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Mark-to-Market Mechanism: MIA? A Response to Avi-Yonah and Gamage

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In this article, Susswein and Brown explore how the most prominent mark-to-market proposal, from Senate Finance Committee Chair Ron Wyden, D-Ore., could impose double taxation by allowing only limited carrybacks of mark-to-market losses against prior mark-to-market gains, and would thus appear not to provide the refund mechanism that professors Reuven S. Avi-Yonah and David Gamage have said is needed to prevent double taxation. They also consider whether Congress would support unlimited carrybacks against prior mark-to-market gains or a similar refund mechanism.

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Introduction and Overview

What happens if an investor or business owner is taxed on an unrealized capital gain in one tax year and that paper gain is wiped out by a loss on the same asset in a later tax year? If the asset is income producing, our previous *Tax Notes Federal* article said the result could be double taxation.[1] A similar problem could occur if the asset is a share of publicly traded stock that goes up in one year and back down in a later tax year.

In their thoughtful response to that article, professors Reuven S. Avi-Yonah and David Gamage explained their view that there was no cause for concern.[2] They noted that the later loss (or losses) would be recognized under the mark-to-market rules and that "loss recognition prevents double taxation." Loss recognition, they explained, prevents double taxation because "all serious [billionaire income tax] BIT reforms have mechanisms for refunding [later mark-to-market] losses, at least to the extent of prior recognized [mark-to-market] gains." Unfortunately, the mechanism the professors describe, and say is needed to prevent double taxation, does not appear to exist in the leading proposal in this area.

We apply the bill introduced by Senate Finance Committee Chair Ron Wyden, D-Ore., to a series of simple but realistic examples and show that the problem of potential double taxation — or taxation when there is no income or gain at all on the taxpayer's investment — is quite real. That is because the Wyden bill does not allow a later-year

[1] Donald B. Susswein and Kyle Brown, "Is It Time to Tax Disney's Unrealized Capital Gains From 1965?" *Tax Notes Federal*, June 13, 2022, p. 1717.

[2] Reuven S. Avi-Yonah and David Gamage, "Billionaire Mark-to-Market Reforms: Response to Susswein and Brown," *Tax Notes Federal*, July 25, 2022, p. 555.

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mark-to-market loss to offset a prior-year paper gain — generating a refund of the prior year tax — if the later-year loss occurs more than three years after the prior-year paper gain.[3] That is true even if the later-year loss occurs on the same asset that generated the paper gain. That pattern would be very common with income-producing assets.

A perfect illustration is provided by the professors' example involving the discovery of valuable mineral deposits on land (which might be marked-to-market if the land were owned by a publicly traded natural gas pipeline partnership). If the land were acquired in year 1 with a basis of $1 million, and it appreciated to $1.5 million in year 2 as the result of the discovery of valuable minerals, there would be a capital gains tax on the $500,000 unrealized gain in year 2.

If the actual sale of the minerals did not occur until year 6 (and was completed entirely in year 6), and the mineral sales generated $500,000 of ordinary income in year 6 (which might be realistic if the gain calculation had been done when interest rates were zero percent) the value of the land would drop back to $1 million at the end of year 6, producing a recognized capital loss of $500,000 in year 6. As a result, there would be a double inclusion of $500,000 (once as capital gain in year 2 reflecting anticipated future income and again when the $500,000 was actually realized in year 6). There would also be a capital loss of $500,000 in year 6, but that capital loss could not be carried back to generate a refund of the year 2 tax.

Under the facts assumed in the professors' example, a carryback is permitted (under the Wyden bill) because the minerals are exploited and sold entirely in year 3 (one year after their discovery in year 2). That would produce a refund of the year 2 tax — which we gather is the "refund" the professors have in mind when they state that, "all serious [billionaire income tax] BIT reforms have mechanisms for refunding [later mark-to-market] losses, at least to the extent of prior recognized [mark-to-market] gains." But that refund is not available for losses arising more than three years after the paper gain.

