Is It Time to Tax Disney's Unrealized Capital Gains From 1965?

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In this article, Susswein and Brown argue that taxing unrealized capital gains on income-producing assets makes little sense because the taxpayer still owns the asset generating the income and would thus be taxed twice on the income: once as an increase in anticipated future ordinary income and twice when the ordinary income is actually received. They contend that double taxation would result even if a basis adjustment were permitted and even if the mechanism used was an interest charge rather than outright mark-to-market taxation.

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Introduction and Overview

The Biden administration, Senate Finance Committee Chair Ron Wyden, D-Ore., and others have proposed legislation that would treat unrealized capital gains as income for some taxpayers. The White House has also advanced an economic study suggesting that this may be the only proper method of measuring taxable income generally. In fairness, the White House study only assumes (without discussing the issue) that a correct or comprehensive definition of income should include unrealized capital gains.[1] But the study's conclusions — if that assumption is correct — are stunning, particularly as summarized by the mainstream media.

The White House study would demonstrate that the failure of Treasury, the Joint Committee on Taxation, and the Congressional Budget Office to treat unrealized capital gains as income has caused those agencies to systematically overstate the average income tax rate of high-income taxpayers and to dramatically overstate the progressivity of the income tax.[2] Those agencies consistently report that the top income group bears an average income tax rate above 20 percent, much higher than the 5.7 percent rate reported for

[1] Greg Leiserson and Danny Yagan, "What Is the Average Federal Individual Income Tax Rate on the Wealthiest Americans?" The White House Council of Economic Advisers Blog, Sept. 23, 2021. The study suggests that the assumption is a valid interpretation of the oft-cited Haig-Simons or economists' definition of income as including the taxpayer's consumption, plus any increase in the taxpayer's wealth. On that point, it quotes the JCT, but only for the proposition that "economists generally agree that in theory, a Haig-Simons measure of income is the best measure of economic well-being." Of course, the income tax is not a tax on economic well-being (and certainly not a tax on wealth). It is a tax on income.

[2] Mainstream media reports included statements such as: "The White House's calculation of what the wealthiest pay in taxes is well below what other analyses have found." (Jim Tankersley, "In Push to Tax the Rich, White House Spotlights Billionaires' Tax Rates," *The New York Times*, Sept. 23, 2021); "The White House noted that its estimate of the tax rate for the wealthiest households is 'much lower' than other groups' estimates of top income tax rates." (Naomi Jagoda, "White House: 400 Wealthiest Families Paid Average Tax Rate of 8.2 Percent," *The Hill*, Sept. 23, 2021); Greg Iacurci, "America's Richest 400 Families Pay a Lower Tax Rate Than Average Taxpayer," CNBC, Sept. 23, 2021); and even that "the wealthiest Americans pay *far less in taxes* than others" (emphasis added). (Nandita Bose, "White House Analysis Says Wealthy Americans Pay Far Less in Taxes Than Others," Reuters, Sept. 23, 2021.)

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middle-income taxpayers with incomes between $100,000 and $200,000. In contrast, the White House study found that an admittedly smaller and wealthier group in their top cohort had an average income tax rate of only 8.2 percent, possibly lower if unrealized capital gains on assets other than publicly traded stock had been included in their study.

Moreover, if a proper definition of income would include unrealized capital gains, one would expect the proposals from Biden, Wyden, and others to be expanded to cover all taxpayers — not just the 400 wealthiest. Even a taxpayer with no income at all under current law or with a substantial operating loss might have substantial unrealized capital gains.

Although the White House study (along with the proposals from Biden, Wyden, and others) also criticizes the existence of a reduced rate on long-term capital gains, that reduced rate is taken into account in the average tax rate estimates of the other agencies. Although the group studied by the White House is smaller and wealthier than the top income groups studied by the other agencies, the deferral of tax on unrealized capital gains, a benefit enjoyed by all the groups studied by the other agencies, is the only tax law assumption or definition that differs in the White House study. That expanded White House definition of income enlarges the denominator and causes the same amount of taxes paid by the group studied by the White House to be a smaller fraction or percentage of their total income.[3]

Thus, the crucial question addressed in this article is whether the White House study is correct to assume that a proper definition of income includes unrealized capital gains. We conclude that, in the case of income-producing assets, such as an equity interest in an operating business or property held for the production of rents or royalties, the idea of treating unrealized capital gains as income is irretrievably flawed. Upon close examination, treating such unrealized appreciation as income would do little more than tax the same income twice to the same taxpayer. Conversely, if that double inclusion were eliminated — by allowing the capital gain to be reversed through an equal amount of future amortization deductions — the overall positive effect on government revenues appears to be inconsequential and may even be slightly negative.

