mirrors the

For example, if the threshold were expanded to the top 0.5 percent of taxpayers, double the number of taxpayers would be affected (534,556), but the annual income of the entire group would be only one-third greater ($327 billion in 2000). In contrast, the 0.01 percent wealthiest (average income of $5,349,795 in 2000) numbered only 13,354 in 2000, but their aggregate annual income was only $174 billion.

Kopczuk and Saez, Top Wealth Shares, supra note 53 (corporate stock, bonds, and cash and deposits represent approximately two-thirds of the total wealth for the top one-third of the 0.5 percent wealthiest individuals).

Capital gains for the top 1 percent of income earners represent 57 percent of their total income. See Gregg A. Eisenwein and Jane G. Gravelle, “An Analysis of the Tax Treatments of Capital Losses,” at 8 (Congressional Research Service) (Oct. 9, 2002) (between 1979 and 1988, 57 percent of the income of the top 1 percent consisted of capital gains). The percentage is even higher for the elite taxpayers. See Leonard E. Burman and Deborah I. Koster, “Composition of Income Reported on Tax Returns,” Tax Notes, Nov. 10, 2003, p. 785 (in 2000, 71 percent of the income of the 400 highest-income taxpayers consisted of capital gains). In 2003 journalist Martin Sullivan compared the aggregate tax bill for the 400 highest-earning households between 1992 and 2000 ($76 billion) to the aggregate net worth increase of the Forbes 400 during that period ($380 billion to $1.235 trillion, representing an increase in net wealth of $855 billion). Although the long-term capital gains tax rate during that period was significantly higher than today (28 percent until 1997, when it was reduced to 20 percent), if the Forbes 400 paid the same amount of tax as the group of the 400 highest-earning taxpayers, the effective tax rate on their wealth would be something less than 9 percent (76/855). However, it is likely that this estimate grossly understates the tax savings, because it is highly unlikely that many of the Forbes 400 were in the group of 400 highest earning households. The effective tax rate on the appreciation of wealth of the Forbes 400 is likely a fraction of 9 percent.
$5 million threshold that establishes a “qualified purchaser” under the Investment Company Act of 1940. Under the proposal, the threshold would be presumed to be satisfied for any taxpayer in any tax year if the taxpayer represents (or is the beneficiary of a trust or the 10-percent-or-greater equity holder of any vehicle that represents) that it is a “qualified purchaser” for purposes of the Investment Company Act of 1940 in connection with the purchase of a security and the security is not directly used in, and reasonably necessary for, an active trade or business.

The asset test is designed to be set sufficiently high so that it applies only to those taxpayers who are sufficiently wealthy and sophisticated that they have access to adequate liquidity to borrow to pay tax on their mark-to-market gains. Those investors have a greater number of investments and financial products available to them that avoid current taxable income.

However, the asset test does not precisely correspond to the ‘40 Act test, which is designed to measure sophistication rather than liquidity. Therefore, the $5 million threshold is based only on a taxpayer’s publicly traded positions, cash, and cash equivalents that serve as investment assets. Thus, nontraded assets and assets that are directly used in and reasonably necessary for an active trade or business would be excluded.

Also, for purposes of determining whether an individual satisfies the $5 million gross asset test, assets in qualified retirement plans (for example, 401(k)s, HR10s, and IRAs) and assets generated by up to $1 million of premiums paid for insurance policies or annuities would be excluded from the asset test. However, if an individual had paid more than $1 million in insurance or annuity premiums, a proportionate amount of the assets corresponding to the excess would be included for purposes of the asset threshold.

The exclusion from the $5 million threshold for the assets generated by up to $1 million of life insurance premiums will encourage individuals at the $5 million threshold to maximize their investment in insurance to benefit from the exclusion. However, that inefficiency is relatively insignificant.

The asset test is based on gross assets rather than net assets. If the test were based on net assets, a taxpayer with $5 million of publicly traded securities could escape mandatory mark-to-market treatment by borrowing against the assets (and thereby reducing his or her net assets below the $5 million threshold) and using the proceeds to purchase non-mark-to-market assets (such as a bigger home). Tracing liabilities to assets would be an impossible task.

However, a gross asset test may cause some individual taxpayers with relatively low net worth to be subject to mandatory mark-to-market treatment, and conceivably could invoke liquidity and psychological concerns. For example, if a taxpayer has $5 million of publicly traded assets, but is subject to $5 million in debt, the taxpayer would be subject to mandatory mark-to-market treatment even though the taxpayer has no net assets. However, the ability of taxpayers to borrow to pay their tax liability mutes some of the liquidity concerns and it is unlikely that taxpayers with $5 million of investment assets will invoke much sympathy.

For purposes of determining whether a taxpayer satisfies the gross asset test, a taxpayer would be treated as owning her distributable share of the publicly traded assets held through a subchapter S corporation or any non-publicly-traded partnership, trust, registered investment company, real estate investment trust, and any non-mark-to-market domestic C corporation that satisfies the asset or income test for a passive foreign investment company or is organized (or marketed) with a principal purpose to avoid mark-to-market treatment. Those vehicles would be required to provide each mark-to-market partner, shareholder, and beneficiary with her share of the gross value of its publicly traded property. (Those vehicles are referred to as reporting vehicles.) Those reporting requirements are described in Part III.

Those attribution and reporting rules are not perfect, and add complexity, but are preferable to a series of antiabuse rules designed to prevent mark-to-market taxpayers from holding their publicly traded property in non-mark-to-market domestic C corporations.

The asset test would exclude nontraded assets, such as homes, real property, and collectibles. That exclusion would encourage taxpayers at the margins to invest marginal assets in nontraded property, or give them away. However, the cost of that strategy would be illiquidity. This topic is discussed in greater detail in Part III.B.

Also, the $5 million gross asset test produces a “cliff effect”. A taxpayer with less than $5 million worth of publicly traded investment property (and less than $1.6 million of income) would remain a realization taxpayer for all of his property, but a taxpayer with $5 million of publicly traded investment property would be subject to mark-to-market on all of his publicly traded property. An alternative approach would have exempted the first $5
million of publicly traded investment property.⁷⁸ Although that approach would avoid the cliff effect, it would reduce revenue and create complexity (that is, the need to maintain both realization and mark-to-market accounts and rules to decide which securities are subject to each). For those reasons, the alternative approach was rejected.

B. Exempt Taxpayers

Unmarried individuals with annual taxable income of $29,050 or less, and married individuals with annual taxable income of $58,100, and investment assets of $50,000 or less (excluding assets in tax-exempt retirement accounts and assets generated by up to $50,000 of premiums paid for insurance polices or annuities), would be exempt from all tax on investment income as long as they are not otherwise mandatory mark-to-market taxpayers.⁷⁹ This exemption is designed to satisfy the president’s objective of encouraging savings and investment.⁸⁰

C. Realization Taxpayers

All taxpayers that are not mandatory mark-to-market taxpayers or exempt from tax on investment income would remain realization taxpayers. Realization taxpayers would be permitted to irrevocably elect mark-to-market treatment for any of their publicly traded property on acquisition.

D. Treatment of Mark-to-Market Corporations

Under the proposal, all mark-to-market corporations would be required to mark to market (that is, treat as sold and repurchased) their mark-to-market positions (and the positions attributed to them through reporting entities), report the resulting gains or losses, and adjust their basis accordingly.⁸¹ Corporations would treat their mark-to-market gains as ordinary income.⁸² The decision to retain the 35 percent rate for mark-to-market gains of corporations assumes that the desire for revenue and simplicity will overcome arguments for a reduced rate of tax. However, it is true that requiring corporations to mark to market their corporate equity securities would exacerbate the double taxation inefficiencies of our classical tax system.

Because a mark-to-market system eliminates the ability of taxpayers to “cherry-pick” losses, the proposal would treat any mark-to-market losses as ordinary losses.⁸³ Accordingly, mark-to-market losses would be fully available to offset both capital gains and ordinary income of corporations.⁸⁴

E. Special Rules for Individuals

1. Overview. Mark-to-market gains of individuals would be subject to tax at the long-term capital rate of 15 percent. Qualified dividends received by individuals would also be taxed at 15 percent, but the holding period requirement would be eliminated for stock that is mark-to-market property. Interest and other ordinary income of individuals would remain subject to tax at ordinary rates.

Mark-to-market losses of individuals could offset mark-to-market and other capital gains, and then 43 percent (15 percent/35 percent) of any remaining mark-to-market losses would be available to offset ordinary income, or could be carried over indefinitely.⁸⁵ The straddle rules and section 263(g), the wash sale rules, the constructive ownership and constructive sale provisions, the foreign currency rules, and the PFIC rules would not apply to mark-to-market property whose gain is fully recognized.

The proposal would bifurcate prepaid forwards, convertible bonds, and contingent payment debt instruments (CPDIs) into a nonconvertible/noncontingent debt component that would accrue original issue discount (taxable at the ordinary income rate of 35 percent), and a mark-to-market component (taxable at the long-term

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⁷⁸ The author is grateful to Prof. Daniel Shaviro for suggesting that alternative.
⁷⁹ Alternatively, tax-free retirement accounts could be expanded more generally.
⁸¹ As described below in Part II.P., under some forms of the proposal, preenactment built-in gain would not be required to be recognized immediately. In that event, mark-to-market losses would be limited to actual realized losses. Thus, assume that mark-to-market taxpayers are required to mark their securities to market but not recognize the preenactment built-in gain. If a taxpayer has mark-to-market property with a basis of $100 and a fair market value of $1,000 on the date of enactment, and at the end of the first year following enactment, the value of the property is $800, no loss would be recognized; if the value were $60, the taxpayer would recognize a $40 mark-to-market loss.
⁸² To the extent that it is necessary to preserve the character of interest (and similar items of income and expense), either (i) the current law rules could be retained (see prop. Treas. reg. section 1.475(a)-1), (ii) the special rules in 2(f), for determining interest income for individuals, could be applied to corporations, or (iii) corporations would treat an amount equal to their net investment in all mark-to-market property (other than stock and debt, (Footnote continued in next column.)

which would remain subject to the current rules) times an AFR-based rate, and would increase their tax basis in those securities by an equal amount to determine their mark-to-market gains or losses.
⁸⁴ If preenactment built-in gains are grandfathered (and not required to be recognized on a mark-to-market basis), then mark-to-market losses on built-in gain property would be required to be realized to be recognized. Thus, if a mark-to-market taxpayer owns publicly traded stock with a basis of zero and value of $100 on the effective date of the proposal, and the “weak form” of the proposal (described in Part II.N) is adopted so that the $100 of built-in gain is not required to be recognized before sale, then, if the value of the stock declines to $90 at the end of year two, the taxpayer would not be permitted to recognize the unrealized loss of $10.
⁸⁵ As discussed above, if preenactment built-in gain were not subject to mark-to-market taxation, any mark-to-market losses on built-in-gain property could be recognized only to the extent realized.
capital gains rate of 15 percent). The bifurcation rules are described in Part II.G.3., below.

2. Tax rates. The tax rates for mark-to-market gains and losses, and ordinary income, reflect a balance between the generation of revenue, political acceptability, and simplification.

The proposal taxes mark-to-market gains of individuals at the long-term capital gains rate of 15 percent because it is highly unlikely that a mark-to-market proposal could gain political acceptance if the rate for individuals is set higher than the current long-term capital gains rate. That rate has the effect of reducing the marginal rate for short-term capital gains and section 1256 contracts. The decision to tax all mark-to-market gains at a single rate increases efficiency and simplicity.

The proposal would permit any realization individuals to voluntarily (but irrevocably) elect to mark to market a particular capital asset. Those individuals would report any first-year gains as short-term capital gain (taxable at 35 percent). Otherwise, realization taxpayers would mark to market all of their short-term assets and remain subject to realization for their long-term investments. However, a realization individual who irrevocably elects mark-to-market treatment for all of her mark-to-market property would be treated identically to a mandatory mark-to-market taxpayer, and all mark-to-market gains would be subject to tax at the long-term capital gains rate of 15 percent.

Under the proposal, individuals who are dealers in securities, and managers of investment partnerships that receive a carry for their investment advisory services, would not benefit from the reduced rates of tax for mark-to-market gains from their dealer activity or mark-to-market gains allocated to them for the investment services they provide because, for those taxpayers, those incomes and gains are wage equivalents, and permitting those taxpayers to receive a reduced rate of tax for those incomes and gains would not ensure that “everyone pays her fair share.”

