Moving Away From the Realization Principle

By Alan D. Viard

More than three decades ago, William D. Andrews identified realization-based taxation as “the Achilles’ heel” of income taxation.1 More recently, Daniel Halperin included mark-to-market taxation as a key part of “saving the income tax”2 and Clarissa Potter described it as “the way to save the income tax.”3 In this article, I describe the pitfalls of the realization principle and assess its future.

Under the individual and corporate income tax systems, taxpayers generally don’t recognize income until it is realized. Section 61(a)(3) includes income “derived from dealings in property” in its definition of gross income, and section 1001(a) defines gain from the sale or other disposition of property as the excess of the amount realized over the taxpayer’s adjusted basis in the property. Section 1012 defines basis as the cost of the property with some adjustments.4

Realization-based taxes apply to investors who sell appreciated assets to finance consumption and to those who sell them to reinvest in other assets, but do not apply to investors who refrain from selling appreciated assets. That pattern of taxation does not serve any coherent tax policy goal. If the goal is to tax exercises of the power to consume, which is the objective of consumption taxation, only investors who sell to consume should be taxed. If the goal is to tax increases in the power to consume even if that power is not exercised, which is the objective of income taxation, all holders of appreciated assets should be taxed. Even holders who refrain from selling have an increased power to consume, because they could have sold and consumed but chose not to do so.

Moreover, implementation of the realization principle requires arbitrary basis allocation rules. It also distorts investor behavior by encouraging investors to delay the realization of accrued gains and accelerate the realization of accrued losses. To counteract those distortions, the tax system must impose complex restrictions on the deductibility of realized losses. The use of realization-based taxation has helped maintain the existence of the distortionary corporate income tax, which is often justified as a way to ensure that tax is imposed on reinvested corporate profits that give rise to unrealized capital gains.

Because mark-to-market income taxation consistently applies to increases in the power to consume and consumption taxation consistently applies to exercises of the power to consume, each of those taxes has a coherent rationale. In contrast,

4Regulations suggest that the realization principle is a necessary feature of other countries’ income tax systems, as well as our own. Reg. section 1.901-2(b)(2) provides that a foreign tax is an income tax for which U.S. taxpayers may claim credit under section 901 only if it satisfies a realization requirement. That requirement is not as stringent as it appears, however, because the regulation allows the foreign tax to be imposed before realization under broadly defined conditions.
realization-based income taxation is betwixt and between, neither fish nor fowl.

A complete shift to progressive consumption taxation, in the form of a personal expenditure tax or Bradford X tax, would offer the most complete solution to the difficulties posed by the realization principle and would be desirable on other grounds. Alternatively, if the federal tax system continues to make significant use of income taxation, as it is likely to do, the difficulties posed by the realization principle can be addressed by applying mark-to-market taxation to publicly traded assets. The federal tax system is already making incremental movements toward mark-to-market taxation.

At first glance, the taxpayer’s realization of a gain may appear to offer the natural opportunity to impose tax on the gain. Closer consideration reveals, however, that realization is an artificial concept that has little relation to consumption or increases in the power to consume.

**Realization and Consumption**

The realization of a gain need not be associated with consumption. A taxpayer may realize the gain and reinvest the sale proceeds in other assets, thereby delaying consumption of the gain to a later date.

Alternative, the taxpayer may consume the gain before it is realized. The taxpayer can borrow, securing the loan with the appreciated asset. Or the taxpayer and a lender can agree on an unsecured loan, knowing that the asset appreciation increases the taxpayer’s ability to repay it. Finally, the taxpayer can write a put option against the appreciated asset.

Consumption before realization can occur even without those financial transactions. Consider a taxpayer who earns $50,000 of wages and holds an asset that appreciates in value from $100,000 to $110,000 during the year. The asset appreciation may prompt the taxpayer to choose a higher level of consumption than she would otherwise have chosen. Perhaps the taxpayer would have consumed $40,000 if the asset value had remained unchanged but consumes $41,000 in the wake of the asset’s appreciation. The taxpayer need not realize any portion of the gain to engage in the additional consumption, as she can continue to hold the asset and simply save $9,000 of her wages rather than $10,000. Although none of the gain has been realized, $1,000 of it has been consumed in the relevant economic sense. Because $1,000 of the taxpayer’s consumption would not have occurred in the absence of the gain, that amount is economically attributable to the gain, even though the consumption superficially appears to be financed from the taxpayer’s wage income.

