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Henry Ordower
Saint Louis University School of Law

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HENRY ORDOWER†

INTRODUCTION

The Tax Cuts and Jobs Act of 2017[1] [hereinafter "TCJA"] was unusual in at least two respects. First, it was enacted with one major political party introducing and advancing the legislation without input from the other major party.[2] Second, several of its features overtly favor certain taxpayers over others.[3] The TCJA also imposed a tax, the "transition tax," on as much as thirty-one years of undistributed, accumulated corporate income.[4] This article focuses on that transition tax by evaluating the function and constitutionality of the tax and considers whether the transition tax might serve as a model for addressing the

†Professor of Law, Saint Louis University School of Law, A.B. Washington University, M.A., J.D. The University of Chicago.

1. Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, 131 Stat. 2054 (2018).

2. Thomas Kaplan & Alan Rappeport, *Republican Tax Bill Passes Senate in 51-48 Vote*, N.Y. TIMES (Dec. 19, 2017), https://www.nytimes.com/2017/12/19/us/politics/tax-bill-vote-congress.html.

3. *See, e.g.,* TCJA, § 11011(a), 131 Stat. at 2063 (2017) (amending Title 26 of the United States Code, adding I.R.C. § 199A (Supp. 2017) providing a twenty percent deduction of the income of certain individuals engaged in a trade or business other than as employees).

4. TCJA, § 14103(a), 131 Stat. at 2195 (2017) (amending I.R.C. § 965 to include the "transition tax," replacing its existing but obsolete predecessor).

broader problem of deferred income in the United States. The article recommends a broad-based, one-time marking to market of all property, inclusion of the net gain in the holders' incomes at a significantly reduced rate of tax, followed by a transition to an accrual system of taxation under which growth in the value of taxpayers' property is included in income annually. Such a scheme might permit taxpayers to pay the tax in installments over an extended period or, in some instances, defer payment of the tax until disposition of the property. Under such circumstances, deferral of the unpaid tax could incur an interest charge.

Part I of the Article evaluates the transition tax in the context of offshore deferral of income in the U.S. worldwide taxation system. Part II describes the operation of the transition tax in its departure from tax precedent. Part III reviews the leading U.S. Supreme Court decision of *Eisner v. Macomber*,[5] with facts closely resembling the transition tax facts, and the increasing number of departures from the realization/income requirement which have become part of the tax law. Part IV examines the controlled foreign corporation [hereinafter "CFC"] rules through which the transition tax operates to ascertain if those rules provide independent support for departure from the realization principle. Part V considers first the abandonment of realization and the current taxation of appreciation and depreciation in the value of property against the backdrop of a Haig-Simons comprehensive income tax definition of income[6] and then the relationship between the capital gain

5. 252 U.S. 189 (1920).

6. The classic Haig–Simons definition of income is "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question." HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 50 (1938).

tax preference[7] and the realization principle.[8] Part VI concludes by proposing adaptation of the transition tax single incident of taxation as a model for the design of a broad-based transition tax that would lay the foundation for accretion taxation of gain and loss from property consistent with comprehensive tax bases following the Haig-Simons income model.

I. THE TRANSITION TAX

The transition tax[9] requires the one-time inclusion of "deferred foreign income"[10] in the income of United States shareholders[11] of CFCs[12] and other "specified foreign corporations."[13] The concepts of "deferred income" and "deferral" with respect to foreign source income refer to the income from the conduct of a corporate trade or business outside the U.S. through one or more non-U.S. subsidiary corporations. Since the U.S. taxes U.S. citizens, residents and domestic corporations on their income from all sources

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7. Net capital gain is taxed at a rate lower than ordinary income, making long-term capital gain favored gain. I.R.C. § 1(h) (2012). *See also* I.R.C. § 1222(11) (Supp. 2017) (defining net capital gain as the excess of net long-term capital gain over net short-term capital loss).

8. *See* Walter J. Blum, *A Handy Summary of the Capital Gains Arguments*, 35 TAXES 247, 249 (1957) (*see* discussion *infra* Part V).

9. I.R.C. § 965.

10. *Id.*

11. The definition of United States shareholder [hereinafter "U.S. shareholder"] is a shareholder of a controlled foreign corporation (*see infra* note 12), who owns ten percent or more of the voting interests and value of said corporation. I.R.C. § 951(b) (Supp. 2017).

12. The definition of controlled foreign corporation is a corporation having U.S. shareholders who own more than fifty percent of the voting rights or value of the corporation's shares. I.R.C. § 957(a) (Supp. 2017).

13. Specified foreign corporations are foreign corporations having a U.S. shareholder that is a domestic corporation, even if the foreign corporations are not CFCs. I.R.C. § 965(e)(1)(B). For a discussion of the new international tax provisions and elimination of deferral through foreign corporations that is a function of the realization requirement, *see* Daniel N. Shaviro, *The New Non-Territorial U.S. International Tax System*, 160 TAX NOTES 57 (2018).

worldwide,[14] the foreign source income of a domestic corporation is subject to current U.S. taxation. With limited exceptions,[15] the foreign source income of a foreign corporation,[16] whether or not owned by U.S. persons, is not subject to the U.S. income tax.[17] Use of the term "deferral" contemplates that the U.S. parent corporation could have conducted the corporate trade or business outside the U.S. and earned the foreign income itself, but chose not to do so and remains the ultimate, indirect owner of the income through its share ownership in the foreign corporation.[18] In

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14. I.R.C. § 61 (Supp. 2017) (defining gross income as "all income from whatever source derived"). In addition, Part III of subchapter B of the I.R.C. expressly excludes certain items from gross income. *See* the participation exemption found in I.R.C. § 245A (Supp. 2017) (excluding dividends by means of a dividends received deduction out of the foreign source income of foreign corporations from the income of their domestic corporate owners owning ten percent or more of the foreign corporation). *See also* CHARLES H. GUSTAFSON, ROBERT J. PERONI, AND RICHARD CRAWFORD PUGH, TAXATION OF INTERNATIONAL TRANSACTIONS: MATERIALS, TEXT AND PROBLEMS 169 (1997).

15. Foreign source income of a foreign corporation that is effectively connected with the conduct of a U.S. trade or business is taxable in the U.S. under the worldwide taxation principle as the U.S. trade or business is taxable on its worldwide income. I.R.C. § 882(a) (Supp. 2017). Subpart F income, as defined in I.R.C. § 952 (Supp. 2017), is includable in the gross income of the U.S. shareholders of a CFC on a limited pass-through basis under I.R.C. § 951. *See* discussion *infra* note 120 and accompanying text.

16. Certain U.S. source income of a foreign corporation is taxable through a withholding tax in the U.S. under I.R.C. § 881 (2012), and both U.S. source and foreign source income that is effectively connected with the conduct of a U.S. trade or business is taxable. I.R.C. § 882(a) (referring to effectively connected income).

17. Shaviro, *supra* note 13, at 70 (discussing the history of deferral). Similarly, U.S. parent corporations are not taxable on the income of their U.S. subsidiaries because they are separate taxable entities. The parent and its subsidiaries may combine their incomes by consenting to file a consolidated income tax return. I.R.C. § 1501 (2012).

18. Some seek to give the use of the term "deferred" in the statute greater definitional significance by distinguishing deferred from excluded income. Hank Adler & Lacy Williams, *The Worst Statutory Precedent in Over 100 Years*, 160 TAX NOTES 1415–17 (2018). This article views use of deferred and deferral as simply the adoption by Congress of the term customarily used for offshore corporate profits.

the case of working control of the subsidiary,[19] the control would enable the U.S. corporation to cause the foreign corporation to distribute the foreign source income earned by the foreign corporation to the domestic corporation and possibly other shareholders. In the case of other specified foreign corporations,[20] which are not CFCs and over which U.S. shareholders do not have working control, the power to cause the foreign corporation to distribute the income may be absent, leaving the shareholder with transition tax liability and no source of funds with which to pay the tax.

Unless a corporation and its shareholders make certain elections,[21] corporate income is taxable only to the corporate entity, and not to its shareholders, until the corporation distributes the income to its shareholders. Distributions need not be actual distributions directly to the shareholders but may be constructive as well. Constructive distributions constitute dividends and include payments to third parties that benefit a shareholder, payments to persons related to a shareholder,[22] and payments to shareholders mischaracterized as payments for services because they exceed reasonable amounts of compensation.[23] The excess compensation amount is reclassified as a non-deductible dividend rather than tax deductible compensation.[24]

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19. Here the term "control" is used to refer to the voting power to direct distribution from the corporation as opposed to the tax definition of control under the CFC or other corporate tax rules.

20. Shaviro, *supra* note 13 and accompanying text.

21. *See* I.R.C. § 1362 (Supp. 2017) (permitting election to be an S corporation with corporate income taxable to the corporation's shareholders); I.R.C. § 1501 (permitting consolidated returns with consent of all affiliated corporations in group).

22. Arnes v. Commissioner, 102 T.C. 522, 530 (1994) (concluding that redemption of shares from divorced spouse is a constructive dividend to husband who continued to own the corporation).

23. I.R.C. § 162(a)(1) (Supp. 2017) (allowing a deduction for compensation only to the extent the compensation is reasonable).

24. *See generally* INTERNAL REVENUE SERVICE, REASONABLE COMPENSATION JOB AID FOR IRS VALUATION PROFESSIONALS (2014) https://www.irs.gov/pub/irs-

Shareholders of regulated investment companies may consent to reinvest their dividends without receiving the dividends in cash with the constructive distributions that are reinvested being classified as ordinary income and long term capital gain on a limited pass-through method under which the corporation is itself not taxable on the income.[25] Similarly, shareholders of passive foreign investment companies [hereinafter "PFIC"] may make qualified electing fund elections and include their shares of a foreign corporation's income and long-term capital gain annually.[26] The PFIC itself is taxable in the U.S. on its U.S. source income, if any, and may be taxable in other jurisdictions on its income earned there. Only in the case of U.S. shareholders of CFCs are shareholders of a corporation taxable on some corporate income in the absence of a distribution or an election to become taxable without a distribution.[27]

Historically, the foreign source income, other than its subpart F income,[28] of a foreign subsidiary became subject to U.S. tax only when it was "repatriated." Repatriation refers to the distribution by the foreign corporation of all or part of its accumulated income to its U.S. owners as a dividend, possibly when those U.S. owners vote their shares to require the distribution. The term applied to such distributions, "repatriation," like the term "deferral," rhetorically views the

utl/Reasonable%20Compensation%20Job%20Aid%20for%20IRS%20Valuation%20Professionals.pdf.

