TOWARD AN ECONOMIC MODEL FOR THE TAXATION OF DERIVATIVES AND OTHER FINANCIAL INSTRUMENTS

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I. Introduction

Our federal income tax system, a hundred years old this year, was conceived in an age of nascent capital markets, characterized by illiquidity¹ and high volatility.² Time value concepts were little understood,³ options could not be priced,⁴ and the concept of economic income was still decades away.⁵

The tax system revolved around cash, and realization was the guiding principle—the concept that income is not earned, and therefore not taxed, until a taxpayer actually

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¹ The NYSE share volume on October 3, 1913 (the date of the enactment of the federal income tax) was 223,344. Daily Share Volume in NYSE Listed Issues from 1900 through 1919, NYSE EURONEXT, http://www.nyse.com/marketinfo/stats/vol00-19.dat (last visited Feb. 27, 2013). In the first five months of 2012, the average daily trading volume of the NYSE was about 3.8 billion shares. Joe Light, Stock Market Loses Face, WALL ST. J., May 29, 2012, at C1, available at http://online.wsj.com/article/SB10001424052702304065704577429111951625728.html.


³ See MICHAEL J. GERAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES 738 (6th ed. 2009) (“The Internal Revenue Code did not recognize the significance of compound interest until 1982 and even now uses compound interest concepts only in certain contexts.”).


sells property for cash or exchanges it for materially different property. The realization requirement was viewed as so fundamental to our income tax system that for some time it was imbued with constitutional significance.

However, taxpayers soon realized that financial and commercial transactions revolve not around cash and realization, but around economic income, and this allowed them to exploit the artificial realization requirement, again and again. Each time, eventually, Congress or the Internal Revenue Service (IRS) reacted.

After a century, our federal system for taxing financial instruments is truly Ptolemaic. Realization remains at its center, but Congress and the IRS have again and again attempted to adjust it to function in a world that truly revolves around economic income. The wash sale rules, the straddle rules, the capital loss limitation rules, the contingent payment debt instrument rules, the constructive ownership rules, the constructive sale rules, and the contingent swap rules are the epicycles of our tax system. And yet we retain our realization tax system as stubbornly as Europe retained Ptolemy’s geocentric system through the Middle Ages.

But perhaps this will change. On January 24, Congressman Dave Camp (R-MI), the Chairman of the House Ways and Means Committee, released the discussion draft of a bill that would tax derivatives under a mark-to-market system of taxation. This truly Copernican proposal would replace our entire federal system of taxing derivatives with a radically different but infinitely simpler model that would finally correspond to economic reality. If it were enacted, it would represent the most significant change in the history of our federal tax system. But, by shattering the realization paradigm, the Camp proposal suggests the possibility of something even more revolutionary: a fundamental

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7 In Eisner v. Macomber, the Supreme Court held that stock dividends are not “income” within the meaning of the Sixteenth Amendment because they had not been realized and therefore could not be taxed by Congress without apportionment to the states. 252 U.S. 189 (1920). However, the Court subsequently discredited the reasoning of Macomber. See, e.g., Helvering v. Horst, 311 U.S. 112, 116 (1940) (stating that the realization requirement is “founded on administrative convenience”). Most commentators have unequivocally concluded that the realization requirement is merely an administrative—and not a constitutional—rule. See, e.g., David M. Schizer, Realization as Subsidy, 73 N.Y.U. L. REV. 1549, 1576 & nn.108–10 (1998); MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION 73 (11th ed. 2009) (“realization is strictly an administrative rule and not a constitutional, much less an economic, requirement of ‘income’”).
8 In the second century, the astronomer Claudius Ptolemy succeeded in predicting the positions of the sun, moon, and the planets under a geocentric model of the heavens. His model was used for over 1,400 years. To explain and predict heliocentric planetary patterns in a geocentric model, Ptolemy’s planets traveled in a series of epicycles around the earth. But this alone was insufficient. To correct further, Ptolemy had the planets move closer and then further away from the earth, and even slow down and reverse in their orbits. See generally PTOLEMY’S ALMAGEST (G.J. Toomer trans., 1984) (translating Ptolemy’s treatise on astronomy into English).
reformation of our entire concept of taxable income.