In his article on a partial system of mark-to-market taxation for publicly traded securities, Prof. David Weisbach recommended that the tax rate for mark-to-market gains be set at the effective rate for realization gains (which he approximated as the “average” rate on realization gains); otherwise, if the rate of tax on mark-to-market property is set higher than the rate for realization assets, Weisbach argued, the tax law would create an artificial incentive for taxpayers to purchase real estate and other nontraded assets. The proposal, by failing to adopt that recommendation, would produce some marginal inefficiency. That inefficiency is discussed in Part III.B.

3. Qualified dividends. The proposal taxes qualified dividends received by mark-to-market individual taxpayers on mark-to-market equity securities at the 15 percent rate. Once gains on all mark-to-market stock are subject to a 15 percent maximum rate, a higher rate for dividends is difficult to justify and would simply encourage mark-to-market taxpayers who have not held their stock for the requisite dividend holding period to sell their shares immediately before a dividend record date, repurchase them immediately thereafter, and claim the 15 percent rate on the gain.

4. Interest income and other ordinary income. Although the mark-to-market gains and dividends of individuals are taxed at the reduced long-term capital gains rate of 15 percent, the proposal taxes all interest and other ordinary income at the ordinary income rates of 35 percent, and requires market discount to be accrued currently by mark-to-market taxpayers. That rate differential introduces complexity into the proposal, but there are four reasons why it is necessary.

First, the proposal would be too generous if interest and other ordinary income earned by mark-to-market taxpayers were reduced from 35 percent to 15 percent, and the proposal would generate significantly less revenue.

Second, the preferential rate for dividends helps to mitigate the double taxation of corporate earnings under our classical system. No similar reason exists to reduce the rate of tax on interest and other ordinary income.

Third, as David Weisbach pointed out, stock investments benefit from a lower effective rate of tax than debt because, under current law, noteholders are subject to tax currently on their return on investment (either as interest, if paid currently, or original issue discount, if not), but shareholders of non- or low-dividend-paying stock may defer their return indefinitely until a sale, taxable exchange, or other disposition. That lower effective rate for stock helps balance the strong tax incentive for corporate taxpayers to issue debt (which permits the corporate taxpayer to claim deductions) rather than equity (which does not). If the deferral for corporate equities is eliminated for mark-to-market taxpayers, the incentive for debt financing would increase. Retention of the 35 percent rate for interest is designed to avoid exacerbating the tax law’s incentive to debt finance.

And finally, if the effective tax rate for interest is reduced, the cost of funds for states and municipalities...
from tax-exempt bonds would increase, and the market value of outstanding tax-exempt bonds would drop precipitously.

However, if taxpayers are denied deductions for interest expense, the first three reasons for imposing the higher rate on interest and other ordinary income earned on mark-to-market debt instruments would become less important; if all income and gain on mark-to-market property were taxable at a single rate, individuals would be subject to the same simple rules as corporations and the special rules for individuals that are discussed in this section would be unnecessary.

5. Section 1258. Section 1258 provides that if a taxpayer enters into a straddle (or certain other transactions) and “substantially all” of the taxpayer’s expected return from the transaction is attributable to the time value of the taxpayer’s net investment in the transaction, the transaction is treated as a “conversion transaction,” and any capital gain is treated as ordinary income to the extent of the interest that would have accrued on the taxpayer’s net investment in the conversion transaction for the term of the taxpayer’s investment at a rate equal to 120 percent of the applicable federal rate. Section 1258 would be retained for individuals and applied to treat a portion of the mark-to-market gains of an individual mark-to-market taxpayer that enters into a conversion transaction as ordinary income.

6. Market discount and acquisition premium. Under the proposal, individual mark-to-market taxpayers would be required to accrue market discount on a mark-to-market debt instrument at the 35 percent ordinary income rate (and would be permitted to deduct amortizable bond premium, as under current law). However, the proposal would modify current law to provide that market discount need not be accrued on any bond (i) that is in default, (ii) to the extent the market discount yield is greater than AFR plus 5 percent, or (iii) with a credit rating that is less than “junk.” Moreover, any loss following a default would be treated as an ordinary loss to the extent of prior accruals of ordinary income.

7. Convertible bonds, contingent payment debt instruments, and prepaid forwards and swaps. The proposal would change the treatment of individual mark-to-market holders of convertible bonds, CPDIs, and prepaid forward contracts, swaps, and other derivatives. Under the proposal, a mark-to-market individual that holds a mark-to-market convertible bond or CPDI that itself publicly traded or references mark-to-market property would deconstruct the convertible bond or CPDI into a nonconvertible/noncontingent debt instrument with a yield equal to the issuer’s comparable yield and a non-debt option or other derivative contract (that is, the convertible bond or CPDI would be treated as the equivalent unit).

Also, the taxpayer would deconstruct a prepaid forward, deep-in-the-money option, or prepaid swap into a debt instrument (or deposit) with an issue price equal to the prepayment or premium and a yield equal to the counterparty’s comparable yield, and a mark-to-market derivative. The taxpayer would accrue OID (taxable at 35 percent) on the debt instrument component, add any accrual to its basis, and treat the difference between the fair market value of the instrument and its adjusted basis as mark-to-market gain or loss taxable at the 15 percent rate. The issuer of a debt instrument or the financial institution counterparty on a derivative would be responsible for the bifurcation, and a designated position mark provider would be responsible for the valuation of each component. (Mark providers are described below in Part II.K.)

Those aspects of the proposal are optional (and complicated), but without them, individual mark-to-market taxpayers would still have an incentive to structure their investments as forwards, convertible bonds, prepaid forwards, and deep-in-the-money options and convert their time-value-of-money returns into mark-to-market gains, taxable at the 15 percent long-term capital gain rate.

8. The use of mark-to-market losses to offset ordinary income. Under the proposal, mark-to-market gains of individuals are subject to a reduced 15 percent rate of tax. If mark-to-market losses of individuals were permitted to

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91Thus, although the proposal generally repeals the straddle rules for mark-to-market taxpayers, the straddle rules would continue to be used to determine whether a mark-to-market taxpayer had entered into a conversion transaction.

Under an alternative approach, mark-to-market individual taxpayers would report ordinary income (taxable at the 35 percent rate) equal to their net investment in all mark-to-market property (other than stock) times an AFR-based rate, and would increase their tax basis in the portfolio by an equal amount to determine their mark-to-market gains or losses. Stock would be excluded to permit taxpayers to retain the 15 percent rate for gain on actual stock purchases.

92Cf. American Bar Association Section of Taxation, “Comments Regarding Application of Market Discount Rules to Speculative Bonds” (Apr. 24, 1991). It is possible that an individual would accrue interest on a bond and pay tax at the 35 percent rate and then sell or mark the bond at a loss attributable to a decline in the issuer’s credit rating (or an actual default in accrued interest). The proposal does not permit an ordinary deduction in this situation on grounds of complexity, although some ordinary deduction could be economically justified.

93The proposal would, therefore, permit appreciation on a CPDI (or gain on sale) to be taxable at the reduced 15 percent rate. Appreciation or depreciation attributable to changes in the issuer’s credit would be taxable as mark-to-market gains or losses.

94See generally Schizer, Balance, supra note 6, at 1912 (“It is well understood that taxpayers prefer a low effective tax rate on time-value returns, and might engage in planning to attain it.”).
offset ordinary income on a dollar-for-dollar basis, the government would effectively subsidize taxpayers’ losses and encourage them to take riskier bets. Therefore, under the proposal, mark-to-market losses would be fully deductible to the extent of individuals’ mark-to-market gains, then could be used to offset other capital gains, and then 43 percent of any remaining mark-to-market losses would be available to offset ordinary income or could be carried over indefinitely.

9. Assets held in retirement accounts and through insurance and annuity policies. Under the proposal, assets held in qualified retirement plans and the assets generated by up to $1 million of premiums paid on insurance policies and annuities would be excluded from the definition of mark-to-market property. The tax reform panel would tax currently all inside build up in insurance policies and annuities. However, if a mark-to-market individual had paid more than $1 million in insurance or annuity premiums, a proportionate amount of the assets corresponding to the excess would be treated as mark-to-market property and subject to current tax. Because there are no limitations on the amount of income that may be sheltered through an insurance policy (other than the amount of insurance an insurance company is willing to write), in the absence of this rule, mark-to-market individuals could shelter unlimited amounts of assets from mark-to-market treatment with insurance.

F. Inflation Indexing

The proposal does not provide for inflation indexing. On one hand, the failure to index for inflation imposes an “inflation penalty” on mark-to-market taxpayers that arguably violates fairness. On the other hand, proper inflation indexing would significantly increase the complexity of the proposal and decrease the revenue generated (and thereby affect the progressivity benefits). In a relatively low-inflation environment, simplicity and progressivity win.

G. The Scope of Mark-to-Market

1. Publicly traded property. Mark-to-market property would be defined broadly to include any property for which price quotations are readily available, so long as there exists a reasonable basis for determining fair market value. Mark-to-market property would include stocks, securities, publicly traded partnership interests, commodities, foreign currency, and potentially any other publicly traded property.

More specifically, mark-to-market property would include all actively traded personal property as defined under Treas. reg. section 1.1273-2(f)(4) and all property for which price quotations are “readily quotable” within the meaning of Treas. reg. section 1.1273-2(f)(5) (but determined without regard to the exclusions in Treas. reg. section 1.1273-2(f)(5)(ii)). Also, property would be treated as mark-to-market property if quotations are available from the issuer (that is, a RIC or hedge fund that redeems interests periodically) or persons other than dealers, brokers, or traders.

Property would qualify as mark-to-market property if price quotations are available at least quarterly; less frequent quotations would be determined on a case-by-case basis, governed by the inclusive “reasonable basis for determining fair market value” standard. Also, any property on that date, and they appreciate to $200. That taxpayer should receive a full-year inflation adjustment. However, if taxpayer B, who receives a wage of $100 on December 30, immediately invests those funds in publicly traded property and they appreciate to $200, she should receive only one day of inflation adjustment. The United Kingdom provides corporations with an inflation adjustment for capital gains calculated on a monthly basis.

Conrad de Aenlle, “Keeping a Tight Lid on Inflation,” The New York Times, Aug. 9, 2005, at Cl (“Inflation is dormant, and there are sound reasons to expect it to stay that way.”).

That standard would correspond to the standard under FAS 115 (security is marketable if it has a “readily determinable fair value”). The Equity Method of Accounting for Investments in Common Stock, APB Opinion No. 18, section 6a (March 1971).

Under Treas. reg. section 1.1273-2(f)(4), property is treated as actively traded personal property if it appears on a system of general circulation that provides a reasonable basis to determine fair market value by disseminating either recent price quotations of one or more identified brokers, dealers, or traders or actual prices of recent sales transactions.

In general, under Treas. reg. section 1.1273-2(f)(5), a debt instrument is readily quotable if price quotations are readily available from dealers, brokers, or traders. However, under Treas. reg. section 1.1273-2(f)(5)(ii), a debt instrument is not treated as regularly quotable if (A) no other outstanding debt instrument of the issuer is (i) listed on an exchange, (ii) traded on a board of trade or an interbank market, or (iii) appears on a quotation medium, (B) the original stated principal does not exceed $25 million, (C) the conditions and covenants relating to the issuer’s performance regarding the debt instrument are materially less restrictive than the conditions in covenants included in all of the issuer’s other traded debt, or (D) the maturity date of the debt instrument is more than three years after the latest maturity date of the issuer’s other traded debt.
nontraded property that is convertible into publicly traded property and any nontraded property that is substantially similar to publicly traded property would qualify as mark-to-market property.\textsuperscript{105} The IRS would have the power to treat any non-publicly-traded property as publicly traded if restrictions are imposed to avoid characterization of the property as publicly traded.\textsuperscript{106}

It is anticipated that, under those rules, stocks that appear on the NASDAQ bulletin boards would be treated as publicly traded, and stock traded only on the “pink sheets” would not generally be treated as publicly traded. However, if trading on the pink sheets is sufficiently robust to permit a reasonable basis to determine fair market value, then even pink-sheet-traded stock could be treated as mark-to-market property.

Finally, if a mark-to-market taxpayer reports earnings under GAAP, any property required to be marked-to-market under GAAP would be presumed to be mark-to-market property.

