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THE MYTH OF REALIZATION: MARK-TO-MARKET TAXATION OF PUBLICLY-TRADED SECURITIES

by

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I. INTRODUCTION

In the Greco-Roman world, touching right hands as a greeting demonstrated that one was weaponless and contributed to a more convivial atmosphere.¹ In Medieval Europe, warriors grasped the right hand of their adversaries during a truce as a precaution against treachery. Similarly, when greeting a friend, a knight would extend an ungloved right hand as a token of confidence in the peaceful intentions of his comrade.² A handshake is still the traditional form of greeting. It continues to denote friendship, or at the least a lack of hostile intent, even though the circumstances in which it arose may no longer be relevant.

Like the handshake, legal rules and concepts oftentimes survive the situations that fostered their adoption. Originally developed as means to contend with certain conditions, they can acquire a life of their own and be applied, out of habit or inertia, even where there is no justification for their existence. However, unlike the innocuous handshake, blindly applying rules and concepts in situations other than those with which they were developed to contend can be counterproductive.

In the field of income tax, one of those rules and concepts is the doctrine of realization. Although a serious deviation from the pure concept of income, it was adopted nonetheless as a means of contending with practical difficulties inherent in taxing appreciation of assets held by the taxpayer. However, the doctrine of realization continues to be applied even in situations in which there is no practical impediment to imposing tax on appreciation as it accrues. For example, gain from appreciation of publicly-traded securities could easily be taxed as those securities appreciate in value. However, so strong a grip does the doctrine of realization have on the minds of both policymakers and the public that the tax system tenaciously applies the realization doctrine to gain from publicly-held securities.³ The thesis of

1. It has been noted that the right-hand touch was promoted by none other than Julius Caesar. Being left-handed, Caesar could thus obtain an advantage by concealing a weapon in his dominant hand. Melissa Roth, *The Left Stuff: How the Left-Handed Have Survived and Thrived in a Right-Handed World* 28 (2005).

2. Leopold Wagner, *Manners, Customs, and Observances: Their Origin and Significance* 102 (1995). In the Orient, the traditional greeting is a bow, not the shaking of hands. It is interesting to speculate that perhaps, where unarmed martial arts were commonly practiced, extending one's right hand was not considered a friendly gesture. Instead, one bowed from a safe distance.

3. As noted by Francis Bacon: "People usually think according to their inclinations, speak according to their learning and ingrained opinions, but generally act according to custom." Quoted in Jean-François Quéguiner, *The Principle of Distinction: Beyond an Obligation of Customary International Humanitarian Law*, *in*

this Essay is that, for purposes of income tax, publicly-traded securities should be marked to market, with gain or loss recognized as it accrues and not deferred until realization.⁴ This thesis is based on a theoretical analysis of the realization doctrine and on the practical advantages of taxing gain from publicly-traded securities as they accrue.

Part II will examine the realization doctrine from a theoretical perspective as a deviation from the accepted definition of income. Its adoption is required when it is impractical to tax gain as it accrues.⁵ However, when circumstances allow the application of fundamental principles there is no justification to defer accounting for the gain just because the taxpayer has chosen to continue holding the asset.

Part III will explore the practical advantages of imposing tax on gain from publicly-traded securities on an accrual basis. Part III.A. discusses the economic effects of the alternate tax regimes. It will explain how deferring tax until realization can cause economic resources to be diverted from their most efficient uses and can contribute to the volatility of the stock market. On the other hand, mark-to-market taxation interferes to a lesser extent with the free flow of economic resources and may actually constitute a factor in

The Legitimate Use of Military Force: The Just War Tradition and the Customary Law of Armed Conflict 161, 161 (Howard M. Hensel ed., 2008).

4. For previous discussions of similar themes, see John P. Bransfield, Proposal to Change the Federal Income Taxation of Marketable Securities, 2 Hous. Bus. & Tax L.J. 328 (2002); Samuel D. Brunson, Taxing Investors on a Mark-to-Market Basis, 43 Loy. L.A. L. Rev. 507 (2010); Eric D. Chason, Naked and Covered in Monte Carlo: A Reappraisal of Option Taxation, 27 Va. Tax Rev. 135 (2007); Daniel Halperin, Saving the Income Tax: An Agenda for Research, 77 Tax Notes 967 (1997), *reprinted in* 24 Ohio N.U. L. Rev. 493 (1998); Timothy Hurley, "Robbing" the Rich to Give to the Poor: Abolishing Realization and Adopting Mark-to-Market Taxation, 25 T.M. Cooley L. Rev. 529 (2008); Mark L. Louie, Note, Realizing Appreciation Without Sale: Accrual Taxation of Capital Gains on Marketable Securities, 34 Stan. L. Rev. 857 (1982); Deborah L. Paul, Another Uneasy Compromise: The Treatment of Hedging in a Realization Income Tax, 3 Fla. Tax Rev. 1 (1996); Clarissa Potter, Mark-to-Market Taxation as the Way to Save the Income Tax—A Former Administrator's View, 33 Val. U. L. Rev. 879 (1999); David J. Shakow, Taxation Without Realization: A Proposal for Accrual Taxation, 134 U. Pa. L. Rev. 1111 (1986); David Slawson, Taxing as Ordinary Income the Appreciation of Publicly Held Stock, 76 Yale L.J. 623 (1967); David A. Weisbach, A Partial Mark-to-Market System, 53 Tax L. Rev. 95 (1999).

5. It should be emphasized that the Essay will proceed from the assumption that gain from publicly-traded securities will continue to be taxed under an income tax. When the tax base is consumption, realization loses its significance. William D. Andrews, A Consumption-Type or Cash Flow Personal Income Tax, 87 Harv. L. Rev. 1113, 1131 (1974) ("The problems of defining realization and prescribing nonrecognition would obviously disappear under either a true accretion-type or a pure consumption-type tax."); Louie, *supra* note 4, at 861 n.18.

mitigating stock market volatility. Part III.B. considers tax planning strategies that attempt to exploit the realization doctrine in order to avoid or minimize tax liability. Part III.C. discusses the deduction of losses. It will show that the serious restrictions imposed on the deduction of capital losses, limitations that contract the ideal of a tax imposed on accession to wealth and are the source of both inequity and economic inefficiency, are a direct consequence of the realization doctrine and are unnecessary under an accrual tax regime. Thus, mark-to-market taxation would allow unrestricted deduction (or a freely usable credit in lieu) of capital losses from the holding of publicly-traded securities.

Part IV will contend with arguments in favor of retaining the realization rule for publicly-traded securities. Part IV.A. considers the claim that unrealized gain should not be taxed because of the possibility that the value of the security will decrease in the future, erasing some or all of the already-reported gain. Part IV.B. will discuss the effect of prevailing public opinion that “paper gain” is not an appropriate subject for taxation. Part IV.C. will examine the argument that taxing publicly-traded securities on an accrual basis while other gain is taxed only at realization would create a disequilibrium in the tax structure and that the negative consequences of such a disequilibrium would overwhelm the positive consequences of mark-to-market taxation. Part IV.D. will consider the argument that it is possible to achieve results similar to those obtainable through mark-to-market taxation without abandoning the realization doctrine. Part V will summarize the findings.

II. REALIZATION

In accordance with the theoretical definition as formulated by Robert Haig and Henry Simons, “income” is the sum of (a) the value of the taxpayer’s consumption during the period of assessment and (b) the change—whether positive or negative—in the net value of her assets.⁶ Change in net value of assets includes change due to appreciation of those assets. Nevertheless, although the owner of property experiences an accession to wealth—and thus “income” in the Haig-Simons sense of the term—at the time that property appreciates in value, gain is not ordinarily

6. Robert Murray Haig, *The Concept of Income—Economic and Legal Aspects*, in *The Federal Income Tax* 1, 7 (Robert Murray Haig ed., 1921); Henry Calvert Simons, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* 50 (1938). There are those who claim that the originator of the concept was the German economist Georg von Schanz in an article published toward the end of the nineteenth century, Georg von Schanz, *Einkommenbegriff und die Einkommensteugesetz*, 13 *Finanz-Archiv* 1 (1896), and that the definition should be referred to as the Schanz-Haig-Simons definition. See, e.g., Stanley S. Surrey & Paul R. McDaniel, *Tax Expenditures* 4 (1985).

taxed until the property is sold or exchanged. The classic reason for deferring taxation on unrealized appreciation is that an attempt to tax unrealized gain would encounter the twin problems of liquidity and evaluation.

A. *Liquidity*

Problems of liquidity arise when accession to wealth is not accompanied by a receipt of liquid assets. In such a situation, the taxpayer, despite being economically better off, may not have access to cash with which to pay the tax.