[3]*The Wall Street Journal* noted the limited carryback provision when the bill was first introduced. Richard Rubin, "How the Billionaires Income Tax Would Work," *The Wall Street Journal*, Oct. 27, 2021.

It is true, of course, that current law would allow a capital loss carryforward, but only $3,000 per year of capital loss carryforwards could be used against any future ordinary income generated by the minerals (or any other source). If a single individual was the owner of the land in the professors' example, it would take 167 years to use a $500,000 capital loss carryforward against ordinary income. As we illustrate below, a similar problem could occur with paper gains on shares of publicly traded stock that are wiped out by losses on the same shares, if the losses occurred more than three years after the paper gains are subjected to tax.

It is also true that some taxpayers that suffer capital losses may have other investments, or may acquire other investments, that generate capital gains in the future. That is generally not something that can be assumed or assured, even if the taxpayer has the funds to invest and wishes to invest in assets that have the capacity to generate a capital gain. Even a billion dollars invested in a so-called capital asset (or section 1231 asset) does not ensure that the assets will generate future capital gains. Capital assets (and section 1231 assets) generally produce ordinary income — such as rent from an office building or royalties from a pipeline partnership. It is only when the capital asset begins to produce more future revenue or more future ordinary income than was originally projected that a capital gain can arise — as the professors' mineral example illustrates. Certainly, as a rule of general application, it would not be accurate to say that mere recognition of the later capital loss "prevents double taxation."

The Wyden bill — or other bills — certainly could be modified. Accordingly, we explore whether it is realistic to expect that Congress would ever approve the refund mechanism the professors say is needed — such as an unlimited carryback of mark-to-market losses against prior mark-to-market gains — or perhaps some other mechanism. We explain why we think Congress and the general public would have serious problems with such a mechanism.

For now, the important point is that the leading proposal in this area, Wyden's, does not have the provision the professors say is necessary to ensure that there is no double taxation (and no taxation where there is no income at all on the

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investment). At a minimum, this may indicate — as we suggested in our article — that the idea of taxing unrealized gains has not been fully vetted, even at the conceptual level.

It may also suggest that the fundamental idea is unworkable. Some tax economists and academics have long advocated mark-to-market taxation as a theoretical panacea. In practice — because it would require unlimited capital loss carrybacks or another refund mechanism like that described by the professors — it may be opening Pandora's box.

The Professors' Example

To visualize the problem with income-producing assets we use the professors' example and introduce a few small variations.

Their article assumed that a valuable mineral deposit is discovered (let us say on the last day of year 2), and let us assume by a publicly traded natural gas pipeline partnership — that is subject to the mark-to-market provisions of the Wyden bill — that acquired the land on the first day of year 1. That discovery generates a mark-to-market gain of $500,000 in year 2 (for the holders of the partnership interests if they are wealthy enough to be subject to the Wyden bill). In the professors' example, that gain is reversed by the recognition of a $500,000 mark-to-market capital loss (on the partnership interests) as the minerals are sold in year 3 (generating $500,000 of ordinary income passed through to the partners). The example assumes that the land or the partnership interests are not otherwise increasing or decreasing in value.

The $500,000 capital loss in year 3, the professors state, produces a refund, which we presume arises because it can be carried back against the capital gain in year 2. Aside from that brief acceleration, they say, the partners only pay tax on the $500,000 of ordinary income actually generated in year 3, exactly as they would under current law. The full example is provided below.

This example works under the Wyden bill only because the minerals are exploited so quickly.

If it took a few years to obtain needed regulatory approvals, and the actual mineral sales did not occur until year 6 (and were completed in year 6), the capital loss would arise entirely in year 6. It could not be carried back under the Wyden bill. Using the professors' terminology, the recognition of the loss in year 6 would not "prevent double taxation."

If the mineral sales began in year 3, but it took 15 years until they were exhausted in year 17 (not an unusual pattern), the capital losses would be spread over a 15-year period from year 3 through year 17. In that case only the losses in year 3, year 4, and year 5 could be carried back. If the decline in value occurred on a straight-line basis (it would probably occur more slowly), 12/15ths of the capital losses or $400,000 could not be carried back. To that extent, the problem would be similar to the case in which the minerals were exploited and sold entirely in year 6.