For income-producing assets, both basic finance and well-established tax law[4] tell us that their market value is the market's assessment of the present value of the stream of future revenues they will generate[5] (net of any anticipated operating expenses of generating those revenues, such as the amounts a popular restaurant will have to pay for groceries, salaries, utilities, and so forth). For tax purposes, the resulting net income will generally be taxed as ordinary income. As a result, an unrealized capital gain is generally nothing more than an increase in the market's assessment of the present value of the asset's future cash flows — including the portion treated as income and any portion treated as a return of capital.[6] If the income-portions of those amounts

[3] CBS News reported that, "The analysis by economists from the Office of Management and Budget and the White House Council of Economic Advisers . . . says the disparity is driven largely by how the tax code treats income generated from wealth — such as income from stocks, *whose worth increases over time* — rather than wages, which are immediately taxed" (emphasis added). Sarah Ewall-Wice, "America's Billionaires Pay an Average Income Tax Rate of Just 8.2 Percent, Biden Administration Says," CBS News, Sept. 23, 2021.

[4] As explained by the court in *United States v. Dresser Industries Inc.*, 324 F.2d 45 (5th Cir. 1963): "The only commercial value of any property is the present worth of future earnings or usefulness. If the expectation of earnings of stock rises, the market value of the stock may rise; at least a part of this increase in price is attributable to the expectation of increased income. The value of a vending machine, as metal and plastic, is almost nil; its value arises from the fact that it will produce income. At common law, the right to receive income from land was ownership of the land. Lord Coke said: 'If a man seized of land in fee by his deed granteth to another the profits of these lands, to have and to hold to him and his heirs, and maketh livery secundum forman chartae, the whole land itself doth pass. *For what is land but the profits thereof?*'" (Emphasis added.)

[5] *Id*. Regarding stock in particular the concurring opinion in *Dresser* added: "Hence it is that among those who trade in corporate securities on established national exchanges or over-the-counter markets, there are recognized rules of thumb by which the present value, hence market price, is determined for a given stock. The same is true in the contemporary, frequent practice of large-scale corporate acquisitions by one corporation of the stock or assets of another corporation. Value — market or sales price — is determined by capitalizing earnings. Whether the formula is the conservative one of six or seven times earnings, or something less, or one considerably more speculative, what the buyer offers is his estimate of the present, discounted value of the future earnings of the assets or enterprise."

[6] To the extent the taxpayer has no basis in the asset, such as where its anticipated stream of future income was created with sweat equity or expenditures that were deducted, the capital gain would equal the total present value of anticipated future revenues.

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are taxed once,[7] as an increase in the amount of anticipated future income, they cannot be taxed again when the cash and income are actually received. That would not be a better definition of income; it would only be a double inclusion of the same income.

If the asset that generated the gain is depreciable (like the goodwill of an operating business), the potential double inclusion of income could be avoided if the deemed seller were treated as a deemed buyer of his own asset and allowed depreciation or amortization deductions over its restated useful life, equal to the capital gain. The tax rules that apply in the case of actual sales suggest that there would generally be little or no net change in the present value of government revenues (although the facts of any particular case might vary), and the exercise would seem to be pointless, or nearly so. Certainly, the effects would be of less import than if the capital gains were being taxed with no recovery allowed to prevent a double inclusion. That approach would obviously raise considerable revenue, as would any proposal to tax gross income without allowing for timely deductions for the cost of generating that income. But that would not be an income tax or a proper method of defining income for income tax purposes.

If the asset generating the gain is non-depreciable, like land or an intellectual property right lacking an ascertainable useful life, there is an unavoidable double inclusion. We illustrate that point using the example of Disney World. It is a useful example, even if you assumed that the Walt Disney Company had been a partnership of individuals. Perhaps the most important point is that allowing the taxpayer a stepped-up basis equal to the capital gain, without a reasonable method of amortizing that step-up, would not eliminate the double inclusion problem. Also, the problem would exist whether unrealized capital gains were taxed under an annual mark-to-market system, or by imposing an interest charge at a later date to compensate the government for not imposing a mark-to-market system. This double-inclusion problem is the fundamental and seemingly intractable problem with the idea of treating unrealized capital gains on income-producing assets as income. We also discuss some other practical and conceptual problems with the idea, related to the taxation of corporate and business income generally, that would exist even if the double-inclusion problem could be solved.

In fairness, if the only assets whose unrealized gains were treated as income were non-income-producing assets (such as gold coins, fine art, or regulated futures contracts, some of which are already subject to tax on a mark-to-market system), the idea could have some merit. The practical problem is whether Congress would be willing to truly treat unrealized losses comparably to gains. As an economic matter, however, if gains were taxable but losses did not reliably give rise to offsetting tax refunds, the resulting tax would not be a tax on economic income, any more than a purported income tax imposed on gross income without any deductions for the expenses of generating such income.

The Double Inclusion Problem

A simple example will illustrate the double inclusion problem.

Consider the new owner of a restaurant, which was purchased for $1 million based on the market's projection that it would likely generate $100,000 of ordinary, net operating income for the next 15 years. If we use a 5.56 percent discount rate (for this and all other computations), $1 million is the present value of that projected stream of future ordinary income. Assume that shortly after purchase, the owner decides to obtain a liquor license. He projects that this will increase his projected annual profits to $150,000 over the same period. If the market agrees, and interest rates and market conditions do not change, the market value of the restaurant will increase to $1.5 million. The result is an unrealized capital gain of $500,000. That gain is nothing more than the present value of the extra $50,000 of annual profits (mostly from liquor

[7] To be clear, future revenues that would be treated as a return of capital should already be reflected in the taxpayer's basis, and thus should not add to the amount of capital gains. In that sense, it is a simplification to say that the capital gain should equal the market's assessment of the present value of the anticipated increase in the asset's future ordinary income. Also, the actual sales price or market price in any particular case may be based on a projection of future revenues, and not on a tax projection of future ordinary income, but the underlying stream of future revenues must either be taxable income or a return of capital. Thus, the analysis made here, perhaps somewhat simplified, is nonetheless valid.