It may be necessary to define mark-to-market property to include (i) any property that would have been mark-to-market property on the date the proposal is introduced (or some period before introduction), (ii) any nontraded stock or security issued by a public company and held by any shareholder who has the legal or practical ability to cause the company to convert the nontraded stock into publicly traded stock, or even (iii) all stock and securities issued by a publicly traded company. In the absence of the first rule, a controlling mark-to-market shareholder of a publicly traded company could convert all of his publicly traded common stock into nontraded preferred stock, and thereby “lock-in” his built-in gain and avoid mark-to-market treatment.\textsuperscript{107} In the absence of the second or third rule, a mark-to-market shareholder who had control of a public company could purchase nontraded preferred shares of the company and at some later time cause the company to convert the nontraded shares into publicly traded common stock, and thereby achieve deferral.

2. Treatment of debt and other liabilities of a mark-to-market taxpayer. Under the proposal, a mark-to-market taxpayer would not be required to mark to market the “plain vanilla” fixed-rate debt instruments and variable-rate debt instruments (VRDIs) that it issues (including plain vanilla — non-CPDI — convertible debt), even if the debt is actively traded, unless the taxpayer so elects. The current tax treatment of issuers of those instruments reasonably reflects their economic cost, and GAAP does not require an issuer to mark those liabilities to market.\textsuperscript{108} Also, taxing a taxpayer that had issued a fixed-rate debt instrument in a rising interest rate environment might not accurately reflect the taxpayer’s overall economic health if the taxpayer’s non-mark-to-market business is experiencing a simultaneous decline.\textsuperscript{109} And finally, there is a strong nontax policy to defer the tax that would be due by a troubled debtor as its credit deteriorates.

Nevertheless, the issuer of those instruments would be permitted to mark them to market. A convertible debt instrument that is marked to market by its issuer would be bifurcated into a nonconvertible debt instrument issued at a discount and an option on the issuer’s equity (that is, a convertible debt instrument would be treated as the equivalent unit). The issuer would be permitted to deduct the OID attributable to the discount debt instrument (as adjusted for the market value of the deemed instrument), but would not recognize gain or loss on the section 1032 component. However, if an issuer did elect to mark to market a convertible debt instrument, all holders (and not only mark-to-market holders) would be required to treat the instrument as if it were the equivalent unit.\textsuperscript{110} (That treatment would maximize the issuer’s interest deductions and holders’ inclusions; however, that treatment is already effectively elective under current law.)

All other debt instruments and other liabilities of a mark-to-market taxpayer (other than fixed-rate debt instruments and VRDIs that the taxpayer has not elected to mark to market) for which price quotations are “readily available” would be treated as mark-to-market positions, and would be required to be marked to market. Moreover, if a mark-to-market taxpayer has actively traded debt outstanding for which price quotations are readily available, all nontraded debt of the taxpayer (other than fixed-rate debt instruments and VRDIs that the taxpayer has not elected to mark to market) would be treated as a mark-to-market position so long as there exists a reasonable basis to determine the fair market value of the nontraded debt (or a portion of the debt) by reference to the traded debt. Finally, all privately traded CPDIs that reference actively traded property (including the issuer’s stock or dividend rate) issued by a mark-to-market taxpayer would be subject to mark-to-market treatment.

\textsuperscript{105} Thus, a class of nontraded supervoting “control shares” that bears all of the economics and supervoting power of a class of publicly traded stock would be treated as mark-to-market property.

\textsuperscript{106} Cf. Treas. reg. section 1.1273-2(e) (“For purposes of determining the issue price and issue date of a debt instrument under this section, sales to bond houses, brokers, or similar persons or organizations acting in the capacity of underwriters, placement agents, or wholesalers are ignored.”).

\textsuperscript{107} The author is grateful to Richard Reinhold and Steven Todrys for suggesting that strategy and the rules that would help defeat it.


\textsuperscript{109} See generally Edward D. Kleinbard, “Beyond Good and Evil Debt (and Debt Hedges): A Cost of Capital Allowance System,” 42 Taxes 943 (December 1989) (posing a corporate taxpayer that has issued fixed-rate debt in a rising interest rate environment liability and wooing the company’s mark-to-market tax bill “at precisely the same time that its operating business feels the business cycle slowdown of a credit crunch”).

\textsuperscript{110} Analogous rules would apply to partnerships unless the equity interests in the partnership are marked to market.
All mark-to-market debt instruments issued by a taxpayer that reference the equity of the taxpayer or a related party or are payable or convertible into the equity of the issuer or related party would be deconstructed into a debt instrument that does not reference the taxpayer’s (or the related person’s) equity and one or more section 1032 derivatives (and possibly one or more non-section-1032 derivatives). The taxpayer would be entitled to interest deductions only with respect to the debt instrument, section 1032 would apply to the section 1032 derivatives, and section 163(l) could be repealed for mark-to-market taxpayers.

A mark-to-market CPDI issued by a mark-to-market taxpayer directly or through a reporting vehicle would be deconstructed into a plain vanilla fixed- or variable-rate debt instrument and one or more other mark-to-market property interests. The plain vanilla debt component would accrue interest or OID (and would not be marked to market absent a specific election by the taxpayer), and the mark-to-market components would be marked to market (that is, the treatment will be identical to the treatment of the issuer under current law that issues a unit consisting of a discount obligation and one or more derivatives). That bifurcation rule would create complexity but appears necessary to achieve parity between an issuer of a plain vanilla debt instrument and an independent CPDI, on one hand, and an issuer of a single CPDI that is the economic equivalent of the two instruments, on the other.

If a mark-to-market taxpayer is subject to mark-to-market treatment with respect to debt or the debt component of a CPDI, the mark-to-market taxpayer would accrue interest or OID on the debt (or debt component) as under current law, and would adjust the adjusted issue price of the debt instrument accordingly. Differences between the fair market value of the debt instrument and its adjusted issue price at the end of the year would be reported as ordinary income or loss to the extent attributable to increases or decreases in the credit quality of the issuer and as mark-to-market gain or loss to the extent attributable to external market factors (such as interest rate changes or the value of property referenced in the debt instrument). The adjusted issue price of the debt instrument would be adjusted accordingly.

Mark-to-market gains on debt or other liabilities of a mark-to-market issuer that are attributable to a decrease in the creditworthiness of the issuer would be treated as ordinary income and would benefit from cancellation of indebtedness (COD) relief under section 108 only if the taxpayer is insolvent or bankrupt at the time of the mark. Mark-to-market losses that are attributable to an increase in the creditworthiness of the mark-to-market issuer would give rise to ordinary deductions to the extent of prior “credit” inclusions.

Issuers of mark-to-market indebtedness would be responsible for deconstructing it into its components, but primary responsibility for the valuations of the components would lie with the financial institution that is designated as the mark provider for the particular instrument, as described below in Part II.K.

3. Treatment of derivatives and compound instruments held by a mark-to-market taxpayer. Any derivative or compound instrument that directly or indirectly references mark-to-market property would be treated as mark-to-market property to the extent its value changes based on changes in the mark-to-market property. Thus, an on-market equity swap referencing publicly traded stock would be treated entirely as mark-to-market property. A swap that provides for a significant upfront payment to the taxpayer would be bifurcated into a fixed-rate debt instrument or a VRDI issued by the taxpayer, and an on-market swap. The mark-to-market taxpayer would not be required to mark to market the fixed-rate debt instrument or VRDI component, but could elect to do so.

If a compound derivative or debt instrument references both mark-to-market and non-mark-to-market property, the derivative would be bifurcated into a derivative that references solely mark-to-market property and a derivative that references solely non-mark-to-market property, based on relative fair market values.

Thus, a nontraded CPDI held by a mark-to-market taxpayer with a redemption price equal to the greater of par and a portion of the appreciation in a publicly traded index would be treated as a zero coupon bond plus a mark-to-market property interest in the index. Because positions in publicly traded foreign currency are treated as mark-to-market property, the proposal would require a taxpayer that purchases a nontraded debt instrument denominated in a foreign currency to bifurcate the instrument into a mark-to-market foreign currency swap and a non-mark-to-market dollar-denominated debt instrument. (However, as described below in Part II.H.3, if the foreign currency swap or the debt instrument functions as a hedge, the taxpayer could exclude it from mark-to-market treatment.)

All derivatives that reference the issuer’s stock or dividend rate would also be bifurcated into a section 1032 derivative and a non-section-1032 derivative and the

111 The deconstruction would generally be relevant to a corporate taxpayer only for purposes of determining the portion of gains and losses that are treated as interest expense rather than mark-to-market gains and losses.

112 Two other alternatives exist. First, changes in value attributable to changes in the creditworthiness of an issuer could be

Footnote continued in next column.)
taxpayer would recognize gain or loss only on the mark-to-market value of the hypothetical derivative that does not reference the issuer’s stock or dividend rate. (In that respect, section 1032 would be expanded along the lines recommended by the Tax Section of the New York State Bar Association.114) Also, members of the issuer’s consolidated group would recognize gain but not loss on any section 1032 gains relating to the issuer’s stock.115

The requirement that taxpayers bifurcate “compound” derivatives (that is, a derivative that references mark-to-market property and either non-mark-to-market or section 1032 property) will increase the difficulty of valuing derivatives. However, that complexity is necessary to prevent arbitrage.116

Issuers of debt instruments would be responsible for deconstructing the instrument into its components and reporting the components to holders; however, as described below in Part II.K., the “position mark provider” would be responsible for valuing the components. Financial institution parties to derivatives would be responsible for deconstructing the components and, as the position mark provider, would report their respective values.

4. Deferred compensation and compensatory options. Under the proposal, if a mark-to-market taxpayer is entitled to deferred compensation and the deferred compensation directly or indirectly references mark-to-market property, the mark-to-market taxpayer would be subject to tax on the fair market value of the deferred compensation if (and when) it is no longer subject to substantial risk of forfeiture. Also, if a mark-to-market taxpayer receives a compensatory option with respect to the stock of a publicly traded employer (or a compensatory option with respect to any other entity if 25 percent or more of the entity’s gross assets consist of mark-to-market property), the mark-to-market taxpayer would be subject to tax on the fair market value of the option to the extent it is in the money and not subject to a substantial risk of forfeiture. If such an option is issued by a nonpublic employer, it would be bifurcated into an option on the mark-to-market property of the employer and an option on the non-mark-to-market property, and the deemed mark-to-market option would be subject to mark-to-market treatment based on its fair market value when it is not subject to a substantial risk of forfeiture.117

The initial tax would be imposed on the employee at the 35 percent rate, and the employer would be entitled to an ordinary deduction when the mark-to-market employee reports the income. Thereafter, the mark-to-market employee would be subject to mark-to-market taxation on the deferred compensation or option (that is, the option would be valued) at mark-to-market rates (that is, 15 percent for mark-to-market individuals) and the employer would not report any gain or loss.

That aspect of the proposal is particularly controversial because it would accelerate recognition for stock options and other deferred compensation for some executives of publicly traded companies and managers of hedge funds.118 However, it would permit those executives to qualify for a 15 percent rate of tax on appreciation after the initial inclusion. Moreover, permitting mark-to-market taxpayers to defer their nonqualified deferred compensation or stock options on publicly traded property would permit an unjustified exemption from mark-to-market treatment on publicly traded property.119 And the proposal would tend to conform the tax and accounting treatment of publicly traded employers: Under FAS 123R, companies must take a charge against earnings when granting share-based payment awards, including stock options, stock appreciation rights, restricted stock, bonuses, and other deferred compensation.

The proposal does permit deferral of compensation for as long as the mark-to-market employee’s compensation is subject to a significant risk of forfeiture; it also permits holders of compensatory options on public stock to defer their tax until the option is in the money, and the proposal does permit mark-to-market employees to defer compensation so long as the deferral does not reference publicly traded property.120 Those concessions anticipate

117Bifurcated options would be taxable before the date they are in the money; otherwise, it would be too difficult to determine whether the option is in the money.
118Under current law, employers are not permitted deductions for deferred compensation until the employee reports the compensation into income. The proposal would accelerate the taxable event and also the employer’s deduction. However, thereafter the mark-to-market employee’s stock options or other deferred compensation would be taxable on a mark-to-market basis. Unless the employer is also on a mark-to-market basis on all of its assets, the proposal would tend to generate additional revenue as the employer’s stock price increases.
119That aspect of the proposal would generate revenue if the stock of the employer appreciates unless the employer marks to market all of its assets.
120Thus, the proposal does not go as far as the rule suggested by the JCT staff, which would include all deferred compensation in income when there is no substantial risk of forfeiture.