Individuals can certainly carry forward their unused capital losses and even use them against $3,000 of ordinary income per year. That is not likely to change the analysis. If a $400,000 capital loss were the capital loss carryforward of a single individual, it would take 133 years to use the carryforward against future ordinary income from other sources. The size of the investments, capital gains, and potentially unusable capital losses for the investors targeted by the legislation in this area could easily be much larger than $400,000.

And if the pipeline partnership continued to generate income at its normal level (not from any new discoveries of minerals, or unexpected managerial improvements in the operation of the pipeline partnership), no future capital gains could reasonably be projected or anticipated. Even a billion dollars invested in a capital asset does not guarantee that the investment will produce any capital gains. Capital assets (and section 1231 assets) generally produce a stream of ordinary income. (In the case of stocks, the ordinary income is generated by the corporation.) Capital gains generally arise only when something happens (like the discovery of valuable minerals on the property of a publicly traded pipeline partnership) to cause the asset's projected future revenue or future ordinary income to increase. Otherwise, a steady stream of revenue or ordinary income, no matter how large, will only generate future ordinary income.

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An Example With Corporate Stock

Consider Jane, age 62, who purchased publicly traded corporate shares with $100x of after-tax cash in the last week of year 1. Assume that represented all of her investable assets. The shares increase to $150x in year 2, keep their value for several years, but drop back to $100x on the last day of year 6. Jane, now approaching 70, sells the shares at the beginning of year 7 for $100x of cash. Perhaps fearful of continued volatility and possible losses at her age, she invests the $100x of cash in highly rated, adjustable-rate bonds. Her investment adviser tells her she can live comfortably on the interest income without any fear of capital losses (or any prospect of capital gains).

Her tax adviser is more concerned. If the Wyden bill applied to Jane, it would not permit her $50x of capital losses in year 6 to generate a refund of the taxes paid on her $50x of paper gains in year 2.

In our view, the tax on Jane's $50x of mark-to-market gains in year 2 would not appear to be a tax on income. Be that as it may, this example clearly fails the professors' test.

There is no mechanism — in Jane's case — "for refunding [mark-to-market] losses, at least to the extent of prior recognized [mark-to-market] gains."[4] That is because under the Wyden bill, if mark-to-market gains are taxed in one year, and those gains are wiped out by losses that occur more than three years later, those losses cannot be carried back against the mark-to-market gains taxed in the earlier year.

Jane's case also demonstrates that the professors' test — requiring a usable loss carryback or something very similar — is an entirely appropriate test. For the typical investor targeted by the legislation in this area, capital loss carryforwards against future ordinary income would be meaningless. If Jane's $50x capital loss carryforward were $500,000, it would take 167 years to use her carryforward against her future ordinary income. Also, in this example, Jane has no prospect of generating any future capital gains.

[4] Avi-Yonah and Gamage, *supra* note 2.

Could the Legislation Be Revised?

The Wyden bill, or other bills, might take another approach, but we think it is unlikely that Congress would decide to permit individuals — billionaires or investors generally — to enjoy an unlimited capital loss carryback, even in the context of a mark-to-market system. Consider the recent market correction — or even worse a bear market. If the IRS began sending million-dollar tax refund checks to billionaires, and only to billionaires, the outcry would be deafening, no matter what the statute initially provided. The fact that they were only refunding taxes arguably overpaid on assets that appreciated and later declined in value would not likely make any difference to the general public.

This does not seem to be a direction in which Congress would want to go. In recent years, it has acted to eliminate net operating loss carrybacks and increase the basketing of different types of income. After years of disparaging passive losses and limiting their use, it recently began disparaging and limiting active losses. It seems that Congress doesn't like losses any more than investors.