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sales) the market now projects for the next 15 years. The total amount of extra profits would be $750,000 ($50,000 * 15 years). The present value is $500,000.

Here is the problem. If the restaurant owner is taxed on $500,000 as if he had sold the restaurant, even though he continues to own it, he will be taxed twice on the same $500,000. First, he will be taxed on $500,000 representing the present value of an extra $50,000 anticipated each year over the next 15 years. Then he will be taxed again, each year, as the extra $50,000 is actually received. For those familiar with tax accounting, that is called a double inclusion of income. It would violate a fundamental axiom of proper income measurement no less than if it involved a double deduction.

To avoid the double inclusion, the first $500,000 of projected future income would have to be deducted or subtracted from the $750,000 of actual income. That is how the tax law would work today (assuming the value of the restaurant is attributable entirely to its depreciable goodwill) if the restaurant were sold and the taxpayer reinvested the $1.5 million in a substantially similar restaurant with the same projected cash flows of $150,000 per year for 15 years.

In the case of an actual sale, the $500,000 capital gain (on the old restaurant) would be matched by $500,000 of extra amortization deductions usable against the $150,000 of annual operating income generated by the new restaurant. That is, in addition to the $1 million of amortization deductions that would have inured to the taxpayer in the ordinary course had the asset not been sold (or that would inure to him if he used $1 million of his $1.5 million proceeds to purchase a new restaurant) there would be an additional $500,000 of amortization deductions since the restaurant was purchased for $1.5 million.

In total dollars of income or deduction over time, it would be a complete wash. It would be no different, in total dollars of income or deduction over time, than if the owner had simply retained ownership of the old restaurant to enjoy its increased annual profits. Regardless of whether he retains the old restaurant after its profitability has increased (by $50,000 per year to $150,000 per year) or sells it at a capital gain of $500,000 and reinvests the $1.5 million of proceeds in a substantially similar restaurant (generating $150,000 per year — reduced by $500,000 of additional amortization deductions), his total income over time is the same.

Regarding the present value of government revenues, the system is designed to be revenue neutral in the case of an actual sale and repurchase of substantially similar assets, although the applicable capital gains and ordinary income rates, prevailing interest rates, and the tax lives and actual economic lives of the assets involved may cause the results to vary in any particular case. So, if a deemed sale (to trigger realization of an unrealized capital gain) is also treated as a deemed purchase of the same asset, and the gain is entirely attributable to the appreciation of depreciable or amortizable assets, the double inclusion issue goes away, just as it does in the case of an actual sale and a realized capital gain, followed by the reinvestment of the sales proceeds in a substantially similar asset. In that case, however, it is hard to see any reason for changing current law (to provide for a deemed sale and a deemed purchase) or any substantial revenue effect of doing so.

If the idea is to tax unrealized capital gains in a case like this and not to give the deemed seller any increased amortization deductions, treating him as a deemed seller but not as a deemed buyer, then we are not talking about a more scientific or comprehensive definition of income. We are simply taxing the same income twice.

Similarly, when the appreciated income-producing asset is not a depreciable or amortizable asset, such as land, there is no prospect of any increased amortization or depreciation deductions from a deemed repurchase of the asset that was deemed sold. There will always and automatically be a double inclusion.

We submit that no definition of income could support or justify this double inclusion of the same income for the same taxpayer.

To visualize a dramatic, real-life illustration of the double inclusion problem, consider the story of Disney World. Imagine that our tax laws required America's wealthiest taxpayers — including its wealthiest corporations — to compute their taxable income by treating their

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unrealized capital gains as current income. If income is systematically understated by not including unrealized capital gains, that theory would seemingly apply to corporations (like Disney) as well as individuals. In any event, the story of Disney World is a useful illustration, even if you vary the facts by assuming that Disney (or a similar theme park developer) were a partnership of individuals.

In the early 1960s, Disney quietly acquired more than 27,000 acres of Florida swamp and ranch land to build Disney World. The purchases were made anonymously to avoid publicity that would drive up land prices. After the land was acquired, Florida Gov. Haydon Burns announced that Disney World would be the greatest attraction in the history of Florida. Undoubtedly, the market value of Disney's land jumped when the market realized that it would generate a massive stream of future ordinary income for its new owner — not from Disney's reselling the land for a quick profit but from selling tickets to future attractions like Space Mountain or Pirates of the Caribbean.

