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INDEXATION OF ASSETS

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UNITED STATES SENATE

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INDEXATION OF ASSETS

THURSDAY, FEBRUARY 16, 1995

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to recess, at 9:30 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Bob Packwood (chairman of the committee) presiding.

Also present: Senators Moynihan, Graham, Moseley-Braun, Simpson, D'Amato.*

OPENING STATEMENT OF HON. BOB PACKWOOD, A U.S. SENATOR FROM OREGON, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. Now, gentlemen, if you would come forward.

We have got Mr. Edwin Cohen, who has appeared before this committee on a number of occasions; Mr. Christopher Dent, the senior tax manager from Price Waterhouse; Mr. Alan Reynolds, the director of economic research for the Hudson Institute, and Mr. Michael Schler, member of the executive committee and former Chair of the New York State Bar Association Tax Section.

Mr. Cohen, how many times have you been before this committee?

Mr. COHEN. Someone asked this question of me a short time ago, and I have no count. But I said that when I was in the Treasury there was another Under Secretary, Paul Volcker, who was later the head of the Federal Reserve Board, and he had somebody on his staff count the respective number of times that we had testified before Congressional committees and said he and I were in a tie. I could not believe that.

The CHAIRMAN. Well, if you are tied with him you have been here a lot.

Let me just explain to the witnesses what we have been trying to do in the course of our hearings. We started out with the hearings, asking the question of whether the Tax Code tilts toward consumption? Most witnesses said, yes, probably if you mean as between savings and investment and consumption, it probably tilts toward consumption.

The second question we would ask is, well, if that is true, should it tilt toward consumption or should it tilt toward savings and investment, assuming the two are contradictory? Some witnesses preferred to tilt it toward consumption and they made a pretty good argument. Most witnesses, I thought, tilted the other direction.

* Joint Committee on Taxation published a print related to this hearing entitled "Tax Treatment of Capital Gains and Losses," (JCS–4–95), February 13, 1995.

They said we would be better off in this country if we saved more now, even if we had to consume slightly less now.

The third question becomes, if we are going to tilt toward saving and investment, how? Is that IRAs, capital gains, a capital gains differential or indexing, is it the Nunn-Domenici plan, is it a flat tax, is it a value added tax? Those are all variations on consumption themes.

So you are here today very specifically to talk about capital gains and indexing, and we appreciate it very much.

I think, Mr. Cohen, you are first on the list, and we will start with you.

STATEMENT OF EDWIN S. COHEN, JOSEPH M. HARTFIELD PROFESSOR OF LAW EMERITUS, UNIVERSITY OF VIRGINIA SCHOOL OF LAW

Mr. COHEN. Thank you, Mr. Chairman. As you have mentioned, I served some time 25 years ago as Assistant Secretary for Tax Policy in the Treasury, and later as Under Secretary. I am currently a Visiting Professor at the University of Miami Law School and an Emeritus Professor at the University of Virginia, where they retired me when I reached 70. But, last fall, when I passed 80, they brought me back to teach.

I am also counsel to the law firm of Covington & Burling here in Washington.

I speak to the problem of indexing. I do not necessarily quarrel with the academic or theoretical arguments in favor of indexing, but I am concerned about the complexities of it, particularly with the proposals that are currently pending which would apply indexing for inflation to investments in common stock, real estate, and perhaps some other items, but not to amounts placed in bank savings accounts, money market mutual funds, or to investments in U.S. Government bonds, or other corporate bonds, nor to investments in mortgages on real estate.

I think that is fundamentally wrong to give an inflation adjustment to people who put their money in one type of investment and not give it to those who put their money in other types of investments, such as savings accounts or U.S. Government bonds.

I will try to illustrate the problem because it goes beyond discrimination, and I think ends up with the wrong result. I use illustrations in my written statement, but I will give you one which I think would come out of Wall Street.

Suppose that Wall Street bankers have the opportunity to buy a large company for $250 million, a lot of money. They have $50 million of their own they can put together. To raise the other $200 million, they issue notes to the public, to you, Mr. Chairman, to me, to all of us in this room and others, and we buy those notes for $200 million because we like the interest return.

