The Wonderful Mark-to-Market Tax

To the Editor:

Whatever its role in the current U.S. budget decisions, the proposal for mark-to-market taxation is a wonderful idea, so good to be inevitable — at some point. Mark-to-market taxation would tax shareholders on the annual gain from publicly traded stock even when those gains have not been reduced to cash.

Today's law basically taxes only cash from a sale of the stock or corporate distributions during life. Taxing only cash is inequitable and distorting. Cash does not reflect the income readily available to our billionaires.

Jeff Bezos, for example, reports an annual base salary of $82,000, which is taxable income.[1] But he achieved a readily accessible gain of $17 billion to $18 billion this year,[2] more than two million times higher than his base salary, and none of it was visible on his tax returns. Bezos's Amazon stock, over the years, has grown to be a $185 billion piggy bank. It's reachable when he needs it, but he paid no tax as it arose and most likely never will.[3] Today's law forgives tax on gain from investments held until the owner's death. On average, more than 75 percent of all gains disappears forever by reason of death.[4] The richest taxpayers probably exempt an even higher percent because they can borrow what they need without taxable sale.

[1]The website Salary.com reports Bezos's $82,000 base salary, which has held steady for many years. Bezos also reported $1.6 million from "other types of compensation" last year, which would make his cash income at 1/10,000 of total economic income, not 1/2,000,000 of economic income. Salary.com and the other web reports draw their information from SEC-mandated financial reports on Amazon.

[2]Fidelilty.com (and many competing websites) report that Amazon stock has appreciated by 10 percent in the past 12 months to a current $1.8 trillion market net worth.

[3]Forbes.com reports (from SEC reports) that Bezos owns 10.3 percent of Amazon, now worth $1.8 trillion market capitalization for $185 billion of Amazon stock. Forbes also reports Bezos has a personal net worth of $210 billion, or $25 billion not from Amazon.

[4]Jane G. Gravelle and Lawrence B. Lindsey, "Capital Gains," *Tax Notes*, Jan. 25, 1988, p. 397, 400; Laurence J. Kotlikoff, "Intergenerational Transfers and Savings," 2 *J. Econ. Persp.* 41 (Spring 1988) (estimating that between 76 and 78 percent of individual capital gains are held until death).

Further, taxing only cash harms the economy because investors avoid sales to avoid tax, when they should sell the investment and move on, or at least diversify their portfolio. A mark-to-market tax on gains on ownership interests whether or not sold would not suppress rational sales.

Publicly traded stock is a cash equivalent, indeed more convenient than cash. When the stock market is open, shareholders can get or transfer money from stock faster than they can withdraw money from an ATM. No one wants cash anymore; it's too much trouble.

As a matter of good theory, it's the taxpayer's claim over resources that counts, and not just what the taxpayer has reduced to a cash asset. Cash is a trivial part of the economic position of any well-run company – it is only the petty cash drawer more or less.

Determining the gain measured from quoted market price has only trivial administrative cost. Both the IRS and taxpayer can look it up any time of day or night from any place with an internet connection.

The quoted market price of publicly traded stock is also the best measure of the fundamental value of stock, that is, the discounted present value of future cash flows. The quoted price is the resultant of the assessment of future cash by thousands of highly motivated investors, working in service of their own interests. Bulls and bears push and pull in different directions to reach a single price. Quoted price changes rapidly when assessments change about future cash, which is a virtue of any measurement of economic position. The real economic world does not stay frozen in time.

Taxing based on quoted market price does sometimes require that the law cut through some taxpayer-constructed fog machines. The law should ignore restrictions imposed or accepted by the shareholder. If the shareholder liked the restriction, the stock's value did not really drop below the value of the quoted market price. Publicly traded stock held by a trust, partnership, or corporation that is itself not publicly traded should be passed through to the owners, and they should be taxed on the gain. Quoted market price is the best measure of future cash, even for a shareholder who holds a large block of stock.

When gain is taxed under a mark-to-market system, accrued losses should logically be allowed immediately. The law restricts recognition of losses but only because the taxpayer has control over showing gains and losses and can show only losses, even in a portfolio that is gaining overall. If a shareholder has no choice about when to show gains, the restrictions on recognizing losses become unnecessary.

So similarly, if gains are taxed involuntarily even without a sale for cash, the rationale for lower tax on capital gains disappears. Individual taxpayers have access to step up in basis that will make all capital gain disappear at death, lower tax rates on capital gains are provided to convince investors to realize their gains during life, and not take advantage of the exemption at death. Corporations, for example, get no exemption upon liquidation or distribution, and since they get no exemption at the end for capital gains, they also get no reduced tax rate on capital gain. Whatever the appropriate tax rate on income from capital in general, that rate appropriately applies to mark-to-market gains.

If the investor's interest is not publicly traded, determining market value becomes harder because it's no longer simply a matter of looking up quotes on the internet. Fundamental value is discounted future value of future cash flows, and as Yogi said, almost, future cash flows are very hard to predict because they haven't happened yet. It is the assessment of discounted present value of future cash by thousands of bears and bulls that makes quoted public market price so attractive as a measure of fundamental value. For nonpublicly traded interests, the best choice might be to impute income on invested capital, tax it annually, and then true up the results that depart from the imputed annual income when the interest is finally sold.[5]

Publicly traded stock can bear some extra tax above identical nontraded interests as a description of the economic situation because public trading awards extra value when investors can hit the panic button and sell if an investment turns disappointing.[6] Still, it's important to keep the tax on nonpublicly traded investments near the level of tax on publicly traded interests so as not put too much strain on public trading.

Taxing only cash sales comes from an archaic accounting convention: that assets be listed at their historical cost. The original purchase price quickly ceases to be an accurate assessment of economic condition, after a while not unlike listing Manhattan at its original cost of $24 in beads. Accounting standards now allow or require mark-to-market for publicly traded assets in the reporting of corporate income to investors.[7] Accounting standards also condemn waiting for cash as a method that does not reflect income.[8]

Similarly, the standard economic definition of income includes increases in command over resources during the year, even when that command has not been reduced to cash.[9] It is the claim over resources and not the cash drawer that measures the economic position of any taxpayer.

Both accounting and economics define income to include mark-to-market gains. The 16th Amendment specifically authorizes a tax on income. That alone is sufficient.

Bezos's tax return reports basic salary that is only one two-millionth of his economic income. It's time to apply the income tax to our billionaires' real income.

Calvin H. Johnson
University of Texas Law School
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[5]Mark P. Gergen, "How to Tax Capital," 70 *Tax L. Rev.* 1 (2016).

[6]Calvin H. Johnson, "Replace the Corporate Tax With a Market Capitalization Tax," *Tax Notes*, Dec. 10, 2007, p. 1082 (arguing that the government could replace the corporate tax with a tax amounting to sale of public trading, just as it auctions offshore drilling rights, grazing rights, timber rights, mining rights, and broadcast spectrum).

[7]Financial Accounting Standards Board, "Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs" (May 2011).

[8]Accounting Principles Board Statement No. 4, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," para. 25 (Oct. 1970).

[9]Henry C. Simons, *Personal Income Taxation* 50 (1938) (explaining the Haig-Simons definition of income as the "sum of (1) the market value of rights exercised in consumption and (2) the change in value of the state of property rights between the beginning and end of the period in question").