25. I.R.C. § 852 (Supp. 2017).

26. I.R.C. § 1293 (Supp. 2017).

27. *See* I.R.C. § 551 (2000), *repealed by* American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 413, 118 Stat. 1418, 1506 (imputing dividends from foreign personal holding companies and taxing them currently to their owners in the U.S.). Repeal served a tax simplification purpose to eliminate overlapping anti-deferral regimes. H.R. Rep. No. 108-548(I), at 127. *See also* Henry Ordower, *The Expatriation Tax, Deferrals, Mark to Market, The* Macomber *Conundrum and Doubtful Constitutionality*, 15 Pitt. Tax Rev. 1, 18 (2017) (arguing that the foreign personal holding company inclusion probably was unconstitutional).

28. I.R.C. § 952 (Supp. 2017) (defining subpart F income). *See generally* discussion of subpart F and CFC *infra* text accompanying note 127.

income as belonging to the U.S. parent corporation owner even if earned and held by the foreign corporation.

II. OPERATION OF THE TRANSITION TAX

The transition tax[29] departs from the longstanding tax principle that corporate income is taxable to the corporation's shareholders only when distributed to them. Previously, Congress encouraged repatriation of accumulated foreign income by temporarily reducing the rate of tax for repatriations with an 85 percent dividends received deduction for certain cash distributions from CFCs to their corporate U.S. shareholders.[30] Formerly, Internal Revenue Code Section 965 required an actual distribution, without which the U.S. shareholders would have had no inclusion in income. Now, Section 965 requires neither actual nor constructive distribution[31] from the foreign corporation, as it includes the foreign corporation's accumulated foreign source earnings and profits[32] in the foreign corporation's subpart F income for the corporation's taxable year beginning in 2017.[33] The subpart F income in turn is includable pro rata in its U.S. shareholders' incomes under

29. I.R.C. § 965 (Supp. 2017).

30. I.R.C. § 965 (2004). The 2004 statute was effective for only a single tax year under the I.R.C. § 965(f) election.

31. Both actual and constructive distributions are includable under I.R.C. § 301 to the extent of the distributing corporation's current and accumulated earnings and profits. There is a constructive distribution when the recipient could have taken an actual distribution but elected not to do so. Constructive distributions are common in mutual funds when account holders check the box for an election to reinvest dividends.

32. I.R.C. § 965 uses the term "post-1986 deferred foreign income" rather than accumulated earnings and profits in order to exclude amounts that would not have generated taxable dividends if distributed by foreign corporation to its U.S. shareholders because the amounts either already were taxed under the CFC rules to the US shareholders and or were taxed in the U.S. as income effectively connected with the conduct of a U.S. trade or business.

33. I.R.C. § 965(a) (explaining that if the foreign corporation has more than one year beginning in 2017, the applicable year is the last of those years).

the CFC rules.[34] In addition, the inclusion under the transition tax also applies to U.S. shareholders of foreign corporations that are not CFCs if they have at least one corporate U.S. shareholder.[35]

The portion of the subpart F income includable under the transition tax is accompanied by a deduction that has the effect of reducing the rate of the transition tax to fifteen-and-a-half percent of the foreign corporations' assets, consisting of cash and cash equivalent positions, and eight percent on the remaining amount included under the transition tax.[36] The higher rate of tax on cash equivalents than on operating assets reflects the view that deferral and holding of investment assets is an unnecessary accumulation of the deferred income, while operating assets represent a historically justified investment. In the case of a corporate U.S. shareholder in the foreign corporation, the deduction amount does not qualify for the indirect foreign tax credit[37] or the deduction for the taxes paid outside the U.S.,[38] while the net amount of the inclusion does qualify for the indirect foreign tax credit or deduction.[39]

By taxing some or all of the foreign corporation's pre-2018 accumulated foreign source earnings and profits in 2017,[40] the transition tax[41] facilitates the shift to a

34. I.R.C. § 951(a) (Supp. 2017).

35. I.R.C. § 965(e)(1)(B) (other foreign corporations with a corporate U.S. shareholder). The deferred foreign earnings attributable to U.S. owners who are not U.S. shareholders, *supra* note 11, remain "deferred" and would be taxed to their U.S. owners when distributed.

36. I.R.C. § 965(c) (an incomplete participation exemption).

37. I.R.C. § 902, *repealed by* TCJA, Pub. L. No. 115-97, 131 Stat. 2054 (2017).

38. I.R.C. § 164(a)(3) (Supp. 2017) (forbidding deduction for foreign taxes if the taxpayer claims a foreign tax credit under I.R.C. § 275(a)(4)).

39. I.R.C. § 965(g) (denial of foreign tax credit).

40. *But see* I.R.C. § 965(h) (permitting the taxpayer to elect to pay the transition tax in installments over eight years without interest).

41. I.R.C. § 965.

participation exemption system[42] for distributions from certain foreign corporations to their domestic corporate U.S. shareholders. The participation exemption[43] introduces limited territoriality into the U.S. federal income tax system by eliminating the U.S. tax on dividends from foreign source earnings of a foreign corporation (other than a PFIC)[44] to a domestic corporation that is a U.S. shareholder of the foreign corporation. Elimination of U.S. income tax results from a 100 percent deduction for dividends received out of the foreign source income of the foreign corporation.[45] Except to the extent of the amount included under the transition tax, no similar prospective deduction is available to non-corporate U.S. shareholders of a CFC, even if they were subject to the transition tax.[46] Insofar as post-2017 distributions of foreign source earnings from the foreign corporation to its corporate U.S. shareholders will not become subject to income tax in the U.S.,[47] the immediate inclusion of the accumulated foreign source earnings and profits in the foreign corporation's subpart F income in 2017 under the transition tax[48] limits the amount of foreign earnings accumulated before 2018 that will never be taxed in the U.S. because of the participation exemption. The transition tax clears away the backlog of potential tax to make room for a new participation exemption system.

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42. I.R.C. § 245A(a) (Supp. 2017) (dividend received deduction for CFC distributions).

43. I.R.C. § 245A.

44. I.R.C. § 1297 (Supp. 2017).

45. I.R.C. § 245A(a).

46. I.R.C. § 959(a) (Supp. 2017) (exclusion of previously taxed earnings and profits). Note, however that amounts distributed to non-corporate U.S. shareholders out of pre-2018 accumulated, foreign source earnings and profits of the foreign corporation in excess of the amount included to the shareholder under the transition tax would seem to remain taxable as dividends.

47. I.R.C. § 245A.

48. I.R.C. § 965 (Supp. 2017).

The participation exemption[49] for distributions from foreign corporations removes the U.S. tax barrier to ongoing repatriation of income earned through foreign subsidiaries and simplifies U.S. international taxation by eliminating the indirect foreign tax credit.[50] As it facilitates the change to the participation exemption, however, the transition tax requires the immediate inclusion of the accumulated foreign source earnings and profits of those foreign subsidiaries, without accompanying distributions,[51] in the foreign corporation's subpart F income and hence in the incomes of its U.S. shareholders.[52] That inclusion is contrary to judicial precedent and may be constitutionally infirm.[53]

A strong constitutional challenge to the transition tax, however, is unlikely to follow.[54] Like an earlier incursion on the realization requirement in annually marking to market certain commodities positions,[55] the transition tax also offers a significantly reduced rate of tax[56] and interest free

49. I.R.C. § 245A.

50. I.R.C. § 902 (2004) *repealed by* TCJA, Pub. L. No. 115-97, 131 Stat. 2054 (2018).

51. I.R.C. § 965.

52. *See supra* text accompanying note 29.

53. Eisner v. Macomber, 252 U.S. 189, 219 (1920) (holding a stock dividend not to be income under the 16th Amendment). *See also* Adler & Willis, *supra* note 18; Mark E. Berg & Fred Feingold, *The Deemed Repatriation Tax—A Bridge Too Far?*, 158 TAX NOTES 1345, 1345 (2018) (arguing the tax is a direct tax in violation of the apportionment clause because it taxes property and not income).

54. *But cf.* Berg & Feingold, *supra* note 53, at 1350 (identifying taxpayers who would have an interest in challenging the application of the statute). *See also* Moore v. United States, No. 2:19-CV-01539 (W.D. Wash. Oct. 9, 2019) (Westlaw) (challenging the statute on constitutional grounds).

55. I.R.C. § 1256 (2012) (codifying mark to market inclusion in income of appreciation and depreciation of commodities positions). *See also* Henry Ordower, *Revisiting Realization*: *Accretion Taxation, the Constitution,* Macomber*, and Mark to Market*, 13 VA. TAX REV. 1, 96 (1993) (arguing that market participants benefit from the exception to the realization requirement because of the 60/40 split of gain into long term and short term without regard to actual holding period).

56. I.R.C. § 965(c); *supra* note 36 and accompanying text.

installment reporting[57] of the taxable amount to U.S. shareholders who must include the subpart F income created by the transition tax. The simultaneous or subsequent actual repatriation by a distribution from the foreign corporation is free from further U.S. income taxation even if it precedes the inclusion in income deferred through installment reporting.[58] Certainly, many U.S. shareholders would have participated voluntarily and happily in a no-strings-attached tax reduction for repatriations,[59] and will seize the opportunity to repatriate the earnings of their foreign subsidiaries at a reduced tax rate.[60]

III. *MACOMBER* AND REALIZATION

The Sixteenth Amendment permits federal taxation of incomes without apportionment among the states.[61] Neither the constitutional amendment nor any taxing statute defines income and the amendment is silent concerning realization

57. I.R.C. § 965(h)(1) (U.S. shareholders generally); § 965(i)(4) (S corporation shareholders); *supra* note 40 and accompanying text.

58. I.R.C. § 959(a) (Supp. 2017) (exclusion of distributions from income if out of earnings and profits of a foreign corporation previously included under I.R.C. § 951(a)).

59. *See* discussion of the temporary dividends received deduction for *repatriations supra* text accompanying note 30. The 2004 tax holiday required the investment of repatriated funds in the U.S. but the discussion of a further tax holiday for repatriation continued actively in years preceding the TCJA. *See, e.g.*, Chye-Ching Huang, *Three Types of "Repatriation Tax" on Overseas Profits: Understanding the Differences*, CTR. FOR BUDGET AND POL'Y PROCS. (Oct. 7, 2016), https://www.cbpp.org/sites/default/files/atoms/files/4-10-15tax.pdf (outlining differences in types of tax holidays).