It might seem that liquidity problems should not present an impediment to imposition of tax. Facing a tax bill resulting from the appreciation of property, a taxpayer who does not have cash available can sell the appreciated property.⁷ Furthermore, such a forced sale would actually conform to the principles of horizontal equity. The situation of one who does not have the cash to pay tax on appreciation of property and who is forced to sell to pay the tax is similar to the situation of one whose pre-tax income is enough to purchase that same property, but whose post-tax income is insufficient. In both cases, the tax is what prevents the taxpayers from having the property. There is no substantive difference between a tax that prevents the purchase of property and a tax that requires its sale. Taxing only realized gain means, in effect, that those holding on to appreciated property can finance their investment using pretax dollars, while new purchasers must finance their investment using post-tax dollars.⁸

7. Another way to raise the funds necessary to pay the tax without selling the property is to borrow the necessary funds. As collateral, the taxpayer could pledge the appreciated property: as long as the tax rate is less than 100%, the property will be necessarily worth more than the tax liability. Nevertheless, this solution is problematic. Property that is not easily marketed is not easily borrowed against. An obvious example is human capital. A less extreme case is pension rights. When the property is speculative, leveraging the investment increases the level of risk of holding the asset. Andrews, *supra* note 5, at 1143. The taxpayer may not be willing to incur the additional risk. Furthermore, taxpayers may be reluctant to invest in speculative assets if they know that the tax system might force them to increase the level of risk in the future. In effect, the choice is between imposing the burden of financing the tax on the unrealized appreciation on the taxpayer or on the government. Zelinsky argued that imposing the burden on the government is preferable as its borrowing costs are presumably lower. Edward A. Zelinsky, *For Realization: Income Taxation, Sectoral Accretionism, and the Virtue of Attainable Virtues*, 19 *Cardozo L. Rev.* 861, 889–91 (1997).

8. Refraining from taxing unrealized gain violates not only horizontal equity but also vertical equity as capital gain is heavily concentrated among the wealthier segments of the population. See, e.g., Slawson, *supra* note 4, at 629–31. For example, in 2007, the top 1% of the population owned 42.7% of the financial wealth in the United States, while the bottom 80% owned a total of 7%. G. William

Nonetheless, liquidity is routinely touted as an obstacle to the taxation of unrealized gain. The possible reasons are as follows:

1. *Sentimental Attachment*

The holder of an asset may develop a sentimental attachment to that asset, so that for the person concerned the asset has added value beyond the objective economic value. Obvious examples include a home, a wedding ring, and a family heirloom. A person may develop a sentimental attachment not only to “personal” assets, but also to “commercial” assets such as a business that the taxpayer has built up over a period of years. One who is forced to sell such property in order to pay tax on its appreciation is not in the same position as one who is unable to purchase the property, as the forced sale could involve significant psychological costs.⁹

2. *Marketability*

Not all assets are marketable. Examples include goodwill, pension rights, and human capital. Imposing tax on the appreciation of these assets

Domhoff, Wealth, Income, and Power (2005), <http://sociology.ucsc.edu/whorules/america/power/wealth.html>.

9. The notion that forcing a sale is more traumatic than preventing a purchase is particularly significant in the public discourse regarding property taxes. Whether or not it has any basis in economic theory, the idea that people should not be forced to sell property in order to pay their property tax is widespread. As noted by Radin: “The successful argument in recent tax limitation initiatives has been the appeal to save longtime homeowners from losing their homes because of property tax increases.” Margaret Jane Radin, *Reinterpreting Property* 228 (1993).

See also *Nordlinger v. Hahn*, 505 U.S. 1 (1992), upholding the constitutionality of California’s Proposition 13, which bases property tax assessment on the value of property at the time of purchase and, as a consequence, during periods of rising property values places a much greater tax burden on more recent purchasers:

A new owner has full information about the scope of future tax liability before acquiring the property, and if he thinks the future tax burden is too demanding, he can decide not to complete the purchase at all. By contrast, the existing owner, already saddled with his purchase, does not have the option of deciding not to buy his home if taxes become prohibitively high. To meet his tax obligations, he might be forced to sell his home or to divert his income away from the purchase of food, clothing, and other necessities. In short, *the State may decide that it is worse to have owned and lost, than never to have owned at all.*

Id. at 13 (emphasis added).

could force a taxpayer into bankruptcy even though she is solvent in the sense that the value of her assets is greater than the amount of her liabilities.

3. *Transaction Costs*

Other assets, although marketable in principle, cannot be sold without incurring significant transaction costs. For example, consider the land upon which a business is located. Abandoning the realization principle would require the owner each year to pay the government its share of any appreciation in the value of the land. If the necessary funds were not available, the owner might be forced to sell the land and move the business elsewhere, along with all that such a move would entail—locating substitute property, perhaps assembling a new workforce, building up new clientele, and so forth. Economic resources would be wasted, to the detriment of both the taxpayer individually and the economy as a whole.

It should be added that the imposition of tax on unrealized appreciation might dissuade taxpayers from investing in assets which cannot easily be converted into cash. The fear itself could prevent economic resources from being directed to their most efficient uses.

B. Valuation

Unrealized gain cannot be taxed without periodic valuation of assets.¹⁰ Such a tax regime would require taxpayers, their advisors, the government, and the courts to devote considerable resources to property valuation, and even then there is no guarantee that the evaluation arrived at would equal the actual economic value of the asset. It is highly doubtful whether the advantages of accrual taxation are worth the cost.¹¹ Furthermore, for certain assets—such as goodwill or human capital (i.e. capitalized future earning power)—any attempt to quantify their value is an exercise in futility.

C. The Realization Principle

Due to the problems of liquidity and valuation, the taxation of gain is typically deferred until the asset is sold. At that point, it is no longer necessary to estimate the value of the asset. In addition, as the taxpayer

10. See, e.g., Louie, *supra* note 4, at 865.

11. As examples of taxes requiring asset valuation, Zelinsky mentions the estate tax and property taxes. He claims that the degree of accuracy of the valuations obtained in the implementation of those taxes is highly questionable. Zelinsky, *supra* note 7, at 881–82 and sources cited therein.

typically receives cash in exchange for the asset, requiring the payment of tax at that point will not impose an undue hardship.¹²

Thus, the convention of deferring tax until realization results from administrative convenience and the willingness to consider the possible hardship of imposing tax on unrealized appreciation. Nevertheless, the principle of realization has permeated the public consciousness and has acquired an undeserved independent status as a fundamental principle of taxation. The idea that unrealized appreciation does not represent true economic gain and that it should not be subject to taxation is widespread.¹³

It is arguable that the very term “realization,” describing the sale of the asset, bears part of the responsibility for exaggerating the significance of the principle. Although merely semantic, the connotation is that the *unrealized* gain is *unreal*. This conception could lead to the conclusion that refraining from taxing unrealized gain is not simply a concession to practical considerations, but is rather necessitated by the Platonic nature of income. Such is not the case. Deferral until realization is warranted to the extent, and only to the extent, dictated by considerations of cost and benefit. When the price of deferral exceeds the benefits thereof, its adoption is no longer justified. In other words, we need to choose the most convenient time—from the perspective of the administration and from the perspective of the taxpayer—to impose the tax.¹⁴ Whether we call that moment “realization” or whether we say that we should occasionally deviate from the concept of realization—the difference between the two is semantic—choosing the appropriate time to calculate the gain and to impose tax thereupon requires

12. Realization has been described as the Achilles’ heel of the income tax. William D. Andrews, *The Achilles’ Heel of the Comprehensive Income Tax*, in *New Directions in Federal Tax Policy for the 1980s* 278 (Charls E. Walker & Mark A. Bloomfield eds., 1983).

13. In one of its first decisions concerning the 16th Amendment, which authorized Congress to impose tax on “incomes, from whatever source derived,” the Supreme Court held that “income” means realized income. The realization principle thus acquired constitutional status. *Eisner v. Macomber*, 252 U.S. 189, 212–14 (1920). Today it is widely accepted that realization is not a constitutional requirement, but rather a rule of administrative convenience and that Congress is authorized to tax unrealized gain if it chooses to do so. See, e.g., *Helvering v. Horst*, 311 U.S. 112, 116 (1940) (“[T]he rule [is] founded on administrative convenience”); Andrews, *supra* note 5, at 1129 n.27; Shakow, *supra* note 4, at 1112–13. For a discussion of the effect of public perception on the possibility of imposing mark-to-market taxation in practice, see Part IV.B.

14. Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* 778 [1776] (Edwin Canaan, ed., 1937) (“Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it.”).

balancing the advantages and disadvantages inherent in each of the various options.

D. Publicly-traded Securities

The rationale of the realization principle is inapplicable to publicly-traded securities. The market value of each security is determined on a constant basis as willing sellers and willing buyers meet on the floor of the exchange. No external valuation is necessary. The fact that an investor or analyst may judge the “true value” of a security to be different than the value at which it is traded is irrelevant: the definition of market value is the price at which a marginal willing seller will sell to a marginal willing buyer.¹⁵

With regard to liquidity, the forced sale of an appreciated asset to pay tax on the unrealized appreciation is, as noted above, not always a reasonable option due to sentimental attachment, the difficulty of liquidating the asset, and the transaction costs involved. As a rule, these considerations are irrelevant when the asset considered is a publicly-traded security.

The sentimental attachment of an investor to the publicly-traded securities in her portfolio—if such an attachment is even possible—does not reach a level that warrants consideration by the tax system. The attachment between an investor and the securities she holds is entirely unlike the attachment between an individual and, for example, her home or business.

Ordinarily, liquidation of publicly-traded securities requires no more than a phone call or a click on a computer screen. The costs involved are typically minimal. Clearly, the commission one normally pays for selling shares is in an entirely different league than the cost of moving a business to a new location due to the forced sale of the land on which it is located.