Part II of this Article briefly recounts the history of the federal taxation of financial instruments with a series of vignettes. Part III discusses the Camp proposal and the hope it offers for our federal income tax system.

II. A Brief History of the Federal Income Taxation of Financial Instruments

A. The Wash Sale Rules

The federal income tax was enacted on October 3, 1913 but didn’t take effect until 1916.\(^\text{10}\) Within five years, wealthy taxpayers had already learned how to use the realization requirement to generate “paper” tax losses while deferring their real economic gains. At hearings before the Senate Finance Committee on October 1, 1921, T.S. Adams of the Treasury Department testified:

Men are now selling securities at 10 o’clock in the morning and buying them back at 12 o’clock. In order to claim a loss. The House believed that that should not be permitted. We have had considerable trouble with it, where the taxpayer does that and gets back identically the same securities at the present time.\(^\text{11}\)

Senator Charles Curtis from Kansas interjected.

The men doing that are men with enormous incomes . . . One man told me—who was many times a millionaire—that he did that, and that that year he made over $1,000,000; and yet he deducted from his tax where he sold his stock at a loss, gave himself what he was allowe

That year, Congress enacted the wash sale rules, which prevent a taxpayer who sells stock or securities at a loss and also acquires substantially identical stocks or securities within a specified period of time from claiming that loss.\(^\text{13}\) The wash sale rules do not modify the realization requirement; instead, they simply defer the taxpayer’s

\(^\text{10}\) GRAETZ & SCHENK, supra note 3, at 7.
\(^\text{11}\) An Act to Reduce and Equalize Taxation, to Amend and Simplify the Revenue Act of 1918, and For Other Purposes: Hearings on H.R. 8245 Before the S. Comm. on Fin., 67th Cong. 51 (1921) (statement of Dr. T.S. Adams, Tax Adviser, Treasury Department).
\(^\text{12}\) Id. at 51–52 (statement of Sen. Charles Curtis, Member, S. Comm. on Fin.).
\(^\text{13}\) H.R REP. NO. 67-350, at 10 (1921); S. REP. NO. 67-275, at 14 (1921).
loss.\textsuperscript{14}

The initial wash sale rules proved ineffectual and were amended substantially in 1988 and again in 2000 to address increasingly sophisticated derivative transactions.\textsuperscript{15} Despite these changes, the wash sale rules present insufficient barriers to abuse. For instance, David Schizer has listed seven “perfect end runs” around them.\textsuperscript{16}

\textbf{B. Straddles}

Revenue Ruling 77-185 describes a transaction in which a taxpayer on August 1, 1975 simultaneously sold silver future contracts for July delivery and purchased an identical number of silver futures contracts for March delivery, effectively hedging her economic exposure.\textsuperscript{17} Three days later, after the March contracts depreciated, the taxpayer sold them at a loss and purchased an identical number of May contracts.\textsuperscript{18} The taxpayer reported a loss from the sale of the March silver contracts in 1975.\textsuperscript{19} On February 18 of the following year, the taxpayer simultaneously sold the May contracts and purchased July contracts to cover the short position.\textsuperscript{20} That year, the taxpayer reported a long-term capital gain.\textsuperscript{21}

While a wash sale allowed a taxpayer to recognize a tax loss without changing her economic position, at least the taxpayer experienced an economic loss. The straddle transaction described in Revenue Ruling 77-185 had no appreciable effect on the taxpayer’s economic position (because the taxpayer remained completely hedged), the taxpayer had no reasonable expectation of deriving an economic profit, and the transaction was consummated only to generate a current short-term capital loss offset by a future long-term capital gain.\textsuperscript{22} Although the transaction was a tax shelter,\textsuperscript{23} the realization rule made it possible.