They do this in February 1995. Five years later, in February 2000, these bankers, having bought the company for $250 million, find that inflation has amounted at about four percent a year, to a total of 20 percent in the five years intervening. So their cost, under the pending indexing proposals, would be raised from $250 million to $300 million.

So, suppose that in February of 2000 they sell the company for $300 million. Today they would pay a tax on $50 million. Under the indexing proposal, they will pay zero tax because they will be selling it for their inflated adjustment cost.

Out of the $300 million which they have, they will give us back $200 million. They will then have $100 million left. When we get back the $200 million, it will not buy the same amount of groceries that we could buy with $200 million for all of us today, so we ask, where is our inflation adjustment? And the IRS will say, Congress did not provide an inflation adjustment for people who lend money; they only provided an inflation adjustment for people who buy stocks and real estate.

So we, as lenders, get no inflation adjustment though we have paid full tax on all our interest. But what about the bankers? They are sitting with $100 million left, which is a 100 percent gain on the $50 million that they put up, but they have no tax to pay because they got the inflation adjustment not only on their own $50 million, but on our $200 million as well. They get the benefit of the inflation adjustment; we get nothing. I think that is wrong. I think that is giving an inflation adjustment that belongs to lenders to borrowers instead. It is a wrong result and I do not think we should do it.

There are other objections to it which I am confident Mr. Schler, on behalf of the New York State Bar Association, will tell you about.

I would like to reserve a few moments because Mr. Dent is from Price Waterhouse and I have been a long-time client of Price Waterhouse for 40 years. I just would like to say that when Mrs. Richardson sends me my 1040, as he sends it to you, Price Waterhouse has taken to sending me a document that is Price Waterhouse's list of questions for me that is just as thick as what Mrs. Richardson has. I feel I have to have an opportunity to speak to that when Mr. Dent has finished.

I might also say with respect to the complexities involved, while I will not take up the time, I have here in my hand a pamphlet handed to me in 1936 when I had just arrived in New York out of law school.

This is the entire Federal income tax as it was enacted by the Congress in June of 1936, 100 pages, given to me by my boss who said, "Read it." I did. I read it twice. When I went back to him, he gave me the regulations, 400 pages. I read those. Then he said to me, now you are ready to practice law.

If somebody did that today, it would take them six months. I think that this proposal for indexing, when we got through, would be the largest single addition to the Code, with the possible exception of the alternative minimum tax.

Thank you, Mr. Chairman.

The CHAIRMAN. If we had a flat tax we could go back to that thin book again.

Mr. COHEN. I would be in favor of some changes that would take us back there.

If I may, I would like to submit for the record a brief speech that I gave in 1988 on this subject to the New York State Bar Associa-

tion. It interested them in the work that they have since done to a much greater extent on indexing, which Mr. Schler will refer to.

The CHAIRMAN. We will be delighted to have it.

Mr. COHEN. Thank you, Mr. Chairman.

[The information referred to above along with Mr. Cohen's prepared statement appear in the appendix.]

The CHAIRMAN. Now, we have Mr. Dent and we have an advantage in having him. While he is with Price Waterhouse, he is a British chartered accountant. He is here on a short stint and is the head of their United Kingdom Taxation Department.

The United Kingdom has a form of indexing, not all assets, but a form of it and can probably give us a bird's eye view of advantages and disadvantages in the United Kingdom.

Mr. Dent?

STATEMENT OF CHRISTOPHER H. DENT, SENIOR TAX MANAGER, PRICE WATERHOUSE LLP, NEW YORK, NY

Mr. DENT. Mr. Chairman, thank you. Mr. Cohen, thank you for your loyalty to Price Waterhouse.

Mr. Chairman, as you have already said, I am a British chartered accountant. I have been employed by Price Waterhouse since 1981, and since April 1994 I have been employed by Price Waterhouse LLP in New York to head up their U.K. Tax Services Department. It is a great honor for me to have been asked to summarize the U.K.'s experience of indexation.

In my oral statement I propose to talk through the conclusions which you will find on page 11 of my written testimony, which I have submitted for the record.

My first conclusion was this. Although there was some Parliamentary opposition to indexation when it was introduced in 1982, it has since been regarded as a relatively non-controversial aspect of the U.K. tax system and is generally regarded as fair.

