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Mark-to-Market Taxation of Capital Gains

Capital gains are subject to tax only when realized upon sale of an asset. The tax does not apply to gain on assets passed on at death, due to tax rules that apply to capital gains realized by heirs. This exclusion from the tax base limits the taxes, in particular, that can be imposed on high-income taxpayers who hold most of the assets that yield capital gains. Senator Wyden, chairman of the Finance Committee, has proposed to tax gains realized by high-income taxpayers on an accrual basis (i.e., regardless of whether the asset is sold), a method called mark-to-market. President Biden’s budget proposal includes a 20% minimum tax on income plus unrealized capital gains on those with wealth of \$100 million or more. Because the minimum tax payment would be the minimum tax minus regular tax, the additional tax would largely arise from mark-to-market treatment of gains.

What Are Capital Gains?

Capital gains are the increase in the value of an asset, such as corporate stock, land, a building, or the increase in the value of a business. The gain is the difference between the market value and the basis. For a corporate stock, the basis is the price paid for the stock when acquired. For a physical asset such as a building, the gain is the cost of acquiring or constructing the building plus the cost of any subsequent capital improvements minus depreciation taken on the original building or any capital improvements.

The Capital Gains Tax

Assets yielding capital gains benefit from (1) deferral of tax until gains are realized, (2) a lower rate if held for a year or more, and (3) exclusion of gain at death. As with other elements of the tax code measuring capital income, gains are not adjusted for inflation.

Short-term gains, on assets held for less than a year, are taxed at ordinary rates of up to 37%. Long-term gains, on assets held for at least a year, are taxed at up to 20%. The lower rates are tied to the permanent tax brackets (ordinary tax rates are temporarily lower through 2025). For 2021, no tax is due for returns with taxable income below \$80,800 for married couples (\$40,400 for singles). For married couples with income below \$501,000 (\$445,580 for singles), the long-term capital gains tax rate is 15%. For taxpayers with higher incomes, the tax is 20%. For married taxpayers with income above \$250,000 (\$200,000 for singles), capital gains, along with other types of passive capital income, are subject to an additional 3.8% net investment income tax. (This rate equals the Medicare A tax imposed on earnings.)

Certain types of capital gains have special rules. Gain from depreciation of assets is subject to ordinary rates, although gain arising from depreciation of real property is subject to

a 25% ceiling. Gain on collectibles is taxed at 28%. The law excludes \$500,000 for a married couple and \$250,000 for a single person from gain on home sales.

Capital gains are taxed only if the asset is sold and not as gains accrue. This treatment allows the tax to be deferred. If the asset is passed on to heirs at death, any capital gain escapes tax because the basis to the heirs is the market value at the time of death, referred to as stepped-up basis. If an heir were to sell an appreciated asset immediately, no tax would be due.

Concentration of Gains in High Incomes

Capital gains are largely realized by high-income taxpayers. **Table 1** indicates that the top 10% of taxpayers by income were responsible for almost three-quarters of capital gains but only a quarter of income. The top 0.001% of taxpayers (representing fewer than 1,500 returns) were responsible for about 15% of capital gains and 2% of income.

Table 1. Distribution of Capital Gains (Income Amounts in Millions of Dollars), 2017

Income Percentile	Average Income	Share of Adjusted Gross Income	Share of Capital Gains
0.001	178.8	2.3	14.6
0.01	39.5	5.2	29.8
0.1	8.0	10.5	48.6
1.0	1.6	21.0	68.2
10.0	0.4	26.4	74.4

Source: Internal Revenue Service, Statistics of Income, Individual Statistical Tables by Tax Rate and Income Percentile, Table 3, <https://www.irs.gov/statistics/soi-tax-stats-individual-statistical-tables-by-tax-rate-and-income-percentile>.

For the top 0.001% of taxpayers by income, capital gains accounted for 56.4% of income and wages less than 8.7%. For the top 10%, capital gains accounted for 16.8% of income and wages accounted for 55.4%.

Survey of Consumer Finances data indicate that unrealized gains are also concentrated on higher-income individuals, although that survey excludes the wealthiest individuals. Overall unrealized gain is estimated to be approximately equal to realized gain, or about 50% of total accrued gain. Unrealized gain may be an even higher share for wealthy families that are the founders of successful corporations and retain shares to maintain control.