60. Indications are that the transition tax and its accompanying opportunity to repatriate triggers stock buybacks rather than increased U.S. investment. Matt Egan, *Tax cut triggers $437 billion explosion of stock buybacks*, CNN MONEY (July 10, 2018), https://money.cnn.com/2018/07/10/investing/stock-buybacks-record-tax-cuts/index.html; Alix Langone, *Here's How America's Biggest Companies Are Spending Their Trump Tax Cuts (It's Not on New Jobs)*, MONEY (May 17, 2018) http://time.com/money/5267940/companies-spending-trump-tax-cuts-stock-buybacks/.

61. U.S. CONST. amend. XVI.

as a requirement for inclusion of income.[62] While the early tax acts do not define income or realization, the years of intervening practice and judicial decisions have shed much light on the concepts of "income" and "amount realized" under the amendment, but not for the concept of realization.[63] That same statute determines the amount of gain or loss from the sale or other disposition of property relative to the amount realized.[64]

Under the governing statute, a taxpayer realizes gain or loss when the taxpayer sells or otherwise disposes of property, changing the taxpayer's relationship to the property.[65] A taxpayer who receives consideration from the sale or other disposition of property realizes gain equal to the excess of the amount of consideration received[66] over the taxpayer's adjusted basis[67] in the property, or realizes a loss if the taxpayer's adjusted basis exceeds the amount of consideration received.[68] The statute measures the amount realized as the sum of the money plus the fair market value of property other than money the taxpayer receives.[69] When there is uncertainty about the value of the taxpayer's property but not the value of the consideration received, or vice versa, the properties or properties plus money paid are assumed to be equal in value under a doctrine of exchange equivalency,[70] so long as the parties are dealing at arm's

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62. *Id.* The amendment reads: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

63. I.R.C. § 1001(b) (2012) defines "[t]he amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received."

64. I.R.C. § 1001(a).

65. *Id.*

66. The "amount realized." I.R.C. § 1001(b).

67. I.R.C. § 1011(a) (2012).

68. I.R.C. § 1001(a).

69. I.R.C. § 1001(b).

70. Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184,

length. If all or part of the consideration is services rendered to or for the benefit of the seller, the amount realized includes the value of those services.[71]

The concept of sale is reasonably straightforward but the disposition to which the statute refers is less so. In the case of a sale, the person who relinquishes the property receives money, other property, services or a combination of types of consideration. The concept of "other disposition" is vague.[72] Abandonment of property is a disposition for zero consideration and not a sale or exchange unless the property is encumbered by debt, which the abandoning taxpayer will not have to repay. Absent a sale, the taxpayer should be able to deduct the amount of the taxpayer's adjusted basis in the property if the taxpayer holds the property for investment or use in the taxpayer's trade or business.[73] If the property is encumbered, however, the taxpayer is deemed to have sold the property for the amount of the liability encumbering it plus any additional consideration and has not abandoned it.[74]

Similarly, a gift might seem to be an "other disposition" with the amount realized being zero but resulting in no

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188–89 (Ct. Cl. 1954).

71. Neither the realization statute nor the regulations under the statute express this concept. However, I.R.C. § 83 requires a service provider to include in income the fair market value of property he or she receives for services in income—subject to possible deferral of the inclusion until the property becomes transferable or ceases to be subject to a substantial risk of forfeiture. I.R.C. § 83(a)(1) (2012). *See also* 26 C.F.R. § 1.83-6(b) (2017) (interpreting the interplay between I.R.C. § 83 and I.R.C. § 1001 to treat the service providers' inclusion in income as an amount realized for the property).

72. On other dispositions, *see* Jeffrey L. Kwall, *When Should Asset Appreciation Be Taxed?: The Case for a Disposition Standard of Realization*, 86 IND. L.J. 77, 78 (2011) (arguing for giving effect to the "other disposition" language).

73. I.R.C. § 165 (2012).

74. Comm'r v. Tufts, 461 U.S. 300, 307 (1983) (property encumbered with debt exceeding the fair market value of the property is a sale for the amount of the debt). *See also* the statutory codification of the *Tufts* rule found in I.R.C. § 7701(g) (2012) (fair market value of property encumbered by non-recourse debt not less than the amount of the debt).

taxable loss because the gift is a personal transaction and neither a trade or business transaction nor a transaction engaged in for profit and it is not a casualty loss.[75] In addition, gifts burden or benefit the gift recipient with the donor's historical adjusted basis[76] and preserve pre-gift appreciation for future inclusion by the donee.[77] Charitable gifts, on the other hand, do generate a deduction for the donor but not a loss from an "other disposition" for zero consideration.[78] The donor realizes no gain or loss on the charitable disposition but may be denied a deduction if the donor received the property in a transaction in which the donor had no income from the receipt and did not pay for the donated property.[79] Preservation of basis in the hands of the charitable donee is usually of little or no significance as the pre-gift appreciation will not produce realized and taxable gain in the future because the charitable owner of the property is exempt from taxation.[80]

"Other disposition" also might refer to encumbrance of property in exchange for a loan in which the taxpayer receives consideration and relinquishes a non-possessory

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75. I.R.C. § 165(c)(3).

76. I.R.C. § 1015(a) (2012). If the fair market value of the property is less than the donor's adjusted basis at the time of the gift, for purposes of determining loss, the donee's basis is that fair market value, yet the donor does not realize a loss at the time of the gift disposition.

77. Gifts from decedents differ from gifts from living donors. Decedents' donees take a new fair market value basis in the property thereby eliminating historical appreciation as a source of gain without an inclusion in income. I.R.C. § 1014(a)(1) (2012).

78. I.R.C. § 170 (2012).

79. Haverly v. United States, 513 F.2d 224, 226–27 (7th Cir. 1975) (denial of deduction for complimentary text books donated to charity).

80. I.R.C. § 501(a) (2012). If a charitable donee ceases to remain exempt from taxation or later uses the property in an unrelated trade or business and then sells the property, the sale would be taxable insofar as the sale price exceeds the donor's adjusted basis (although the necessary records of basis may be unavailable). And the charity would adjust the basis, if the property otherwise were depreciable, on a straight line schedule during the charitable use period. Treas. Reg. § 1.1016-4(b) (as amended in 1963).

interest in the property as security,[81] but does not realize gain because the taxpayer has an obligation to repay the loan.[82] There are transactions in which the taxpayer does not relinquish the property, but receives consideration for it and may realize gain.[83] For example, a payment of damages is applied against the owner's adjusted basis and the amount in excess of basis is gain realized.[84]

Realization is usually a precursor to inclusion in income. Without realization of gain, there is no taxable event and traditionally nothing to tax. Only if the taxpayer realizes gain and there is no exception deferring inclusion in income,[85] and there are many exceptions,[86] is gain realized from the sale or exchange[87] of property includable in the income of the owner of the property.[88] Conversely, absent a sale or other disposition, appreciation in the value of property is not includable in income. Statutory exceptions to the realization requirement for gain on the appreciation of property exist and are growing slowly in number. The exceptions include the periodic inclusion of original issue discount on debt instruments;[89] annual marking to market

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81. *E.g.* a mortgage or Uniform Commercial Code Article 9 security interest.

82. But the owner is deemed to have sold the property for the outstanding balance of loan, plus any additional consideration if a buyer assumes or takes subject to the debt, or the owner fails to repay the debt and yields the property to the lender in lieu of foreclosure.

83. Taxpayers may elect to defer, recognizing the gain with an election. I.R.C. § 1033 (2012).

84. Treas. Reg. § 1.1001-1(c) (2017).

85. I.R.C. § 1001(c) (2012).

86. Exceptions include, for example, exchange of property for entity interests under I.R.C. §§ 351, 721 (2012) and like kind exchanges under I.R.C. § 1031 (2012).

87. I.R.C. § 1001(c). The recognition and inclusion provision in I.R.C. § 1001 introduces the terms "exchange" and "recognize," but excludes any reference to "other disposition."

88. *Id.*

89. I.R.C. § 1272 (2012) (an embedded contractual increase in value substituting for current payment of interest on the debt). Original issue discount

and inclusion in income of unrealized appreciation, or deduction of unrealized depreciation, of certain commodities, financial instruments[90] and dealer held securities,[91] similarly marking to market of the property of individuals who expatriate at the time of expatriation;[92] and most recently, the transition tax.[93]

While the realization concept has been critical to determining the income taxable under the Sixteenth Amendment,[94] realization is not a function of the amendment. The amendment permitted the taxation of income without apportionment among the states.[95] Neither the amendment[96] nor the taxing statute[97] defined income. The amendment permitted the taxation of income without apportionment and the statute exercised Congress's power to tax income including wages, dividends, and gains derived from property. Before adoption of the Sixteenth Amendment,

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accrual is, arguably, not a realization, but an accounting matter forcing cash basis taxpayers onto accrual accounting for original issue discount. I.R.C. § 267(a)(2) (Supp. 2017) places accrual basis tax transparent entities onto the cash basis method of their owners who receive otherwise deductible payments from the entity.

90. I.R.C. § 1256 (2012) (annual marking of regulated futures contracts, foreign currency contracts, nonequity options, dealer equity options, and dealers securities futures contracts but gain or loss sixty percent long term capital and forty percent short term capital regardless of actual holding period).

91. I.R.C. § 475 (2012) (security dealers' inventory marked to market).

92. I.R.C. § 877A (2012) (expatriation tax imposed which also terminates other deferrals of income and gain).

93. I.R.C. § 965 (Supp. 2017).

94. U.S. CONST. amend. XVI.

95. U.S. CONST. art. I, § 9, cl. 4. Congress had the power to tax income before the Sixteenth Amendment, but could do so only if the income tax was apportioned among the states. Brushaber v. Union Pac. R.R., 240 U.S. 1, 25–26 (1916) (holding the Revenue Act of 1913, imposing the income tax after the adoption of the Sixteenth Amendment to be constitutional without apportionment).

96. "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states . . . ." U.S. CONST. amend. XVI.