When we introduced indexation in the U.K. in 1982—that was one of Mrs. Thatcher's Conservative government's pieces of legislation—we had seen very high inflation in the U.K. in the late 1970's, which peaked at more than 25 percent.

Although only a minority of people paid capital gains tax, everyone was only too well aware of the ravages of inflation, and the idea that people should not pay tax on purely inflationary gains was readily accepted.

The fiscal cost of indexation is difficult to quantify, but it is believed to halve, approximately, the capital gains tax which is assessed on individuals.

Indexation is also available to corporate taxpayers, but the impact there in fiscal terms is rather difficult to determine and public figures are not readily available.

My second conclusion was that indexation has not caused widespread administrative problems, either for taxpayers or Inland Revenue officials in the field. This is probably because most individuals are unaffected by capital gains tax as there are exemptions which cover most normal personal transactions.

There are, however, I admit, serious difficulties in calculating capital gains and indexation relief in relation to complex shareholdings. The vast majority of individuals are unaffected by

capital gains tax because of exemptions which include a person's principal home, no matter how big it is, most personal possessions, including anything which would not have a normal life of 50 years, most fixed-interest securities, and if anything is left in tax there is an annual exemption of about $9,000 per person.

These exemptions mean that most individuals never make capital gains tax returns. For those who do, the main items which might fall into the capital gains tax net include stocks, mutual fund investments, second homes, antiques or works of art, and any business assets which they own in their own name, such as farms or business real estate, goodwill, assets like that.

Now, for most of those assets, indexation is fairly easy to calculate. It does not represent a significant added burden over and above the calculations which are already needed for capital gains tax purposes, generally.

As I said earlier, complex shareholdings are a particular problem. What I mean by a complex shareholding is a shareholding which is built up over a period of time through a series of acquisitions and disposals along the way.

Now, many of the difficulties which we have with complex shareholdings are, I believe, due to the fact that after we first introduced indexation in 1982, we made significant amendments again in 1985, 1988, and 1994, and there were other amendments in the intervening years as well. I believe that many of the U.K.'s problems with indexation could have been avoided if a single permanent system had been set up at the outset.

For corporations I do not believe that indexation makes their tax computations significantly more difficult, and, of course, most corporations have their tax returns and tax computations produced by tax accountants anyway.

My third conclusion was that the system currently proposed for the U.S. has two features which the U.K. experience suggests could be concerns. Similar problems arose in the original 1982 U.K. system, and putting them right later in 1985, 1988, and 1994 considerably complicated the position.

My concerns are, first, that the historical base cost is used to calculate future inflation relief which will not, therefore, fully reflect current values, and, second, pre-introduction inflation gains, or gains which have already accrued, are not protected at all.

I will try to explain what I mean by way of a simple example. Supposing you acquired an asset in 1980 for $100 and, by the end of 1994, it is worth $1,000. That means that the future indexation relief will be based on the $100 and not the $1,000, which means that future inflationary increases in value will only be 10 percent protected. Furthermore, the inflationary part of the $900 increase in value between 1980 and 1994 will not be protected at all.

We put those problems right in 1985 by introducing a market value rule which meant that, taking my example, future inflation would be based on the value of the asset at the introduction date, and then we introduced another amendment in 1988 which took the pre-introduction capital gains out of the charge to tax altogether.

Of course, both those decisions would have significant revenue implications, but they do make it a full inflation protection system as opposed to partial protection.

Now, my fourth conclusion is concerning abuse. The U.K.'s system of indexation has not been abused on a widespread scale. Neither individuals, nor companies have geared up on any significant scale to exploit indexation, although this may partly be due to the fact that individuals cannot deduct investment interest expenses as they can in the U.S.

I believe people are naturally averse to borrowing to make speculative stock investments, and in the U.K. they are even less likely to do so because they cannot get relief for the interest paid. The yield on those stocks would, however, remain taxable. This means that the type of gearing up arbitrage, which I know is of concern here, just is not viable in the U.K.

Companies can get relief for interest expenses but tend only to borrow to finance assets they need for their business rather than for speculation, although no doubt it does happen to small extent.

There have also, of course, been various sophisticated schemes set up by banks, et cetera, to make the most of indexation, but they are relatively rare, very complex, and they are vulnerable to a whole host of different anti-abuse provisions. Many of these abuses have been blocked, which brings me on to my final conclusion.