It may be desirable to treat some of the financial transactions discussed above as realization events. As part of the Shelf Project, Calvin H. Johnson has proposed treating secured borrowing, short sales, the writing of options, and purchases of forwards as realization events. Even if a broad definition of realization is preferable to a narrow one, however, no definition can escape the fundamental conundrum posed by the realization principle.

Under any definition of realization, some ways of financing consumption are taxed and others are not. Treating secured borrowing as a realization event eliminates the tax disparity between secured borrowing and the sale of the asset, but it introduces tax disparities between secured borrowing and other methods of consuming the gain, including through unsecured borrowing and reduced saving from wages and other outside income. Those changes may be desirable, on balance, but they don’t yield a consistent tax base. Regardless of its definition, realization is an artificial category that includes some transactions and excludes other similar transactions.

T axing the realization of gain therefore does not accurately tax consumption. As one would expect, that goal can only be achieved through consumption taxation.

One might think, however, that realization-based taxation does a better job of meeting the objectives of income taxation. In accord with the precepts set forth by Robert M. Haig, Henry C. Simons, and George Schanz, income is commonly defined as consumption plus increases in wealth. That definition is intended to include all increases in the power to consume, whether or not that power is exercised. Realization-based taxation does not, however, consistently apply to increases in the power to consume.

**The Power to Consume**

Although some taxpayers who realize gains choose to reinvest the sale proceeds rather than consume them, all of them have the power to consume the proceeds. At first glance, that may seem to justify taxing the realization of gains as an increase in the power to consume. In reality, however, realization provides no new power to consume. Any taxpayer who holds an appreciated asset has the power to sell it and consume the gain.

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4Harvey S. Rosen and Ted Gayer, Public Finance 376 (2014) (discussing the economic definition of income and observing that it requires “the inclusion of all sources of potential increases in consumption, regardless of whether the actual consumption takes place” (emphasis in original)).
A taxpayer who sells the appreciated asset and reinvests the proceeds in another asset and a taxpayer who does not sell the asset both have an increased power to consume because of the appreciation. Both of them choose not to exercise that power. If the goal is to tax increases in the power to consume, both should be taxed, as is done under mark-to-market income taxation. If the goal is to tax the exercise of the power to consume, both should be exempted from taxation, as is done under consumption taxation. There is no coherent case for taxing only the first taxpayer, as is done under realization-based income taxation.

The tenuous link between realization and the power to consume is even clearer in the context of mutual funds and other pass-through investment vehicles. No tax is imposed on a mutual fund’s shareholders if an asset held by the fund appreciates and the fund does not realize the gain. If the fund realizes the gain, however, section 852 requires that it be distributed to the shareholders and taxed. If a shareholder has an automatic dividend reinvestment plan in place, however, there is no practical distinction between the realized and reinvested gain and the unrealized gain. The realized gain undoubtedly increases the shareholder’s power to consume, because the shareholder could have refrained from adopting the automatic dividend reinvestment plan and consumed the distributed dividend. But, the increased power to consume isn’t due to the realization. An unrealized gain similarly increases the shareholder’s power to consume, as it increases the values of the mutual fund shares, which the shareholder could readily liquidate at any time, obtaining funds with which to consume.

The accrual of the gain, not its realization, increases the power to consume. Consistent taxation of increases in the power to consume can therefore be achieved only under mark-to-market taxation.

If a taxpayer holds an asset for decades before selling it and then realizes the gain that accrued over that extended period, realization-based taxation deviates sharply from contemporaneous taxation of the increases in the taxpayer’s power to consume. It might seem like realization-based taxation works better when taxpayers buy and sell assets frequently. But in some respects, realization-based taxation is actually more problematic in that context because of the complexity and arbitrariness resulting from basis allocation.