That jump in land value would be an unrealized capital gain for Disney in 1965. As with the restaurant example, the gain was attributable to the anticipated future revenues projected from the theme parks that would be built on the land. Although those would require additional investments, a portion of every ticket sale and other item of park revenue would necessarily include an implicit fee or implicit rent for the market value of the land — not as swamp or ranch land but as the land under a theme park. (If you have any doubt about the value of location, take a look at the price charged for a Coke delivered by room service the next time you are staying at a nice resort hotel.) This point may be easier to visualize if you imagine that an individual developer or a group of individual real estate investors had quietly and anonymously assembled 27,000 acres of contiguous land and planned to lease the bulk of the land exclusively for future rental income to other developers (including Disney itself) who would build and operate their own theme parks, hotels, and other attractions. There, the taxpayer's unrealized capital gain on the land would represent the increased present value of its anticipated future rental payments from the other developers — increased, that is, from the rental value of the land when it was a swamp. In that case, if the law treated unrealized capital gains as income in the year the appreciation occurred, the individual developers who had assembled and purchased the land would be taxed once on the increased present value of their anticipated future rental income. They would then be taxed again when those rents were paid in the future.

Even if there were a stepped-up basis in the land equal to the capital gain, that would be useful only if the land were later sold. Disney's business plan was to buy the land and use it to develop Disney World and Epcot — not to manipulate the Florida real estate market. If Disney were facing a double inclusion of the land portion of its future income, that would not be reversed unless and until it sold the land — Disney would have to plan its departure from Florida before it even arrived. And the longer it delayed its sale of the land it had just purchased, the worse the double tax problem would be, in present-value terms.

For example, if Disney planned in 1965 that it would abandon and sell its Florida properties in 2022, the 2022 reversal of a $100 tax incurred in 1965 would have a value of $100 in 2022. In 1965 the present value of that 2022 benefit would be approximately $5. Thus, 95 percent of the double inclusion problem would remain. (And if the definition of income is being reconsidered based on an economic argument, it is the economics that matter, which is a function of the delay between the imposition and reversal of the additional tax.)

The same analysis would apply if the land had been purchased by a group of individuals for lease to Disney or other developers. They would also have to plan their departure from Florida before they arrived. Otherwise, their business projections would make no sense.

Importantly, even if the tax law did not impose mark-to-market taxation on assets like Disney's land — but imposed an interest charge on any later sale of the land (or at some other point in the future) designed to compensate the government for the cost of not imposing a mark-to-market requirement — the economic effects on Disney or the individual developers when they incurred the interest charge would be the same.

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The interest charge — due in 2022, for example, if the Florida properties were sold — presumably would be based on the taxpayer's not having paid a mark-to-market tax in 1965. To avoid having the effect of a double-inclusion, the interest charge (for not having paid, until 2022, a capital gains tax that should have been paid in 1965) should be reduced to give credit for Disney's having paid ordinary income taxes on the same amount from 1965 through 2022. That is, the actual amount of deferral of income was shorter, and the rate of tax paid on the ordinary income may have been higher than the rate of tax that would have been paid in 1965 under a mark-to-market system.[8]

Other Tax Implications

It could be argued that unrealized gains on corporate shares — as opposed to partnership interests and interests in other passthrough entities holding income-producing assets — should be viewed more like unrealized gains on a non-income-producing asset, like a commodity futures contract or a collection of gold coins.

More accurately, we believe, the corporation would continue to be taxed at a 21 percent rate on its properly determined income (without an acceleration or any risk of double inclusion), but the shareholders would be taxed at a maximum 20 percent capital gains rate (effectively increasing the total rate to around 37 percent) both on their share of corporate income (without acceleration or double inclusion) and on an additional amount, reflecting a double-inclusion of certain amounts, but only for purposes of the shareholder's portion of the total current and projected future income of the corporation.

Even though this would only be a partial double inclusion (or partial acceleration if there were some amortization to make up for it), if this approach were applied generally to corporate shareholders, or even to all taxable corporate shareholders with incomes above, say, $500,000, there would probably be an impact on the cost of capital for corporations, just as there would be if the capital gains tax rate were increased on gains from the sale of corporate shares.

The question is whether Congress is willing to consider marginally raising the cost of capital for corporate America in this fashion — perhaps because it is concerned with the appearance that corporate managers are deferring or avoiding dividends or engaging in stock buybacks or merger activity that allows shareholders who do not sell their shares to defer taxes on their corporate investments. This is arguably what Wyden has referred to as giving rich investors the ability to decide whether and when to pay taxes. If stopping such deferral is the direction Congress wishes to go, as a matter of corporate tax policy, there may be a better approach to consider.

That would be to impose a tax on the unrealized capital gains of corporate shareholders — as suggested by the Biden and Wyden proposals or even more generally for a larger group of corporate shareholders. However, it would define those unrealized gains without any reference to fluctuations in the market price of the shares, thus avoiding both some thorny administrative problems (such as dealing with market declines) and all of the conceptual double-inclusion problems discussed above.