An unlimited capital loss carryback (or similar mechanism that would refund or return the prior year's tax) does not seem to be a realistic possibility — even under a mark-to-market system. Even corporations can only carry back capital losses for five years, and NOL carrybacks were subject to similar limitations until they were eliminated in 2017 (although temporarily restored during the pandemic).

Are These Issues Related?

The long-standing congressional desire to avoid unlimited loss carrybacks may be closely linked to the long-standing congressional decision *not* to treat unrealized gains as income. As long as Congress continues to follow the realization rule, the problem of unrealized gains occurring in one year and those paper gains being wiped out in a later year (without any intervening sale or disposition of the asset) simply cannot occur under current law. Under current law, it is not until Jane disposes of her publicly traded stock (say, in year 3 to realize a $50x gain) that any capital gain is triggered.

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This may explain why Congress is entirely comfortable *not* allowing capital loss carrybacks. The realization rule effectively treats Jane as having an open transaction until she is no longer "long" her stocks. That is, her stocks may go down before she sells them. Because she is not required to pay any tax until that long position in the shares is closed — by a sale or taxable exchange — Congress does not have to worry about the obvious problem of taxing her paper profits and not allowing a tax refund when the paper profits disappear.

The professors seem to agree that you cannot properly tax paper gains without a rule allowing unlimited carrybacks of paper losses against prior paper gains (or providing a similar mechanism to ensure that the losses generate a "refund"). The lack of that mechanism would result in a permanent difference, not a timing difference.

What if Jane Is a Billionaire?

We hope it is clear that our concern is not with billionaires. There are plenty of ways to raise taxes on billionaires without creating a special definition of income that applies only to them.

The traditional role of a tax expert includes pointing out when special provisions — like taxing the capital gains of some taxpayers on a mark-to-market system — depart from a generally applicable baseline, normal or economic, definition of income. That is our concern in discussing this important topic.

There may be some who believe that billionaires or those with hundreds of millions of dollars never lose money. That is not our understanding. Some may believe that a well-managed portfolio of stocks and other business interests will never decline and will only go up. That is not our experience.

Also, sometimes an investor who is getting older and less tolerant of risk will be advised to exit the equity markets and shift their investments into assets (like adjustable-rate debt instruments or inflation-adjusted government bonds) that are unlikely to generate any future capital gains, and the investor will not live long enough to generate enough ordinary income to use any capital loss carryforwards.

Certainly, all possibilities must be considered in defining the baseline of what constitutes income — and when capital gains and losses should be included. All possibilities must also be considered if Congress agrees that realization is the baseline but decides to depart from the baseline for any reason.

If the idea of this proposal is to overtax some high-income investors who happen to generate gains followed by losses (and do not live long enough or have the good fortune to generate enough future income to use the losses) because they have high incomes, it would seem that a more sensible and equitable approach would be to simply raise the tax rates on their actual income and not apply a special definition of income. If the idea is to overtax some high-income investors because some other high-income investors may enjoy some other tax benefit, that also does not seem to make sense, as we explain below.

The Timing Issue and Section 1014

The professors are entirely correct to point out that some assets appreciate, hold their value, and are later sold at a capital gain. The issue is one of timing. We believe the Joint Committee on Taxation, Treasury, and the Congressional Budget Office are correct *not* to treat unrealized gains as income — in measuring and comparing the average tax rates of different taxpayers and in measuring tax expenditures. Our previous article did not address the timing issue, once we noticed the more obvious permanent problem created when mark-to-market gains are followed by losses on the same asset.

The timing issue is also beyond the scope of this article, although we would welcome the opportunity for further dialogue on that topic, with the professors or others, assuming that the permanent problem noted here can be addressed and resolved. We would only offer two observations on the timing issue.

First, the baseline timing rule, the rule that defines income for purposes of the computation and comparison of average tax rates and the identification of tax expenditures, must be a single rule that provides a baseline definition of income for all taxpayers. Otherwise, it would be impossible to compare the average tax rates of different taxpayers. Indeed, the concept of a tax expenditure could not exist. For that reason, the White House study, which applied a special

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definition of income only to one small group of taxpayers, is obviously invalid (or at least incomplete).[5]

Second, as we see it, the timing issue has very little to do with the exclusion issue presented by section 1014.