Basis Allocation

The challenges posed by basis allocation, the inescapable bane of realization-based taxation, can be illustrated with the following example. Suppose that a taxpayer purchases 100 shares of a stock in year 1 at a price of $10 per share, 200 shares in year 2 at a price of $15 per share, and 100 shares in year 3 at a price of $12 per share. In year 4, the taxpayer sells 40 shares at a price of $16 per share. In year 5, the taxpayer purchases 100 shares at a price of $14 per share. In year 6, the taxpayer sells 160 shares at a price of $20 per share.

The treatment of the transactions is simple under a personal expenditure tax. The taxpayer deducts all the purchase costs when the purchases are made ($1,000 in year 1, $3,000 in year 2, $1,200 in year 3, and $1,400 in year 5) and pays tax on the $640 in gross sale proceeds in year 4 and the $3,200 in gross sale proceeds in year 6. The taxpayer need not refer back to earlier transactions or track shares over time. The treatment is more complex under a mark-to-market income tax because the taxpayer must compute the accrued gain each year.

Under realization-based taxation, there are no taxes or deductions in years 1, 2, 3, and 5. In year 4, however, the taxpayer must pay tax on the $640 in sale proceeds minus her basis in the 40 shares that she sold. In year 6 the taxpayer must pay tax on the $3,200 in sale proceeds minus her basis in the 160 shares that she sold. Determining the basis deduction introduces another layer of complexity.

The taxpayer has a total basis of $6,600 in the 500 shares that she purchased during the entire period. But how should that basis be attributed among the 40 shares sold in year 4, the 160 shares sold in year 6, and the 300 shares still held at the end of year 6?

Reg. section 1.1012-1(c) specifies the first-in, first-out method as the default allocation method. Under that method, the 40 shares sold in year 4 are deemed to be part of the 100 shares purchased in year 1, giving each of the 40 shares a $10 basis and allowing the taxpayer to deduct $400. Of the 160 shares sold in year 6, 60 shares are deemed to have been purchased in year 1 at $10 each and the other 100 shares are treated as having been purchased in year 2 for $15 each, allowing the taxpayer to deduct $2,100. The 300 shares held at the end of year 6 have a basis of $4,100, because 100 of the shares are deemed to have been purchased in year 2 for $15 each, 100 are deemed to have been purchased in year 3 for $12 each, and 100 are deemed to have been purchased in year 5 for $14 each.

The taxpayer need not use the FIFO method. Reg. section 1.1012-1(c) allows the taxpayer to identify the shares deemed to be sold. Current tax liability is minimized by identifying the sold shares as those having the highest cost basis. The taxpayer can identify the 40 shares sold in year 4 as part of the

7The taxpayer must deliver stock certificates corresponding to the identified shares or, if the shares are held by a broker or other agent, specify to the agent the shares he wishes to sell and obtain written confirmation of the specification from the agent.
100 shares purchased in year 2 for $15 each, allowing him to deduct $1,500. He can identify the 160 shares sold in year 6 as the 160 remaining shares purchased in year 2, allowing him to deduct $2,400. The 300 shares held at the end of year 6 have a basis of $3,600 because 100 of the shares are deemed to have been purchased in year 1 for $10 each, 100 are deemed to have been purchased in year 3 for $12 each, and 100 are deemed to have been purchased in year 5 for $14 each.

Further, reg. section 1.1012-1(e) allows the taxpayer to use an average cost method if the shares are mutual fund shares or if they were acquired after December 31, 2010, in connection with a dividend reinvestment plan. Assume that the average cost method is available and that the taxpayer elects it. Because the 400 shares purchased in years 1 through 3 had a total cost of $5,200, the average basis is $13. Therefore, the taxpayer can deduct $520 for the 40 shares sold in year 4. Because the remaining 360 shares each have a $13 basis (for a total of $4,680) and the 100 shares purchased in year 5 cost $14 each (for a total of $1,400), the 460 shares held at the end of year 5 have a total basis of $6,080, and the average basis is $13.22. Therefore, the taxpayer can deduct $2,115 for the 160 shares sold in year 6. And the 300 shares held at the end of year 6 have a basis of $13.22 each, for a total of $3,965. Under the average cost method, basis depends in a particularly complex way on the pattern of purchases and sales over time.