Instead, the shareholders' unrealized capital gains would be defined by reference to the corporation's own tax books and records. That is, the amount of actual corporate taxable income reported, less the 21 percent corporate tax imposed on that income, minus the amount of any dividends paid out of that income. Any actual dividends would be distributing those after-corporate-tax earnings and subjecting them to tax at the shareholder level. To the extent current taxable income (after the 21 percent corporate tax) was not distributed as a dividend, the shareholder's wealth would arguably have increased by that undistributed amount. More importantly, that undistributed amount would

[8] Form should not matter, if one is making an economic analysis. And form would not matter in projecting whether the burden imposed by an interest charge would be borne by the person who pays it, as is generally the case with an income tax, or passed-on. If a purported income tax computed a 10 percent tax on the gross proceeds of a business, never actually collected that gross proceeds tax, but imposed an interest charge every year for, say, 99 years, for the taxpayer's failure to pay that gross proceeds tax for 99 years, the result would be indistinguishable from a 10 percent sales tax. If the period was shorter, the interest charge would be smaller (as a percentage of the original, hypothetical amount of loan "principal") and the effect might be that of a 9 percent or 8 percent sales tax, and so forth. No business could afford to stay in business under such a regime unless, as is the case with virtually all sales taxes, the sales price for the company's goods or services were increased to the extent necessary to cover the 10 percent sales tax and generate sufficient profits to attract capital.

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reflect their share of actual, corporate income, realized and recognized under the same rules applicable to taxpayers generally, not a projection of future income.

For example, assume a corporation with $1,000 of assets, and one outstanding share with a basis of $1,000, that generated a modest $100 of current cash earnings taxed at 21 percent, leaving $79. Even without looking at the stock market, one would know — mathematically — that the shareholder's wealth had gone up by $79, from $1,000 to $1,079. That would be an unrealized capital gain — equal to the company's undistributed after-tax, taxable income. The share's market price might well have increased above $1,079, say another $200 to $1,279, if the market projected future increases in revenues and profits. While the full $279 would be taxed, if the shareholder were subject to the Biden or Wyden proposals, only $79 would be taxed under this approach. Moreover, any unrealized capital gains (such as the excess of $279 over $79 in the previous example) or unrealized capital losses (say, the stock price had dropped below $1,079 for reasons unrelated to current earnings) would be disregarded until they were realized.

This is essentially the way partners in partnerships are taxed — on their share of the entity's income whether or not it has been distributed. It also does not seem inconsistent with the famous *Eisner v. Macomber* decision,[9] which held that a shareholder could not be taxed on his share of current corporate earnings (whether or not symbolically reflected in an economically meaningless stock dividend). In that case, of course, Congress had decided by statute to treat the corporation and the shareholder as distinct taxpayers, and the Supreme Court refused to look through or disregard that statutory distinction. If Congress, by statute, mandated that taxable, domestic shareholders of corporations should be taxed as if the corporation were a partnership (with a credit or allowance for the corporate tax paid by the corporation) that would seem to be permissible. In any event, it should certainly be as permissible to impose such a shareholder tax on their share of actual corporate earnings, as it would be to impose a tax on the shareholder's portion of what the market projects to be the corporation's future earnings.

This would seem to be a pure policy decision, whether to tax corporations (directly and at the taxable shareholder level) on 100 percent of their current income at rates approximately equal to 100 percent of the top individual tax rate.

The policy argument against that is that the corporate tax system was designed and intended by Congress, in part, not to fully tax all of a corporation's current income, and to provide an incentive for it to reinvest a significant portion of that income, by setting the corporate rate at 21 percent, providing for a maximum 20 percent rate on corporate dividends paid to individuals, but only if actually paid, and allowing taxable shareholders to defer both the dividend tax (if no dividends are paid) and any tax on a later sale of the shares until the shares were sold. Our point is not to argue for, or against, that policy decision. Our only point is that (1) treating a shareholder's income as including unrealized capital gains on corporate shares, but only if defined by reference to accumulated, after-corporate tax, taxable income, would effectively repeal or replace that system with an approach very similar to treating corporations as if they were partnerships, and (2) going farther and taxing the shareholders also on an estimate of the corporation's future income, would be going much farther to repeal, eliminate, or substantially weaken that longstanding tax policy. Either approach would ostensibly also raise issues of global competitiveness and the tax rates applicable to corporate activity in other countries.

We would also note that far from the deferral now allowed being an exception from a general policy of taxing realized gains, a clear-headed look at our business-oriented tax policies indicates that it may be the norm, rather than the exception. Even when capital gains from income-producing assets owned by individuals have clearly been realized, Congress's long-standing policy has been to encourage entrepreneurship by not taxing those realized gains when the assets continue to be deployed in an income-producing activity, such as a corporation or partnership, or even a materially different type of activity, and no

[9] *Eisner v. Macomber*, 252 U.S. 189 (1920).

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cash or property is taken out by the individual as boot. One of the oldest examples of nonrecognition of realized capital gains is in section 351 and reg. section 1.351-1(a)(2). In that example, the owner of a valuable intellectual property right (apparently an individual, judging from the pronouns) contributes the IP right to a newly formed corporation for a 25 percent share of the stock. Another individual (judging from the pronouns) who owns a manufacturing business contributes that business to the same entity for 75 percent of the stock. Because the corporation is considered to be controlled by the two individuals acting as a control group, no gain or loss is recognized. Both parties have realized capital gains by swapping their existing assets for something entirely different — not just legally or formally but economically — but the gain is not recognized (and not taxed) as long as they do not take any cash or other property out of the deal and there is no step-up in the basis of any assets. Similar results can be obtained through joint ventures, partnerships, or corporate mergers.

