InvestmentNews
The Leading News Source for Financial Advisers

A better approach to taxing gains?

Paying tax on unrealized capital gains has some advocates, but it is ultimately unworkable.

By Robert N. Gordon

April 22, 2012

Late last year, I attended a hearing of the congressional Joint Committee of Taxation on the taxation of financial products.

One of the four speakers testifying that day was attorney David S. Miller, who put forth the idea that really rich people should mark their assets to market at year-end and pay tax on unrealized profits every year. A professor from Columbia University testifying at the hearing also thought that an annual tax on unrealized profits wasn't a bad idea.

Tax lawyer Andrea Kramer was the lone voice of skepticism, having thought through the practical problems with such an idea.

On April 1, the blog TaxProf reported that Warren E. Buffett liked Mr. Miller's idea so much that he would start the ball rolling by paying a 15% tax on his unrealized appreciation in Berkshire Hathaway Inc. The blog reported that Mr. Buffett had sent a check for $1.2 billion to the Internal Revenue Service voluntarily.

Thankfully, on later inspection, I found out that his largess was only an April Fools' Day hoax. But the drumbeat for mark-to-market taxation can still be heard.

In looking for literature on the subject, I found that every 20 or 30 years, Congress toys with the idea of changing the realization-based capital gains taxation model.

A few of these forays ended after pretty much everyone came to the conclusion that asking people to pay tax on phantom profits just isn't fair.

Others got past the fairness issue but got bogged down on the problems that taxpayers would face trying to find the money to pay the tax on the unrealized appreciation. I was aghast when I read one paper blithely suggesting that investors just take out margin loans to pay the tax as long as the tax rate isn't above Regulation T's 50% borrowing limit.

If the analysis gets past these hurdles, the practical realities of administering the tax come into play. Are capital losses marked to market, too? Can taxpayers start deducting capital losses?

If not, can the losses at least be carried back? How much money does the Treasury lose by allowing the deductibility of losses?

The really big headache: How does one value a fine-art collection or real estate?

Mr. Miller's answer is to apply this concept only to those publicly traded securities that have easily ascertained year-end values.

Previous analyses have discussed creating asset classes of winners and losers, and concluded that doing so would cause massive economic distortions. To minimize taxes, people would move out of publicly traded securities, hurting the markets.

A behavioral change leading investors to favor insurance-wrapped products, over-the-counter derivatives and private securities would be inevitable.

The reason that Congress contemplates the marking to market of assets every so often is the perception that investors have too good a deal under the realization system. The ability to cherry-pick what gains or losses to realize and pay tax on is indeed an important tool in tax-efficient investing, but that isn't all that Congress fears.

Under our system, the IRS is your partner when you make money, but when you lose, you're on your own — unless you have been lucky enough to have taken some gains that year. The limitation on the deductibility of capital losses is the trade-off for being able to time the realization of gains.

The wash sale rule hinders a true ability to manipulate gains and losses. The straddle rules inhibit any possible problems with cherry-picking gains and losses.

The root of the problem is the favorable rate given to long-term capital gains. The tax code encourages investors to alter their behavior and tilt toward long-term capital gains.

Once the government asks taxpayers to alter their behavior in a particular way, they will oblige.

In the case that publicly traded securities were singled out for harsh tax treatment, there would be an evolution of new financial products. These investments wouldn't fit within the definition of marked-to-market securities, yet would mimic direct holdings as best they could.

Most studies and testimony on the subject of timing capital gains taxes conclude that realization-based taxation is the right way to go. In addition, even if it were preferred philosophically, the mark-to-market method couldn't be levied on all assets and thus wouldn't work. Like democracy, a realization-based taxation system may not be perfect, but it is still the best method that exists.

Robert N. Gordon (bob@twenty-first.com) is chief executive of Twenty-First Securities Corp. and an adjunct professor at New York University's Leonard N. Stern School of Business.