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114See generally New York State Bar Association (Tax Section), Report on Section 1032 (June 15, 1999) (detailing proposal to expand the scope of 1032).
115Cf. Treas. reg. section 1.1502-13(f)(6)(i) (loss of member of a consolidated group in respect of stock of parent company is permanently disallowed).
116For example, a taxpayer might embed a section 1032 position in a derivative. If the position is out of the money as to the taxpayer, the taxpayer might settle the derivative with cash and claim the entire loss. Conversely, if the position is in the money as to the taxpayer, the taxpayer may accept cash for a modification of the derivative that eliminates the section 1032 component and claim that the gain is excluded. Current law does not provide for a bifurcation of derivatives containing section 1032 elements and therefore invites those transactions.
the sympathetic psychological “paper gains” arguments that would be made by an employee who can be fired and lose his deferred compensation, an employee who cannot yet exercise his option and receive cash, and an employee whose deferred compensation remains subject to the company’s creditors.

H. Foreign Tax Credit Issues

The proposal could give rise to, or increase, the excess foreign tax credits of mark-to-market taxpayers because it will tend to increase disparities between the timing of gain and loss under U.S. tax law and under foreign law. Rules could be developed to ease those timing issues (which exist to some extent under current law, but would be exacerbated under a mark-to-market system). For example, a mark-to-market taxpayer might not be required to carry back her foreign tax credits and instead might be permitted an indefinite carryover of the foreign tax credits generated by mark-to-market property.

I. Exceptions From Mark-to-Market Property

1. Greater-than-50-percent-owned publicly traded subsidiaries of publicly traded corporations. The proposal excludes greater-than-50-percent owned subsidiaries of mark-to-market corporations from mark-to-market treatment for two principal reasons. First, subjecting parent corporations to tax on the appreciation in their subsidiaries exacerbates the double level of tax; majority ownership establishes a convenient threshold, between an investment that is appropriately subject to mark-to-market taxation and an integrated — albeit publicly traded — division. Second, 50 percent is the threshold used for purposes of section 475 and the proposal would create an awkward anomaly if it departed from that threshold. Alternative natural thresholds would be 20 percent, which is the threshold under GAAP, and 80 percent, which is the threshold for a consolidated return.

2. REMIC residuals. Although REMIC residuals are rarely, if ever, publicly traded property, the proposal would exclude them from mark-to-market treatment as the regulations under section 475 currently do.

3. Inventory of an active trade or business (other than a dealer in securities). Under the proposal, all publicly traded property of a mandatory mark-to-market taxpayer would potentially be subject to mark-to-market taxation. That broad scope could conceivably cause the producer of a farmer, the livestock of a rancher, the gasoline of a (particularly well-to-do) gas station owner, and the jet fuel of an airline to be subject to mark-to-market taxation. An exclusion for those taxpayers is appropriate because, if the commodity constitutes inventory (or is regularly used or consumed), the commodity would be expected to turn over rapidly and therefore does not present significant deferral or character-conversion issues; although the commodities held by those taxpayers are publicly traded, the nature of the commodities held by them may differ materially in value from the publicly traded version. Finally, because that property is not a capital asset in the hands of those taxpayers, permitting them a reduced rate of tax on the appreciation in that publicly traded property would be inappropriate.

Therefore, mark-to-market property would exclude commodities that are (i) stock in trade (or other property of a kind that would properly be included in inventory) of an active producer, processor, merchant, or handler of commodities, (ii) used in the trade or business of a taxpayer and are subject to the allowance for depreciation under section 167, or (iii) supplies of a type regularly used or consumed by the taxpayer in the ordinary course of a trade or business.

However, that reasoning should not apply to the “inventory” of dealers in financial instruments (whether securities, commodities, or other property), which are subject to mark-to-market treatment under section 475; therefore, the publicly traded inventory of those taxpayers would not be excluded. Also, antiabuse rules may be necessary to prevent publicly traded inventory from being held for excessively long periods of time.

4. Hedging transactions. Under the proposal, a taxpayer could elect to exclude any mark-to-market position (including mark-to-market components) that is used in a hedging transaction (as defined in Treas. reg. section 1.1221-2) with respect to non-publicly-traded property from mark-to-market treatment. Thus, if a farmer were to purchase futures contracts to hedge price movements for his crops, the farmer would not be required to mark to market the futures contract. Similarly, a taxpayer that enters into an interest rate swap to hedge non-mark-to-market debt could treat the interest rate swap as a hedge and would not be required to mark to market either the

121For example, assume that a taxpayer holds publicly traded foreign securities. In one year, the taxpayer receives a foreign dividend of $100, subject to a $30 dividend withholding tax, but the portfolio also suffers a $100 mark-to-market loss that offsets the dividend income. That taxpayer would not be entitled to a U.S. foreign tax credit in the first year because the taxpayer would have insufficient worldwide income. That taxpayer would be permitted an indefinite carryforward of the foreign tax credits generated by his mark-to-market property.

The author is grateful to Kimberly Blanchard for pointing out those issues.

122See Statements of Financial Accounting Standards No. 115, available at http://www.fasb.org/pdf/fas115.pdf (May 1993) [hereinafter, FAS 115]. Under FAS 115, a holder is not subject to mark-to-market treatment if the holder holds more than 20 percent of the stock. See also Keinan, Book Tax Conformity, supra note 21, at 734. (“Equity securities, on the other hand, will be subject to cash or accrual method, unless the taxpayer holds less than 20 percent of the issuing corporation, and the securities are marketable.”)

123For a discussion of the reasons for excluding REMIC residuals from mark-to-market treatment, see Kleinbard and Evans, “The Role of Mark-to-Market Accounting in a Realization-Based Tax System,” 75 Taxes 788 (December 1997).


125GAAP requires that all derivatives (both assets and liabilities) be recognized in the statement of financial position at fair value. See generally FAS 115.
swaps or the debt. Finally, a mark-to-market taxpayer would be permitted to identify one mark-to-market position (including a component of a financial instrument that is subject to mark-to-market treatment) as a hedge of another and mark them two positions as a unit so long as the integration reflects economic income at least as clearly as separate marks.

J. Intrayear Transfers

If a mark-to-market taxpayer ceases to be the owner of a mark-to-market position at any time during the year (including by reason of death), the taxpayer would immediately recognize gain or loss on the property as if it were sold for its fair market value immediately before the taxpayer ceased to be the owner (even if the transfer would not be subject to tax under current law). Thus, mark-to-market taxpayers would recognize gain or loss immediately on the contribution of mark-to-market property to a partnership or corporation, or on a gift of mark-to-market property.126

K. Reporting by Entities

Under the proposal, a mark-to-market taxpayer would be required to mark to market its distributive share of the mark-to-market property held by any non-publicly-traded non-mark-to-market trust, partnership, S corporation, RIC, REIT, qualified electing fund (QEF), PFIC, CFC, or foreign insurance company (even if the foreign insurance company is not a PFIC).

Also, mark-to-market taxpayers would be required to mark to market their distributive share of the mark-to-market property of any non-mark-to-market domestic C corporation that satisfies the asset or income test for a PFIC,127 or is organized (or is marketed) with a principal purpose to avoid mark-to-market treatment. Shareholders in those domestic C corporations would be taxable on those mark-to-market gains at the mark-to-market rate (that is, 15 percent for individuals) and would be permitted to deduct mark-to-market losses to the extent of prior mark-to-market gains from the corporation. Mark-to-market gains from those corporations would increase (and mark-to-market losses would decrease) the shareholder's basis in the stock.128

Those domestic entities would be required to supply each of their mark-to-market shareholders, partners, and beneficiaries their distributive shares of the entity's mark-to-market gains and losses; however, mark-to-market shareholders would be required to obtain that information from foreign entities. A mark-to-market taxpayer that fails to obtain monthly marks would be taxable at ordinary income rates and would be subject to a deferred interest charge, based on the constructive ownership rules, on their share of the gain on sale that is attributable to mark-to-market property (and all gain would be presumed to be attributable to mark-to-market property unless the taxpayers could demonstrate some lesser amount).

Two aspects of those reporting requirements are particularly controversial. First, the proposal imposes a modified QEF regime for the mark-to-market taxpayers of any non-publicly-traded foreign insurance company, even if the foreign insurance company would otherwise qualify for the exception for PFIC treatment for insurance companies engaged in an active trade or business.129 Thus, under the rule, mark-to-market taxpayers would be required to report their distributive share of the mark-to-market gains of the foreign insurance company (but unless the foreign corporation is a PFIC, no other undistributed income or gain).130 Without that rule, the tax law would effectively encourage mark-to-market taxpayers to invest in foreign insurance companies that rely on the active insurance company exception from the PFIC rules because, through that investment, the mark-to-market taxpayer could avoid mark-to-market treatment for the mark-to-market property of the insurance company.

Second, mark-to-market taxpayers would be required to mark to market their distributive share of the mark-to-market gains of any non-mark-to-market domestic corporation that satisfies the asset or income test for a PFIC or is formed (or marketed) with a principal purpose to avoid mark-to-market treatment for its shareholders. That rule would add administrative costs and complexity for those C corporations and their shareholders, and would discourage U.S. taxpayers from investing in them. However, in the absence of a rule of that type, individual mark-to-market taxpayers with more than $5 million of assets could hold them through multiple private domestic C corporations (none of which satisfies the mark-to-market asset threshold for corporations), or a promoter could offer interests in a C corporation that holds publicly traded securities and has a value of less than $50 million to multiple mark-to-market investors to permit them to avoid mark-to-market treatment. Although the individuals would be mandatory mark-to-market taxpayers, because the stock of the privately held C corporation would not be publicly traded property, the stock would not be subject to mark-to-market treatment and, because the C corporation would have less than $50 million of assets, it would not be a mark-to-market

126 An exception could (but need not necessarily) be made for donations of mark-to-market property to tax-exempt organizations.

127 In general, a corporation is considered a PFIC if (a) at least 75 percent or more of the corporation's gross income for the tax year is passive income or (b) at least 50 percent of the corporation's assets measured by value on a quarterly average basis produce or are held for the production of passive income. Section 1297(b) and (f).

128 A de minimis exception would exempt those entities and shareholders from the reporting and mark-to-market provisions if the only mark-to-market property, derivative, or liability of the entity is publicly traded debt held or issued by the corporation, and interest rate or currency swaps.

129 See section 1297(b)(2)(B) ("Passive income does not include income, derived in the active conduct of an insurance business by a corporation which is predominantly engaged in an insurance business and which would be subject to tax under subchapter L if it were a domestic corporation.").

130 For instance, if a foreign insurance company earns non-subpart F income from non-mark-to-market assets, the mark-to-market shareholders of the foreign insurance company would not be required to report that income.
taxpayer. (For those taxpayers, subjecting the publicly traded property to a corporate level of tax may result in a significantly lower effective tax rate than mark-to-market treatment. Moreover, subsequent conversion to an S corporation might avoid even corporate-level tax.)

Use of the PFIC asset and income tests as the requisite threshold strikes a balance between the administrative costs of compliance and potential revenue and abuse prevention. That mechanism is not perfect, and adds complexity, but is preferable to a series of antiabuse rules designed to prevent mark-to-market taxpayers from holding their publicly traded property in non-mark-to-market domestic C corporations.131

L. Administration and Valuation

Under the proposal, a financial institution would be designated as the “position mark provider” for each mark-to-market position and would provide valuations to mark-to-market taxpayers. Also, each mark-to-market taxpayer could designate one or more “taxpayer mark providers” to value their mark-to-market positions under alternative valuation conventions, or on a hedged or portfolio basis. A taxpayer that relies on the valuation of a mark provider in good faith would be subject to tax on any gain resulting from the misvaluation, and interest at a mark provider's rate, but would not be subject to penalties.

Dealers in securities, traders in securities electing under section 475(f), mutual funds, qualified institutional buyers,132 and other large taxpayers that receive approval from the IRS would be permitted to value their own positions. However, those taxpayers could be subject to penalties for improper valuation.