In addition to administrative complications, basis allocation highlights deeper problems with the realization principle. Because the shares purchased in the various years are fungible, the identification of which shares are sold in a particular year is economically meaningless. The realization principle’s dependence on that arbitrary determination reflects its fundamental limitations. None of the measures of taxable gain correspond to the increase in the power to consume in years 4 and 6.

Realization-based taxation also has distortionary effects on taxpayers’ decisions of when to sell assets. Space does not permit a discussion of the additional distortions arising when tax shelter transactions are used to manipulate the realization and basis allocation rules.

**Lock-In Effect**

Because many taxpayers have flexibility regarding the timing of asset sales, realization-based taxation can cause significant changes in taxpayer behavior. Taxpayers facing constant tax rates have an incentive to realize and deduct losses as early as possible and to realize and pay tax on gains as late as possible. The deferral of realization of gains is often called the “lock-in effect.” Taxpayers facing different capital gains tax rates in different years also have an incentive to realize losses in high-tax-rate years and gains in low-tax-rate years. Empirical studies have found that capital gains rates affect the volume of capital gains that taxpayers choose to realize.8

A realization-based tax system must counteract those incentives. The current tax system includes measures intended to serve that purpose, including a preferential rate for long-term capital gains and restrictions on the deductibility of capital losses.

Section 1(h)(1) provides preferential tax rates for most long-term capital gains, defined by section 1222(3) as gains on capital assets held for longer than one year. The rate is zero for gains that would otherwise fall in a taxpayer’s 10 or 15 percent bracket; 15 percent for gains that would otherwise fall in a taxpayer’s 28, 31, or 36 percent bracket; and 20 percent for gains that would otherwise fall in a taxpayer’s 39.6 percent bracket. After an asset has been held for one year, the lower rate reduces the tax savings from delaying sales and thereby diminishes the lock-in effect.9

Section 1211(b) provides that individuals generally may not deduct capital losses in excess of the amount of capital gains plus $3,000. The $3,000 limit has not been changed since 1978 and is not indexed to inflation. Losses that exceed the limit cannot be carried back to earlier years but can be carried forward to all subsequent years under section 1212(b). That restriction is designed to address cases in which a taxpayer accrues losses on some assets during the year while accruing comparable or greater gains on other assets, and selectively realizes the losses while deferring realization of the gains. Unfortunately, the restriction also delays deductions for taxpayers who have accrued significant net losses.

Section 1091 defers recognition of losses from wash sale transactions. Section 1091(a) provides that a taxpayer who has realized a loss from the sale of stock or securities may not deduct it if she purchases “substantially identical” stock or securities within a period beginning 30 days before the sale and ending 30 days after the sale. Under section 1091(d), the nondeductible loss is added to the cost

8For a recent study by an economist at the Joint Committee on Taxation and two economists at the Congressional Budget Office, see Tim Dowd, Robert McClelland, and Athiphat Muthitacharoen, “New Evidence on the Tax Elasticity of Capital Gains,” CBO Working Paper 2012-09, June 2012.

9Ironically, however, the provision reinforces the lock-in effect during the first year that the asset is held, by giving taxpayers an incentive to delay selling until the minimum holding period is satisfied and the lower rate becomes applicable. Section 1014’s provision allowing basis to be stepped up to fair market value at death also reinforces the lock-in effect by giving taxpayers an incentive to hold assets until death.
basis of the newly purchased stock or securities, potentially allowing it to be recognized when the stock or securities are sold. The basis adjustment adds complexity. Some judgment can be required to determine when stock or securities are substantially identical to other stock or securities. For example, revenue rulings indicate that two bonds issued by the same borrower with similar maturity and call dates may, or may not, be substantially identical to each other, depending on their other characteristics. Convertible preferred stock can be substantially identical to common stock. Section 1092 similarly restricts the deductibility of losses from straddles.

Still, those measures can only ameliorate, not remove, the distortion to the timing of sales, even as they add further complexity to the tax system.