Such abuse as has taken place has necessitated relatively sophisticated tax planning, but has almost entirely exploited two particular features of the U.K. system which have now been eliminated and are not in the H.R. 9 proposals.

First, between 1985 and 1994, it was possible to use indexation to create a capital loss. Second, in 1985 indexation was available on many fixed-interest bonds and debts and companies could set up group loans and also group equity investments partly or purely in order to accumulate indexation relief.

Over a period of years, these opportunities were blocked by a more or less annual tightening of anti-abuse rules and by gradually taking more and more types of fixed-interest security and debt outside the capital gains tax net altogether.

We have now reached the stage where more or less the only securities left in the capital gains tax net are stocks. Finally, in 1994 the government abolished the ability to create indexation losses altogether.

So, to summarize in a single sentence, I would say that indexation has broadly been a success in the U.K., but the concept of it and our experience of its administration do demand careful analysis before any similar proposals should be introduced in the U.S. This would enable the U.S. to get it right the first time and avoid many of the problems which we had which led to later amendments.

Thank you for your attention. I will be pleased to answer questions at the appropriate time.

The CHAIRMAN. How long have you been in the United States?

Mr. DENT. Since April 1994.

The CHAIRMAN. Because when you said "our ability to get it right the first time," I thought you had been here a short period of time. [Laughter.]

Next, we will take Mr. Reynolds, who is the Director of Economic Research for the Hudson Institute, a well-known research institute in this town.

Mr. REYNOLDS?

[The prepared statement of Mr. Dent appears in the appendix.]

STATEMENT OF ALAN REYNOLDS, DIRECTOR OF ECONOMIC RESEARCH, HUDSON INSTITUTE, WASHINGTON, DC

Mr. REYNOLDS. Thank you.

I began my written testimony by adopting sort of a zero-based budgeting approach, asking why do we impose a capital gains tax in the first place. Then we can build up from there rather than starting with where we are and taking it down.

Is the capital gains tax really no different from income? I argue that it is quite a bit different and everybody realizes it, otherwise they would be willing to give up a salary for an uncertain amount of money at some uncertain date. I have never found anyone who could pass that test.

Does the tax fall mainly on owners of labor or on owners of capital? I argue that it falls mainly on labor, quoting Joe Stiglitz to that effect, a member of the President's Council of Economic Advisors.

Does the capital gains tax raise any revenue over time when you consider the impact on the economy and the impact on other taxes such as the corporate tax? I argue that it probably does not raise any revenue at all. And, because of these reasons, I come to the conclusion that it is a pretty indefensible tax and that the ideal rate we ought to be shooting for is zero. We can then talk about what we do from there, short of perfection .

Income tax is inherently biased against savings, unless we either deduct the amount saved, as we do with IRAs, or we deduct the amount that is earned on those savings, as we do with municipal bonds. But, for a wide variety of assets we do neither, and that is a double tax on savings.

As I am sure you have heard before, the trouble with the capital gains tax is it is a third, or triple layer, of taxation on the same earning stream. Because the value of the asset—stock or real estate—is a discounted present value of the future earnings of that asset, those earnings will later be taxed when earned. All you can do by double taxing the appreciation that is capitalized in the price is to drop that price, reduce the demand for the asset, depress equity values, depress real estate values. That has widespread implications. It raises, for example, debt/equity ratios, and contributed to the S&L crisis. So, zero is the ideal benchmark by which to judge lesser reforms. I spend the rest of the time doing that.

I go through some of the objections to indexing, contrasting the views of Joe Minarik of OMB with those of Treasury Undersecretary Leslie Samuels. Now, the Minarik objection is one we heard today from Mr. Cohen: that the Treasury, in effect, makes too much money from taxing nominal interest income. That is supposedly unfair; we ought to tax only real interest income.

Mr. Samuels, on the other hand, says the Treasury loses too much money from deducting nominal interest expense. Now, if you put those two arguments together you can make a very good argu-

ment for indexing both interest income and indexing also the deduction, but you cannot make a very good argument for indexing only one. And, if you are not indexing only one, then the whole story looks quite different, because you have to look at both the borrower and the lender.