In 1981, Congress addressed these transactions with a narrow mark-to-market rule in section 1256 that applied a reduced “blended” rate of tax to certain futures contracts

\textsuperscript{14} \textit{See}, e.g., I.R.C. § 1091 (2012).
\textsuperscript{17} Rev. Rul. 77-185, 1977-1 C.B. 48.
\textsuperscript{18} \textit{Id}.
\textsuperscript{19} \textit{Id}.
\textsuperscript{20} \textit{Id}.
\textsuperscript{21} \textit{Id}.
\textsuperscript{22} \textit{Id}.
\textsuperscript{23} Columbia Law School Professor Michael Graetz has described a tax shelter as a “deal done by very smart people that, absent tax considerations, would be very stupid.” Lynley Browning, \textit{How to Know When a Tax Deal Isn’t a Good Deal}, N. Y. TIMES, Sept. 10, 2008, at SPG4, available at \url{http://www.nytimes.com/2008/09/10/business/businessspecial3/10TAX.html?pagewanted=all}. 
and short-term options.24 Perversely, by reason of the blended rate, these marked-to-market futures contracts and options are more lightly taxed than they were under realization.25 For all other instruments, Congress let realization lie, but attempted to shackle it with the straddle rules, which deny deductions, defer losses, and toll holding periods for positions in straddles.26 As was the case with the wash sale rules, however, the collar was too loose and in 1984, Congress tightened it.27

The 1984 Act was not a decade old before taxpayers found a chink in the straddle armor. A new financial product, initially called DECS—for Dividend Enhanced Convertible Stock—allowed corporate taxpayers with appreciated securities to hedge and monetize their economic exposure and claim current deductions for the cost of the financing, seemingly in violation of the rule that denies deductions for positions in a straddle.28 The IRS attempted to rein in DECS with regulations in 199529 and more proposed regulations in 2001,30 but it finally took an act of Congress in 2004 to unambiguously deny interest deductions on DECS used to hedge appreciated positions.31

C. Shorts-Against-the-Box: The Lauder Transaction and the “Constructive Sales” Rules of Section 1259

In 1995, Estée Lauder and her sons, Ronald and Leonard, invoked the realization requirement to avoid all tax on their highly appreciated Estée Lauder stock.32 Estée loaned her stock to her sons; they loaned theirs to her; and they all sold the borrowed stock into the market.33 This transaction was a “short-against-the-box.” Under realization’s great generosity, because none of the three had sold their own shares, all of their tax was deferred indefinitely, even though they were subject to none of their stock’s benefits or burdens, and they received cash. Congress responded in predictable fashion. Realization was retained, but the specific transaction was shut down with the “constructive sale” rules of section 1259.34

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24 Section 1256 options are subject to tax at a rate equal to 60% of the long-term capital gains rate plus 40% of the short-term capital gains rate. I.R.C. § 1256 (2012).
25 Today this subsidy amounts to $4.4 billion over five years. JOINT COMM. ON TAX’N, 112th Cong., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2011–2015, JCS-1-12, at 38 (2012).
33 Id.
These examples are not the only ones. The loss limitation rules,\textsuperscript{35} the original issue discount\textsuperscript{36} and contingent payment debt instrument rules,\textsuperscript{37} the conversion transaction rules of section 1258,\textsuperscript{38} the constructive ownership rules of section 1260,\textsuperscript{39} and the contingent swap rules\textsuperscript{40} were all legislative or regulatory responses to realization rule abuse by taxpayers. Yet these rules still have not thwarted taxpayers and so today, taxpayers remain free to choose a tax treatment that minimizes their taxes. Three examples follow.