Before moving on to other topics, it is useful to consider how the realization principle performs in the presence of asset pricing bubbles.

**Asset Pricing Bubbles**

Although some economic models predict that asset markets will set prices based on a rational expectation of assets’ future payoffs, both recent and historical experience suggest that market prices are sometimes higher than rational values. That situation is often referred to as an asset pricing bubble.

If an asset’s price increases because of a bubble, it is unclear whether a taxpayer who continues to hold the asset has experienced a genuine benefit. Although the accrued gain increases the amount that the taxpayer could have consumed by immediately selling the asset, it generally does not increase the amount that the taxpayer can consume in the future. That realization-based tax systems do not tax that gain may seem to be a point in favor of the realization principle.

Still, the realization principle offers an unsatisfactory solution to the problem. If a taxpayer sells the asset and invests the sale proceeds in another asset whose price is also inflated by the bubble, the taxpayer’s realized gain is just as illusory as the unrealized gain of a taxpayer who continued to hold the original asset. Consumption taxation offers a better solution because the holder of the appreciated asset is taxed only if she consumes the price appreciation, in which case she clearly enjoys a real benefit.

The treatment of asset appreciation resulting from bubbles is related to a broader policy question. Suppose that the market level of interest rates, and the rates of return that investors demand on other assets, falls, perhaps because of an increase in people’s willingness to save. The interest rate reduction causes asset values to increase, even if there’s no change in the assets’ expected future payoffs. For example, an asset that is expected to yield a payoff of $1,000 per year forever is worth $20,000 if investors demand an expected return of 5 percent per year, but is worth $25,000 if investors demand an expected return of only 4 percent per year. A sudden permanent reduction in the rate of return demanded by investors from 5 percent to 4 percent therefore increases the asset’s value by $5,000. That situation is similar to a bubble because the asset price has increased, while the rationally expected rate of return on the asset has declined, leaving rationally expected future payoffs unchanged. Someone who believes that asset appreciation caused by interest rate declines should be taxed, as Richard Goode has argued, should also favor taxing appreciation caused by bubbles and should support mark-to-market taxation. Someone who believes that appreciation caused by interest rate declines should not be taxed, as Nicholas Kaldor argued, should oppose taxing appreciation caused by bubbles and should support consumption taxation. Neither belief should lead to support of realization-based taxation.

Another drawback of the realization principle is that it complicates efforts to eliminate or reduce the corporate income tax, the most distortionary component of the federal tax system.

**Corporate Income Tax**

Even if the United States had a closed economy, the corporate income tax would be highly distortionary, artificially penalizing equity-financed investments by C corporations. But the tax is even more harmful in the open economy. The territorial taxation of corporate income creates a disincentive for corporations to invest, and to book profits, in the United States.

The current corporate income tax system attempts to counteract that disincentive by imposing U.S. tax on overseas profits earned through a U.S.-chartered corporation or its subsidiaries. Still, charter-based taxation cannot provide an effective long-run solution. Taxing the overseas profits of U.S.-chartered corporations does not change the disincentive for foreign-chartered corporations to

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invest and book profits in the United States. Moreover, it creates a new distortion by artificially favoring foreign-chartered corporations over U.S.-chartered corporations. As a result, it induces some business operations to be conducted through foreign-chartered corporations even when they could be carried out more efficiently through U.S.-chartered corporations. (Inversion transactions in which corporations effectively shed U.S. charters and obtain foreign charters are merely one manifestation of that distortion.) Further, once operations are conducted through foreign-chartered corporations, the disincentive to invest and book profits in the United States is fully restored. The limitations of charter-based taxation presumably explain why the current tax system embraces it so halfheartedly, generally taxing the overseas earnings of subsidiaries of a U.S.-chartered corporation only when the earnings are repatriated and allowing foreign income taxes on the earnings to be credited against the U.S. tax.  

The problems of territorial and charter-based taxation could be avoided by eliminating the corporate income tax and fully taxing capital gains and dividends received by U.S. holders of corporate stock. The preferential rate for qualified dividends provided by section 1(h)(11) would be removed, and the preferential rate for long-term capital gains provided by section 1(h)(1) would no longer apply to gains on corporate stock. Tax would be based on the individual shareholder’s residence rather than the source of income or the corporate charter location.