1. Annual valuations by mark providers. Under the proposal, a position mark provider would be designated (as described below) for each mark-to-market position issued by a U.S. taxpayer, marketed to U.S. persons, or for which a U.S. withholding agent exists, unless monthly valuations are widely available to the public.

Position mark providers would be required to provide annual calendar-year valuations to mark-to-market holders and, on request, monthly valuations.133 Mark-to-market taxpayers would report the values determined by the position mark provider unless the mark-to-market taxpayer is permitted to value its own positions or has designated a taxpayer mark provider that values the taxpayer’s position under some other acceptable method. Position mark providers would include financial institutions described in Treas. reg. section 1.165-12(c)(4) and other approved persons.

Although the issuer of a compound debt instrument would be responsible for deconstructing it into its components, the position mark provider for the instrument would be responsible for valuing the components. As mentioned above in Part II.K., a financial institution that enters into a derivative with a non-financial-institution mark-to-market counterparty would be the position mark provider for the derivative. Since the financial institution would also be the mark provider for that position, the financial institution would be responsible both for decomposing the derivative into its components and valuing them.

Specific rules would determine the proper position mark provider for any particular mark-to-market position. Those rules would be designed so that they are (i) efficient (that is, the mark provider would be the financial institution that is in the best position to value the position, and one mark provider would provide marks for all positions that are identical or substantially identical); (ii) consistent (that is, the mark provider would value the position under the same method each year, and holders of economically identical positions would report identical values, or would report values under identical method); and (iii) symmetric (that is, holders and issuers would report identical values, or values under identical methods).

For example, it would be expected that the issuer of a mark-to-market security would designate the position mark provider for that security (which would normally be the underwriter) and the issuer and holders would report marks on a consistent basis. The financial institution that is the counterparty to a derivative would generally be the mark provider for that derivative.

Flow-through and reporting entities would designate a single mark provider for their equity interests (unless monthly valuations are widely available to the public) so that all mark-to-market holders of an interest in the entity would report valuations under an identical method. Any mark provider that believes there are other mark providers valuing identical or substantially identical positions would be required to disclose the other mark providers.

Position valuations would be based on fair market value, with specific adjustments. For example, the values of “long” positions would not be permitted to take into

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131 An alternative regime to prevent mark-to-market taxpayers from organizing a private C corporation, contributing their publicly traded property to the corporation, and maintaining the corporation’s net asset level below the $50 million threshold would require that, for purposes of determining whether a corporation has satisfied the $50 million threshold, the corporation would include all of the assets of all of the corporations in the “controlled group of corporations” (as defined in section 1563) that include the corporation. For that purpose, the 80 percent threshold in section 1563 might be reduced from 80 percent to 50 percent and insurance companies would be included. Thus, if an individual with $75 million of net assets were to contribute them equally to two C corporations, each of the C corporations would be treated as having $50 million of net assets, and therefore, each of them would be mandatory mark-to-market taxpayers.

That mechanism was rejected because it would lead to structures under which C corporations are organized to permit their mark-to-market shareholders to avoid mark-to-market. The proposal is designed to eliminate the possibility of tax planning to avoid mark-to-market treatment.

132 In general, a qualified institutional buyer includes an institution that manages at least $100 million in securities and a registered broker-dealer owning and investing, on a discretion ary basis, $10 million in securities of nonaffiliates. See 17 C.F.R. section 230.144A(a)(1).

133 In other words, if an instrument has a single calendar-year holder, the position mark provider would be required to value the mark-to-market position each calendar quarter.
account blockage, minority, marketability (or illiquidity), fragmentation, or investment company discounts.\textsuperscript{134}

Also, each mark-to-market taxpayer could designate one or more taxpayer mark providers. Taxpayer mark providers would value (i) positions for which no position mark provider has been designated (for example, foreign securities not offered to U.S. persons), (ii) hedged positions, and (iii) positions on a portfolio basis.

Taxpayers would be permitted to instruct their taxpayer mark providers to use some averaging conventions (for example, over the 30-day period preceding the tax year) that are consistent with the method used by the position mark provider and do not systematically understate or overstate value. If a taxpayer adopts an averaging convention other than closing value on the last day of the taxpayer’s tax year, the taxpayer would be required to use the method consistently. Taxpayer mark providers also would not be permitted to take into account blockage, minority, marketability (or illiquidity), fragmentation, or investment company discounts.

Dealers in securities, traders in securities electing under section 475(f), mutual funds, qualified institutional buyers, and other large taxpayers that receive approval from the IRS would be permitted to value their own positions.

The IRS would establish broad principles by revenue procedure or other guidance to value derivatives, and methods could be subject to specific approval by the IRS (analogous to advance pricing agreements).\textsuperscript{135} For example, it would be anticipated that the method described in Part II.K.2. (GAAP with adjustments) could also be used for taxpayers that are not GAAP reporters.\textsuperscript{136}

As long as a taxpayer relies in good faith on a mark provider’s valuation, the taxpayer would not be subject to penalties for reporting an inaccurate value; instead, the taxpayer would be subject only to additional tax based on the correct value and a market rate of interest on any deferral. However, a taxpayer could not rely in good faith on the valuations provided by a mark provider that represents or implies that its valuation method results in lower tax liability than a competitor. Taxpayers that value their own positions could be subject to penalties for improper valuation.

A mark provider (or a taxpayer valuing its own positions) that complies in good faith with the published guidance or an approved method would not be subject to penalties, even if a valuation is inaccurate. However, a mark provider would be presumed to be acting in bad faith if it attempted to gain a competitive advantage by claiming or implying that its valuation method results in a lower tax liability than a competitor.

Mark providers (and taxpayers valuing their own positions) would be required to disclose to the IRS any differences between the methods used to determine valuations for mark-to-market purposes and the valuations used for the mark provider’s (or taxpayer’s) own internal purposes (for example, compensation), for purposes of the mark provider’s financial reports under GAAP, or other mark providers’ valuations of the same or substantially similar positions. The disclosure of the differences would permit the IRS to choose between competing valuation methods, but those differences would not imply bad faith.

2. Taxpayers maintaining ‘reliable financials.’ Under the proposal, any taxpayer maintaining “reliable financials” could elect to use GAAP valuations (subject to specific adjustments) in lieu of using the valuations provided by a mark provider to value any position that is marked to market both for tax and GAAP purposes.\textsuperscript{137} An election to use GAAP valuations would be irrevocable and would apply to all of the taxpayer’s mark-to-market positions that are marked to market both for tax and GAAP purposes. A taxpayer that makes a GAAP valuation election would be required to disclose differences between the GAAP valuation and the valuation provided by the taxpayer’s mark provider.

\textsuperscript{134}See H.R. Conf. Rep. 103-213 at 616 (legislative history to section 475, providing that valuation is generally determined on an individual security basis without taking any blockage discounts into account); Staff of the Joint Comm. of Taxation, \textit{Options to Improve Tax Compliance and Reform Tax Expenditures}, JCS-02-05 396-399 (Jan. 27, 2005) (proposing to disregard minority, marketability, fragmentation, and investment company discounts for purposes of estate tax valuations). Cf. Treas. reg. section 1.83-2(a) (disregarding lapse restrictions in valuing property).

\textsuperscript{135}The proper valuation of derivatives has received increasing attention from a variety of regulatory bodies, each of which are developing principles of valuation. See, e.g., Floyd Norris, “U.S. Rejects Cisco Plan on Options,” \textit{The New York Times}, Sept. 10, 2005, at C1 (quoting Christopher Cox, chair of the Securities Exchange Commission: “Over time, as issuers and accountants gain more experience in valuing employee stock options for financial accounting purposes, particular approaches may begin to emerge as best practices, and the range of potential methodologies will likely narrow.”); Staff, SEC, \textit{Implications of the Growth of Hedge Funds} (September 2003) (recommending that the SEC consider mandating the specific procedures that a hedge fund must follow in valuing its assets); International Organization of Securities Commissions, Technical Committee, \textit{Regulatory Approaches to the Valuation and Pricing of Collective Investment Schemes} (May 1999) (listing various pricing methods in different jurisdictions).


\textsuperscript{137}Cf. prop. Treas. reg. section 1.475(a)-4(b)(2) (use of GAAP valuations available only for positions that are properly marked to market under section 475). Under FAS 115, securities purchased from customers and intended to be held to maturity and commodities are not marked to market. In addition, an issuer does not mark to market its debt unless the debt contains an embedded derivative. FAS 115; see Keinan, Book Tax Conformity, \textit{supra} note 52, at 725. That approach is analogous to the approach adopted by the United Kingdom in the U.K. Finance Act 2002. Under the Finance Act 2002, some derivatives that are marked to market for accounting purposes are also marked to market for tax purposes.
The proposal embraces the approach of prop. Treas. reg. section 1.475(a)-4. Thus, mark-to-market taxpayers could use the valuations reported on “applicable financial statements” (as adjusted) for purposes of marking their securities to market for tax purposes.

M. Penalty for Failure to Mark

Any mark-to-market taxpayer that did not report a mark-to-market position on a mark-to-market basis would be required to report any gain as ordinary income and would be subject to a deemed interest charge based on the amount of interest (at the underpayment rate) that would have resulted if the gain had accrued at a constant rate equal to the AFR over the taxpayer’s holding period.

N. Illiquidity Loans

Under the proposal, the government would make or guarantee loans to permit taxpayers to pay their taxes on illiquid or restricted mark-to-market property. The loans would be administered by mark providers for a standard fee. The loans would bear market rates of interest (or market rate plus a spread); in all events, that rate of interest would be less than the penalty rate for deferral. The loans would be secured by the publicly traded property.

O. Taxpayers That Flip In and Flip Out

A taxpayer that becomes subject to mark-to-market taxation in a particular year would be subject to mark-to-market treatment for that entire tax year. The taxpayer would have until the date its tax return is due to designate mark providers for the taxpayer’s mark-to-market property and liabilities; the mark provider would be required to mark the taxpayer’s mark-to-market property as of the first day and the last day of the tax year.

A taxpayer that was a mark-to-market taxpayer in a previous year but is no longer subject to mark-to-market treatment would return to realization taxation at the beginning of the tax year with an adjusted basis in its assets that reflects prior mark-to-market taxation.

P. Grandfathering

The grandfathering aspect of the proposal is one of the most important variables affecting revenue, complexity, and political acceptability. Three different forms of grandfather rules are suggested. Under each form, a mark-to-market taxpayer’s mark-to-market securities would be valued (in accordance with the valuation methods described above) on the effective date of the proposal.

Under the weak form, mark-to-market taxation would apply only to changes in value after the date of enactment. Preenactment gain and loss would remain on the realization system. However, carryover basis would apply to property received from a decedent.

Under the moderate form of the proposal, all preenactment built-in gains would be required to be recognized over a period of years (for example, 10 percent of any aggregate net built-in gain as of the first valuation date could be required to be recognized in each tax year over a specified period (for example, 10 years)), or on a specified date in the future (for example, 5 or 10 years).

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138 On May 22, 2005, the IRS proposed regulations that would permit taxpayers to use the valuations they report on certain financial statements for section 475 purposes. See prop. Treas. reg. section 1.475(a)-4.

FAS 133 generally requires all derivatives to be recorded on the balance sheet at “fair value” (that is, marked to market). Unrealized gains and losses on speculative derivatives and hedges of assets, liabilities, and firm commitments are recorded in net income. Unrealized gains and losses of hedges of the variable cash flows of forecasted transactions are recorded in equity as part of comprehensive income. In addition, the hedged item associated with a “fair value hedge” also must be marked to market to the extent the fair value of the hedged items are attributable to the risk being hedged. See generally FAS 133 para. 4 and summary; Keinan, Book Tax Conformity, supra note 52, at 740.

139 An applicable financial statement includes any financial statement prepared in accordance with U.S. GAAP and that is required to be filed with the SEC or another federal agency, or is given to creditors for the purposes of making lending decisions, provided to equity holders for purposes of evaluating their investments in the taxpayer, or for other substantial nontax purposes, and which the taxpayer anticipates will be directly relied on for the purposes for which it was created, if the financial statement (i) contains values for eligible positions, and (ii) is significantly used by the taxpayer in most of the significant management financials in a manner that is related to the management of all or substantially all of the taxpayer’s business.

140 Cf. section 1260(b) (imposing interest charge on deferral of gain recognition for a “constructive ownership transaction” under that method).
and any assets inherited by a mark-to-market taxpayer would immediately become subject to mark-to-market for all gain.