The fact that the Treasury is not suggesting that we index both interest income and deductions shows that they do not really believe they lose any revenue from the failure to index. It also shows that the argument is probably insincere.

The example that is given in Mr. Samuels' Ways and Means testimony involves no real capital gains at all. Yet he argues that the taxpayer should pay a tax anyway because he borrowed the money to get no gain. It is not, however, possible to arbitrage between credit that does cost something and an asset that yields nothing, no real gain.

The loan, after all, is not interest free just because of the deduction, and real interest rates do not typically fall in inflation. The Federal Reserve has been known to push them up pretty high in an inflation. This is important because the example that Samuels puts forth does not specify what the interest is.

Mr. Schler's testimony has a better example and does specify the interest rate, but in his example the real interest is zero. That is where this alleged unfairness comes. It is pretty hard to find a lender who will loan you money at a zero real interest rate, particularly during an inflation, unless he gets caught by surprise. Yet in Mr. Schler's testimony, the nominal interest rate is 5%, inflation is 5%, so the real interest rate is zero.

Minarik has the right answer to this question about indexing of interest. He wrote that, "The markets offer higher interest rates to compensate lenders and penalize borrowers for the inexact taxation of the interest income and deductions of business interest expense."

That is, markets incorporate taxes and have a "tax premium," much as they incorporate inflation, and contain an inflation premium. This makes it, at least for U.S. levels of inflation, not a real problem. It also means that many of the alleged arbitrage opportunities do not exist, because the market makes sure they do not exist.

Let me give some textbook examples of tax arbitrage. I will argue that tax arbitrage becomes less advantageous with lower and/or indexed capital gains rather than more so.

First, one example, a common one: Borrow money, deduct the interest rate, and buy tax-free municipal bonds. Sounds good, but does not really work because the market, in fact, incorporates that borrowing advantage in the interest rates. But notice that this example has nothing to do with capital gains. It has to do with interest, with whether there is a profitable spread between the interest paid and received, after taxes.

A second example of tax arbitrage: Buying short the same stock or commodity and then realize whichever position goes down. That is, take the loss and ride with the gain. That is a hedge strategy. I do not know anyone who actually practices it, but academics talk about it.

But, this strategy has nothing to do with interest, capital gains or inflation. It would make just as much or as little sense whether

you were using cash or credit. You could go short and long on a security or asset either way.

A third example of tax arbitrage is the one that matters. Take out a really big mortgage on your principle residence. That is a genuine, big tax avoidance strategy. But I would argue that if we were to treat capital gains on other assets nearly as nicely as we do on homes, then what we would be doing would be leveling the playing field and making this form of tax arbitrage much less attractive.

That is to say, less punitive taxation of capital gains on, say, equities or real estate, would narrow the advantage that is now given to homeowners—an advantage which is not unreasonable, by the way; rollover of capital gains makes a lot of sense).

Another objection that people fret about is converting income into capital gains. Take your money off the W-2 and get it onto Schedule D. Not easy to do. When you press them, the example they give is that corporations may cut dividends and retain more earnings.

That is, corporate savings goes up, or the stockholders will prefer growth stocks to dividend-paying blue chips, junk bonds and municipal bonds. I happen to think that is not so bad. But the story is wrong because it leaves out debt. The existing system is very biased in the other direction. In effect, it induces capital gains to be turned into income.

What kind of income? The income on junk bonds and municipal bonds, for example. The existing system induces corporations to raise debt/equity ratios because they can deduct the interest payments from their taxable profits.

It induces individuals to prefer the certainty of interest income now to the mere possibility of a capital gain somewhere down the road, since both are taxed at roughly the same rate. So, it is the existing system that is biased, not the removal of that system. A lower tax rate on real capital gains would make debt securities less attractive to both borrowers and lenders relative to equity.

Another example given of converting income to gains is "churning" of real estate, buying and selling buildings over and over again. That was a shelter problem before 1986, but it did not have anything to do with capital gains.

It had to do with the fact that we set up a depreciation system in 1981 that assumed a high rate of inflation. Inflation came down, the depreciation system became overly generous, and the write-offs were too fast.

Why does that have nothing to do with capital gains? Selling buildings more frequently does not ensure capital gains. If it was that easy to be rich, we would all be rich.