97. Revenue Act of 1913, ch. 16, § 2(A), 38 Stat 114, 166 (exercising Congress's new power to tax income without apportionment).

the taxation of income, including gain from the sale or other disposition of property, was permissible but impractical because it could not be apportioned among the states in any reasonable manner. Thus, direct taxation of income was impermissible because it was not apportioned and not because it was unrealized.[98]

Under various definitions, including the classic Haig-Simons definition,[99] appreciation in the value of property is income. Nevertheless, the U.S. Supreme Court definitively rejected that formulation of income in *Macomber*[100] and has neither reversed nor modified its position on income since that decision. *Commissioner v. Glenshaw Glass Co.*[101] is not to the contrary. Citing *Macomber* with approval,[102] *Glenshaw Glass* clarifies that income is not only the produce of labor or capital or both, but may result from other forms of enrichment, although not from the growth in value of capital without realization.[103]

Macomber dealt with the taxability of stock dividends that the governing statute[104] expressly included in gross income to the extent of their cash value. The Supreme Court stated that it intended to address the constitutional issue regarding the stock dividend[105] and emphasized that the taxation of anything other than income remains subject to the apportionment requirements of the Constitution.[106] The Court held that income includes gain derived and separated

98. Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429, 607–08, *aff'd on reh'g*, 158 U.S. 601 (1895), (holding unapportioned taxes under the Income Tax Act of 1894 unconstitutional because they were not apportioned).

99. SIMONS, *supra* note 6, at 41.

100. Eisner v. Macomber, 252 U.S. 189, 218-19 (1920).

101. 348 U.S. 426 (1955).

102. *Id.* at 430–31.

103. *Id.* at 431.

104. Revenue Act of 1916, ch. 463, § 2(a), 39 Stat. 756, 757.

105. *Macomber*, 252 U.S. at 205.

106. U.S. CONST. art. I, § 9, cl. 4.

from capital but not the simple increase in the value of the capital or gain accruing to the capital.[107] Further the Court observed that the earnings of a corporation are not the property of the shareholder. The corporation may distribute its earnings among the shareholders as cash dividends or liquidating distributions but until distributed the earnings remain corporate property and not shareholder property. Stock dividends do not separate property from the corporation and place it in the hands of the shareholders,[108] since the shareholder owns only the same interest in the corporation as before the dividend and no greater interest in the corporation's underlying assets. The separateness of the corporation from its shareholders is fundamental.[109] The Court stated:

> We are clear that not only does a stock dividend really take nothing from the property of the corporation and add nothing to that of the shareholder, but that the antecedent accumulation of profits evidenced thereby, while indicating that the shareholder is the richer because of an increase of his capital, at the same time shows he has not realized or received any income in the transaction.[110]

Further: "enrichment through increase in value of capital investment is not income in any proper meaning of the term."[111] And "what is called the stockholder's share in the accumulated profits of the company is capital, not income."[112]

The transition tax includes in U.S. shareholders' incomes the shareholders' proportional share of a foreign corporation's retained profits without any distribution or

107. *Macomber*, 252 U.S. at 207.

108. *Id.* at 211.

109. *Id.* at 214. That separation breaks down to some degree in the CFC rules, *infra* note 116 and accompanying text.

110. *Id.* at 212. The Court also points out that the shareholder lacks liquidity to pay the tax following a stock dividend without selling shares and diminishing her proportional interest in the company. *Id.* at 213.

111. *Id.* at 214–15.

112. *Id.* at 219.

separation from the corporation's assets. It is difficult to imagine facts more closely resembling the issues addressed and resolved in *Macomber*. In defining accumulated foreign earnings as subpart F income, the transition tax includes the accumulation as income to the corporation's shareholders even though, under *Macomber*, it clearly is not.

IV. CFC AND THE TRANSITION TAX

While there can be little doubt that the transition tax respects neither the realization nor the income requirement of *Macomber*, or *Glenshaw Glass* for that matter, perhaps the threshold of realization was crossed long ago with the enactment of the CFC provisions of the Internal Revenue Code and later diminished further as a barrier to inclusion in income by the mark to market rules and the expatriation tax. Recent scholarship argues that the transition tax is unconstitutional as a direct tax that must be apportioned. One argument is that the transition tax simply is not a tax on income but a tax on property because it reaches events not in the current tax year.[113] Another argument for an unconstitutional direct tax identifies the income taxed as excluded rather than deferred income so that retroactive inclusion of the income becomes a direct tax.[114] A third related argument characterizes the tax as a direct tax on wealth also subject to apportionment.[115]

The transition tax enters gross income through the subpart F door. The longstanding CFC rules[116] include

113. Berg & Feingold, *supra* note 53, at 1358-59 (the authors offer some specific computations on the effect of the tax and suggest the characteristics of taxpayers who might challenge the tax and limitations on how they could do so in light of statute of limitations concerns).

114. Adler & Willis, *supra* note 18, at 1415.

115. Sean P. McElroy, *The Mandatory Repatriation Tax is Unconstitutional*, 36 YALE J. REG. BULL. 69, 81 (2018).

116. Subpart F was added to the Code by the Revenue Act of 1962. *See generally* Melissa Redmiles & Jason Wenrich, *A History of Controlled Foreign Corporations and the Foreign Tax Credit*, INTERNAL REVENUE SERVICE (Sept. 13,

portions of the income of CFCs in the incomes of U.S. shareholders despite the income being earned, but not distributed, by the CFC. While the inclusion to the U.S. shareholders of subpart F income seems a violation of the *Macomber* holding, the inclusion does not impute a taxable dividend, as the possibly unconstitutional foreign personal holding company provisions did before their repeal,[117] nor would it force a realization of gain as the mark to market rules do.[118] Instead, the CFC inclusion relies more closely on the assignment of income doctrine for support.[119] Certain types of CFC income have either i) a minimal or no connection with the CFC's jurisdiction and a closer connection with another jurisdiction;[120] or ii) no non-tax, business reason for placement in the CFC rather than in the hands of the CFC's U.S. shareholders.[121] Accordingly, from a business perspective, the link between the subpart F income and the CFC is tenuous. Since assignment of the income to the CFC is arbitrary, the CFC provisions simply assign the income to the taxpayers who control the decision on placement of the income.[122] Were there no CFC provisions,

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2013), https://www.irs.gov/pub/irs-soi/historycfcftc.pdf (history of the CFC provisions).

117. I.R.C. § 551 (2000), *repealed by* American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 413(a)(i), 118 Stat. 1418, 1506. *See also* Ordower, *supra* note 27, at 18 (arguing that the foreign personal holding company inclusion probably was unconstitutional).

118. *E.g.*, I.R.C. § 1256 (2012) (commodities futures); I.R.C. § 475 (2012) (dealer securities), I.R.C. § 877A (2012) (expatriation tax).

119. The principle barring assignment of income in some circumstances emerges from Lucas v. Earl, 281 U.S. 111, 114 (1930) (taxing husband on the share of his income from his personal services that he anticipatorily assigned to his wife under a binding contract because he, and not his wife, was the one who produced the income).

120. *E.g.*, I.R.C. § 954(a)(2)-(3) (Supp. 2017) (foreign base company sales and services income).

121. *E.g.*, I.R.C. § 954 (a)(1) (foreign personal holding company income).

122. I.R.C. § 951(b) (Supp. 2017) (defining U.S. shareholders of a CFC). CFCs are only those foreign corporations in which U.S. shareholders own more than 50 percent voting control and value but the CFC inclusion rules occasionally may include some U.S. shareholders who have no control, even as part of a control

the IRS might use the more general income allocation rule to achieve the same end for the subpart F income.[123]

This assignment of income analysis of the CFC rules is imperfect. Under the CFC regime, it is possible that the CFC's subpart F income will be subject to the income tax in another taxing jurisdiction such as the CFC's country of residence, while under general assignment of income principles, the income would be attributed to the correct taxpayer and away from the taxpayer to which it in fact was assigned.[124] That limitation on the analysis seems less problematic when compared with the transfer pricing instances in which income is properly attributed to a taxpayer different from the taxpayer reporting the income, but the jurisdiction in which the taxpayer reported the income does not relinquish its claim to tax the income so that more than one taxing jurisdiction taxes the income.[125]

A second limitation on the analysis is the character of the income. Unlike expressly tax transparent entities,[126] the CFC provisions do not preserve character. Instead, the CFC inclusion transforms all subpart F income into ordinary income of an unspecified character.[127] For purposes of the foreign tax credit however, a "look-thru (*sic*)" rule applies[128]

group, over the activities of the CFC.

123. I.R.C. § 482 (Supp. 2017).

124. *Id.* (as applied to the statute's primary use, transfer pricing). *See also* Treas. Reg. §§ 1.482-1–9 (2017).

125. For example, absent an advance pricing agreement or the concurrence of the competent authorities from both or multiple jurisdictions, a U.S. taxpayer may be allocated income from a transaction that another country also taxes.

126. *E.g.*, I.R.C. § 702(b) (Supp. 2017) (partnerships); I.R.C. § 1366(b) (Supp. 2017) (S corporations); I.R.C. § 852 (Supp. 2017) (regulated investment companies distributing their income and separating and preserving the character of ordinary income, long term capital gain and exempt interest as the income passes through to shareholders as dividends); I.R.C. § 1293 (Supp. 2017) (qualified electing funds under the PFIC regime separating ordinary income from net capital gain as it passes through to shareholders).

127. I.R.C. § 951(a)(1) (inclusion of pro rata share of subpart F income).

128. I.R.C. § 904(d)(3) (Supp. 2017).

and characterizes the portion of the CFC inclusion attributable to passive category income of a CFC as passive category income to the U.S. shareholder.[129] Unclear is whether subpart F income attributable to the active conduct of the CFC's trade or business would be passive activity income in the hands of its U.S. shareholders for purposes of the passive activity loss limitations.[130] In addition to character change for some income, the inclusion of subpart F income is limited to the CFC's current earnings and profits—a dividend concept and limitation. Non-subpart F losses of a CFC may diminish the current earnings and profits and prevent the inclusion of some or all of the subpart F income in the income of the U.S. shareholders.[131] Application of assignment of income principles to shift income produces a less favorable outcome for the U.S. shareholders because assignment of income is specific to the gross shifted income. It would include shifted income in the U.S. shareholders' incomes but would not permit the non-subpart F losses of the CFC to reduce the net amount shifted.