Under the strong form of the proposal, mark-to-market taxpayers would be subject to mark-to-market taxation on all of their mark-to-market property on a date certain (for example, the second succeeding tax year after the date of enactment). However, the rate of tax on preenactment built-in gains might be subject to a reduced rate.146

III. Addressing the Critics

This part attempts to anticipate and address criticisms of the proposal.

A. Political Viability

The proposal would directly affect the high-net-worth individuals who serve as the financial base of the Republican party. That fact alone could doom the proposal.

However, the other proposals for tax reform suffer far more serious political infirmities. The tax reform panel’s proposals to reduce or eliminate deductions for state and local taxes, mortgage interest, and charitable deductions are widely viewed as unenactable. A VAT or national sales tax lacks political support and would affect far more taxpayers.147

Thus, although the proposal affects a key Republican constituency, which instantly renders its prospects slim, it would adversely affect a very small number of taxpayers, and therefore it shines alongside the other alternatives.

B. Economic Inefficiency

One of the most forceful criticisms of a partial mark-to-market system is that, by subjecting only publicly traded securities to mark-to-market treatment, the tax law would discourage mark-to-market taxpayers from investing in publicly traded property and artificially encourage them to invest in “private” property.148 For example, Edward Zelinsky has suggested that if only publicly traded securities are subject to mark-to-market treatment and, as a result, their effective tax rate is higher than nontraded securities, resources would “flee” the publicly traded assets for privately held ones.149 David Schizer has made a similar point, arguing that, under a partial mark-to-market system, mark-to-market taxpayers might be expected to shift their equity investments from publicly traded securities to private “Rule 144A” securities to avoid mark-to-market treatment.

Those concerns, while valid at the margins, should not be overstated. First, the higher effective rate of tax would apply to only a very small percentage of taxpayers. While the wealthiest 0.1 percent of taxpayers control a meaningful portion of the wealth in the nation, more than a third of all publicly traded securities are held by pension plans and other tax-exempt holders.

Second, the benefits to investors of liquidity (and to issuers of access to the capital markets), which would be available only for mark-to-market securities, will outweigh the tax costs of a higher effective rate on gains. For example, Google’s initial public offering (IPO) was apparently driven by the venture capital funds that financed it. The incentive mechanisms of those funds operate to encourage pretax return maximization, which generally occurs following an IPO. It is unlikely that enactment of a mark-to-market regime would alter those incentives.150

In no small measure, our tax system already discourages public offerings because operating companies may avoid a corporate level of tax only if they remain private and limit trading in their interests.151 Nevertheless, companies regularly choose liquidity for their shareholders and access to the capital markets despite the corporate income tax. For example, Goldman Sachs voluntarily incurred a corporate income tax after its 1999 IPO, and this year Lazard subjected its U.S. operations to a U.S. corporate tax in connection with its public offering.152

Third, while nontraded Rule 144A securities would be exempt from mark-to-market treatment, any listing on a general system of circulation (such as Bloomberg), could cause the security to be subject to mark-to-market treatment. Thus, in some sense, the inefficiencies would be self-limiting. Moreover, mark-to-market treatment could not be avoided by imposing restrictions on trading.

In the end, as long as the marginal benefits of liquidity comfortably outweigh the higher effective rate of tax for mark-to-market taxpayers, and while the proposal will create some artificial incentives, the level of inefficiency in the marketplace should remain acceptable.

If the proposal is implemented, mark-to-market corporations will have a disincentive to offer more than 50 percent of the stock of their subsidiaries to the public.

146Cf. section 965 (granting a dividend received deduction for some repatriations from foreign subsidiaries).
147See Kirkpatrick, Talk of Taxes, supra note 10, at 22.
148See Edward S. Zelinsky, For Realization, supra note 46, at 861; Louie, Realizing Appreciation, supra note 143, at 870 n. 7; Weisbach, A Partial Mark-to-Market Tax System, supra note 47, at 103-5 n. 5.
149See Zelinsky, For Realization, supra note 46, at 915.
because the corporation would be required to immediately recognize its built-in gain. However, that threshold is significantly higher than the 20 percent threshold of consolidated returns (which discourages IPOs of more than 20 percent).

The proposal will also give rise to inefficiencies to the extent taxpayers at the margin of the $5 million threshold convert their publicly traded securities into a larger home or collectibles to remain below the asset thresholds. However, those marginal inefficiencies should remain modest; also, those taxpayers would forgo liquidity.

By subjecting mark-to-market gains to tax at the existing tax rates, the proposal differs from the proposal offered by David Weisbach. In his article on a partial mark-to-market system of taxation, Weisbach proposed that, to maintain efficiency, the nominal tax rate on mark-to-market assets should equal the average effective rate on realization assets.155 However, the “average” effective rate on realization assets is not a meaningful number,154 and setting the effective rate on mark-to-market gains at the average effective rate on realization assets will not necessarily improve efficiency. Moreover, although a reduced rate of tax for mark-to-market gains is not inconsistent with the proposal, it would reduce the revenue the proposal generates, and could frustrate its progressive effect.

C. Valuation

The primary criticism of any mark-to-market system is the difficulty of valuing mark-to-market positions.156 But those concerns are undercut by the existing requirement that publicly traded securities be marked to market under GAAP (and for purposes of U.K. corporate taxation) and by dealers and traders under section 475.157

Valuation is increasingly relevant for federal income tax purposes,157 and both mandatory and voluntary mark-to-market taxation have increasingly appeared in the code and the regulations.158

Second, the proposal addresses valuation concerns directly. First, it permits taxpayers to use their GAAP valuations and thereby relies on the check and balance of conflicting incentives to arrive at proper valuations (that is, the incentive to overvalue for book purposes and undervalue for tax). Second, in all other cases, the proposal places valuation responsibilities on the financial institutions that are best positioned to undertake the valuation, and adopts a process-based approach that looks primarily to the integrity of the valuation method rather than the specific dollar valuation of a position. Third, the proposal accepts variation in actual valuations, and imposes no more than a market-based interest charge on taxpayers that rely in good faith on an incorrect valuation to pay their tax.

D. Complexity

Critics will charge that the proposal, by deconstructing some financial instruments, and by requiring annual valuations of mark-to-market property, fails to reduce complexity but merely replaces existing complexity with new complexity.

There is some merit to those charges. Deconstructing and valuing derivatives is complex, but derivatives remain relatively rare instruments generally used only by sophisticated taxpayers and those deconstructions generally reflect the economics of the derivatives and the method used by financial institutions to price and hedge them. Thus, the case could be made that this is precisely the complexity that should be present in a tax system that accurately measures income in an economically complex world. Moreover, although the proposal would introduce some complexity, because it eliminates planning for mark-to-market positions and effectively exempts them from a number of existing provisions, on the whole, the proposal should significantly simplify federal tax law “to reduce the cost and administrative burden of compliance,” as the president has directed.159

E. ‘Second Best’

Partial mark-to-market systems are sometimes dismissed as “second best” under the theory that only ideal

153 See Weisbach, “A Partial Mark-to-Market Tax System,” supra note 47, at 101. Prof. Weisbach drew on a paper written by Jane Gravelle suggesting that at a time when the capital gains rate was 28 percent (the average on noncorporate capital gains in 1994 was about 20 percent) the average rate on mark-to-market gains should be 20 percent (but would be higher for high-income individuals and lower for low-income individuals).

154 Short-term gains are subject to a significantly greater effective rate than long-term capital gains.

155 See Schenk, A Positive Account, supra note 44, at 359-60, 383 (2004); Evans, The Realization Doctrine, supra note 46, at 898 (“an attempt to repeal the realization doctrine on a wholesale basis for individual taxpayers would create such a firestorm of political opposition that few politicians would seriously consider such a proposal”); Zelinsky, For Realization, supra note 46, at 893-900 (discussing resistance to taxation of paper gains); Schizer, Realization, supra note 46, at 1607, 1595; Potter, Mark to Market, supra note 46, at 881 (“a partial mark-to-market system would be unsaleable.”).

156 See section 475; see also Treas. reg. section 1.148-6(e)(5) (requiring mark-to-market for some commingled funds with longer-term investment portfolios); Treas. reg. section 1.1296-1 (providing mark-to-market election by “eligible RICs” for some marketable stock in a PFIC); Treas. reg. section 1.988-2(b)(15) (mark-to-market treatment for hyperinflationary foreign currency debt instruments); cf. temp. Treas. reg. section 1.1297-3T (deemed sale election for a shareholder in a PFIC that fails to be treated as a PFIC).

157 See TAM 200513027, Doc 2005-6737, 2005 TNT 63-8 (publicly traded company valued based on trading price of stock at time of merger to determine section 382 limitation); LTR 200513018, Doc 2005-6728, 2005 TNT 63-19 (foreign corporation uses fair market value election for interest allocation purposes).

158 For example, the recent “contingent swap” regulations would permit any taxpayer to elect mark-to-market treatment for their contingent swaps so long as their counterparty is a mark-to-market taxpayer that is willing to value the swap. See prop. Treas. reg. section 1.446-3(b); see also prop. Treas. reg. section 1.988-5(f) (permitting a mark-to-market election for foreign currency transactions so long as the treatment is consistent with the taxpayer’s financial accounting treatment).

159 See Part IV.D., below (outlining simplification).
or “first best” proposals should correct existing distortions. However, as Deborah Schenk has suggested, dismissal of second best is appropriate only in a first best world. Otherwise, reform proposals should be evaluated against existing law and the alternatives.

F. Too Harsh

In his 1992 article, Daniel Shaviro proposed to expand realization and impose a tax on loan proceeds in excess of the basis of any assets pledged as loan security, or otherwise when the proceeds from a taxpayer’s loans exceed the basis of all of the taxpayer’s noncash assets.

As Deborah Schenk has suggested, dismissal of second best is appropriate only in a first best world.

Shaviro’s proposal would address the valuation and liquidity concerns of a mark-to-market proposal because a taxpayer’s gain would be measured by cash borrowed and the cash would always be available to pay the tax. However, such a proposal would not meaningfully accelerate realization; by permitting taxpayers to borrow the amount of their basis before being subject to tax, wealthy individuals would enjoy long periods of deferral. Moreover, the proposal is easily avoided and the countermeasures are burdensome.

G. Increased Debt Financing

The proposal, by eliminating the deferral that currently exists for stock, would increase the relative cost of equity financing and would tend to make debt financing even more attractive than it is today.

However, our current tax system already favors debt over equity, but there is no shortage of IPOs or equity investors. Although a marginal effect might result, the large number of tax-exempt, foreign, and realization investors should moot any significant effect. And, if the effect is meaningful, reducing the deduction for interest expense would moderate the debt advantage.

H. Difficulties of Estimating Revenue

Government revenue under a mark-to-market system would rely to a greater extent on changes in market values and therefore revenue would be more susceptible to changes in market valuations and more difficult to estimate for planning purposes. However, securities market values already have a tremendous effect on the economy, and the relationship between incremental market changes and tax revenue under the proposal should be predictable.

I. Market Flooding

If taxpayers are subject to mark-to-market taxation on an annual or quarterly basis, the market could be flooded with securities as mark-to-market taxpayers sell to pay their tax. However, it is far more likely that the sophisticated taxpayers subject to mark-to-market treatment would time their market sales and hedges so as not to disrupt the market. And the proposal would permit valuations based on averaging conventions.

J. Resistance From Financial Institutions

The proposal imposes responsibility for valuations on financial institutions, and in some circumstances imposes penalties on them if the valuation is incorrect. Financial institutions are likely to strongly resist that added cost, expense, and potential liability. Under the proposal, insurance companies would be subject to mark-to-market taxation on their reserves. It would be expected that those two groups of influential taxpayers would lobby against the proposal.

IV. Benefits of the Proposal

A progressive mark-to-market system would achieve all of the president’s objectives — it would permit a new federal tax system that is simpler, more efficient, and progressive; eliminate loopholes; better encourage saving and investment; and retain home mortgage interest and charitable donation deductions. It would be revenue-neutral, and help fix the AMT, but not deny deductions, raise rates, or impose new taxes. It could be implemented immediately without the monumental transitional issues of a VAT or national sales tax and it could serve as an element of any fundamental reform proposal that retains an income tax element (such as the tax reform panel’s “Plan B” or Prof. Graetz’s hybrid VAT/income tax).