D. The Continued Benefits of Realization

1. The Taxation of Credit Default Swaps

Credit default swaps can be structured as options for tax purposes or they can be structured as “notional principal contracts.”\textsuperscript{41} If they are structured as options, under the realization rule, the taxpayer can defer tax on the premiums.\textsuperscript{42} If they are structured as notional principal contracts, the taxpayer can rely on the “contingent swap” regulations proposed by the IRS to claim immediate ordinary losses when the risk of default increases.\textsuperscript{43} The proposed contingent swap regulations turn off realization and require a modified mark-to-market system of taxation for these contracts.\textsuperscript{44} Some taxpayers initially took the position that credit default swaps were options and deferred the premiums, and then, after the market turned downward, changed their minds and treated the very same credit default swaps as notional principal contracts to claim immediate ordinary losses.\textsuperscript{45}

2. The Use of “Variable Prepaid Forward Contracts” To Monetize Appreciated Stock

Wealthy individuals with appreciated stock can enter into variable prepaid forwards that hedge their downside risk, and provide them with cash, all tax-free.\textsuperscript{46}

\textsuperscript{35}See id. § 1211.
\textsuperscript{36}See id. §§ 1271–1273.
\textsuperscript{38}See I.R.C. § 1258 (2012).
\textsuperscript{39}See id. § 1260.
\textsuperscript{44}See id.
\textsuperscript{45}See Lee A. Sheppard, News Analysis: Credit Default Swaps in Bankruptcy Court, 132 TAX NOTES 323 (July 25, 2011).
Although the IRS challenged one variant of this transaction, in Revenue Ruling 2003-7, it declared the basic technique completely legal.  

3. Structured Notes and the “Open Transaction” Doctrine

Finally, in the past ten years, over $250 billion in structured notes have been issued in public transactions registered with the SEC. Among these structured notes is a type that promises its holders a relatively secure principal amount at maturity plus contingent interest tied to the return of an equity index like the S&P 500. Notes like these resemble contingent payment debt instruments that would subject an investor to annual original income accruals and ordinary income at maturity. But these notes are structured as prepaid forward contracts. Under the open transaction doctrine of our realization-based tax system, holders pay no tax until maturity and then, at maturity, are eligible for long-term capital gains rates.

These notes are not tax shelters in any nefarious sense. They are registered with the SEC in public documents, and their beneficial tax treatment is simply the natural consequence of our realization tax system.

The deferral permitted by credit default swaps, variable prepaid forwards, and structured notes is an artifact of our realization system. The ability of taxpayers to choose their tax treatment arises because there is no single guiding principle governing the taxation of financial instruments. Ultimately, our system is numbingly complex because Congress and the IRS must repeatedly correct it because it has no basis in reality.

III. The Camp Proposal

Chairman Camp’s proposal would require any derivative held by a taxpayer at the end of a taxable year to be treated as sold for its fair market value on the last day of the taxable year. Any mark-to-market gain or loss (and any gain or loss on an actual sale) would be treated as ordinary gain or loss; the taxpayer’s basis in the position would be adjusted for the gain or loss; and any loss could be carried forward to offset other

48 According to figures available at StructuredRetailProducts.com, the aggregate amount of SEC-registered notes (both listed and unlisted) in the US between 1/1/2003 and 12/31/2012 totaled $253,088 billion. See Wrappers Report, http://structuredretailproducts.com/analysis/reports (last visited Mar. 6, 2013) (select “USA” in Select Database; then select “Calendar Year” and From “2003” To “2012” in Select Period; then select “Wrappers” in Select Report and include “non retail,” “leverage,” and “flow & others”; then select “USD” in Select Currency).
ordinary income.\textsuperscript{51} Moreover, if a taxpayer uses a derivative to hedge a non-derivative, the non-derivative would also be subject to mark-to-market treatment.\textsuperscript{52} For example, if a taxpayer were to hedge his appreciated stock by buying a forward or a put option, not only would the forward or put be marked-to-market, but also the stock.