Even if the assignment of income doctrine helps the CFC inclusion to reconcile, albeit less than comfortably, with *Macomber*'s characterization of stock dividends as not being income because they alter nothing in the relationship between the corporation and its shareholders and do not generate realized and includable gain, the assignment of income doctrine does not help with the transition tax. The transition tax does not redirect foreign earnings of a foreign corporation to its U.S. shareholders as the earnings accrue. Rather, the transition tax redefines accumulated foreign source earnings and profits of a foreign corporation as subpart F income in 2017. *Macomber* expressly rejected taxing accumulated earnings and profits to a corporation's shareholders in the absence of a distribution. Such

129. I.R.C. § 904(d)(3)(B).

130. I.R.C. § 469 (Supp. 2017).

131. I.R.C. § 952(b)(1)(A) (Supp. 2017).

accumulated earnings and profits are not income but are part of the capital ownership that corporate shareholdings constitute. The transition tax does not alter the foreign corporation's ownership of any of its property acquired with its earnings nor does it alter the U.S. shareholders' relationship to that property. Inclusion in the U.S. shareholders' incomes may encourage the corporation to distribute the accumulated earnings to its U.S. shareholders or cause the shareholders to demand distributions, but the income tax cannot compel those distributions nor has it ever before sought to do so.

Use of the CFC provisions does not change the taxation of accumulated earnings and profits into current corporate earnings or shareholder income so long as the Supreme Court has not overruled its *Macomber* precedent. The transition tax, despite its use of the CFC mechanism, taxes U.S. shareholders on their capital ownership of foreign corporations. In so doing, it joins the ranks of previously enacted mark to market inclusion provisions[132] limiting the constitutional realization principle as underpinning income inclusion under the Sixteenth Amendment.

V. ABANDONING REALIZATION

With the transition tax, Congress selectively abandoned the realization requirement and partially cleared the accumulation of foreign earnings that were a possible barrier to a systemic change in the tax law, that is, the new participation exemption.[133] While the transition tax limits tax planning opportunities for a specific class of taxpayers, it leaves intact opportunities for other taxpayers to plan their tax deferrals and avoidances that rely on the realization principle. An investor in real estate, for example, may claim depreciation allowances[134] while operating real estate that

132. *E.g.*, I.R.C. § 1256 (2012); I.R.C. § 475 (2012); I.R.C. § 877A (2012).

133. *See supra* note 42 and accompanying text (discussing I.R.C. § 245A).

134. I.R.C. § 167 (Supp. 2017) (depreciation generally); I.R.C. § 168 (Supp.

does not in fact depreciate in value and yet not be taxed on the gain in the value of the property as it appreciates in the market or as the investor rolls it over into other real estate without recognizing the gain realized in the exchange.[135] Ultimately the increase in value may escape taxation permanently when the investor dies and the beneficiaries of the investor's estate sell the property free from any taxable gain because the property takes on a new, fair market value basis at the investor/owner's death.[136]

Legislating reduced rates of tax, as it did with a previous selective abandonment of the realization principle,[137] Congress bought the cooperation of many of those taxpayers the legislation affects adversely. On this occasion, in addition to a reduced rate of tax, the possibly illusory elimination of tax on future offshore earnings accompanied the reduced rate of tax.[138]

This selective legislation traverses ground similar to that of the expatriation tax as well. With the transition tax, Congress chose a single moment on which to impose a tax on a limited group of taxpayers who earned no income and engaged in no otherwise taxable transaction. As the expatriation tax isolates an expatriating taxpayer from all other taxpayers, marks that taxpayer's assets to market and includes the cumulative increase in value at the moment of expatriation even though the taxpayer changes no

2017) (accelerated cost recovery as the depreciation allowance).

135. I.R.C. § 1031 (2012) (permitting the deferral of realized gain in a like-kind exchange of real property).

136. I.R.C. § 1014 (2012) (basis of property received from a decedent's estate by reason of the decedent's death).

137. I.R.C. § 1256 (2012) (characterizing sixty percent of the gain, without regard to holding period, as reduced rate long term capital gain).

138. The combined impact of the new provisions governing global intangible low-taxed income, I.R.C. § 951A (Supp. 2017) [hereinafter GILTI], foreign derived intangible income, I.R.C. § 250 (Supp. 2017) [hereinafter FDII], and the base erosion anti-abuse tax, I.R.C. § 59A (Supp. 2017) [hereinafter BEAT], undercut the benefit of the expanded dividend received deduction for foreign source income under I.R.C. § 245A (Supp. 2017).

relationship between any asset and herself, the transition tax includes the accumulated foreign earnings of a corporation in the incomes of its shareholders on a statutorily fixed date. Like the tax on long term capital gains, both the expatriation tax and the transition tax are cumulative rather than periodic taxes. Both the expatriation tax and the transition tax reach an accumulated amount of appreciation in property that may have accrued over a lengthy period but was not yet taxable under general tax rules. Both provisions tax cumulative appreciation at a single moment as the inclusion of realized and recognized long term capital gain taxes economic income accumulated over an extended period at the moment of the sale or exchange of the appreciated property. Neither the taxation of long term capital gain nor the expatriation tax is retroactive as they tax accumulated gain. The transition tax's subpart F mechanism could be viewed as retroactive in that it redefines a foreign corporation's income as subpart F income even though when that income was earned it became classified correctly as not subpart F income.[139] Yet, in its resemblance to mark to market inclusion, the transition tax is taxing accumulated but previously untaxed appreciation in value. The transition tax could have used a mark to market mechanism for taxing all the accumulated foreign income, but avoided double taxation arguments and uncertainties by focusing instead on accumulated foreign earnings and profits not previously included in subpart F income.

The practical outcome of both the expatriation and transition tax statutes is substantially the same as both will fail to reach all income that they might or should have captured. The expatriation tax will miss taxing the full value of many expatriating taxpayers' assets as those taxpayers exploit discounting techniques developed in the estate

139. Adler & Willis, *supra* note 18, at 1423 (arguing the income was excluded, not deferred, income).

planning industry to minimize the mark to market inclusion.[140] Similarly, the transition tax will miss much unrealized appreciation in the assets of CFCs and other specified foreign corporations because the measure of the foreign corporation's earnings and profits does not include that unrealized appreciation and, when realized, that income may remain free from U.S. tax because of the extended dividends received deduction.[141] Both taxes disregard the *Macomber* precedent and tax the unrealized appreciation in the taxpayer's assets. The expatriation tax views expatriation, a change in the taxpayer's status, as a taxable event.[142] The transition tax goes a further step from realization as it taxes at a moment when neither the taxpayer's relationship to the property nor the taxpayer's status changes but there is a change in tax law.

If constitutionally permissible under the Sixteenth Amendment, enactment of the transition tax reflects Congress's power to abandon the realization requirement and impose a tax on accumulated but deferred economic income. At Congress's whim, further targeted limitations on

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140. Stephen J. Leacock, *Lack of Marketability and Minority Discounts in Valuing Close Corporation Stock: Elusiveness and Judicial Synchrony in Pursuit of Equitable Consensus*, 7 WM. & MARY BUS. L. REV. 683, 686 (2016). On the use by the Trump family of sophisticated discounting techniques, *see* David Barstow, Susanne Craig & Russ Buettner, *Trump Engaged in Suspect Tax Schemes as He Reaped Riches From His Father*, N.Y. TIMES (Oct. 2, 2018) https://www.nytimes.com/interactive/2018/10/02/us/politics/donald-trump-tax-schemes-fred-trump.html?searchResultPosition=9.

141. I.R.C. § 245A (referring to the participation exemption, i.e., the one hundred percent dividends received deduction for distributions from the foreign source earnings of a CFC). Congress appears not to have considered unrealized appreciation and its potential for increasing earnings and profits when it imposed the transition tax even though such unrealized appreciation affects other areas of tax law. For example, it is a factor in measuring whether or not an accumulation of earnings is beyond the reasonable needs of the business for purposes of the accumulated earnings tax. *See* I.R.C. § 532 (Supp. 2017) (accumulation of earnings beyond reasonable needs determinative of purpose to avoid shareholder level tax); I.R.C. § 531 (Supp. 2017) (accumulated earnings tax imposed).

142. For example, a taxpayer who is expatriating changes her status from U.S. person to non-U.S. person.

realization may take effect and create sub-groups of taxpayers who will capture a significant benefit or suffer a substantial detriment from the changes without outright abandonment of the historical realization-based income inclusion structure. Realization survives as the precursor to inclusion of gain on property but no longer limits the taxing power of Congress.[143]

In its current, newly limited form, the realization requirement will continue to serve the propertied segments of American society,[144] even though abandonment of realization would offer the opportunity to reexamine and separate those instances in which realization supports a significant tax policy purpose from those in which it no longer does or never did have a sound policy foundation. Unless abandoned, the realization requirement will continue to facilitate the accumulation of wealth by postponing, frequently forever, the contribution of any part of the growth in value of a taxpayer's property to public needs.[145] In

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143. The TCJA also expressly undercuts the principle of horizontal equity that like taxpayers be taxed alike, as it separates the class of wage earners from the class of independent contractors. *See* I.R.C. § 199A (Supp. 2017) (allowing a twenty percent deduction for income derived from an unincorporated trade or business excluding the trade or business of an employee). Unlike realization with its constitutional underpinning in *Macomber*, horizontal equity in taxation is not a constitutional requirement in the United States unless a statute discriminates against a constitutionally protected group, so imposing a higher rate of tax on a specific group would be impermissible if embedded in the statutory language but would not be unconstitutional if the statute were facially neutral but had a disparate impact on a specific group. *See* Henry Ordower, *Horizontal and Vertical Equity in Taxation as Constitutional Principles: Germany and the United States Contrasted*, 7 Fla. Tax Rev. 259, 290–96 (2006). For example, I.R.C. § 199A may have such a disparate impact if a specific group has disproportional numbers of employees relative to sole proprietors. Germany, on the other hand, has express constitutional jurisprudence requiring horizontal equity in taxation. *Id.* at 301–26.

144. *See supra* notes 134–36 and accompanying text.

145. The wealthiest taxpayers may continue to be subject to an estate tax at death but most taxpayers will remain free from the estate tax at its current $11.4 million (or $22.8 million for married individuals combining their exemptions) inflation-adjusted exclusion. I.R.C. § 2010 (2012) (unified credit deduction equivalent). *See also* Rev. Proc. 2019-57 (showing most recent inflation

addition, selective abandonments of realization introduce uncertainty for taxpayers and encourage them to devote resources unnecessarily to tax planning to develop contingent tax plans.[146] A stable, predictable set of rules on which to rely would be more efficient economically than the current state of uncertainty.