Furthermore, the high degree of liquidity of publicly-traded securities means that the taxpayer can easily repurchase the securities at any time. The sale of publicly-traded securities does not involve the same degree of finality as does the sale of other assets. A taxpayer who sells a security due to a temporary cash-flow problem knows that she can repurchase the security when the cash-flow problem is resolved. Repurchasing land or shares in a privately-held corporation is an entirely different matter.

15. Moreover,

[a] shareholder could not justly complain if in his opinion the market was too low a measure of the value of his shares for tax purposes, because the tax difference would be in his favor. He could not justly complain that it was too high either, because . . . he could sell the shares and, with no tax penalty for liquidating his investment, make an extra profit on the market’s apparent miscalculation.

Slawson, *supra* note 4, at 645.

Perhaps even more significant is the divisibility of publicly-traded securities. In most cases, an investor facing a tax liability resulting from the appreciation of securities in her portfolio can sell that portion of her portfolio that represents the government's share of the appreciation and retain the remainder. This high degree of divisibility is not typical of most assets.

Thus, the concept of realization is inapplicable to publicly-traded securities; gain from the appreciation of publicly-traded securities should be taxed on an accrual basis rather than only at realization. Calculation of the accrued gain, even without an actual sale, generally requires no more than a grade-school exercise in arithmetic. Requiring the investor to pay tax annually on the accrued gain imposes no insurmountable hardship. In the worst case scenario, she can sell some of her securities to satisfy the demands of the tax collector.

III. PRACTICAL ADVANTAGES OF ACCRUAL TAXATION

The conclusion that publicly-traded securities should be taxed on an accrual basis is at this stage no more than provisional. We still need to consider the practical effects of the realization requirement when applied to the securities market and compare them with the expected effects of rescinding the requirement of realization. Should it appear that taxing gain only when realized is more efficient economically or simpler administratively, the advantages of realization would need to be weighed against the violation of both horizontal and vertical equity inherent in the realization doctrine. To avoid any unnecessary build-up of suspense, I will note already at this juncture that the conclusions will be the opposite. In most cases the realization requirement complicates the tax system, leads to greater inequity than has already been noted, contributes to economic inefficiency, and can undermine public faith in the tax system.

A. *Economic Effects of Deferring Tax until Realization*

1. *Lock-in Effect*

Deferring tax on unrealized gain creates an incentive to retain appreciated property. A taxpayer holding such property might, therefore, continue to do so even though she would prefer—in the absence of tax considerations—to sell. In other words, the advantage of continued deferral might outweigh the advantage of moving into a different investment. This phenomenon—known as “the lock-in effect”—impairs the flow of economic resources to their most productive uses, creating economic inefficiency and reducing societal welfare.

For example, assume that a taxpayer is holding on to a security whose value has risen since it was purchased. Due to the accrued gain,

selling the security will impose an immediate tax burden, while refraining from selling will allow continued deferral of the tax. If the taxpayer is considering selling the security and purchasing another security in its place, she will need to consider not only her expectations regarding the return that each security will deliver in the future, but also the tax cost involved in moving from one security to the other. She may determine that the alternative investment will provide a greater return than her current investment but that the tax cost of adjusting her portfolio will outweigh the advantages.¹⁶

The substitution effect prevents resources from being directed to their most efficient uses and, by doing so, negatively impacts total societal

16. Specifically, the lock-in effect will be felt whenever

$$r_a a_p / [a_p - t(a_p - a_c)] > r_b > r_a$$

where

r_x = the expected return of security x (e.g., when security x is expected to increase by 10%, then r_x will equal 0.1)

a = the currently held security

b = the alternative security

x_p = the present market value of security x

x_c = the taxpayers basis in security x

t = the relevant tax rate.

For example, assume that the taxpayer purchased a security for \$100, its present market value is \$300, the relevant tax rate is 15%, and the taxpayer expects the security to rise in value by a further 50%. She is considering selling the security in order to invest the proceeds in a different security. The question is, what must the anticipated future appreciation of the alternative security be in order to justify the switch?

Disregarding tax considerations, she would sell the current security and invest in the alternative security whenever the expected appreciation of the alternative security over the period of time during which the current security is expected to increase by 50% is greater than 50%. In other words, she will make the switch whenever $r_b > r_a$.

However, if she were to sell the current security she would be liable for tax in the amount of $(\$300 - \$100) \times 15\% = \$30$, and will be left with only \$270 to reinvest. In order to persuade her to move to the alternative investment, the alternative investment must promise a return of 56% over the same time period. When the expected appreciation of the alternative investment is greater than the expected appreciation of the currently held investment, but the additional return is insufficient to counteract the disadvantage inherent in the fact that the taxpayer's investment in the alternative investment is limited to the after-tax proceeds of the sale of the currently held asset, whereas by continuing to hold the current asset she can, in effect, invest the entire value of the asset, tax considerations will dissuade the taxpayer from altering her investment and the substitution effect of the tax will be felt. In our example, where the expected return from the alternative investment is greater than 50% but less than 60%, the substitution effect will cause the taxpayer not to make the change in her investment portfolio.

welfare. This is particularly true with regard to the capital markets. For example, a corporation trying to raise funds on the market must offer a return at least equal to the prevailing return for securities of comparable risk. A corporation offering a lower return will not be able to convince investors to purchase the securities it is offering. Thus, in theory, only those corporations that can put investors' funds to use in the most efficient manner will be able to sell their securities.

However, due to the lock-in effect, a corporation attempting to sell securities may have to convince investors not only that the expected return is not less than that of comparable alternative investments, but that the expected return is sufficiently greater so as to compensate for waiving the advantages of continued deferral of the unrealized gain inherent in currently held assets.¹⁷

The lock-in effect is not an inevitable consequence of taxing income, in general, or of taxing capital gains, in particular. It results not from imposing tax on gain, but from deferring the tax until the gain is realized and thereby creating an incentive to continue holding the asset. Tax imposed on an accrual basis would not create such incentives. The tax would be imposed whether the asset were sold or held. As the decision to sell would not affect the timing of the tax, the tax would not influence the decision.¹⁸

2. *The Effect of the Proposed Tax on the Volatility of the Market*

Nonrecognition of unrealized gains and losses can accentuate market instability and intensify volatility. Due to both economic and psychological factors, capital markets routinely undergo periods of rising and falling share prices. Where gains and losses are only taken into account for tax purposes when securities are sold, the tax may tend to exaggerate the market's natural volatility.

During a rising market, many securities will contain unrealized gain. Selling the investment will expose the investor to tax on the appreciated value. Continuing to hold the investment allows the investor to continue deferring the gain. Investors may, therefore, prefer holding on to their

17. In the example in footnote 16, in order to convince the investor to sell currently held securities expected to generate a return of 50%, the issuing corporation will need to offer a return, at no greater risk, of no less than 60%.

18. Slawson, *supra* note 4, at 644. The realization principle can also influence the type of investment that the investor will prefer. An investment offering long term appreciation may be preferable to an investment producing currently taxed income. However, it should be noted that economists are unable to quantify the effect of taxes on investors' decisions. James W. Wetzler, *Comments, How Taxes Affect Economic Behavior* 277 (Henry J. Aaron & Jerry A. Pechman eds., 1981). For a discussion of the possible effects of accrual taxation on the ability of corporations to raise funds on the market, see Louie, *supra* note 4, at 867-70.

investments where, in the absence of tax considerations, they might have preferred selling. The tax considerations will not, of course, prevent all investors from selling; many will choose to realize their gain despite the tax cost involved. Nonetheless, if some continue to hold on to shares that, absent tax considerations, they would have preferred to sell, then the number of shares offered for sale will be less than it otherwise would have been. If the demand for shares is unaffected then, in accordance with the most fundamental law of economics, the price at which the marginal seller and the marginal buyer meet will be higher than it would otherwise have been. Thus, taxing appreciation only upon realization may contribute to the creation and intensity of a market bubble.

The realization principle may also intensify bear markets. First, as the market will begin its decent from a higher point, due to the effect of the tax in the prior bull phase, the difference between the value of shares at the peak and at the subsequent bottom will likely be greater. Second, during a bear market, shares will often contain unrealized losses, which are not recognized for tax purposes. In a mirror image of the bull market, investors may sell stock in order to recognize those losses. The additional selling may mean that the price at which shares are traded will be lower than it would have been absent the tax considerations.¹⁹

The phenomenon of exacerbating market volatility is a consequence of recognizing gain or loss only when securities are sold. Were gains and losses recognized on an accrual basis, whether or not the assets were sold, the investor would not obtain any tax advantage or suffer any tax disadvantage from continuing to hold the security: past appreciation or depreciation would be recognized even were the security not sold. With regard to the future, the only relevant question the investor would need to ask

19. It is reasonable to assume that the effect of selling in order to realize capital losses will not be felt to the same extent as will refraining from selling in order not to realize capital gain. Where the taxpayer expects in the future to earn capital gain, against which the capital loss can be deducted, there may be little or no advantage to realizing the gain now as opposed to later on, nearer in time to the realization of the gain. However, if the taxpayer has already realized gain—perhaps during the bull market that preceded the fall—and if the loss can be deducted against that gain, realization of losses may be advantageous. Corporations may carry net capital losses back up to three years. IRC § 1212(a)(1)(A). Individuals are not allowed to carry capital losses back to previous tax years. IRC § 1212(b)(1). Therefore, where the taxpayer is an individual, deducting capital losses against prior gain is limited to gains realized in the same tax year.