Critics may disagree with this policy. But if it does represent sound economic and tax policy, it would not make sense to tax the individual holder of an IP right on an unrealized capital gain, even if he does not transfer his IP right to a new entity, but simply enters an unexpectedly profitable license arrangement with the manufacturer. For example, assume an individual who purchased an IP right for $100,000 because it was projected to generate $10,000 of annual royalty income. Assume he unexpectedly obtains an offer for an exclusive contract, for the term of the IP right, with a single manufacturer expected to generate $15,000 of royalty income annually instead of the originally expected $10,000. That would increase the market value of the IP right, generating an unrealized capital gain — taxable if unrealized capital gains of individuals were taxable.

Under current law, even if he had effectuated the same economic arrangement by exchanging the IP right for corporate stock in a newly formed manufacturing corporation, which is a realization event, and that stock gave him the rights to a similar projected stream of $15,000 of annual income, that projected $5,000 increase in his future income would not be taxable as an unrealized capital gain.

If merely entering the contract, or being offered the contract, triggers taxation of the increased present value of his anticipated future income stream, there is no point in continuing the policy of allowing tax-free formations of partnerships and corporations, mergers, joint ventures, or other business combinations. Indeed, there would not be many realized capital gains to which a nonrecognition rule might apply. The gains would have been included in income already, with a stepped-up basis.

What About Corporate Income?

We have explained that a portion of any shareholder's unrealized capital gains on corporate shares could be defined as relating only to the corporation's past income, which has been taxed at the 21 percent corporate rate but not yet fully taxed because it has not been distributed and subjected to a shareholder-level tax. That would be a partial step in the direction seemingly advocated by the White House study, but it would raise no double-inclusion issues. It would only be fully taxing, now, the corporation's past income.

Some might feel that such an approach is too modest and that something somewhat more aggressive, but without imposing double-taxation, might be warranted.

The Disney example, of course, involved the unrealized capital gains of a public corporation. There, when no depreciation was permitted on land or the increased income from land, and it was clear that Disney intended to permanently hold the Florida land it purchased, taxation of Disney's unrealized capital gains when its plans for Disney World were announced (and the land jumped in value, reflecting the increased present value of its anticipated stream of income from future park operations on the land) would simply be a double inclusion at the corporate level (in addition, of course, to potential taxation at the shareholder level). In that case, taxing Disney's unrealized capital gains at the corporate level could not be justified under any rational definition of income.

In other cases in which amortization might be allowed or other techniques might be applied to mitigate double inclusions, the effects might not be as draconian, and those cases are considered below.

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To see a simplified but realistic example of the possible taxation of unrealized corporate capital gains, assume that a company like Amazon purchased the assets of a company like Whole Foods in a taxable acquisition for $100 million, based on a projection that its future operating income (before amortization of the purchase price) would be $10 million per year for 15 years. (The actual transaction paid the owners of Whole Foods closer to $14 billion of cash.) For simplicity, let us assume that the entire $100 million purchase price is allocable to goodwill and the market's projection of the expected net income of the company after all expenses, including depreciation of its fixed assets, has been taken into account.

When the tax law assumes that the goodwill of an acquired business has a 15-year useful life, it is effectively predicting (albeit in an oversimplification) that, if Amazon does nothing more to maintain or increase the efficiency and effectiveness of the Whole Foods operation, and nothing more to create new, self-generated goodwill, the existing goodwill of the business will gradually dissipate, and the income stream will suddenly dry up after 15 years. That would still be a viable, if somewhat conservative, investment using a discount rate of 5.56 percent. It might be like purchasing a highly rated, self-amortizing, 15-year, adjustable rate or inflation-indexed bond.

More likely, once Whole Foods is acquired, Amazon's outstanding network of customers, managerial efficiencies, and other potential improvements might cause a one-time increase in its projected annual profits to $15 million for the next 15 years, which the market might correctly perceive as increasing the value of that business from $100 million to $150 million. Amazon would probably not stop trying to increase Whole Foods' profitability even more. But for some companies, turning a $100 million investment into a $150 million investment might be enough — and we would be looking only at a one-time unrealized capital gain. That is a useful (if simplified) example to evaluate how much taxing unrealized corporate capital gains on income-producing assets would add to the corporate tax burdens.