We completely agree with the professors that no one should be able to earn millions of dollars over a lifetime and pay no income taxes. But the permanent exclusion provided by section 1014 has nothing to do with the timing of capital gains. The timing issue arises when the taxpayer sells his appreciated capital assets before death. Section 1014 applies only when a taxpayer fails to sell his appreciated assets before death. For many taxpayers, there is no overlap at all.

For example, if Jane, at the much younger age of 30, founded a company like Twitter whose value suddenly jumped to $100 million (when Jane turned 40 and the company went public), and Jane sold her shares for $100 million of cash to Elon Musk when she turned 50, one can certainly discuss whether Jane's capital gains tax should be due on her 50th or 40th birthday — or whether she should pay an interest charge for 10 years of deferral if the tax is deferred until she turns 50. In contrast, if her neighbor Jim bought $100 million of stock in Pfizer when he turned 70 in 2018, the pandemic caused the stock to jump to $500 million in 2020, and Jim unexpectedly died of COVID-19 in early 2021, the problem with Jim's tax returns would be a permanent exclusion of $400 million of gain. That is not a timing issue; it is a permanent exclusion that many believe is inappropriate.

Trying to address the income tax exclusion problem for taxpayers like Jim by making a change to the income tax timing rules that apply to taxpayers like Jane — many of whom may not enjoy the benefits of section 1014 at all — does not make sense to us as a matter of tax policy. Increasing Jane's tax burden does nothing to deal with Jim's exclusion. Indeed, Jim's executor would probably be happy to pay one year of interest on a hypothetical tax (deferred from 2020 to 2021) if that would preserve the exclusion.

[5] 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.

Also, we think there are better ways to address the problem of taxpayers earning millions of dollars of economic income over a lifetime but paying no income taxes over a lifetime. We would be very happy to work with the professors or others to discuss and develop a legislative proposal that would address that problem. We suspect that the proper focus should be on lifetime income and lifetime taxes — not on the treatment of any one item in a single year or at death. Whatever technical approach is pursued, a proposal tailored to the problem of wealthy taxpayers who pay no income taxes over a lifetime (without the issues and collateral damage we think would be caused by changing the capital gains timing rules) is also more likely to be enacted.

Appendix: The Professors' Example

The professors' example, below, well illustrates the economics and mechanics. The example illustrates what we gather is the mechanism the professors have in mind — a carryback of the paper losses against earlier paper gains.

If an immediate and assured refund from the recognized loss is what they have in mind, but the losses are not realized and recognized until more than three years after the gains occur, it should be noted that the Wyden bill would not allow such a refund. That is because the capital losses (as the land declined in value because of the removal of the minerals) could not be carried back against the previously taxed capital gain.

> III. For Wasting Assets, Loss Recognition Prevents Double Taxation
>
> Let us first consider wasting assets. Suppose a land asset with a basis of $1 million appreciates to be worth $1.5 million because valuable minerals are discovered on the land. Under a BIT reform, the owner of the asset would potentially then owe tax on that $500,000 of capital gain in the year in which the market value appreciates because of the discovery of the valuable minerals. To keep things simple, let us then say that the $500,000 materializes as ordinary income for the owner in the following year

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because all the minerals are then taken from the land and sold for $500,000 of profits. At that point, the value of the land asset should be expected to decline back to $1 million (assuming nothing else has changed).

All serious BIT reforms have mechanisms for refunding losses, at least to the extent of prior recognized gains. Thus, following the removal of the minerals and the consequent decrease in the market value of the land asset, the taxpayer should recognize a $500,000 capital loss. This capital loss would fully offset the prior recognized capital gains. The overall net result would leave the taxpayer just with the $500,000 of ordinary income from sale of the minerals, which is the same net overall result that would occur under current law.[6] ■

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[6] Avi-Yonah and Gamage, *supra* note 2.

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