Furthermore, we should not ignore psychological factors, even if they have no basis in cold economic analysis. A taxpayer considering selling a security at a loss may be comforted by the fact that, by doing so, she has at least realized a loss that may be beneficial in the future. Were capital losses deductible from ordinary income, there would be a much great incentive to realize losses. See *infra* Part III.C.

would be whether the anticipated rewards from continuing to hold the security are worth the risks inherent in so doing. This is a purely economic consideration, which is supposed to guide investors in an efficient market.

Moreover, imposing tax on stock market gain on an accrual basis may act to mitigate to a certain extent the market's natural volatility and contribute to market stability.²⁰ During a bull market, investors will be liable for tax on their gains, whether or not they sell. Some will need or prefer to liquidate shares in order to pay the tax. The shares offered for sale will serve to supply some of the heightened demand for shares typical of an overheated bull market. During a bear market, shares will typically contain unrealized losses. As will be demonstrated, a tax regime that recognizes gains and losses on an accrual basis can allow losses to be deducted, subject to certain caveats, from ordinary income. Deducting stock market losses from ordinary income—business income, wages, and so forth—will reduce the investor's tax bill and increase the amount of cash the investor holds. If some of the funds which would otherwise have been paid in taxes are invested in the capital markets, the additional demand should help moderate the decline. Taxing gain from publicly-traded securities on a mark-to-market basis may contain an invisible-hand, countercyclical force to market volatility.²¹

B. Tax Planning Under a Realization Regime

A tax regime that conditions the recognition of gain or loss on the sale or exchange of the security that has either increased or decreased in value opens the door to a wide variety of tax planning techniques.²² The

20. In general, one of the advantages of an income tax is the fact that it is anticyclical. During periods of economic expansion incomes rise: income tax absorbs some of the additional cash in the hands of the public and contributes to easing the inflationary pressure. During times of economic contraction or recession, tax receipts decrease, putting more money in the hands of the public and increasing the demand for goods and services. See, e.g., Graham C. Hockley, *Monetary Policy and Public Finance* 267 (1970); Richard A. Musgrave & Peggy B. Musgrave, *Public Finance in Theory and Practice* 617–18 (1980). Cf. James L. Pierce & Jared J. Enzler, *The Implications for Economic Stability of Indexing the Individual Income Tax*, in *Inflation and the Income Tax* 173 (Henry J. Aaron ed., 1976). On the other hand, a tax on stock market gain imposed only at realization is cyclical. As demonstrated in the text, it exacerbates market volatility instead of mitigating it.

21. For an argument that overly volatile markets cause economic resources to be used inefficiently, see James R. Rapetti, *The Use of Tax Law to Stabilize the Stock Market: The Efficacy of Holding Period Requirements*, 8 *Va. Tax Rev.* 591, 613, 619–620 (1989).

22. See, e.g., George M. Constantinides, *Optimal Stock Trading with Personal Taxes: Implications for Prices and the Abnormal January Returns*, 13 *J.*

common denominator of these strategies is an attempt to accelerate recognition in the case of losses and to defer recognition in the case of gains. Their goal is to allow taxpayers to accrue wealth while deferring, perhaps indefinitely, the payment of tax on such accession to wealth.

Behind each of these tax-planning techniques is an intentionally created disparity between economic gain and taxable income. Economically, the investor experiences an accession to wealth when the value of her securities rises. Non recognition of the gains for tax purposes is what causes the disparity. A taxpayer who can create a situation in which her wealth is held in the form of unrealized gain can accrue wealth without having to pay tax on the gain. A tax regime that refrains from taxing unrealized gain cannot afford to ignore the tax planning possibilities that exploit the realization doctrine. To counter these strategies, Congress must develop statutory responses. As we will see, the effectiveness of such statutory responses is doubtful.

1. Straddles and Constructive Sales

Modern sophisticated financial instruments allow investors to exploit the underlying weaknesses of the realization doctrine and to avoid paying tax on economic gain. One such technique for manipulating the realization rules is by means of a strategy known to market players as a “straddle.” In a straddle, the investor establishes two opposite financial positions so that one cancels out the other. For example, the investor can purchase a stock and simultaneously sell the same stock short. Alternatively, the investor can purchase a stock and simultaneously sell a “synthetic stock” (by purchasing a put option and writing a call option with identical expiration dates and strike prices),²³ or purchase a synthetic stock and simultaneously sell the stock

Fin. Econ. 65 (1984); David M. Schizer, *Sticks and Snakes: Derivatives and Curtailing Aggressive Tax Planning*, 73 S. Cal. L. Rev. 1339 (2000).

23. For example, assume that the investor is holding a share whose market value is \$100. The investor can purchase a put option on the share, where the strike price is \$120. The price of the put option is, say, \$30. Simultaneously, the investor can write a call option, with the same expiry date and the same strike price. Assume that in exchange for writing the option the investor received \$12. The investor is now indifferent to the future price fluctuations of the share because, come what may, she will end up with \$120. If on the expiration date of the option the price of the share is more than \$120, the investor’s obligation under the call option that she wrote will deprive her of any gain above \$120. On the other, if the price of the share on the expiration date of the options is below \$120, the investor’s put option will make up the difference. In effect, the package held by the investor—the share plus the put option offset by the obligation under the call option—is more similar to a bond than it is to a share: the price of the package is \$118 (\$100 for the share plus \$30 for the put option minus the \$12 received for writing the call option), with a guaranteed

short. In each of these instances, the two positions are offsetting: what the investor earns on one she will lose on the other.²⁴

The straddle opens a wide field for tax planning opportunities. Presumably, at the end of the year, one leg of the straddle will represent a gain while the other will represent a loss. From an economic perspective the investor's financial position has not changed—assuming we disregard the commissions involved in establishing and maintaining the straddle—as the gain and loss will cancel each other out. However, the investor will be able to realize the loss in one tax year—and use that loss to offset previously realized gain—while deferring realization of the winning leg of the straddle to the following year. Engaging in similar transactions year in and year out will allow the investor to continue deferring the tax on her gain indefinitely.²⁵

Analytically, the investor—by engaging in the described strategy—transfers into one of the legs of the straddle all of her previously realized gain and transforms it into unrealized gain. By repeating this procedure, gain accruing year after year can be funneled into the unrealized winning leg of a straddle.

A second technique employing sophisticated financial instruments to achieve desirable tax results is the constructive sale. An investor who sells an appreciated security—or, more generally, who closes a profitable position—will be liable for tax on the gain. Of course, the investor can defer tax on the gain by deferring the sale, but that option may not be viable when the investor no longer wishes to continue being exposed to the risks inherent in maintaining the position. In other words, our investor wants to realize the gain without paying the tax.

The suggested planning technique in cases like this is to continue holding the security—thus deferring tax on the gain—while simultaneously acquiring an offsetting position—e.g., selling the share short or selling a synthetic contract – in order to cease exposure to the risks of holding the share. From the investor's perspective, the position is now closed: any gain or loss will be offset by an equal loss or gain in the opposite position. In this

payout of \$120 at the expiration date. For a comprehensive analysis of taxing packages of financial instruments that are fundamentally different from their components, see David A. Weisbach, *Tax Responses to Financial Contract Innovation*, 50 *Tax L. Rev.* 491 (1995).

24. Louie, *supra* note 4, at 859–60.

25. Not in all cases will it be possible to create and realize a loss through means of the described straddle. If the price of the share at the close of the year is similar to its price on the day the straddle was established, it will not be possible to realize a loss by closing one of the legs of the straddle. Nonetheless, if the investor establishes a number of straddles in which the underlying asset is a highly volatile financial instrument, it may be presumed that with regard to at least some of them the investor will be able to realize a loss at the end of the year.

way, the investor, for the price of the commissions involved, can defer the payment of tax on her gain for practically as long as she wishes.

There are three primary methods by which Congress, the courts, and the IRS can confront the aforementioned planning strategies. The first is for Congress to enact, for each planning strategy, a specific legislative provision denying the sought-for tax advantages. Existing tax legislation contains a number of such provisions. Section 1092 of the Internal Revenue Code provides that losses with respect to a position can be taken into account only to the extent that such losses exceed the gains from offsetting positions. The purpose of this provision is to prevent taxpayers from recognizing gain by selling the losing leg of a straddle while refraining from realizing the gain by retaining the winning leg of the straddle. Section 1259 provides that in a constructive sale of an appreciated financial position the taxpayer must recognize gain as if such position had been sold.