A comprehensive tax base model would include annually in each taxpayer's income "the change in the value of the store of property rights between the beginning and end of the period in question."[147] Currently, the realization requirement defers the inclusion in income of the increase in the value of the taxpayer's store of property rights until the taxpayer sells or exchanges those rights for money or other property,[148] or even longer if one of the gain recognition deferral provisions applies.[149] Realization following the series of incursions on its territory is no longer an immutable requirement, if it ever was,[150] but has been a matter of administrative convenience subject to limitation and alteration by Congress as most or all other tax rules.[151]

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adjustments).

146. Professor Dr. Drüen comments on the inefficiency of tax planning: " . . . Steuerumgehung volkswirtschaftlich betrachtet . . . führt zur ineffizienten Allokation von Ressourcen, weil beträchtliches Personal in Unternehmen, Steuerberatung und Staat fern von wirtschaftlicher Nutzenmaximierung gebunden wird." (citations omitted) ("from an economic perspective, tax avoidance . . . leads to inefficient allocation of resources as considerable personnel in business, tax planning industries, and the state remain far from economic production maximization activity.") (author's translation). *Drüen*, Unternehmerfreiheit und Steuerumgehung, StuW 2008, 154 (158).

147. SIMONS, *supra* note 6, at 50.

148. I.R.C. § 1001(a) (2012).

149. I.R.C. § 1001(c). *See, e.g.,* I.R.C. § 1031 (Supp. 2017) (referring to like kind exchange of real property).

150. *See*, *e.g.*, I.R.C. § 1256 (2012) (mark to market for commodities futures); I.R.C. § 877A(a)(1) (2012) (expatriation tax).

151. Compare the assignment of income and tax benefit principles. Most academic commentators agree that, despite *Macomber*, realization is not a constitutional requirement. *See* Stanley S. Surrey, *The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions*, 35 ILL. L. REV. 779, 782–85 (1941) (emphasizing administrative convenience). The literature

Congress could and should require all taxpayers to measure and include in income annually the increase in the value of their respective stores of property rights. Although taxpayers might object to the change in law on a variety of policy grounds, an argument based on longstanding tradition or some vague vested right in continuing the law without change should fall flat following enactment of the transition tax that eliminated the longstanding (and vested) tradition of offshore deferral of business income. While there are policy arguments in favor of continuing a realization-based system, there are powerful arguments for elimination of realization. A great deal of tax simplification would accompany elimination of the realization requirement but elimination also would introduce new, but limited, complexity in valuation and collection. Hope for elimination of realization is certainly an unlikely and utopian dream, but with incursions past the realization barrier, a look at the advantages of eliminating the realization requirement recommends itself.

Annual marking to market of all property for all taxpayers would add to the complexity of determining value for property for which there is no public trading market and cause some, possibly many, taxpayers to have to sell property to meet their tax obligations. In instances in which the sale of illiquid property becomes necessary, compulsion to pay might be ameliorated by deferred payment opportunities,[152] and, in limited instances, a diminished rate of tax.[153] Increases in value of illiquid property are likely to be gradual

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favoring a shift away from realization-based taxation is extensive. *See, e.g.*, Deborah H. Schenk, *An Efficiency Approach to Reforming a Realization-Based Tax*, 57 TAX L. REV. 503, 503 (2004); David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111, 1114–16 (1986); Jeff Strnad, *Periodicity and Accretion Taxation: Norms and Implementation*, 99 YALE L.J. 1817, 1820 (1990).

152. *Cf.* I.R.C. § 877A(b) (2012) (expatriation tax payment deferral).

153. *Cf.* I.R.C. § 965(c) (Supp. 2017) (deduction for transition tax); I.R.C. § 1(h)(1), (11) (2012) (referring to reduced rate on net capital gain and qualified dividends).

most of the time, and the possible decreases in tax rate accompanying a broader comprehensive tax base will prevent many taxpayers from suffering from the increased taxable income attributable to inclusion of appreciation in the value of their assets. The following paragraphs identify some tax simplifications and economic efficiencies that an accrual or accretion tax operating by a mark to market mechanism might generate.[154]

A. *Economic Income Taxed*

Professor Blum correctly pointed out that any argument that capital gains are not income is conclusory and not an argument at all.[155] Arguments that a tax on capital gain is a tax on capital, rather than income, fail for much the same reason as the argument that capital gains are not income.[156] The Haig-Simons comprehensive income formula includes increase in value of capital as income.[157] Although accounting conventions tend to eschew annual revaluation of assets because gain from revaluation may distort the measurement of profit and operating success,[158] there are major segments of the national economy in which periodic revaluation is commonplace and essential to conduct of the effected business. For example, public and private investment funds, real estate investment trusts and pension funds must revalue their assets at frequent intervals to facilitate ongoing investment and withdrawal as well as the payment of management fees. Such investment funds play an ever greater role as the point of assembly of capital as direct individual investment in equities shifts to such

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154. This portion of the article relies in part on Professor Walter J. Blum's classic article: *A Handy Summary of the Capital Gains Arguments*. Blum, *supra* note 8.

155. *Id.* at 248.

156. *Id.*

157. SIMONS, *supra* note 6, at 50.

158. Blum, *supra* note 8, at 249.

indirect ownership through pooled investment vehicles.[159] Even in operating, as opposed to investment industries, asset revaluation becomes critical to facilitate acquisitions and financings and occasionally to support an extraordinary dividend when earned surplus is insufficient.

The current failure to tax all economic income distorts the distribution of tax burdens. Taxpayers whose income is from their labor are taxed annually on all the income their labor produces,[160] while those with property find that the periodic yield from the property that is subject to tax often is accompanied by growth in value of the property which is not taxed until sold. Taxing economic income would level the tax burden between labor and property ownership. In recent years, the U.S. trend and the trend in most highly developed economies has been the opposite, favoring income from capital. Taxes on income from property have retreated and taxes on labor have increased or remained unchanged.[161] As such, a shift to an increased tax on income from property may prove elusive. Nevertheless, the broadened tax base from

159. Philippe Aghion, John Van Reenen & Luigi Zingales, *Innovation and Institutional Ownership* 103 AM. ECON. REV. 277, 302 (2013); Charles McGrath, *80% of equity market cap held by institutions*, PENSIONS & INVS. (Apr. 25, 2017, 1:00 AM), https://www.pionline.com/article/20170425/INTERACTIVE/170429926/80-of-equity-market-cap-held-by-institutions.

160. To a limited extent, taxpayers may divert a portion of their income from labor to tax deferred retirement savings and some non-taxable benefits if they are fortunate enough to have sufficient disposable income to defer and employment providing a structure for the non-taxable benefits. *See* I.R.C. § 402(a) (Supp. 2017) (deferring inclusion to an employee until distribution from the qualified retirement plan). *See also* I.R.C. § 125(a) (2012) (providing an exclusion from gross income for contributions to a cafeteria plan).

161. In the U.S., for example, the TCJA reduced the rate of tax on corporate income to twenty-one percent, I.R.C. § 11(b) (Supp. 2017), and introduced a deduction for income from primarily capital-intensive unincorporated businesses of twenty percent. I.R.C. § 199A(a) (Supp. 2017). In 2003, the rate of tax on dividends declined to the rate imposed on net capital gain. *See* I.R.C. § 1(h)(11) (2000) *amended by* Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 302(a), 117 Stat. 752, 760. In Scandinavia, a change to a dual income tax that imposed more favorable rates on capital than on labor began to manifest itself in 1987 in Denmark. Edward D. Kleinbard, *An American Dual Income Tax: Nordic Precedents*, 5 NW. J.L & SOC. POL. 41, 42 (2010).

taxing economic income would produce more government revenue at current rates, which if unneeded, could be deployed to reduce rates of tax for all taxpayers.

B. *Lock-in*

With increase in value includable annually, tax burdens no longer would distort economically desirable choices to sell or convert property to match its highest and best use.[162] As gain or loss becomes includable annually, the taxpayer would adjust the basis of property to reflect that income inclusion.[163] Whenever the highest and best use of property changes, taxpayers could redeploy their property from unproductive to productive uses and claim depreciation allowances from an adjusted basis closer to current fair market value than under the current realization based system. Similarly, bunching of long-deferred gain into the year of sale no longer would deter taxpayers from selling property. Taxpayers would measure gain in the year of sale from a gradually increasing adjusted basis reflecting the annual inclusions of advances in value in their property. Sale in many instances would generate only a small, one-year gain even though proceeds of sale might be significant. If the taxpayers had been paying their tax on increases in value annually rather than deferring payment, most of their proceeds would be available for reinvestment. Existing statutes designed to overcome lock-in concerns like the like kind exchange provision for real property[164] would become obsolete—a tax simplification.

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162. Rate fluctuations on capital gains have exacerbated the lock in problem. David Kamin & Jason Oh, The Effects of Capital Gains Rate Uncertainty on Realization 21 (Oct. 27, 2018) (unpublished draft) (available at https://www.ntanet.org/wp-content/uploads/proceedings/2017/NTA2017-310.pdf).

163. *Cf.* I.R.C. § 1016(a) (2012) (adjustments to basis).

164. I.R.C. § 1031(a)(1) (Supp. 2017) (deferral of realized gain on a like kind exchange of real property). Before 2018, the like kind exchange provision also applied to personal property used in a trade or business or held for investment. JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF PUBLIC LAW 115–97 184 (2018).

C. *Giving*

Death would cease to be the ultimate tax shelter because adjustment in basis to fair market value basis at death would become unnecessary.[165] Lifetime gifts with respect to which the donee must assume the donor's historical basis under current law[166] and gifts at death yielding a new basis to the donee[167] would become identical for tax purposes so that gift giving decisions would be fully independent of most tax considerations.[168] The current lifetime gift basis rule is designed to neither encourage nor discourage gift giving. Taxing the donor on appreciation at the moment of the gift under current law might discourage gift giving as donors may be reluctant to pay a tax currently. Preserving the donor's basis in the hands of the donee[169] prevents the historical appreciation from escaping taxation when the donee disposes of the property.[170] But the gift basis provision encourages donors to delay their gifts until death so that the recipient will not become taxable on the gain accruing during the donor's period of ownership of the property that is the subject of the gift. With annual taxation of appreciation, donees always would receive property with a new, fair

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165. *See* I.R.C. § 1014(a)(1) (2012) (basis of property received from a decedent is the fair market value of the property at the date of death or, if applicable, the alternate valuation date). The tax community has recognized that the new basis at death rule is unfair and inefficient, yet the effort to repeal that rule was a failure and has not garnered new support despite severe limitation on imposition of the estate tax.