The Camp proposal is transformative. In an instant, our federal tax system for taxing derivatives would abandon the realization rule that characterized its first hundred years and begin its second century based on economic income. This paradigm shift would represent the most dramatic reform to our federal tax system since its introduction, and would do what a century of economists and tax lawyers have said would be impossible.

As the brief history in Part II illustrates, Camp’s proposal would replace half a dozen sets of rules with a single rule: mark-to-market. For the derivatives to which it applies, the proposal would obviate the wash sale rules, the straddle rules, the short sale rules, the capital loss limitations, the notional principal contract rules, the contingent swap rules, and the constructive ownership and sale rules. The law would be infinitely simpler and abuse all but impossible.

The key to the provision is its definition of derivative. Derivative includes any “evidence of an interest” in any share of stock, partnership interest, any evidence of indebtedness, any real estate (except for single parcels or inventory), any actively-traded commodity, and any currency.\textsuperscript{53} It also includes any “notional principal contract” (i.e., a swap, as specially but broadly defined) and any “derivative financial instrument” with respect to a derivative.\textsuperscript{54} Finally, if a debt instrument has an embedded derivative component, the debt instrument is bifurcated into two separate instruments: a derivative that is subject to mark-to-market treatment, and a debt instrument that is not.\textsuperscript{55}

This definition of derivative is notable for its breadth. It would cover not only all publicly-traded options, all futures contracts, and all interest rate, currency and equity swaps, but would also include all employee stock options, all stock purchase contracts, and even a home heating oil contract.\textsuperscript{56} The parties to all of these contracts would have to (somehow) value them at the end of the year, pay tax on any gain, and deduct any loss. The Camp proposal does exclude from the definition of derivative any financial instruments that are part of a “hedging transaction”\textsuperscript{57} and, in a different proposal, Chairman Camp would expand the definition of a hedging transaction.\textsuperscript{58}

\textsuperscript{51} See id. (discussing proposed section 485(a), (b)). The loss would not be a miscellaneous itemized deduction subject to limitations on deductibility.
\textsuperscript{52} Id. (discussing proposed section 485(c)).
\textsuperscript{53} Id. (discussing proposed section 486(a)).
\textsuperscript{54} Id. (discussing proposed sections 486(b), (c)).
\textsuperscript{55} Id. (discussing proposed section 485(e)(3)).
\textsuperscript{56} See id. (describing proposed section 486). Home oil contracts constitute a derivative that must be marked-to-market under the Camp proposal.
\textsuperscript{57} Id. (describing proposed section 486(f)).
\textsuperscript{58} See id. § 402 (discussing proposed section 486, which would amend I.R.C. § 1221 (2012)).
There are several issues with which Chairman Camp will have to grapple as he refines his proposal in subsequent drafts. These issues, while important, should in no way detract from the overall strength of the proposal.

First, as Chairman Camp acknowledges, the proposal raises serious valuation issues because it applies to privately-held derivatives as well as publicly-traded ones. Taxpayers are famous for claiming low values and the IRS for claiming high values of non-publicly traded property.

Second, marking-to-market non-publicly traded derivatives raises liquidity issues. It is unclear how taxpayers that hold non-publicly traded illiquid derivatives will pay the tax on their mark-to-market gains without cash and without any means to raise the cash. The proposal may thus effectively outlaw some legitimate business transactions.

The natural way to avoid these two issues would be to limit the proposal to publicly-traded derivatives and derivatives with respect to publicly-traded property. Publicly-traded derivatives and derivatives with respect to publicly-traded property can be valued easily, and are liquid. Publicly-traded for these purposes could be defined broadly to include all derivatives with respect to which fair market value can be reasonably determined. All other derivatives would remain on the realization system, but an interest charge might apply to gain on prepaid derivatives. Chairman Camp has requested comments on the valuation issue.