The second method by which to confront these planning strategies is to rely on general anti-abuse principles such as the economic substance doctrine, the sham transaction doctrine, and the step transaction doctrine.²⁶

The major problem with these solutions is applying them in practice. For example, the term “offsetting positions” is defined in IRC section 1092 as follows:

A taxpayer holds offsetting positions with respect to personal property if there is a substantial diminution of the taxpayer’s risk of loss from holding any position with respect to personal property by reason of his holding 1 or more other positions with respect to personal property (whether or not of the same kind).²⁷

However, it will not always be clear whether the taxpayer’s investment portfolio contains offsetting positions, particularly as the taxpayer’s entire portfolio may have to be analyzed to determine the risks to

26. The literature involving these doctrines is too vast to be extensively analyzed here. See, e.g., *Knetch v. U. S.*, 364 U.S. 361 (1960); *Gregory v. Helvering*, 293 U.S. 465 (1935); *Rice’s Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985). The common law economic substance doctrine has recently been clarified in IRC § 7701(o): A transaction will not be considered to have economic substance unless, apart from the effects of federal income tax, the taxpayer has a substantial purpose for entering into it and it meaningfully changes the taxpayer’s economic position. For the purpose of making such determinations, potential for profit is taken into account only if the present value of the pretax profit is substantial in relation to the present value of the net tax benefits.

27. IRC § 1092(c)(2)(A). IRC § 1092(c)(3)(A) contains a list of presumably offsetting positions, with IRC § 1092(c)(3)(B) clarifying that the presumption in subparagraph (A) is rebuttable.

which she is actually exposed. The financial instruments available today are many, diverse, and sophisticated, and the affect of each on the overall level of risk inherent in the portfolio may not be obvious. Furthermore, as investment portfolios are not static, the extent to which the risk inherent in any position is offset by another position may change by the minute.

The same doubts can arise with regard to the question of whether a given change in the taxpayer's portfolio constitutes a constructive sale of any of the positions therein.²⁸ Furthermore, the very act of defining terms such as "constructive sale" invites attempts to frustrate the provision by achieving economic realization that does not meet the requirements for a constructive sale as statutorily defined.²⁹

With regard to the general anti-abuse principles, the problems surrounding their application in practice are legendary. A coherent theory as to when courts will ignore a transaction as a sham and when they will recognize it for tax purposes has not yet been articulated, and it is difficult to predict in advance when a court will ignore any particular transaction as a sham.³⁰

28. See David P. Hariton, *The Tax Treatment of Hedged Positions in Stock: What Hath Technical Analysis Wrought?*, 50 *Tax La. Rev.* 803, 805-09 (1995).

29. See, e.g., David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 *Cornell L. Rev.* 1627, 1636 (1999).

From an economic perspective, short-against-the-box transactions look too much like sales for them to be not treated as realization events. Because they eliminate the risk of gain and loss, Congress changed the law to treat them as sales. It is not clear, however, if this change is appropriate. The new law only moves the line between holding and selling incrementally. The underlying problem, that similar transactions are treated differently, is still there—there is just a new line. The new line is substantially more complex than prior law, and taxpayers can probably avoid unfavorable tax treatment just as easily. It is doubtful that the legislation moves us any closer to a clear definition of the realization requirement.

Id. (citations omitted).

For an unsuccessful (pending appeal) attempt to avoid the § 1259 definition, see *Anschutz Co. v. Commissioner*, 135 T.C. No. 5 (2010); See David Cay Johnston, *Anschutz Will Cost Taxpayers More Than the Billionaire*, 128 *Tax Notes* 557 (Aug. 2, 2010); David Cay Johnston, *Anschutz and a 21st-Century Tax System*, 127 *Tax Notes* 699 (May 10, 2010).

30. See, e.g., Christopher H. Hanna, *From Gregory to Enron: The Too Perfect Theory and Tax Law*, 24 *Va. Tax Rev.* 737 (2005); Martin J. McMahon, Jr., *Random Thoughts on Applying Judicial Doctrines to Interpret the Internal Revenue Code*, 54 *SMU L. Rev.* 195, 195 (2001) (“‘Substance controls over form, except, of course, in those cases in which form controls.’ This [is the] immutable law of federal taxation”).

The problems with statutory provisions relying on terms as imprecise as “offsetting positions” or relying on vague common law principles are greatly exacerbated by the practice of self assessment. The IRS’s auditing capacity is limited. The government relies, therefore, on the forthrightness of the taxpaying public, on selective audits, and on the threat of criminal and civil penalties imposed on taxpayers discovered to have filed fraudulent returns. It follows that the more vague and imprecise the rules by which tax liability is determined, the more likely there will be a discrepancy between the tax liability according to the taxpayer-prepared return and the tax liability as it would have been ascertained by the IRS after a thorough audit. When rules are open to interpretation, taxpayers will naturally tend to interpret them so as to reduce their tax liability. When the rules of the game include such terms as “substantial diminution of the taxpayer’s risk of loss,”³¹ it is difficult, except in the more obvious cases, to prosecute taxpayers for fraud even though the IRS or a court might disagree with their self-assessment. Admittedly, statutory provisions cannot describe in precise terms the tax consequences of every possible situation that can occur. In many cases relying on vague and imprecise terms or doctrines is unavoidable. Nonetheless, such terms and principles should constitute the last line of defense. Relying on them as the primary means by which to combat capital market tax-planning strategies is likely to prove ineffective.

The third, and most effective, method of confronting these strategies is to abandon the realization doctrine and tax gains on publicly-traded securities as they accrue. This solution is the simplest, both conceptually and practically.³² Most importantly, it focuses on the underlying problem instead of the symptoms. It is the realization doctrine which, when applied to the capital markets, invites the taxpaying public to manipulate the artificial distinction between realized gain and unrealized gain. Do away with the doctrine and the problem solves itself.³³

31. IRC § 1092(c)(2)(A).

32. This is not to say that the goal of simplifying the tax system will necessarily overcome all other considerations. Nevertheless, when the complexity arises due to a doctrine that, in the circumstances considered, is unnecessary, the goal of simplification is another reason to jettison the doctrine. For a comprehensive discussion of the place of simplification among the various factors that a legislator needs to consider when designing the tax structure, see Edward J. McCaffery, *The Holy Grail of Tax Simplification*, 1990 Wis. L. Rev. 1267 (1990); Daniel Q. Posin, *A Case Study in Income Tax Complexity: The Type A Reorganization*, 47 Ohio St. L.J. 627, 628–629 (1986) (“[V]irtually nothing can be done about the complexity of the federal income tax system.”).

33. Weisbach, *supra* note 4, at 122 (“Much of the complexity of current law stems from the realization requirement. Pure mark-to-market taxation potentially offers dramatic simplification because all of the realization rules could be repealed.”); See also Andrews, *supra* note 5, at 1131.

In certain limited situations Congress has adopted this approach. Section 475 of the Internal Revenue Code describes circumstances in which dealers in securities report gains and losses on a mark-to-market basis. Section 1256 requires regulated futures contracts, foreign currency contracts, nonequity options, dealer equity options, and dealer security futures contracts to be marked to market.³⁴ However, Congress has thus far refrained from adopting a general principle that gains from appreciation (and losses from depreciation) of publicly traded securities be recognized for tax purposes as they accrue.

2. Wash Sales

When the value of a security declines, the investor experiences an economic loss that is not recognized for tax purposes prior to sale. Selling the security will allow recognition of the loss. However, the investor may believe that the decline is temporary and that, given time, the security will recover. Investors in situations such as these often find themselves facing a dilemma: recognizing the loss for tax purposes apparently requires waiving the opportunity of recouping the loss should the value of the investment rise.

In order to benefit both from an immediate recognition of the loss for tax purposes and from the potential rise in value of the security, the investor may consider selling the security and immediately repurchasing it: the sale realizes the loss, while the repurchase allows the investor to benefit from the expected recovery.³⁵ Congress countered this potential action by prescribing that a loss on the sale of a security will not be recognized if during the 61 day period commencing 30 days before the sale and ending 30 days after the sale the investor purchased the same or fundamentally the same security.³⁶

34. Section 1601 of the recently passed Dodd–Frank Wall Street Reform and Consumer Protection Act limits the scope of IRC § 1256 by providing that interest rate swaps, currency swaps, basis swaps, interest rate caps, interest rate floors, commodity swaps, equity swaps, equity index swaps, credit default swaps, and similar agreements are not to be treated as § 1256 contracts. Furthermore, securities futures contracts or options on such contracts are no longer treated as § 1256 contracts unless such contract is a dealer securities futures contract. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, 124 Stat. 1376 (2010).

35. Wash sales and straddles may be combined effectively and efficiently: the investor purchases two offsetting positions and waits for one to rise and the other to fall. The losing position is then closed and a similar position immediately opened. The financial risk is minimal, but for tax purposes the loss is realized while the corresponding gain is deferred. See, e.g., Louie, *supra* note 4, at 859.

36. IRC § 1091(a). The section does not attempt to differentiate between the investor whose sale and repurchase are tax-motivated and the innocent investor

Why did Congress object to wash sales? The question may be clarified by comparing the wash sale to the two strategies discussed above: straddles and constructive sales. In each of these planning techniques, the realization doctrine is manipulated in order to create tax losses unaccompanied by any real economic loss or to realize gain economically without paying tax on that gain. In other words, straddles and constructive sales are exploited with the intention of bringing about disparities between actual accession to wealth, on the one hand, and taxable income, on the other. The motivation to counter these strategies is clear. Ostensibly, wash sales are different. When the value of the security declined, the investor suffered an actual economic loss. The sale and repurchase are not an attempt to manipulate the realization doctrine by creating a non-existent loss; rather, the purpose of the wash sale is to create a situation in which taxable income reflects true economic gain and, thus, to overcome a distortion caused by the realization doctrine. Note that were stock market gains taxed on an accrual basis—as this Essay argues they should be—the tax system would recognize the loss even without the wash sale. What is wrong with the taxpayer engaging in a little self help to achieve the same result?