Looking only at a single, one-time increase in one year's corporate income caused by taxing a one-time unrealized corporate capital gain like that in the Amazon example, here are the tax results that would apply if the capital gain from the post-acquisition enhancements to Whole Foods' profitability were taxed to a buyer like Amazon (taxed either as a corporation or as a partnership of individuals) under several different approaches to the double inclusion issue:

1. Base Case
   a. If a capital gain of $50 million on a 15-year asset were taxed at the corporate rate of 21 percent, the immediate tax payable to the government would be $10.5 million. Without any offsetting adjustments to avoid a double inclusion by Amazon, that could not be justified as proper under an income tax. That is because Amazon would also be taxed on the same $50 million as Whole Foods generated $15 million of profits each year for the next 15 years ($5 million more than the $10 million originally projected when Amazon paid $100 million for the company). In absolute dollars, the added income attributable to Amazon's one-time managerial improvements is $75 million (15 * $5 million). The $50 million unrealized capital gain, taxed here, is effectively an accelerated inclusion of $50 million out of the total $75 million of extra future income. If the full $75 million is also included when it is actually received (or the legal right to receive it arises), there is a double inclusion of $50 million.
   b. If Amazon were a partnership of individuals, the capital gains tax at 20 percent would be $10 million, not $10.5 million.
2. Capital Loss After 15 Years
   a. Assume there will be a usable, future corporate capital loss of $50 million after 15 years (perhaps when Whole Foods might be sold or abandoned, if its goodwill was truly worthless after 15 years). For example, the law might allow the future loss to be carried back (without interest, of course) to the year the gain was incurred. If Amazon were a

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corporation taxable at the 21 percent rate at that time, that future loss would produce future tax savings of $10.5 million. That is the same amount of extra tax it paid on its unrealized capital gains. However, those future tax savings would have a present value of only $4.66 million at the time the $10.5 million of capital gains taxes were originally incurred. The resulting added tax burden to the corporation (and the benefit to the government) as of the time capital gains tax was originally incurred would have a present value of $5.84 million. That is not as bad a double inclusion problem as the first example, but it is still significant. It seems equally hard to justify this as a more accurate or comprehensive definition of Amazon's taxable income. It is really just a double inclusion that is partially ameliorated.

b. Under the same assumptions, if Amazon were a partnership of individuals, the future loss would generate a tax benefit of $10 million, with a present value of $4.44 million. At the time of the original capital gains tax on unrealized gains, the combined present value of the capital gains tax and the future capital loss benefit would be $5.56 million, very close to the burden on Amazon if it were a corporation.

3. Amortization of Capital Gain Over 15 Years as Ordinary Deductions

a. If Amazon were a corporation and treated as a deemed, taxable buyer as well as a deemed seller, the corporation would be entitled to an additional $50 million of cost recovery deductions over the next 15 years. The tax savings from that stream of deductions would have a present value of approximately $7 million, when the capital gains tax was incurred. The resulting added net tax burden to the corporation (and the benefit to the government) as of the time the capital gains tax was originally incurred would have a present value of $3.5 million. That is even a smaller fraction of the "headline" revenue increase of $10.5 million when the unrealized capital gain occurred and was taxed, but still a substantial increase from current law. Of course, this approach is attractive conceptually because it avoids the double inclusion because of the amortization deductions allowed over the 15-year useful life of Whole Foods' goodwill. That still leaves the question whether this acceleration, even with amortization deductions in the same amount spread over the projected useful life of the anticipated increase in future income, is a correct measure of income, but it is not obviously flawed on account of the double-inclusion problem.

b. Under the same assumptions, if Amazon were a partnership of individuals, the future amortization deductions would generate ordinary income tax reductions with a present value of $12.33 million. Once that is combined with the $10 million cost of the original capital gains tax, the required taxation of unrealized capital gains would be a modest present-value tax benefit of $2.33 million. What happens in any given case would be a function of prevailing interest rates, tax rates, and other assumptions. But this result is exactly what would happen if, one year after raising Whole Foods' franchise value through managerial improvements, the individual owner-managers sold the company for a realized capital gain and reinvested the proceeds in other similar businesses. If the gold standard for proper taxation of unrealized gains is an actual sale, then the existence of a modest net benefit in this case should not be a concern. If it is, it may tend to speak against requiring a deemed sale in cases in which the taxpayers, in fact, do not wish to accelerate their income to enjoy a capital gains rate. Why would the government want to force taxpayers to be treated as if they had realized a capital gain if their preference was to continue to hold the

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> asset and pay taxes at ordinary rates on its future ordinary income as it arose? Indeed, this is one of the arguments for allowing tax-free mergers or business combinations when there is no recognition of realized capital gains, as long as the asset basis carries over with no step-up and there is no cash or boot taken out of the deal by shareholders.

If the example with the amortization deduction over 15 years reflects, at a minimum, the absence of a clear double inclusion, and under the tax rate assumptions made this approach would generate some addition to government revenues, the question remains: Would that approach more clearly reflect the corporation's income (or the income of a group of individuals in Amazon's position)? In other words, does the Haig-Simons definition of income really tell us that Amazon should have been taxed on an additional $50 million shortly after it closed the Whole Foods deal? That is, did Amazon's wealth increase because the value to Amazon of Whole Foods was not the $100 million it had paid but was $150 million, due to the synergies and managerial improvements resulting from its being a part of Amazon, and if so, does that increase in Amazon's wealth constitute a valid definition or way of measuring Amazon's income?

Haig-Simons and Future Income

Unfortunately, adverting to the Haig-Simons definition and its reference to an increase in the taxpayer's wealth does not help decide whether an event that increases the likelihood of receiving future revenues should be treated as an accretion to wealth today, and therefore as income today (albeit with appropriate amortization to avoid a double inclusion). It really turns on what is meant by wealth.