A. Economic Efficiency
The realization rule is radically inefficient.168 The proposal would instantly improve the economic efficiency of the federal tax system in five different ways.

1. Elimination of deferral. A mark-to-market system eliminates the principal inefficiency of a realization-based system of taxation — the deferral of tax on economic gains.169 Deferral creates inefficiency because taxpayers retain property to avoid the tax on appreciation and enter into hedging transactions to reduce their economic exposure to appreciated property without triggering a realization event.170 That ability to reduce economic exposure to appreciated assets and preserve deferral is available only to high-net-worth individuals and public and large corporations.

2. Elimination of the ‘timing option.’ The realization rule also permits strategic trading. Not only may taxpayers retain their appreciated assets and defer their gains, but they also may sell their depreciated assets and take their losses.171 The proposal would eliminate the ability of mark-to-market taxpayers to strategically trade their depreciated assets and avoid tax on their appreciated mark-to-market assets.

3. Elimination of lock-in and lock-out. The deferral potential and timing options inherent in a realization-based system spawn two other inefficiencies: the lock-in and lock-out effects. Because reduced rates for long-term capital gains are available only after an asset has been retained for more than a year, and deferral maximizes a taxpayer’s after-tax yield, realization imposes a strong economic incentive on taxpayers to retain and not sell their appreciated assets. Thus, realization locks a taxpayer into an appreciated asset.172 In extreme situations, the lock-in effect contributes to other inefficiencies. For example, by discouraging large shareholders from selling their stock, the realization system reduces the liquidity of the capital markets. However, in a mark-to-market system, a taxpayer’s decision to retain an asset or sell it would be made without tax considerations.

While the timing option encourages taxpayers with depreciated assets to sell them, and claim their loss (and, if the asset has not been held for a year, to sell it quickly), the wash sale rules deny a taxpayer a loss on the sale of a security if it is reacquired within 30 days. That incentive to sell, and not reacquire, locks the taxpayer out of any investment.173 The proposal would eliminate the lock-out effect for publicly traded property, and mark-to-market taxpayers’ buy-and-sell decisions would not be distorted by the tax laws.

4. Elimination of bias toward growth and risky assets. As David Schizer has pointed out, because realization defers tax on appreciation but not on periodic payments such as interest and dividends, realization favors “growth” stocks over “income” stocks.174 Also, because the timing option permits taxpayers to accelerate their losses and defer their gains, realization encourages riskier investments.175 The proposal would eliminate those distortions.

5. Reduction in taxpayer and government transaction and audit costs. The inefficiencies of the realization system, in turn, employ an entire industry of professionals to construct, promote, and describe the financial products that exploit them, and an equal legion of government agents to sniff them out.176 The proposal, by eliminating virtually all domestic tax planning, would significantly reduce transaction costs for taxpayers and audit costs for the government (other than audits of valuation methods), and would eliminate the planning opportunities and therefore the private and public costs of our tax system.

B. Fairness
The realization requirement (which permits deferral and strategic trading) favors capital-investing taxpayers over wage earners (for whom only limited deferral is available). The enhanced ability of capital-investing taxpayers to reduce their effective rate of tax creates “vertical inequity.” The proposal would level the playing field between wage earners, on one hand, and high-income and high-net-worth capital investors, on the other.

Wealthy taxpayers have a superior ability over low-net-worth taxpayers to exploit the realization system by hiring sophisticated advisers to help them defer their gains, take their losses, and engage in strategies that reduce economic risk without realization. That ability creates “horizontal inequity.” Moreover, because wealthy taxpayers earn a disproportionate amount of their income from capital gains, the vertical inequities of the realization system magnify the horizontal ones.177 A mark-to-market system for publicly traded positions and derivatives would significantly reduce those inequities.
C. Abuse Prevention

Once a reliable system of valuation is established for mark-to-market positions, abuse is all but impossible.\(^{176}\) To test that statement, consider the application of the proposal to the six categories of transactions corresponding to prominent tax shelter cases that the JCT would subject to an “enhanced” economic substance doctrine.\(^{179}\)

1. Offsetting position transactions. The JCT defined an offsetting position transaction as a transaction in which (a) the taxpayer holds offsetting positions that substantially reduce the risk of loss and (b) tax benefits would result from differing tax treatment of the positions. That category includes classic straddles,\(^{180}\) as well as the bull/bear note described in Rev. Rul. 2000-12\(^ {181}\) and the “pass-through straddle” loss generator described in Notice 2002-65.\(^ {182}\) Under the proposal, offsetting position transactions consisting of mark-to-market positions cannot generate losses (because the offsetting position would generate a gain).

2. Basis/fair market value disparity transactions. The JCT described a basis/fair market value disparity transaction as a transaction that is structured to result in a disparity between basis and fair market value in turn creates or increases a loss or reduces a gain. Those transactions include income stripping, duplicated loss transactions, transactions in which a distribution represents a return of the taxpayer’s investment, and transactions in which basis does not adequately account for an “economic” liability.\(^ {183}\) None of those results are possible on mark-to-market property.

3. Artificial gain transactions. An artificial gain transaction is a transaction that is structured to create or increase a gain in an asset, any portion of which would not be recognized for federal income tax purposes (for example, by reason of section 1032) if the asset were sold at fair market value by the taxpayer (or a related person). Enron’s “Tomas” transaction was an artificial gain transaction.\(^ {184}\) An artificial gain transaction is impossible under the proposal if all of the relevant property is market to market (and compound positions are deconstructed into section 1032 positions and non-section 1032 positions). Although artificial gain transactions will remain possible even under a mark-to-market system with respect to non-mark-to-market property (as was the case in the Tomas transaction), section 732(f) effectively prevents Tomas transactions with respect to nontraded assets held in a partnership.

4. Tax-indifferent-party transactions. The JCT defined a tax-indifferent-party transaction as a transaction that is structured to result in income for federal income tax purposes to a tax-indifferent party for any period that is materially in excess of any economic income to that party with respect to the transaction for the period. That category is designed to capture the “Compaq”\(^ {185}\)-type situations in which a taxpayer claimed a foreign tax credit in respect of stock held for a very short period.\(^ {186}\) Although the proposal would not affect short holding period transactions,\(^ {187}\) the result in Compaq was reversed by section 246(c)(3) and (4).

5. Short holding period transactions. A short holding period transaction is a transaction in which the taxpayer disposes of property (other than inventory, receivables, or stock or securities regularly traded on an established securities market) that the taxpayer held for a period less than 45 days. That category is designed to capture the “Compaq”-type situations in which a taxpayer claimed a foreign tax credit in respect of stock held for a very short period.\(^ {186}\) Although the proposal would not affect short holding period transactions,\(^ {187}\) the result in Compaq was reversed by section 246(c)(3) and (4).

6. Permanent book/tax difference transactions. A permanent book/tax difference transaction is a transaction that is structured to result in a deduction or loss that is

\(^{176}\) One abuse would remain possible. Under the proposal, because interest earned by individuals would be taxable at ordinary income rates but mark-to-market gains would be taxable at long-term capital gains rates, taxpayers could attempt to construct fixed-income equivalents with straddles. The proposal retains section 1258 to prevent that strategy.\(^ {179}\) See generally Staff of the Joint Comm. on Taxation, Options to Improve Tax Compliance and Reform Tax Expenditures, JCS-02-05 (Jan. 27, 2005).

\(^{180}\) See, e.g., Knetz v. United States, 364 U.S. 361 (1960) (borrowing to purchase a deferred annuity); Goldstein v. Commissioner, 364 F.2d 724 (2d Cir. 1966) (borrowing to purchase Treasury securities); Sheldon v. Commissioner, 94 T.C. 738 (1990) (same); Yoshia v. Commissioner, 861 F.2d 494 (7th Cir. 1988) (commodity straddles).


\(^{183}\) In an income-stripping transaction, a taxpayer purchases income-producing property for $100, retains the right to an income stream (worth, say, $95), disposes of the right to the corpus (that is, worth $5), and claims a $95 loss.

\(^{184}\) The category of artificial gain transactions was intended to include Enron’s Tomas transaction. In Enron’s Tomas transaction, the taxpayer contributed low-basis but high-value property, as well as all of the stock of a corporation, to a partnership. The other partners (affiliates of Bankers Trust) contributed cash, and the corporation that was contributed to the partnership received notes receivable from a Bankers Trust affiliate. The taxpayer was redeemed from the partnership by receiving all of the stock of the contributed corporation. Although that stock had a low basis, the taxpayer liquidated it under section 332, which permitted the taxpayer to acquire the corporation’s high-basis receivable without a reduction in basis. Section 732(f) effectively prevents Tomas-type transactions.

\(^{185}\) See ACM Partnership v. Commissioner, 157 F.3d 231, Doc 98-3128, 98 T.N. 202-7 (3d Cir. 1998). In ACM, the taxpayer used the ratable basis recovery rules under temp. Treas. reg. section 15a.453-1(c) on a sale of short-term notes to generate an uneconomic gain that was largely allocated to a foreign partner. After the foreign partner was redeemed, the corresponding loss was allocated almost entirely to Colgate.


\(^{187}\) Congress has since amended section 901(k)(3) to deny the tax credit that was claimed in Compaq.
allowable for federal income tax purposes but is not allowable for financial reporting purposes. That category is intended to cover Enron’s Tanya, Valor, Steele, Condor, and Teresa transactions, which were intended to produce losses (or duplicated losses) for tax purposes but earnings for financial accounting purposes. By largely matching book and tax treatment for mark-to-market property, the proposal would reduce the situations in which permanent book/tax differences are possible.

D. Simplification

The proposal permits dramatic simplification at three levels. First, it uses revenue generated by a mark-to-market system to eliminate the AMT. Second, the proposal would eliminate much of the domestic tax planning for mark-to-market taxpayers. Finally, by eliminating realization for mark-to-market property, the proposal would eliminate the need for the series of provisions that are designed to prevent abuse of realization. What follows is a list of provisions that would become moot for mark-to-market property.

1. Holding period for reduced capital gains rates. The proposal would eliminate the requirement that mark-to-market property of an individual be held for more than a year to achieve a 15 percent rate. Under the proposal, all mark-to-market gains of mandatory mark-to-market individuals would be taxable at the 15 percent rate.

2. Character issues and the loss limitation rules. Current law denies corporate taxpayers the ability to use their capital losses to offset ordinary income and permits individuals to offset only $3,000 of ordinary income with capital losses each year. Those limitations are necessary under a realization-based system to prevent selective realization of losses, but are not necessary under a mark-to-market system in which all gains and losses for mark-to-market property are recognized annually. Therefore, under the proposal, mark-to-market losses would be fully available to offset the ordinary income of corporate taxpayers and, subject only to a percentage limitation designed to equate the marginal rates, would be fully available to offset the ordinary income of individual taxpayers.

3. Wash sale rules. The wash sale rules are designed to prevent taxpayers from selling property and claiming a tax loss and then, within a short period, reestablishing the position and maintaining their economic position. Wash sale limitations would not exist under the proposal — the realized tax loss would be permitted even if the position is maintained.

4. Straddle rules. The straddle rules (and section 263(g)) are designed to prevent taxpayers from claiming losses and deductions in respect of positions in actively traded personal property before recognizing the untaxed gains in offsetting positions. Those rules would be unnecessary if all of the gain and loss in all of the positions are recognized under mark-to-market treatment.

5. Accounting for swaps, IO interests, and other derivatives. The IRS has an extraordinarily difficult time determining the proper tax treatment of complex financial instruments under our realization-based system, and its attempts to do so have been criticized. The proposal would subject virtually all complex financial instruments to mark-to-market treatment, would eliminate the complex rules for those instruments, and would tax them economically. Moreover, once corporations and extremely high-net-worth and high-income individuals report their derivatives on a mark-to-market basis, there may be greater tolerance for simpler rules that would apply to other taxpayers (even though the simpler rules might not necessarily measure economic income perfectly).