The answer would appear to be that the realization doctrine, an artificial creature of the tax system, inherently creates a disparity between taxable income and economic gain. This disparity operates sometimes to the advantage of the taxpayer (with regard to gains) and sometimes to the advantage of the government (with regard to losses). Were taxpayers to act without regard to the tax consequences of their actions, the cost would presumably be divided arbitrarily between the government and the taxpayers. Reality is quite different. The public is well aware of the tax consequences of its behavior and acts accordingly. A taxpayer may defer the sale of an appreciated asset in order to defer paying tax on the appreciation. Similarly, a taxpayer who has realized a gain may look for an asset whose value has depreciated in order to sell it and deduct the now-realized loss from the gain. This type of gamesmanship is probably unavoidable and is a necessary and predicable cost of adopting the principle of realization.

The line separating acceptable from unacceptable rule manipulation in the context of the realization doctrine is not a matter of substance but rather a matter of degree. When deferring the payment of tax on asset appreciation requires the taxpayer to continue risking the capital invested in that asset, or, alternatively, when the taxpayer needs to sell an asset in order to recognize the loss from its decline in value, there exists a mechanism guaranteeing at least the semblance of symmetry between the non recognition of unrealized gains and the non recognition of unrealized losses. However, if taxpayers are able to recognize losses without forfeiting their

acting in response to market developments. In general, the ensnarement of innocent taxpayers is one of the unfortunate side effects of anti-abuse legislation.

economic interest in the asset concerned, the ostensible symmetry between gains and losses no longer exists.

Accrual taxation is immune to these dilemmas. Selling and repurchasing are not necessary in order to cause the loss to be recognized for tax purposes, as the tax law would recognize the loss even without the wash sale. Nonetheless, symmetry between gains and losses would be retained as unrealized gains would also be recognized. In either case, recognition would be unaffected by the act of sale.

It should also be noted that the practical difficulties inherent in applying the provisions denying recognition of wash sales are no less than those we encountered earlier with regard to straddles and constructive sales. The question of when the new position is substantially identical to the closed position is not always easy to answer. For example, it is well known that it is possible to construct a portfolio, containing relatively few stocks, that more or less tracks a market index. Would the sale of a set of securities with a high degree of coordination with a particular index and the simultaneous purchase of another set of securities, with no security in common but with a similarly high degree of coordination with the same index, be considered a wash sale? Can the IRS effectively monitor these types of transactions, examining daily the degree of coordination of the taxpayer's portfolio, or subsets of it, with the various indexes in order to determine whether the changes leave the taxpayer in the same or a similar position with regard to her exposure to the market? It is highly doubtful that such a level of scrutiny is possible.

C. *Deducting Losses*

One of the more complex aspects of taxing gains, in general, and taxing gain from the stock market, in particular, is the treatment of losses. As will be seen, the source of both the technical and the substantive difficulties encountered result from the realization principle.

Considerations of horizontal equity and economic efficiency require free deductibility of losses. Nonetheless, with regard to capital losses, the Code severely restricts their deductibility and prescribes, in general, that capital losses can only be deducted to the extent of capital gains.³⁷

The primary reason for restricting the deductibility of capital losses is the ability of taxpayers to realize, and thus recognize, capital losses, while retaining those assets containing unrealized capital gain ("selective realization" or "cherry picking"). Were capital losses freely deductible, taxpayers would be able to realize their losses, deduct them against ordinary income, and reduce or even eliminate their taxable income, even though the value of other assets had appreciated.

37: IRC § 1211. Where capital losses exceed capital gains, individuals are allowed to deduct \$3000 of the excess against ordinary income. IRC § 1211(b).

Cherry picking is obviously only possible within a tax regime that defers recognition of gains and losses until they are realized. Abandon the realization doctrine and the problem disappears. Gains and losses would be recognized in the year they accrue, so that selling or retaining the asset would not affect the taxpayer's liability. Ordinary taxable income plus capital gains minus capital losses would equal economic accession to wealth.

For example, assume that at the beginning of the year, a taxpayer purchased capital asset A for \$100 and capital asset B for \$150 and did not sell them before the end of the year; that at the end of the year, asset A was worth \$30 and asset B was worth \$190; and that during the year the taxpayer earned wages of \$300. The taxpayer's accession to wealth during the year would be $\$300 + (\$30 - \$100) + (\$190 - \$150) = \270 . Under a tax regime that recognizes gains and losses as they accrue, taxable income would also be \$270. This would not be the result under a regime that recognizes gains and losses only as they are realized. As the assets were not sold, the gain and the loss would not be recognized and taxable income would be \$300. Selling asset A for \$30 would not change the situation. Because capital losses are only deductible to the extent of capital gains, the \$70 loss would not be deductible and taxable income would still be \$300.³⁸ Selling both assets before the end of the year would also not change the situation. The gain from asset B is \$40 and so only \$40 of the capital loss would be deductible, and taxable income would remain \$300 (ordinary income of \$300 + capital gain of \$40 – deductible capital loss of \$40).³⁹ The fear of selective realization prevents the tax system from appropriately measuring accession to wealth.

Another problem with allowing free deductibility of capital losses concerns the preferential rate of tax imposed on long term capital gains in the hands of individual taxpayers.⁴⁰ Allowing taxpayers to deduct capital losses from ordinary income would mean that the government is, in effect, a 15% partner with regard to gains, but a 35% partner with regard to losses. Nonetheless, the fact that the government's share in losses is less than its share in gains is not necessarily an undesirable result. The critical factor in determining whether this result is indeed undesirable is the policy behind granting preferential rates to capital gains in the first place.

As a thorough examination of the capital gains preference is beyond the scope of the present Essay, a few examples will suffice to demonstrate the relationship between the reason for the preference, on the one hand, and

38. I am assuming that the amount of loss that is allowed to be deducted against ordinary income is relatively insignificant. See *supra* note 35.

39. Should the taxpayer sell asset B while retaining asset A, taxable income would be \$340.

40. The issue of the differential tax rate is irrelevant for corporations, for whom the tax rate imposed on capital gain is the same as that imposed on ordinary income.

the treatment of capital losses, on the other. One common justification for the capital gains preference is the effect of inflation on the measurement of gain. Gain is defined as the difference between the amount realized and the adjusted basis. However, as the adjusted basis is stated in nominal dollars instead of in real dollars, the gain as computed by the provisions of the Code will, during periods of inflation, overstate real gain. The preferential rate for long term capital gain is said to compensate for the overstatement of gain.

Whatever the merits of the argument, if inflation is the underlying reason for the capital gains preference, consistency would require not only that the government participate in capital losses to a greater extent than it participates in capital gains, but that it participate in capital losses even to a greater extent than its share of ordinary income. During periods of inflation, while nominal gain overstates real gain, nominal losses understate real losses. Assume that a taxpayer purchases an asset for \$100 and sells it several years later for \$150. Cumulative inflation over that time period was 30%. Nominal gain, as computed by the provisions of the Code is \$50. Real gain, however, is only \$20. Were nominal gain taxed at full rates (35%), the tax would be \$17.50 ($\$50 \times 35\%$), or 85% ($\$17.50/\20) of the real gain. By taxing long term capital gain at the reduced rate of 15%, the tax is only \$7.50 ($\$50 \times 15\%$), or 37.5% ($\$7.50/\20) of real gain.

Now assume that instead of selling the asset for \$150, the taxpayer sells it for \$60. The nominal loss, as computed by the Code, is only \$40 ($\$100 - \60); the real loss is \$70 ($\$130 - \60). Were the taxpayer to deduct the nominal loss from income subject to tax at the rate of 15%, the tax savings would be \$6 ($\$40 \times 15\%$), or 8.6% ($\$6/\70) of the real loss. In other words, while the government participates in 37.5% of the real gain, it participates in only 8.6% of the real loss. Even if the loss were deductible against income subject to the full rate of tax (35%), the tax savings of \$14 ($\$40 \times 35\%$) would be only 20% ($\$14/\70) of the real loss. Again the government participates to a much greater extent in gains (37.5%) than in losses (20%).

Another justification for the preferential rate imposed on capital gain is the problem of international tax competition (the infamous "race to the bottom"). If this is the reason for the preference, then seemingly the extent to which the government should participate in losses would also be a product of that same competition. If the government can get away with limiting the deduction of losses, then it can, in some small measure, make up some of the cost of the capital gains preference. On the other hand, were other countries to offer preferential rates on capital gains coupled with unrestricted deduction of losses—a situation that, to the best of the author's knowledge, does not exist today—then the United States might be forced to follow suit.