Third, as discussed above, the proposal by its terms applies to employee stock options. Stock options are widely used to compensate middle-income employees who usually cannot negotiate for cash compensation instead of stock options. Subjecting employees who hold stock options to mark-to-market treatment would require the employee to fund his or her tax liability from other sources. For these reasons, the treatment of employee stock options requires serious consideration. The technical explanation of Chairman Camp’s draft does not indicate that the application of the proposal to employee stock options was ever considered. Because the proposal appears aimed at investors, speculators, and high-income individuals (but not middle-income


60 HOUSE COMM. ON WAYS & MEANS, OVERVIEW OF WAYS AND MEANS TAX REFORM DISCUSSION DRAFT: FINANCIAL PRODUCTS 3 (Jan. 24, 2013), http://waysandmeans.house.gov/uploadedfiles/overview_of_wm_discussion_draft_financial_products.pdf (“The Committee recognizes that the discussion draft does not address several technical and policy issues that may need to be resolved in final legislation. The Committee invites comments on how to address such issues, in particular those related to: Valuing derivatives that would become subject to mark-to-market tax treatment.”).

61 See TECHNICAL EXPLANATION, supra note 59, at 8–9.

62 See id. at 8–10.
employees), it would seem more appropriate to exclude employee stock options from the proposal.

Likewise, as mentioned above, the proposal applies to a stock purchase agreement that is expected to close within a reasonable time, and home heating oil and other consumer product contracts. All contracts entered into by individuals that are not in connection with a business or for investment should be excluded, as should purchase agreements that are expected to close within a reasonably short period of time.

Fifth, the proposal applies only to positions established after the end of this year. A less generous grandfather provision may be appropriate. Perhaps all financial instruments that otherwise would qualify as a derivative would be subject to mark-to-market after five years. Otherwise, a mad rush would begin as taxpayers hurry to enter into long-dated derivatives that would be forever grandfathered from the proposal.

Sixth, the proposal does leave open some opportunities for taxpayers to create synthetic derivatives with partnerships and foreign corporations. These loopholes will have to be closed. For example, assume that a taxpayer contributes $10 to a partnership and an investment bank contributes $90. The partnership then uses the $100 to buy publicly-traded XYZ stock and allocates all dividends, losses and the first $10 of gain to the investment bank, and all gain in excess of $10 to the taxpayer. Economically, this transaction results in the taxpayer’s holding a synthetic option, but because the taxpayer does not hold a “derivative” (it holds a partnership interest and not an option), it appears that the taxpayer would not be subject to mark-to-market treatment on this synthetic option. An anti-abuse rule would require this taxpayer to mark-to-market its partnership interest.

Seventh, some clarifications are in order. The proposal defines derivative to include “any evidence of an interest in” a stock and a partnership interest, among others. But that definition would seemingly include actual ownership, which clearly is not intended by the proposal. If the proposal remains limited to derivatives, the definition

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64 Cf. I.R.C. § 1259(c)(2) (2012) (providing for an exception from a constructive sale if “the taxpayer enters into a contract for sale of any stock, debt instrument, or partnership interest which is not a marketable security . . . if the contract settles within 1 year after the date such contract is entered into”).
66 See id. § 401 (describing proposed section 486).
67 See also Victor Fleischer, A Sensible Change in Taxing Derivatives, N.Y. TIMES (Feb. 7, 2013), http://dealbook.nytimes.com/2013/02/07/a-sensible-change-in-taxing-derivatives/ (“There are some additional problems with the legislation that need to be addressed. One is the tax treatment of compensatory stock options, which would be taxed on a mark-to-market basis under the proposal, but were probably not intended to be.”).
of derivative should be modified to clarify that it does not apply to ownership of actual stock or an actual partnership interest.