166. *See* I.R.C. § 1015(a) (2012) (donee takes donor's basis except fair market value at the date of the gift for purposes of computing a loss if the donor's basis in the property exceeded the property's fair market value on the date of the gift).

167. I.R.C. § 1014(a).

168. Transfer of income producing property to lower marginal bracket taxpayers would continue to be advantageous but many of the most likely gift recipients, the donor's children, would be subject to the "kiddie tax" at the donor's marginal rate. *See* I.R.C. § 1(g) (2012).

169. I.R.C. § 1015(a).

170. *See* Taft v. Bowers, 278 U.S. 470, 482 (1929) (holding that the recipient of a gift can be taxed on appreciation in value during the donor's holding period).

market value basis; a substantial simplification of the tax rules. Appreciation or depreciation in value from the end of the previous taxable year to the date of the gift would be taxable to the donor.

D. *Charitable Giving*

The quirky and flawed policy of permitting property to yield a fair market value charitable contribution deduction without inclusion of gain to the donor would disappear, as would much of the complexity in reporting the value of charitable gifts. The current system of charitable contribution deductions subsidizes charities with tax revenue by permitting certain donors to redirect a portion of their income tax liability to the charitable donee.[171] Redirection occurs because the deduction diminishes the donor's income tax liability by removing an amount equal to the deduction from the donor's taxable income. The deduction is available only to taxpayers who itemize their deductions,[172] a small percentage of the taxpaying public

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171. *See* I.R.C. § 170(a)(1) (2012) (allowing a deduction for charitable contributions of money and property). *See also* Daniel Halperin, *A Charitable Contribution of Appreciated Property and the Realization of Built-in Gain*, 56 TAX L. REV. 1, 4 (2002). Whether any tax subsidy through charitable giving is justifiable and desirable seems a settled question and beyond the scope of this article. Nevertheless, the existence of the subsidy assumes that efficiency demands the subsidy because i) charities deliver necessary services more efficiently than the government does; ii) charities deliver necessary services the government will not or cannot deliver; or iii) because of the subsidy, charities capture additional funds that the government could not and apply them to delivery of necessary services.

172. *See* I.R.C. § 62 (2012) (adjusted gross income does not include the charitable contribution deduction as an adjustment); I.R.C. § 63(a) (2012 & Supp. 2017) (taxable income is adjusted gross income less either (i) the I.R.C. § 199A deduction and the standard deduction defined in I.R.C. § 63(c) or (ii) gross income less all deductions including the charitable contribution deduction). Only taxpayers who have itemized deductions including the charitable contribution deduction exceeding in the aggregate the standard deduction will derive a tax benefit from the charitable contribution deduction. Non-itemizing taxpayers can achieve the same or even better benefit than itemizing taxpayers from a charitable contribution if they contribute their services to charity, rather than cash or property, because the value of the contributed services will be excluded

populated primarily by high-income taxpayers.[173]

In the case of a contribution of property, the measure of the deduction in most instances is the fair market value of the property on the date of the gift. Exceptions limiting the deduction amount to the donor's basis in the property apply to property which would not yield long term capital gain if sold by the donor[174] and tangible personal property not related in service and use to the donee's charitable purpose.[175] The donor realizes no gain when contributing even substantially appreciated property to a charitable donee. With such donations, the tax subsidy is not only the amount of tax on the contribution amount but also the amount of tax that otherwise would have been imposed on the long-term capital gain when recognized. The effect is the equivalent to the new basis at death for non-charitable donees of appreciated assets from a decedent's estate while the donor is still alive. If the gain were taxed on contribution, the donor might not make the gift, instead holding the property until the step-up in basis at the donor's death.[176]

Annual marking to market eliminates both the excess subsidy built into the current contribution deduction that currently is a function of not taxing the gain at the time of contribution and the donor's incentive to hold the property

from their gross incomes thus redirecting the tax on their services to the charity. Henry Ordower, *Charitable Contributions of Services: Charitable Gift Planning for Non-Itemizers*, 67 TAX LAW. 517, 517–19 (2014).

173. TAX POLICY CENTER, BRIEFING BOOK, 141 (2019) (ebook) https://www.taxpolicycenter.org/briefing-book/what-are-itemized-deductions-and-who-claims-them.

174. *See* I.R.C. § 170(e)(1)(A) (limiting deduction to basis if gain not long-term capital).

175. *See* I.R.C. § 170(e)(1)(B) (limiting deduction for tangible personal property).

176. *See* Halperin, *supra* note 171, at 16–19 (arguing that gain forgiveness incentivizes charitable contributions when the donor otherwise would hold the property until death). Halperin is not persuaded that the incentive is efficient. *Id.* at 35.

until death to get the new basis.[177] It is possible that some potential donors may shy away from charitable giving without the excess subsidy but the policy decision to ignore that concern seems already to have been made. Congress reduced the number of itemizers who make charitable contributions only because they are deductible when it enacted the TCJA in 2017 by increasing the standard deduction[178] and encouraged cash rather than property donations by large donors with an increase in the charitable deduction limit to $60,000 for cash contributions only.[179] Marking to market also should diminish the number of overvaluations of charitable contributions, as any excess value will attract a tax on the gain to the donor in the year of the gift. If there continues to be a rate differential with the charitable contribution drawing an ordinary deduction while the gain is taxed at a lower rate imposed on net capital gain, the incentive, albeit diminished, for charitable giving of appreciated property and overvaluing that property will remain.[180] But mark to market is likely to diminish the need for supporting appraisals for non-cash charitable contributions[181] and exposure to overvaluation penalties,[182] except in limited circumstances.

E. *Inflation Adjustment to Basis*

A longstanding argument against taxing capital gain is that capital gain is not a real gain but rather a reflection of

177. *See supra* note 167 and accompanying text.

178. I.R.C. § 63(c)(7)(A) (2012 & Supp. 2017) (increasing standard deduction temporarily).

179. I.R.C. § 170(b)(1)(G)(i) (Supp. 2017) (increasing contribution base for cash charitable contributions temporarily).

180. And in those instances where taxpayers donate non-appreciating personal use property in which their basis exceeds the value, there also will remain an incentive to overvalue.

181. I.R.C. § 170(f)(11)(C) (appraisal requirements for contributions in excess of $5,000).

182. I.R.C. § 6662(b)(3) (2012).

inflation. While Professor Blum refuted the argument extensively dismissing it as absurd,[183] the argument endures. In recent years, the argument has manifested itself as individuals proposed adjusting the basis of capital assets for inflation,[184] adding to the many inflation adjustments that already have found their way into the Internal Revenue Code, further adding to its complexity.[185] Marking to market undercuts any remaining arguments concerning inflation as only annual, as opposed to long term, inflation would be of significance. Annual inflation impacts all sources of income. The purchasing power of wages declines with inflation so wage increases are just as artificial as gain on property to the extent of inflation. Inflation impact on wages is ameliorated to a very limited extent by the inflation adjustment to rate brackets.[186] That adjustment should suffice for property value inflation, or a modification of the brackets for income from marking to market if those brackets differ from ordinary income marginal rate brackets.

If appreciation and depreciation are included in the annual tax base, tax law will become a great deal simpler than it is now.[187] Features of the tax law such as depreciation

183. Blum, *supra* note 9, at 255–56.

184. Kyle Pomerleau, *The Economic and Budgetary Impact of Indexing Capital Gains to Inflation*, TAX FOUNDATION, Sept. 2018, at 1–8, https://files.taxfoundation.org/20180910132823/Tax-Foundation-FF610.pdf. *Cf.* Daren Fonda, *Indexing Capital Gains to Inflation Would Be Great for the Rich. There's No Economic Rationale.*, BARRON'S (Aug. 3, 2019 8:00 AM), https://www.barrons.com/articles/indexing-capital-gains-to-inflation-makes-no-economic-sense-51564833600.

185. The IRS annually publishes the inflation adjustments in a revenue procedure. Rev. Proc. 2019-57 (showing most recent inflation adjustments).

186. I.R.C. § 1(f)(3) (2012) (cost of living adjustments) (modified and limited by I.R.C. § 1(j) (Supp. 2017)).

187. Sixty years ago, Walter J. Blum argued that capital gains as a principal source of complexity in tax law that was a sufficient reason for eliminating its preferred treatment. Blum, *supra* note 9, at 266. None of the provisions for depreciation recapture, qualified dividends, or qualified business income, *infra* notes 188–190, were in place when Blum made that observation.

recapture,[188] the reduced rate of tax on qualified corporate dividends,[189] and the new twenty percent qualified business income deduction[190] have diminished the frequency with which taxpayers seek to convert ordinary income into capital gain. At the same time all those provisions have added to the complexity of the tax law. Similarly, limiting exploitation of opportunities to convert ordinary income from services into long-term capital gain through "carried interests" has proven to be particularly troubling for tax policymakers.[191] The carried interest conundrum demonstrates that the timing and rate differentials between sales of property yielding long-term capital gain and ordinary, currently taxable income from business operation and performance of services have a great deal of continuing significance. The timing and rate differentials are a source of considerable complexity in tax law. With annual inclusion, taxpayers would have weaker, if any, incentives for seeking to convert ordinary income into long-term capital gain. Except for the limitation of the Medicare tax to income from services,[192] a limitation mostly eliminated by the tax on net investment income,[193] annual marking to market would simplify an unnecessarily and enormously complex and often manipulated tax law. Nevertheless, the details of transitioning to and

188. I.R.C. § 1245 (2012) (depreciation recapture on personal property).

189. I.R.C. § 1(h)(11) (qualified dividends taxes at net capital gain rate).

190. I.R.C. § 199A (Supp. 2017) (qualified business income deduction).

191. I.R.C. § 1061 (Supp. 2017) (extending holding period requirement for capital gain on carried interest added by TCJA). On carried interest, *see generally* Chris William Sanchirico, *The Tax Advantage to Paying Private Equity Fund Managers with Profit Shares: What Is It? Why Is It Bad?*, 75 U. CHI. L. REV. 1071, 1073 (2008); Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 18 (2008). For an earlier discussion of the profits interest conundrum, *see* Henry Ordower, *Taxing Service Partners to Achieve Horizontal Equity*, 46 TAX LAW. 19, 19–41 (1992).