In other words, the fact that gains are taxed at a preferential rate does not necessarily imply that allowing full deduction of capital losses is

inappropriate.⁴¹ However, even if as a matter of policy it is determined that the tax benefit from losses should not exceed the rate of tax that would have been imposed in the case of a gain, there are techniques that would allow capital losses in excess of capital gains to be taken into consideration for tax purposes, without forcing the government to participate in losses to a greater extent than it participates in gains. For example, where capital losses exceed capital gains, the taxpayer, instead of deducting the loss, could be granted a credit equal to the excess times the capital gains tax rate. Assume that a taxpayer has a capital loss of \$100 and ordinary income of \$300 and that capital gains are taxed at 15% while ordinary income is taxed at 35% (for the sake of convenience, we will ignore the progressive rate structure). The law as it stands today would not allow the deduction of the capital loss, so the taxpayer would pay tax of \$105 ($\$300 \times 35\%$). This is inappropriate as accession to wealth was only \$200, and yet the taxpayer is taxed as if accession to wealth had been \$300. Allowing a deduction might also be considered inappropriate. True, accession to wealth is \$200 and the taxpayer would pay tax of \$70 ($\$200 \times 35\%$); nevertheless, the government is in effect covering 35% of the loss, while it would only have participated in 15% of the gain. The proposed solution is for the taxpayer to receive a credit for the loss in the amount of \$15 ($\$100 \times 15\%$). The total tax liability would be $(\$300 \times 35\%) - (\$100 \times 15\%) = \$90$. The loss would thus result in an immediate tax benefit, while not requiring the government to participate in the loss to a greater extent than it would have participated in a gain. An equivalent technique would be to allow the loss to be deducted but first to multiply it by the ratio of the capital gains rate to the taxpayer's marginal tax rate. In the example, the taxpayer would be entitled to a deduction of $\$100 \times 15\%/35\% = \43 . Taxable income would be \$257 ($\$300 - \43), and the tax would be \$90 ($\$257 \times 35\%$).

Abolishing the realization requirement for publicly-traded securities would eliminate the problem of cherry picking. Once that problem is resolved, the question of how to account for capital losses given the capital gains preference (assuming that for reasons of policy the government does not want to participate in losses beyond the extent of its participation in gains) becomes a relatively simple technical issue.

41. The preferential rate can also be justified as compensation for the restriction on deduction of capital losses. Because of the problem of cherry picking, Congress may have had no choice but to restrict the deduction of capital losses. This restriction upsets the balance between gains and losses—while gains are always taxed, losses are not always deductible. The low rate of tax on capital gains may be compensation for the imbalance. Of course, this reason for the capital gains preference would be irrelevant in the absence of the realization rule.

IV. COUNTERARGUMENTS

This Part will examine arguments supporting retention of the realization principle with regard to capital gains from publicly-traded securities: the fear of future reduction in value, public opinion and the psychological element, the problem of creating a mixed system in which some assets are taxed currently and others are taxed only on realization, the possibility of retaining the realization doctrine while charging interest for the deferral, and the the low degree of liquidity of certain securities that may prevent the imposition of mark-to-market taxation.

A. *Possibility of Future Depreciation*

One argument against imposing tax on “paper gains” is based on the possibility that the value of the asset may decline in the future. In other words, while an asset’s appreciation does constitute accession to wealth, that accession to wealth could dissipate. It is therefore appropriate to wait until the asset is sold before imposing tax in order to ascertain that the accession to wealth is not merely temporary.

True, the fear of depreciation in value exists as long as the taxpayer holds onto the asset. It is also true that the future depreciation could completely or partially obliterate the gain. However, the fear of future loss is not normally sufficient to prevent taxation of current gain. Every taxpayer who reports a positive income in one year may experience a loss in subsequent years. A business owner cannot defer tax on income by arguing that next year might produce a loss. An investor who sold stock A at a gain and reinvested the funds in stock B cannot normally defer paying tax on the gain because of the fear that asset B will decline in value. Their situations are not dissimilar from that of an investor who refrains from selling appreciated securities. In each of these cases the taxpayer experienced an accession to wealth. In each of them there is a fear that the taxpayer’s wealth may decrease in the future. The mere fear of future loss is not enough to defer recognition of gain.

What will happen, though, if after the taxpayer reports the gain and pays the appropriate tax, the value of the security declines, eliminating some or all of the gain? Would this situation not constitute a hardship for the taxpayer? The answer is that the hardship would be no greater than that in any other case in which the taxpayer experiences a profit in one year and a loss in another. Allowing the taxpayer a deduction (or a credit)⁴² for the loss is supposed to remedy the situation. Where for whatever reason it does not, the solution is to be found in the rules governing the deduction of losses. In any case there is no economic or administrative reason to relate differently to

42. See *supra* Part III.C.

taxpayers whose gains and subsequent losses resulted from holding onto the same security.

B. Psychology and Public Opinion

As has been seen, there is no economic basis for distinguishing between “paper profits” and realized profits, at least as far as highly liquid assets are concerned.⁴³ Nevertheless, this distinction is deeply embedded in the public consciousness. Many believe that while asset appreciation presents the taxpayer with the opportunity to profit by selling the asset, until the sale, appreciation is no more than potential gain, and that it is inappropriate to impose tax on mere potential gain.

This broadly-held opinion might be the reason that Congress has thus far refrained from imposing an across-the-board mark-to-market tax regime on stock market gain.⁴⁴ Taxes in a democracy require the consent of the governed. Where “paper gain” is not considered by the public to be an appropriate subject for taxation, a politician who proposed elimination of the realization rule risks alienating her constituents. Even proposals to narrow the scope of the doctrine in order to prevent abuse have sparked heated resistance.⁴⁵

The problem is real. The utility of proposed tax provisions, equitable and efficient as they may be, is limited in practice if public resistance prevents their enactment. The only solution is education. One aspect of the proposal that is likely to appeal to public sentiment is the free deductibility of (or a credit for) capital losses.⁴⁶ This possibility may help convince the public that the fairest and most efficient way to tax stock market gains is by abandoning the realization principle.

C. Taxing Stock Market Gain Differently Than Gain from Other Assets

The tax regime applicable to specific types of income cannot be viewed in isolation from the generally prevailing tax structure. Tax provisions that would be advisable were they imposed universally are not necessarily appropriate when applicable only in certain cases.⁴⁷

43. Even Zelinsky agrees with this argument: “Of course, these taxpayers flunk Econ. 101 for believing these things.” Zelinsky, *supra* note 7, at 894.

44. See David M. Schizer, *Realization as Subsidy*, 73 N.Y.U. L. Rev. 1549, 1606–09 (1998).

45. See, e.g., *id.* at 1606–07.

46. See *supra* Part III.C.

47. See Richard G. Lipsey & Kelvin J. Lancaster, *The General Theory of the Second Best*, 24 *Rev. of Econ. Stud.* 11, 12 (1956).

It is possible that, if adopted as a general rule, the imposition of tax on asset appreciation as it occurs would be better than deferring tax until realization. Nonetheless, practical considerations—particularly evaluation and liquidity—prevent the adoption of a strictly accrual-based tax system and, in most cases, dictate retention of the realization model. In this instance, the tax system deviates from the ideal. This deviation cannot be ignored when considering the proper tax treatment of gains, when circumstances allow for the imposition of accrual-based taxation. In other words, from the fact that a universally applied accrual-based tax would be preferable to a realization-based tax, one cannot necessarily infer that, in an environment of realization-based tax, imposition of accrual-based tax on gain from a specific type of asset is advisable. The fact that different types of gain would be subject to different tax regimes might create distortions the cost of which would be greater than the benefit achievable from the (narrow) imposition of accrual-based tax.⁴⁸

The major disadvantage inherent in a system with differential tax regimes is the likelihood that economic resources will be diverted from their most efficient uses. When different investments incur different tax liabilities, the tax consequences could constitute an important factor in choosing investments. When the investment decision is different than it would have been were the tax consequences not factored into the decision, the result, in most cases, is economic inefficiency. Specifically, imposing a mark-to-market tax regime on the stock market while the tax on appreciation of other assets is deferred until realization could dampen the demand for publicly-held stock, prevent corporations from raising capital, and distort investment decisions. The losses to society from mark-to-market taxation might overwhelm any gain therefrom.⁴⁹

Nonetheless, it does not appear that the fear of creating disequilibrium in the market by imposing different tax regimes on publicly-traded securities as opposed to non publicly-traded assets is a major impediment to the introduction of mark-to-market taxation. Differential tax regimes create economic inefficiencies due to the substitution effect: when a taxpayer faces a choice among several options, she might choose option A because of the attractive tax regime despite the fact that she would have chosen option B in the absence of tax considerations. Accordingly, the lesser the substitution effect, the greater the economic efficiency of the tax.⁵⁰

The substitution effect is a function of the elasticity of the tax base. The more easily the taxpayer can switch from one mode of behavior to

48. See Weisbach, *supra* note 4, at 97.

49. See Zelinsky, *supra* note 7, at 918–47.

50. See Jay Hausman, *in* *Labor Supply, How Taxes Affect Economic Behavior* 27, 27-28 (Henry J. Aaron & Joseph A. Pechman eds., Brookings Institution 1981).

another, the more significant the tax factor becomes. Conversely, the less elastic the tax base, the weaker the substitution effect.⁵¹

Income tax is not imposed in a uniform manner. Income earned through a corporation is taxed differently than income earned directly by an individual; capital gains are taxed differently than ordinary income; passive income is often taxed differently than wages or self-employed income. Various and sundry considerations—some justified and some not—have led Congress to adopt a tax system composed of different, and competing, tax regimes. Just as one who proposes imposing mark-to-market taxation on publicly traded securities cannot ignore the fact that gain from other assets is taxed only upon realization, one who proposes imposing tax on the gain from publicly-traded securities only upon realization cannot ignore the fact that, in any case, the tax structure contains many and varied tax regimes.