There are many potential obstacles to the replacement of corporate taxation with shareholder taxation. Some reflect the irrational belief that the corporate income tax raises revenue without bur- dering individuals, and others reflect legitimate concerns about design and transition issues. But the strongest economic objections are that tax on undistributed corporate profits could be indefinitely deferred if stockholders did not realize the capital gains arising from the reinvested profits, and that the lock-in effect would be amplified at the higher capital gains rates. The tax deferral and lock-in effect would disappear, however, if capital gains on corporate stock were taxed on a mark-to-market basis. As discussed below, Eric Toder of the Urban-Brookings Tax Policy Center and I have presented a plan along those lines.

The Path Forward

In response to the shortcomings of the realization principle, the tax system can move either to consumption taxation or to mark-to-market income taxation. Although the former option would be economically preferable, the latter is far more likely to occur.

The realization principle could be abandoned if the income tax system were replaced by a consumption tax. Full replacement by a VAT or retail sales tax would not be viable, however, because it would dramatically move the tax burden toward the lower portions of the income distribution. Instead, it would be necessary to replace the income tax with a progressive consumption tax — either a personal expenditure tax or a Bradford X tax.  

A progressive consumption tax has much to recommend it. Although consumption taxes and income taxes create similar work disincentives, consumption taxes avoid the income tax’s saving disincentive because they do not favor current consumption over saving for future consumption. Still, it is unlikely that the United States will replace its income tax system with an unfamiliar levy such as the personal expenditure tax or X tax.

Alternatively, the tax system can avoid the difficulties of realization-based taxation by adopting mark-to-market income taxation. It is widely agreed that mark-to-market taxation is impractical for assets that are not publicly traded because their market values cannot be accurately measured and because taxpayers may not have the cash with which to pay the tax. For publicly traded assets, however, mark-to-market taxation is generally feasible.

Incremental movement toward mark-to-market taxation is already underway. That approach has been adopted in some contexts, and proposals to extend it are being considered.

14Those measures are not the best ways to address the problems of charter-based taxation. Alan D. Viard, “PPL: Exposing the Flaws of the Foreign Tax Credit,” Tax Notes, Apr. 29, 2013, p. 553 (explaining why the foreign tax credit is a poorly designed way to lower the U.S. tax burden on foreign income of U.S. taxpayers). The deferral of tax until repatriation is similarly poorly designed.


Section 1256, enacted in 1981, requires mark-to-market accounting for commodity futures contracts. Section 1256(a)(1) provides that any contract held at the close of a tax year is treated as having been sold at its fair market value on the last business day of the year and that any resulting gain or loss is taken into account for that year. Under section 1256(a)(3), 40 percent of the gain or loss is treated as short-term capital gain or loss, and 60 percent is treated as long-term capital gain or loss.

Section 475, enacted in 1993, imposes mark-to-market accounting on securities dealers. Section 475(a)(2) provides that a security held by a dealer at the close of a tax year is generally treated as having been sold at its FMV on the last business day of the year and that the resulting gain or loss is taken into account for that year. Under section 475(d)(3), the gain or loss is generally treated as ordinary. Section 475(e) allows commodities dealers to elect mark-to-market accounting, and section 475(f) permits a similar election by securities and commodities traders. Because the provisions apply only to dealers and traders, mark-to-market accounting is not required or permitted for investors.

Section 1296, enacted in 1997, allows U.S. persons who hold stock in a passive foreign investment company to elect mark-to-market taxation of the stock. Under section 1296(c)(1), the gain or loss is treated as ordinary.

Section 877A, enacted in 2008, imposes mark-to-market taxation on some U.S. citizens who renounce their citizenship on or after June 17, 2008, and on some long-term U.S. residents who terminate their residence on or after that date. Under section 877A(a)(1), all property held on the date that citizenship or residence is terminated is treated as having been sold on the previous day at its FMV, and the resulting gain or loss is taken into account for that year. Under section 877A(a)(3), however, tax applies only to gain in excess of an exemption amount — $680,000 in 2014 — that is adjusted for inflation. Under section 877A(b), the payment of the tax can be deferred in some cases.

