Module 1: Discussion Question

Much of the complexity in the Tax Code results from the difficulty of taxing income from capital. For example, accurate taxation of income from capital requires accurate depreciation schedules and the ability to distinguish between capital assets and non-capital assets.

A second set of problems derives from the realization rule—the rule that income and losses from capital assets are generally not taxed until the income or loss is realized, typically by reason of a disposition. The realization rule makes it necessary to have loss limitations (so that taxpayers cannot realize losses to offset ordinary income while holding on to gains). The realization rule also arguably is the reason that a tax preference for capital assets is necessary. In the absence of a capital rate preference, the incentive to hold on to appreciated property solely to avoid tax becomes too great.

In light of these and other problems, many commentators advocate moving to a system that would not tax income from capital at all. Such a system would tax only amounts spent on consumption. Such a system could dispense entirely with taxation of business entities as well as with all the other complexities associated with taxing income from capital. Other commentators argue, however, that abandoning taxation of capital, and with it taxation of business entities, would be too regressive, because income from capital is disproportionately earned by individuals at the upper ends of the income and wealth spectrums. Moreover, accurate taxation of consumption still requires the ability to distinguish between business and personal outlays. It also arguably requires distinguishing between the consumption of durable goods and goods delivering short-term satisfactions. For example, because the purchase of a personal vehicle delivers consumption over many years, it may not be appropriate to treat the full purchase price as consumption in the year of purchase but rather to treat the consumption as taking place over the expected useful life of the vehicle.

Another alternative is to continue to tax income from capital, but to move to a “mark-to-market” (MTM) income tax system. Under MTM taxation, capital assets are valued annually, and gains and losses that have accrued over the previous year are taxed (or deducted) without regard to realization. An MTM system removes incentives to selectively realize losses and dispenses with the need for a capital gain preference. On the other hand, MTM taxation requires the ability to value assets periodically without the benefit of a disposition that normally discloses value. While valuation of publicly traded property such as exchange-traded stocks and bonds is not difficult, valuation of other assets, such as real estate and collectibles, can be burdensome.

Discuss the pros and cons of the three approaches described above: the current system (or one slightly modified to address some of the problems mentioned), consumption taxation, and MTM taxation. On balance, which do you consider optimal and why? In your answer, it may be helpful to consider the effects of government spending on overall welfare. As a general matter, most government spending is progressive in effect: it tends to benefit the less well-off more than it does the more well-off, regardless of the source of the government’s funds for the spending. It may also be helpful to consider other features of the tax system that have powerful incentive effects, such as §1014.