Thus, the question is not whether to institute a tax structure with differential tax regimes. These regimes exist. The real question is where to draw the line between one tax regime and another. Because any line, wherever drawn, will encourage taxpayers to change their behavior in order to benefit from the more advantageous tax regime, considerations of efficiency would dictate drawing the line so as to minimize the substitution effect.

The economic effect of imposing different tax regimes on publicly-traded securities, on the one hand, and other assets, on the other, depends therefore on the degree of substitutability between the two. For a large number of investors, the advantages of investing in the stock market greatly outweigh any disadvantages of mark-to-market taxation. These advantages include liquidity, the ability to invest relatively small amounts, regulatory oversight, analyst coverage, and more. The absence of these conditions in privately held corporations means that, for a large segment of the population, investing in non publicly-traded shares is not a viable option.⁵²

Moreover, while it is true that gain from the appreciation of non publicly-traded shares is deferred until sale, the tax on dividends and interest—including appreciation due to original issue discount—from publicly-traded securities is not so deferred. Therefore, harmonizing the tax regime imposed on gain from appreciation of publicly-held stock with that imposed on gain from shares in privately-held corporations, requires the creation of a disequilibrium among the various types of income derived from

51. See David Elkins, *Horizontal Equity as a Principle of Tax Theory*, 24 *Yale L. & Pol'y Rev.* 43, 49–50 (2006); Weisbach, *supra* note 29, at 1656.

52. Imposing a special tax regime on publicly-traded stock may influence the decision to offer shares to the public in the first place. Louie, *supra* note 4, at 870–71. Nonetheless, if we have to establish a border for the accrual tax regime, the line dividing publicly-traded from non publicly-traded stock is not a bad place to do so, given the significant differences between the two.

the stock market itself. For example, at present the income from investing in companies that distribute a large portion of their earning as dividends is taxed, to a great extent, on an accrual basis, while the gain from investing in companies that tend to reinvest their earnings is taxed only upon realization.⁵³

As noted, the tax system as a whole is composed of a number of different tax regimes. From an efficiency perspective, the best place to delineate the line between them is the point at which substitution is the least likely. In any case, in the absence of strong empirical data demonstrating that the substitution effect is more significant with regard to the choice between investing in publicly-traded stock, on the one hand, and investing in non publicly-traded stock, on the other, than it is with regard to the choice between investing in publicly-traded non-dividend-producing stock, on the one hand, and investing in publicly-traded bonds or publicly-traded dividend-distributing stocks, on the other, the fear of a substitution effect is not a reason to reject mark-to-market taxation on the stock market gains.

Furthermore, the argument that imposing mark-to-market taxation will deter investment in publicly-traded stock rests on the assumption that taxpayers prefer deferring taxation on gain until those gains are realized. This assumption is not necessarily correct. True, the next best thing to avoiding a tax is deferring it, but mark-to-market taxation allows free deductibility of (or a credit for) losses, a concession that a realization-based system cannot afford.⁵⁴

In summation, one who objects to mark-to-market taxation because of the fact that non publicly-traded investments will continue to be taxed only upon realization must bear a triple burden of proof. First, it must be shown that the elasticity of the choice between publicly-traded securities and non publicly-traded assets (such as land or stock in privately-held corporations) is greater than the elasticity of the choice between publicly-traded growth stock, on the one hand, and bonds, CDs, or publicly-traded income stock, on the other. Secondly, it must be shown that, from the taxpayer's perspective, the tax advantages of deferral outweigh the advantages of free deductibility (or a credit in lieu) of capital loss. Thirdly, it must be shown that the economic distortion due to the different tax rules is more significant than the advantages inherent in mark-to-market taxation. Opponents of mark-to-market taxation have not yet offered such a proof.

53. The text is referring only to the shareholder-level tax and not the corporate-level tax.

54. See *supra* Part III.C.

D. The Possibility of Combining Realization with an Interest Charge for Deferral

It may be argued that the advantages of mark-to-market taxation can be achieved without abandoning the realization rule. The idea is that computation of gain and payment of tax would be deferred until realization, but that the taxpayer would be charged interest for the deferral. The interest would reflect the advantage of deferral and would thus mimic mark-to-market taxation; however, by retaining the principle that income gain is not taxed prior to realization, it would be a less radical departure from traditional income tax doctrine.⁵⁵

Proponents of the interest charge view it as a possible solution to the classic problem of nonrecognition of unrealized gain. In other words, what the commentators have in mind is a typical situation in which valuation and liquidity prevent the imposition of tax on gain prior to realization. The interest charge is intended to mitigate the violation of principles of equity and efficiency inherent in the realization doctrine.

A comprehensive analysis of the interest proposal is beyond the scope of the present Essay. Furthermore, it is unnecessary to consider whether it would be appropriate to adopt a special tax regime for publicly-traded securities were the taxation of gains from the sale of property based on deferral, until realization combines with an interest charge. This Essay considers only the alternative regimes for taxing gain from publicly-traded securities, with the general regime of taxing gains at realization taken as a given.

Under these circumstances, it is difficult to justify deferring the tax until realization and then charging interest for the deferral. The realization doctrine was designed to contend with the twin problems of valuation and liquidity, which prevent taxing appreciation as it occurs. The interest charge was designed to contend with the problems created by the realization doctrine. When considering how to tax those assets for which problems of valuation and liquidity do not exist, it seems hardly logical to adopt a regime of deferring tax until realization coupled with an interest charge.

Moreover, the two regimes—mark-to-market, on the one hand, and deferral coupled with an interest charge, on the other—will not necessarily arrive at the same result. Computing the amount of interest that the taxpayer

55. See IRC § 1297 (passive foreign investment companies). See also, Mary Louise Fellows, *A Comprehensive Attack on Tax Deferral*, 88 Mich. L. Rev. 722 (1990) (discussing the operation of a time-adjusted-realization-event tax); Stephen B. Land, *Defeating Deferral: A Proposal for Retrospective Taxation*, 52 Tax L. Rev. 45, 73–80 (1996); Deborah H. Schenk, *An Efficiency Approach to Reforming a Realization Based Tax*, 57 Tax L. Rev. 503, 537–41 (2004); Weisbach, *supra* note 4, at 100–02

should be charged depends upon data—such as the rate of appreciation of the asset during the holding period and the appropriate rate of interest—that are not always simple to determine. Various systems have been proposed to supply the figures necessary for computation,⁵⁶ but the very existence of these competing systems is enough to give one pause. In attempting to mimic the tax burden of a true accrual system, such systems would base computations on estimations that are often arbitrary. When these estimates are inaccurate the results will be distorted. It is hard to justify such a substitute when it is easier to impose tax on the actual gain accrued each year.

Mark-to-market taxation is not affected by these inexactitudes. Each year the taxpayer pays tax on the actual gain accrued during the year. As tax is paid concurrent with the gain, it is unnecessary to determine the interest rate. Furthermore, the taxpayer has the option each year of selling securities to pay the tax attributable to that year, an option unavailable when tax is deferred until realization. There the taxpayer is, in effect, forced to borrow funds from the government if she wishes to continue holding onto the security.⁵⁷

V. CONCLUSION

The realization convention was designed to deal with those situations in which it is difficult, in practice, to impose tax on asset appreciation prior to sale. Deferring the payment of tax until realization creates economic inefficiency and, more importantly, violates fundamental principles of horizontal and vertical equity. However, in most cases, there is little choice but to surrender to the dictates of reality and wait for sale before the government can claim its share of the gain.

Valuation and liquidity do not pose serious impediments to taxing appreciation of publicly-traded securities. On the contrary, clinging to the realization principle is what causes problems: disruption of the smooth operation of the market, manipulation of sophisticated financial instruments, and strict limitations on the deduction of capital losses.

Mark-to-market taxation, on the other hand, is both equitable and efficient: investors would pay tax on their gain as it accrues, and their choice of whether to sell or to hold would not be affected by tax considerations. Mark-to-market taxation also allows unrestricted deduction (or a credit in lieu) of capital losses, a provision that would contribute not only to the

56. See *supra* note 55.

57. See Schenk, *supra* note 55, at 540 (“[S]uppose the tax rate is 40% and T purchased property for \$1, which he held for 20 years and then sold for \$1,000. T would owe \$400 in taxes plus \$743 in interest at 10%, or \$1,143, more than the sales price.”).

equity and efficiency of the tax structure but also—and no less importantly—to the public perception of its fairness.

Countering these advantages is the conception that mere “paper gain” is not a proper subject for taxation. However, this conception, deeply rooted in the public consciousness as it may be, is unwarranted. Only the fact that it is so deeply rooted gives it any standing whatsoever. By explaining to the public that taxing gains as they accrue will allow losses also to be recognized as they accrue and, furthermore, will provide investors with an immediate tax benefit even in the absence of capital gains, it may be possible to obtain public support for mark-to-market taxation.