192. *E.g.,* I.R.C. § 3101(b) (2012) (hospital insurance tax on wages); I.R.C. § 1401(b) (2012) (hospital insurance portion of the self-employment tax).

193. I.R.C. § 1411(c) (2012) (tax on certain net investment income). The failed attempt to repeal the Affordable Care Act in 2017 permitted I.R.C. § 1411 to survive since it was a primary funding mechanism for the Affordable Care Act.

implementing a general mark to market system for taxing gain and loss are daunting.

VI. CONCLUSION

The transition tax and the expatriation tax dispel any lingering doubts about the power of Congress to tax unrealized gains and losses at a moment Congress selects. Both the transition tax and the expatriation tax choose a single moment at which to tax gains and losses that have accumulated over long time periods. The transition tax reaches accumulations of corporate earnings after 1986[194] while the expatriation tax could reach much further back through generations of accumulated gains and losses[195] as it forces expatriating taxpayers to mark all their property to market on the day before their expatriation.[196] While the expatriation tax selects a taxation date related to the event of expatriation which otherwise might remove some property permanently from U.S. taxing jurisdiction,[197] the transition tax chooses a date to facilitate an alteration in U.S. tax law without any event occurring specific to the taxpayer or the property taxed.

Insofar as imposing tax on value, which has increased over extended periods, is permissible under both the transition tax and the expatriation tax without any realization event. Congress equally might choose a date on which to require all U.S. taxpayers to mark all their property to market and include in income the gain or loss on the

194. I.R.C. § 965(d) (Supp. 2017) (deferred foreign income accumulated after 1986).

195. An expatriating taxpayer who received property from a donor during the donor's lifetime would have the donor's adjusted basis in the property under I.R.C. § 1015 and if the donor also received the property as a gift, the donor might have her donor's adjusted basis reaching back several generations.

196. I.R.C. § 877A(a) (2012) (requiring all property to be treated as sold at fair market value the day before expatriation).

197. I.R.C. § 865 (2012) (sourcing gain from sale of personal property at the taxpayer's residence, for example).

property as if it were sold at fair market value on the date selected to facilitate the transition to an annual mark to market tax system. Following the initial bulk marking to market and inclusion, taxpayers would mark their assets to market annually and again when they dispose of an asset. Dispositions by sale would yield gain or loss measured by the sale price less the adjusted basis as that basis has been adjusted to reflect previous markings to market. A disposition other than a sale would be equated with a sale at fair market value.

Determination of fair market value might be troublesome for some property. The tax law, however, generally rejects claims that value is indeterminate.[198] General asset value reporting is certainly not unprecedented. Reporting is required under the estate tax at each decedent's date of death.[199] While the estate tax now reaches only estates in excess of 11.4 million dollars, for much of estate tax history, the requirement to determine the value of all a decedent's property at date of death affected a broader segment of the taxpayer population than it now does. Moreover, even taxpayers who receive property from an estate not subject to the estate tax have an incentive to determine the value of property received to reset the adjusted basis of the property to fair market value at date of death.[200]

Market quotations are available for a great deal of investment property—securities and currencies, for example—which is actively traded on a public market. Interests in closely held businesses are more difficult to

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198. "The fair market value of property is a question of fact, but only in rare and extraordinary cases will property be considered to have no fair market value." Treas. Reg. § 1.1001-1(a) (amended 2017).

199. I.R.C. § 2001 (2012) (imposing estate tax).

200. I.R.C. § 1014 (Westlaw through Pub. L. No. 116-47) (explaining new basis in property received from a decedent). Annual marking to market would eliminate any lingering arguments for a new basis at death. *See supra* note 167 and accompanying text.

value but some shorthand method for the initial valuation—such as capitalization of operating revenue or income—might suffice to support the systemic transition to mark to market. Over time, annual increments in value will become increasingly accurate as a national value database develops. Much or most U.S. real property already is subject to periodic revaluation under state and local law for determination of *ad valorum* property taxes. Although the locally determined values do not utilize a uniform methodology across taxing jurisdictions and are quite possibly imperfect, they can serve the development of the national database of values. The national database would benefit local tax collectors as its accuracy improves. Other valuable property such as artwork, coins, memorabilia, and even gemstones initially will be subject to imperfect determinations of value but the imperfections will become less pronounced over time as the national value database develops.

Real property located outside the U.S. and other non-U.S. property for which there is no U.S. market may prove difficult to value so that imposition of the initial tax in rare instances may have to await the conversion of the property into cash or other property. A look-back rule like that for PFICs[201] which averages the gain when included over the taxpayer's holding period of the property accompanied by an interest charge may induce taxpayers to be forthcoming in their valuations and seek to determine value.

To a limited extent, Congress can give taxpayers an incentive to identify value initially as accurately as possible through a rate system that favors the initial inclusion of unrealized gain. As Congress did with the transition tax,[202] a significant rate reduction for the initial gain inclusion would serve that purpose accompanying a higher rate for annual inclusions of mark to market gain. The initial tax

201. I.R.C. § 1291 (2012) (inclusion of PFIC assigns gain on sale ratably to each day in the taxpayer's holding period).

202. I.R.C. § 965(c)(2) (Supp. 2017) (applying reduced rate of tax).

might distinguish traded from non-traded property and favor non-market traded assets that are more difficult to value.[203] An opportunity to pay the tax at transition to the mark to market system in installments would ease the burden of the one-time tax.[204]

Marking to market will be burdensome to some, perhaps many, taxpayers. Where an active and open trading market exists for the taxpayer's property, payment of the initial tax should prove uncomplicated. Since the gain will be taxed with or without a sale, sale of some holdings to pay the tax both initially and annually seems unproblematic. Taxpayers will remain reluctant to pay a lump sum tax but payment is, perhaps primarily, a psychological or emotional hurdle. Taxpayers who receive sizeable salary bonuses or severance payments generally have no opportunity to avoid or postpone the tax on those payments even though the tax leaves them with diminished resources. A mark to market tax paid with the proceeds from the sale of liquid assets is no more burdensome.

Personal residences present a more serious difficulty in a mark to market system. Taxing the annual increase in the value of a personal residence in most instances differs little from the annual imposition of a property tax by the local taxing jurisdiction. Often in the context of a political anti-tax campaign, proponents of limitations on property taxes describe homeowners forced out of their homes when they are unable to pay their property taxes. Some jurisdictions offer relief to older citizens whose means of support is social security payments and pension plans described as fixed income individuals. Except in a market with steep appreciation in real property value because a specific neighborhood is gentrifying or a new and desirable resource has become available in the neighborhood, increases in value

203. *Id.* (lower rate by way of a larger deduction for operating, rather than liquid investment assets).

204. I.R.C. § 965(h) (regarding installment payment of the transition tax).

are likely to be moderate and the tax on them small. If exemptions for certain classes of homeowners become necessary to protect taxpayers from losing their homes, postponement of tax payment with low or no interest may be the simplest solution.

Similarly, other illiquid assets, especially those of personal or sentimental value in addition to market value, may require some accommodation. For illiquid assets generally deferral of the tax payment beyond the installment reporting may be essential to prevent distress sales of assets to pay the tax. Deferred payment should draw an interest charge except items of personal or sentimental value. In the case of personal or sentimental property, deferred payment of the tax without interest as the property passes within the extended family might be a reasonable accommodation, but a value limitation simultaneously might be in order. In the absence of an estate tax on most estates, imposition of an income tax on appreciation in the value even of personal or sentimental property would not seem an outrageous demand. For lower income and wealth individuals, an exemption from the tax in the form of a separate zero rate tax bracket also might recommend itself. Although a separate zero bracket might make sense for the initial tax on transition to mark to market, creation of more permanent differential or schedular rates is troubling. Schedular rates discriminate in favor of taxpayers with some appreciating property relative to taxpayers with income only from the performance of services. Distinctions among types of income violate principles of horizontal equity.[205]

Liquidity, especially to pay a concentrated tax at the transition to mark to market, remains a matter of concern. The concern, however, may be no greater with a mark to market system than under a realization-based system. If the realization event is accompanied by the receipt of money,

205. *See supra* note 143 and accompanying text (discussing the deduction for qualified business income with respect to horizontal equity under I.R.C. § 199A).

realization increases the likelihood that the taxpayer will have the money with which to pay the tax. Often, however, even cash transactions do not yield sufficient proceeds to enable a seller to pay the tax on the seller's gain if the property sold is encumbered by debt that the seller must repay. When a taxpayer exchanges property for property, the taxpayer frequently remains illiquid and unable to pay a tax on the gain. Under a realization system with opportunities to defer recognition and inclusion in income,[206] the lack of liquidity is unproblematic. Yet, Congress newly limited the general recognition deferral rule for like-kind exchanges to real property indicating that Congress did not view the need for general deferral as compelling. Annual marking to market will diminish further or eliminate the need for deferral provisions, as unrealized gain at any point is likely to be small.

The TCJA offers a rare opportunity to reexamine systemic characteristics of the U.S. income tax system as the TCJA rejects realization and undercuts the principle of horizontal equity. Although the act seems to favor taxpayers with high income and wealth,[207] it removes historical fetters that may have prevented Congress from reconsidering fundamental and longstanding tax policies hampering enactment of changes in law to distribute tax burdens differently from custom. Timing of the inclusion of gain in income and the capital gain rate preference are functions of longstanding policies that have begun to become obsolete or are not yet obsolete but are obsolescing. Historically, unrealized gain may have been difficult to measure accurately, but current data analytics have progressed and

206. I.R.C. § 1031 (2012) (like-kind exchanges of real property); I.R.C. § 721 (2012) (exchanges of property for a partnership interest); I.R.C. § 351 (2012) (exchange of property for corporate shares).

207. *See, e.g.,* Howard Gleckman, *The TCJA Shifted The Benefits Of Tax Expenditures to Higher-Income Households*, TAX POL'Y CTR. (Oct. 16, 2018), https://www.taxpolicycenter.org/taxvox/tcja-shifted-benefits-tax-expenditures-higher-income-households.

large data base management renders valuation considerably more certain than it was, especially as the database matures. Among the strongest and most enduring arguments for a long-term capital gain rate preference is the concentration of the gain into a single tax period.[208] Except for the year of transition to a general mark to market system when this Article proposes a reduced rate and possibly installment payment following the model of the transition tax, concentration is not an issue and that justification for a reduced rate falls by the wayside.

208. Blum, *supra* note 8, at 253.