6. Constructive sales/constructive ownership. Section 1259 prevents taxpayers from deferring built-in gain recognition after they hedge away all or substantially all of the economic risks and rewards from the appreciated position. Section 1260 prevents taxpayers from using derivatives to obtain all or substantially all of the economic benefits and burdens from particular positions, and deferring their tax and converting income from

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188Tanya and Valor were contingent liability loss generators. See Notice 2001-17, 2001-1 C.B. 730, Doc 2001-2017, 2001 TNT 13-4. In Condor, Enron attempted to use a partnership to shift basis from Enron stock held by the partnership to some depreciable assets. Steele involved the transfer of high-basis assets in exchange for high-basis stock to generate two deductions (one at the corporate level and another at the shareholder level). In Teresa, low-basis assets were contributed to a partnership, and dividend income was generated that was intended to qualify for the dividends received deduction and would increase the partnership’s basis in the low-basis assets, producing greater depreciation deductions. If the proposal were adopted, tax planning would be limited to avoiding the regime by remaining under the asset and income thresholds and avoiding mark-to-market assets.

189The list borrows from Weisbach, “A Partial Mark-to-Market Tax System,” supra note 47, at 122-28. See id. at 124 (mark-to-market taxation eliminates selective realization and, therefore, the capital loss regime would not be necessary for assets (or liabilities) in the mark-to-market base).

190Brown, Complete Accrual Taxation, supra note 43, at 1589.

191See id. at 124 (mark-to-market taxation eliminates selective realization and, therefore, the capital loss regime would not be necessary for assets (or liabilities) in the mark-to-market base).

192See Brown, supra note 43, at 1589.

193See Weisbach, “A Partial Mark-to-Market Tax System,” supra note 47, at 124. (“For example, the straddle rules prevent taxpayers from claiming losses on positions in traded property to the extent there is unrealized gain in related positions.”)

194See Treas. reg. section 1.263(g)-1(b) (section 263(g) does not apply to securities to which the mark-to-market accounting method provided by section 475 applies). The straddle rules may continue to have some vitality for grandfathered positions when preenactment gain has not yet been recognized.

195For example, in February 2004 the IRS proposed exceedingly complicated rules for taxing “contingent swaps” and requested comments on their application. See 64 Federal Register 8886 (Feb. 26, 2004). In Ann. 2004-75, supra note 6, the IRS requested help in constructing a tax regime for REMIC IO interests and, in Notice 2004-52, supra note 6, the IRS opened up a project to characterize and determine the tax treatment of credit derivatives.

196See, e.g., New York State Bar Association Tax Section, Report on Proposed Notional Principal Contract Regulations (June 4, 2005).
ordinary income to long-term capital gains. Each of those sections are unnecessary for market-to-market positions under the proposal.

7. Foreign antideferral rules. The CFC and PFIC rules act to prevent taxpayers from deferring tax on offshore passive income (and converting it from ordinary income to long-term capital gains). The PFIC rules already exempt stock that is marked to market. Similar rules could apply to marked-to-market CFCs.207

8. Foreign currency gain or loss. Under current law, complicated rules determine gain or loss in respect of foreign currency, and foreign currency gain or loss generally is treated as ordinary income or loss. Under the proposal, publicly traded foreign currency would be treated the same as all other publicly traded property: It would be marked to market, and any gain would be taxable at reduced rates.

9. Sections 301, 302, and 305, and the other shareholder provisions of subchapter C. Sections 301, 302, and 305 contain the rules that determine whether a distribution from a corporation is a dividend or a redemption. Those sections will have little effect for mark-to-market individuals because all qualified dividends and marked-to-market gains would be taxable at the 15 percent rate. Moreover, the proposal would render all of the shareholder provisions of subchapter C instantly irrelevant for individual mark-to-market taxpayers, who will be entirely indifferent whether the consideration they receive in a merger or acquisition is “tax-free stock” or taxable boot.198

10. Section 1001. Section 1001 and its regulations contain the rules for determining when the modification to a debt instrument or other property is treated as a taxable exchange for tax purposes.199 Section 1001 would be irrelevant for the mark-to-market positions of mark-to-market taxpayers.

11. Section 163(l). Section 163(l) provides, in general, that no interest deductions are permitted for any indebtedness if (i) a substantial amount of the principal or interest of the indebtedness is required to be paid or converted, or at the option of the issuer or a related party is payable in, or convertible into the equity; (ii) a substantial amount of the principal or interest is required to be determined, or at the option of the issuer or a related party is determined, by reference to the value of the equity; or (iii) the indebtedness is part of an arrangement that is reasonably expected to result in a transaction described in (i) or (ii).

Under the proposal, any mark-to-market debt instrument (other than “plain vanilla” convertible debt) that references the issuer’s equity would be bifurcated into a plain vanilla debt instrument that does not reference the issuer’s or a related party’s indebtedness and one or more other derivatives. Interest would accrue only on the plain vanilla debt component; any mark-to-market loss on the section 1032 components would not be deductible. (In other words, the proposal would transform a section 163(l) security into its equivalent unit and permit interest deductions only on the indebtedness that would not be described in section 163(l).200) Thus, section 163(l) will have no effect for a mark-to-market issuer, and safely could be repealed for those taxpayers.

E. Systemic Efficiency

Recent academic literature has sought to evaluate reform proposals based on their “systemic efficiency.”201 More specifically, Prof. Schenk has suggested that proposals that increase accrual or realization events should be evaluated based on the extent to which they (i) change (preferably decrease) the elasticity of income (that is, make it harder for taxpayers to shift into other methods of enjoying economic gains without recognizing income),202 (ii) change (preferably decrease) marginal administrative and compliance costs,203 and (iii) result in “signaling” benefits (that is, signal that the government is serious about preventing abuse).204

Progressive mark-to-market taxation fares well under that test. First, the proposal would decrease the elasticity of income because both publicly traded securities and the derivatives that reference them would be subject to mark-to-market, and private equity is not an adequate

197 However, as discussed in Part II.H., the proposal would not require 50-percent-and-greater-owned CFCs to be marked to market.

198 However, because corporations are entitled to a dividends received deduction under the proposal, sections 301, 302, and 305 (and section 1059) will continue to be relevant for them. Sections 301, 302, and 1059.

199 For example, Treas. reg. section 1.1001-3 contains a set of rules to determine when a modification to the terms of a debt instrument is so “significant” so that the unmodified debt instrument is deemed exchanged in a taxable transaction. Treas. reg. section 1.1001-3.

200 Cf. Rev. Rul. 2003-97, 2003-34 IRB 380 (the debt component of a “Feline PRIDES” is not subject to section 163(l)).

201 See, e.g., Schenk, Efficiency Approach, supra note 161, at 503; David A. Weisbach, “An Economic Analysis of Anti-Tax Avoidance Doctrines,” 4 Am. L. & Econ. Rev. 88 (2002); Shaviro, Efficiency Analysis, supra note 163. The term systemic efficiency is used here (but not in the literature) to distinguish it from economic efficiency.

202 The elasticity of income is affected by the availability of acceptable substitutes, and the ability of taxpayers to shift their investments to the substitutes, which may be affected by the presence of “frictions,” or restraints on tax planning external to the tax law. For example, as the desire to maximize book income (which tends to frustrate tax minimization strategies). See Schenk, Efficiency Approach, supra note 161, at 509-11.

203 Prof. Schenk identifies four categories of costs: (i) administrative costs borne by the government, (ii) taxpayer compliance costs, (iii) “avoidance costs” (that is, the voluntary costs incurred by taxpayers to search for and adopt substitute nontaxed transactions), and (iv) the “deadweight loss” that results when taxpayers switch to untaxed transactions. Id. at 514-17.

204 See id. at 516-18. Prof. Schenk suggests that the potential benefits of signaling depends on three variables: (i) the nature of the fix (that is, if the government attempts to shut down an aggressive transaction and succeeds, others may be less likely to try similar strategies; however, government failure may have the opposite effect), (ii) knowledge (that is, the extent that taxpayers are aware of the fix), and (iii) the effect of the fix on compliance (that is, if taxpayers believe that others (particularly the wealthy) are forced to comply with their obligations, they may be more likely to comply with theirs).
substitute for publicly traded stock. Administrative costs would increase to the extent that mark providers would be required to value thinly traded securities and derivatives, and deconstruct and value their components. However, now that many securities and derivatives are required to be valued under GAAP, and the methods exist to conduct those valuations, the marginal administrative costs are already significantly less than they were five years ago. And costs would relate only to the corporations that are unable or unwilling to use their GAAP valuations and the relatively few households that meet the income or wealth thresholds.

The proposal would decrease administrative costs to the extent that shelters are no longer available for publicly traded property. While the proposal would give rise to avoidance costs to the extent that taxpayers invest in privately held securities rather than publicly traded property, as discussed above in Part III.B., experience — albeit anecdotal — suggests that the benefits of liquidity will outweigh the tax costs of mark-to-market and will not lead to a flight from the public capital markets.

F. Increased Liquidity

By eliminating the lock-in effect and imposing tax before realization, mark-to-market shareholders might be expected to sell a greater amount of their securities to pay their tax. Thus, the proposal could reasonably be expected to cause a greater number of securities to float on the public markets, which will generally reduce volatility in the capital markets.

G. Greater Book-Tax Conformity

Because GAAP now requires mark-to-market treatment for most publicly traded securities and many derivatives, the proposal would tend to increase book-tax conformity. Conformity alone has many benefits. For example, it tends to encourage more accurate book valuations (because the incentive to value highly for book purposes is balanced by the desire to book low for tax), reduces compliance and avoidance costs, and eliminates an entire class of tax shelters.

H. Global Conformity

The United Kingdom has adopted book-tax conformity regimes, and similar approaches have been suggested for Spain and Australia. If the proposal is adopted, the United States would join those countries and move toward a consistent global tax system for mark-to-market taxpayers.

I. Consumption Tax Transition

One of the most difficult challenges of switching our current income tax to a consumption tax are the transition issues. For example, consider two taxpayers, A and B, who each have $200 worth of stock with a $100 basis. Immediately before the conversion, taxpayer A sells his stock and is left with $165 of cash after tax, but taxpayer B retains her $200 of appreciated stock. Under a consumption tax without transition rules, taxpayer A will be taxed twice (first under the income tax and then under the consumption tax), but taxpayer B only once (she will escape tax on her $100 of built-in gain). By taxing appreciation in mark-to-market property, the proposal would at least prevent the potential problem from worsening. If the moderate or strong form of the proposal — which would require recognition of the built-in gain — is adopted, transition would be easier.

J. Inherent Flexibility

The proposal is presented as a complete plan that satisfies all of the president’s objectives for tax reform, but the mark-to-market component is inherently flexible, could serve as a component of any reform that retains the income tax, and is entirely consistent with most of the alternative income tax systems that have been proposed.

For example, Prof. Michael Graetz has proposed the enactment of a 10 percent-15 percent VAT, coupled with a reduction of the personal income tax rate to 25 percent on income over $100,000, wage subsidies for low-income workers, a reduction of the corporate income tax to 25 percent, greater book-tax conformity, and a 25 percent wealth transfer tax. The proposal could form a component of the income tax under Prof. Graetz’s proposal. It would advance the progressivity objectives of his proposal and help to conform book and tax treatment.

V. Conclusion

President Bush is expected to offer his proposals for fundamental tax reform in his State of the Union address this January. The President’s Advisory Panel on Federal Tax Reform offered him suggestions on November 1, but they are widely viewed as unenactable. A progressive system of mark-to-market taxation would achieve all of the president’s objectives for fundamental tax reform in a more politically viable manner.

First, the proposal would help eliminate the AMT but would adversely affect fewer than 400,000 households. It is enactable.

Second, the proposal would not increase rates, deny deductions, or impose new taxes. Therefore, it does not violate the president’s “no new taxes” pledge.

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205 See Schenk, Efficiency Approach, supra note 161, at 530.


207 See Keinan, Book Tax Conformity, supra note 52, at 676.
Third, the proposal would offer significant simplification. It would permit the repeal of the AMT and would eliminate the straddle rules, the wash sale rules, the constructive ownership and constructive sale provisions, and the capital loss limitations for mark-to-market property.

And, finally, mark-to-market taxation would prevent nearly all abuse and eliminate virtually all loopholes for mark-to-market property, and would help to create a “fair” tax system under the president’s definition.

The irony is, of course, that a proposal by the administration to tax the appreciation in the stock holdings of the very wealthiest taxpayers is unimaginable. But because Democrats and Republicans agree that the tax reform panel’s recommendations will never become law, the president ultimately will have to decide between the unimaginable and the unenactable. Mark-to-market may be unimaginable, but it is enactable.