Prop. reg. section 1.446-7, which was issued in July and was open for public comment through October 27, would allow a mark-to-market method as an optional simplified accounting method for money market mutual funds. The proposed reg was issued in response to an SEC regulatory change. Before that change, money market funds were allowed to round their value off to the nearest penny, which enabled funds to maintain a constant value of $1 under normal economic circumstances. The SEC recently changed course, however, generally requiring that funds report their value out to four significant digits. Accordingly, money market mutual fund values will typically float to some extent.

The small but frequent changes in fund values would make realization-based taxation administratively cumbersome for taxpayers who make frequent deposits into, and withdrawals from, their money market mutual funds. Because each deposit is a purchase and each withdrawal is a sale, trivially small gains or losses would need to be reported upon every withdrawal. Tracking past transactions to properly apply the basis allocation rules would be difficult. Further, if a withdrawal made at a loss occurred within 30 days of a deposit, the wash sale rules would apply, deferring deduction of the loss and requiring a basis adjustment for the deposit. The administrative costs could be larger than the gains and losses that were being tracked.

Prop. reg. section 1.446-7 invokes Treasury’s authority under section 446(b) to prescribe accounting methods that clearly reflect income. It would allow holders of money market funds to choose a simplified method that is essentially identical to mark-to-market accounting. Under that method, the net gain or loss for the year “generally equals the value of the taxpayer’s share in the MMF at the end of the period, minus the value of the taxpayer’s share in the MMF at the end of the prior period, minus the taxpayer’s net investment in the MMF during the period.” The notice of proposed rulemaking aptly observes that the “method takes into account changes in value . . . without regard to realization.”

Gains and losses computed under the simplified method are treated as capital if some or all of the shares held by the taxpayer would otherwise give rise to capital gain or loss, and any capital gain or loss is treated as short term. In conjunction with the proposed reg, Treasury issued Rev. Proc. 2014-45, which provides that the wash sale rules will not apply.

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Proposals to extend mark-to-market taxation to a wide range of financial derivatives have received bipartisan support. The tax reform plan presented by House Ways and Means Committee Chair Dave Camp, R-Mich., on February 26 calls for accrual taxation of derivatives on stocks, bonds and other debt instruments, partnership interests, actively traded commodities, and currencies. President Obama has proposed accrual taxation of derivatives on publicly traded property, most recently in his fiscal 2015 budget plan. The proposals would sweep away the vexing problems of how those transactions are treated today.24

Toder and I recently presented a plan that would be a larger move away from the realization principle.25 Under our plan, the corporate income tax would be eliminated, and U.S. shareholders of publicly traded companies would be taxed on dividends and capital gains at ordinary income rates on a mark-to-market basis. Companies that are not publicly traded would be subject to flow-through taxation, like most of them are under current law. Mark-to-market taxation would also apply to derivatives in accordance with the Camp and Obama proposals discussed above.

The movement toward mark-to-market taxation faces a potential constitutional obstacle. Article I, section 2, clause 3 of the Constitution provides, “Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers” as determined by the decennial census. That restriction is reinforced by Article I, section 9, clause 4, which provides, “No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration.” The 16th Amendment, adopted in 1913, creates an exception to the apportionment requirement, stating, “The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.” Some scholars have argued that a mark-to-market income tax would be a direct tax within the meaning of Article I but would not be a tax on incomes within the meaning of the 16th Amendment, and would therefore be unconstitutional (unless it was apportioned among the states, which would be impractical).26 Many other constitutional scholars argue, however, that a mark-to-market tax would fall within the scope of the 16th Amendment and would therefore not need to be apportioned,27 a position that draws some support from sections 475, 877A, 1256, and 1296 not having been declared unconstitutional.

Conclusion

Realization-based income taxation of liquid assets is inherently flawed. In the long run, it will be necessary for the federal tax system to move away from the realization principle. The most likely outcome is a continuation of the ongoing movement toward mark-to-market taxation of publicly traded assets.