In addition, the proposal should make clear that except for the fact that unrealized gain or loss is recognized at the end of the year, the gain is ordinary gain or loss, and any loss is carried forward, the consequences for taxpayers of holding derivatives should remain the same. Thus, individuals should be subject to the new 3.8% Medicare tax on their net mark-to-market investment gains.\textsuperscript{69} The proposal should not change whether a tax-exempt investor recognizes “unrelated business taxable income” and is taxable on its derivatives.\textsuperscript{70} Likewise, the proposal should not change whether a foreigner is subject to tax by the United States on its derivatives.\textsuperscript{71} Finally, the proposal should not exempt the United States shareholders of a “controlled foreign corporation” from tax with respect to the derivatives held by that corporation.\textsuperscript{72} That is, if gain or loss on a derivative would have been “subpart F income”\textsuperscript{73} of a controlled foreign corporation before the proposal was enacted (and therefore its United States shareholders would be subject to tax on their share of that gain), the mark-to-market gain should also be subpart F income.\textsuperscript{74}

Finally, if enacted, the proposal would accentuate a most curious anomaly. A taxpayer who holds a forward contract on stock would have to mark-to-market the derivative and pay tax on all of her economic income at ordinary income rates.\textsuperscript{75} But a holder of the underlying stock will avoid paying any income tax on his stock by simply holding it until he dies. And so the Camp proposal is as significant for what it does as for what it doesn’t do: It doesn’t affect stockholders.

The ability of stockholders under our realization system to defer tax indefinitely on their economic income creates horizontal inequity with wage earners, who are taxable immediately on their economic income. It also exempts significant wealth from any income tax.

The best way to achieve “horizontal equity” for wage earners (who are taxed on nearly all of their economic income) and entrepreneurs and investors (who are taxed on none), and raise hundreds of billions of dollars of new revenue over the next ten years

\textsuperscript{69} See I.R.C. § 1411 (2012) (3.8% Medicare tax).
\textsuperscript{70} See id. § 512 (defining “unrelated business taxable income”).
\textsuperscript{71} See generally id. §§ 871, 881, 882 (describing taxation of nonresident alien individuals and foreign corporations).
\textsuperscript{72} See generally id. § 957 (defining controlled foreign corporation).
\textsuperscript{73} See id. § 952 (defining subpart F income).
\textsuperscript{74} See id. § 951(a)(1)(A) (requiring United States shareholders of controlled foreign corporations to include in income their pro rata share of the corporation’s subpart F income for the year).
\textsuperscript{75} The highest marginal rate of 39.6% plus the 3.8% Medicare tax is 43.4%. Id. §§ 1, 1411. However, the new Pease limitations, by denying deductions equal to 3% of adjusted gross income in excess of a threshold, have the effect of increasing rates by another 1.302% ((39.6% + 3.8%) x 3%). See Frank Armstrong III, Pease Limitation Puts a Lid on Itemized Deductions for Wealthy Folks, FORBES.COM (Jan. 9, 2013), http://www.forbes.com/sites/greatspeculations/2013/01/09/pease-limitation-puts-a-lid-on-itemized-deductions-for-wealthy-folks/.
without raising tax rates, hurting job growth, or affecting a single small business owner would be to enact a progressive system of mark-to-market taxation.

For individuals and married couples who earn more than $2.2 million in income, or own $5.7 million or more in publicly traded securities (representing the highest earning and wealthiest 0.1% of families), the appreciation in their publicly traded stock and securities (and derivatives with respect to those securities) would be “marked-to-market” and taxed annually as if they had sold their positions at year end, regardless of whether the securities were actually sold.\(^\text{76}\)

The most serious challenge to a progressive system of mark-to-market taxation is the psychological concern about taxing “paper gains.”

Camp’s proposal is revolutionary but it does not address our tax system’s more fundamental horizontal equity issues. By shattering the psychological hurdle to taxing paper gains, however, Camp’s proposal offers hope that what may once have been considered impossible to enact is now possible: the transition to an economic model for the taxation of financial instruments.\(^\text{77}\)