If wealth includes only non-contingent receipts that one is legally entitled to receive, then the argument for taxing unrealized capital gains based on Haig-Simons does not seem to hold water. Neither Disney nor Amazon nor our restaurant owner would have any of those legal rights.

Some, however, would say that a strong likelihood (as judged by the market or other indicia) of an increase in the present value of the future ordinary income expected to be produced by a business or other asset should be treated as wealth and therefore as income.

If that view is correct, what would we say if one of the restaurant's kitchen staff decided to enroll at the Culinary Institute of America to obtain a valuable degree and certification as a gourmet chef, which was acknowledged to give rise to a dramatic increase in his projected future lifetime income as a salaried employee? That might be as a returning employee of the same restaurant or another establishment. He might hope to make a good career as a catering manager at one of Disney World's top hotels or its cruise line. There are many examples of salaried individuals who experience dramatic and sustained increases in their salary levels and in the present value of their projected future salaries. In some cases, they even have a legal right to those future salaries, such as when a college athlete signs a long-term, no-cut contract with a professional sports team.

No one is suggesting that the tax code should tax salaried workers if they invest in their human capital and dramatically increase the present value of their projected future lifetime salaries. But these examples should put to rest the claim that business owners, and owners of property held for the production of rents or royalties, are taxed more favorably than salaried workers because they are not required to pay taxes today on an increase in the present value of their future ordinary income. As we have shown, that is what an unrealized capital gain is in the case of an income-producing asset.

If taking into account, as income, an increase in the present value of expected future income would be a better or more comprehensive definition of income — as applied to an increase in the market value of the future income of a restaurant owner who obtains a liquor license — then it would also seem to be the correct definition of income when there is a jump in the anticipated future salary income of a medical student upon graduation from medical school.

It is the same issue — in economic terms even if not as a matter of practical political realities. This is particularly the case if the argument for taxing unrealized capital gains of property or business owners is supposedly based on treating

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income from labor or services no worse than income from property or capital. If an increase in the present value of the future income of a business owner is taxable, but there is no acceleration of tax when there is an increase in the present value of the future income of someone whose future income will come from salaries or fees — even if they are demonstrably expected to be much higher in the future than was previously assumed — it is the business owner or property owner who is being taxed unfairly, compared with the salaried service provider.

Of course, in many of the cases described, the business or property income is increased as a result of labor or services performed by the owner that benefit the business. It was not just luck that persuaded our hypothetical restaurant owner to decide to get a liquor license, which the previous owner had not done. He might have had to study or learn about the restaurant business, study or learn about the potential benefits of obtaining a liquor license, and take the steps necessary to get the liquor license.

Conclusion

Without allowing the amortization of capital gains on income-producing assets over a reasonable estimate of the period in which the increase in future income that produced the capital gains is likely to be realized, the notion that unrealized capital gains are income does not hold water. It is merely taxing the same income twice. The Disney example involving land is the most egregious and would be equally problematic for an individual developer in a similar position. It is not easy to see how the double inclusion problem could be solved, either for corporations or for individuals who make similar entrepreneurial investments in non-depreciable property.

One approach that could be considered, that does not involve any double-inclusion problem at all, would simply tax corporate shareholders on their unrealized capital gains, defined as their share of the corporation's accumulated, after-corporate-tax taxable income, that has not yet been distributed as a dividend. That would clearly be a permissible, and perhaps economically sound and sensible way to define the shareholder's income, and it might be a good first step to consider if shareholder deferral of taxation is considered problematic. Simply put, corporate shareholders would be taxed like partners in a partnership, without regard to whether corporate income was distributed.

If, however, Congress decides to continue its longstanding policy of not treating as income an increase in the present value of the future income of a property owner, this does not create or continue any unfairness, as between salaried workers and business or property owners. The treatment of future income is the same issue for both.

Indeed, an increase in the present value of a taxpayer's future salary or fee income is exceedingly common, perhaps even more common than a continuous increase in the amount of income generated by a property investment. Our system of depreciation and cost recovery seems to assume that all property investments generate income over their anticipated useful lives, almost as if they were self-amortizing bonds with a yield similar to that of a highly rated corporate bond. In some cases, the depreciation is more or less front-loaded. The prototype, however, is that of a constant yield. In the case of a human being, however, at almost all levels of performance and income, the ability to generate income in exchange for services tends to increase over time — perhaps more substantially from ages 18 to 25, a little less rapidly from 25 to 50, and perhaps less rapidly again after age 50 — with age and experience and the learning of new skills. Yet an increase in the projected future income of an individual from wages, salaries, and fees for services is never treated as income. Those increases may come even if the worker is only gaining more experience, skills, or contacts over time. When there is a significant investment of money or time in education or training — possibly leading to a valuable degree or certification — the similarity between a salaried worker and a taxpayer who decides to invest time or money instead in his own business (or a business in which he is a partner) is readily apparent.

For all these reasons, the idea that the definition of income should include an unrealized capital gain on an income-producing asset, which is nothing more than an increase in the market's

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assessment of the present value of the stream of future ordinary income the asset is expected to generate, does not appear to have any validity as a tax principle of general application. ■

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