Mark-to-Market Proposals

A mark-to-market proposal would measure gain each year based on market value and thus would include not only realized gains but also unrealized gains. The recognized gain would be added to the basis for measuring future gain. Most proposals would limit this treatment to high-income taxpayers, in part to avoid compliance and administration problems for other taxpayers. The Wyden proposal would apply this regime to taxpayers with either \$1 billion of assets or \$100 million of earnings over the past three years, affecting approximately 700 taxpayers (so-called billionaires). Taxpayers would stay in this regime, until they fell to half of both thresholds for three years. The Biden proposal would apply to taxpayers with \$100 million or more in wealth.

One of the challenges of a mark-to-market proposal would be in the treatment of assets that are not publicly traded, such as real estate, land, and private businesses. Tax data suggest these assets account for about a third of capital gains realized.

Excluding non-traded assets would encourage investments in forms not subject to tax. It is possible to apply a look-back method or interest charge that would account for the value of deferring the tax. To complete the equating of tax on these assets, gains would be taxed at death or subject to a carry-over of the original basis. (See CRS In Focus IF11812, *Tax Treatment of Capital Gains at Death*, by Jane G. Gravelle for a discussion of these approaches to addressing the step-up in basis that leads to the exclusion of gains.) Senator Wyden's proposal would incorporate these elements, using an interest charge method and treating transfers by gift, death, or trusts as a taxable event. Spouses would be exempt but would retain the original basis of the asset. President Biden's proposal would require a valuation of nontradeable assets but allow taxpayers with tradeable assets that are less than 20% to defer tax on nontradeable assets with an interest charge.

There are also issues about whether to grandfather existing unrealized gains; if so, those gains would be recognized only if and when assets are sold. Senator Wyden's proposal would include existing gains over a five-year period, and President Biden's proposal would allow an initial nine-year installment period for paying the tax.

Another issue is how to treat accrued losses. Net capital losses are restricted to reducing ordinary income of \$3,000 and unused losses are carried forward. Loss limits may be considered appropriate in light of the tax rate differentials on ordinary income and capital gains and the discretion individuals have over realizations. Accrual taxation eliminates the latter concern. One option would be to allow losses in proportion in the tax rate differentials. For example, if the capital gains tax rate is 20% and the ordinary rate is 37%, each dollar of net loss could offset 54 cents (0.20/0.37) of income. The Wyden proposal would allow a three-year carry-back of losses against gains taxed due to mark-to-market. Because the Biden proposal is a minimum tax, accrued losses mean the tax does not apply.

A final issue is whether to index gains for inflation, if the ability to defer and possibly eliminate tax on unrealized capital gains occurs under mark-to-market. A case against this treatment could be made based on rate differentials and the allowance of nominal interest deductions for borrowing to finance assets that yield capital gains. Deducting interest based on rates that reflect inflation and taxing only the real part of gains would lead to tax arbitrage.

Issues in a Mark-to-Market Regime

One of the benefits of mark-to-market taxation is that it would permit higher tax rates on capital gains, likely without inducing behavioral responses. Some part of the revenue gain from raising taxes on realized capital gains is lost because it increases the lock-in effect, as individuals reduce their realizations as a result of higher taxes. There is a considerable range in the estimates of the magnitude of this effect (see CRS Report R41364, *Capital Gains Tax Options: Behavioral Responses and Revenues*, by Jane G. Gravelle for a review). For taxpayers subject to accrual methods, rates could be raised without a loss of revenue from the lock-in effect.

A mark-to-market regime would also increase the progressivity of the tax system by increasing the amount of income subject to tax for high-income taxpayers. Some of these taxpayers pay a small effective tax rate on their economic income. A White House study, released on September 23, 2021, estimated that the Forbes 400 paid an effective tax rate of 8.2% for the period 2010-2018 on income including unrealized gain.

The revenue gain from a mark-to-market regime would depend on the income floor, the rates applied, and the coverage of assets. Batchelder and Kamin estimated an \$80 billion revenue gain, if the top 0.1% of taxpayers were covered and the income taxed at ordinary rates. The Biden proposal is estimated to gain about \$40 billion.

Two concerns about mark-to-market are (1) costs of administration and compliance and (2) liquidity. These issues are less important if mark-to-market is confined to tradeable assets and high-income individuals, who have the resources to comply with the new regime and access to other income or borrowing as well as selling shares to pay the tax.

Alternatives to Mark-to-Market

One alternative is to change the treatment of capital gains at death by taxing capital gains at death or imposing carry-over basis so that heirs would take as their basis the basis of the decedent rather than market value. Both approaches could be designed to apply only to high-income taxpayers. See CRS In Focus IF11812, *Tax Treatment of Capital Gains at Death*, by Jane G. Gravelle for a discussion of these approaches. Another alternative is to increase the corporate tax rate.

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