Then there are the simplicity arguments. Secretary Samuels spends a lot of ink on concern about "forcing" taxpayers to keep records. There is nothing in an indexing proposal that forces anyone to keep records. If someone decides not to take advantage of indexing, he would be free to do so.

So, if a taxpayer generally prefers the simplicity of paying taxes on a nominal, illusory, phony gain, he is free to do that. I think, as a matter of fact, most taxpayers with significant nominal gains, such as a farmer who has held on to his land for 29 years—the average), would welcome indexing quite a bit.

I do have one proposal in my testimony that would simplify the capital gains tax quite a bit and has other advantages. I suggested that instead of a 50 percent exclusion, we go to a 15 percent flat tax. The reason for that is, that if you have a graduated tax on capital gains, taxpayers have a very strong incentive to realize those gains in years in which they fall into lower tax brackets on their other income.

Many high-income taxpayers have highly variable income, they have considerable discretion about shifting income back and forth from years. We learned that in December of 1992 when a lot of people brought their income forward to avoid the 1993 tax increase. We are likely to have this kind of inter-temporal distortion with any graduated system of capital gains tax.

Finally, on the revenue estimates, I do not believe tax policy should be guided by revenue estimates in three areas in which static estimates are notoriously wrong for reasons that are well-known. The three areas are: capital gains tax, estate tax, and high marginal tax rates on second earners. Economics knows perfectly well that there is a strong taxpayer response in these cases that is not taken into account in the revenue estimates.

The best example is the 1986 Congressional Budget Office estimates on capital gains that were supposed to be coming in and never did. They were twice as high as realizations that have actually occurred, an error of about $100 billion a year.

And the CBO, in 1993, then reduced its estimates of future income tax revenues by as much as 1 percent of GDP forever, sort of acknowledging the error. They said that half of that mistake was capital gains. Well, a half a percent of GDP is $35 billion now, and more later. That is a pretty big error.

I am not faulting the CBO with a method that is common to all of the revenue estimating procedures. They all assume that growth is given, that is to say, no policy has any effect whatsoever on economic progress. And they also assume absolutely no tax evasion, no effort to avoid the tax. Those are not, for this particular tax, relevant assumptions.

There is no more reason to take the 1995 Treasury estimates of the revenue loss from a lower tax—or from indexing the capital gains tax—any more seriously than we should have taken the 1986 CBO estimates of the big revenue gains from a higher tax.

The CHAIRMAN. I have got to ask you to wind down, Mr. Reynolds, if you would.

Mr. REYNOLDS. Yes. All right. I am sorry.

Anyway, I believe, in summary, that is time for good policy to take precedence over bad estimates.

The CHAIRMAN. Lastly, we will have Mr. Michael Schler, who is a member of the executive committee, and he is former Chair of the New York State Bar Association Tax Section. And I might say, Mr. Schler, one of your predecessors that was invited here by Senator Moynihan in 1985 first introduced us to the problem of passive losses. We took care of a fair portion of that in the 1986 Tax Reform Bill, thanks to your Tax Section.

[The prepared statement of Mr. Reynolds appears in the appendix.]

STATEMENT OF MICHAEL L. SCHLER, MEMBER OF THE EXECUTIVE COMMITTEE, AND FORMER CHAIR OF THE NEW YORK STATE BAR ASSOCIATION TAX SECTION, NEW YORK, NY

Mr. SCHLER. Thank you very much. My name is Michael Schler. The New York State Bar Tax Section is dedicated to furthering the public interest in a fair and equitable tax system, and to the development of sound tax policy.

We strongly oppose indexing because it will vastly increase the complexity of the tax system and will lead to the return of the tax shelter days of the 1980's. But, before expanding on these reasons, I would like to emphasize several points.

First, we are a completely nonpartisan organization. Our strong opposition to indexing is essentially the unanimous view of all the members of our executive committee, Republican as well as Democrat.

Second, our strong opposition to indexing is longstanding. We wrote to Chairman Rostenkowski in 1990 strongly opposing indexing and our extensive report from 1990 is included with my statement.

Finally, we do recognize the theoretical correctness of indexing. If you buy an asset with your own money for $100 and later sell it for $150 after there has been 50 percent inflation, you have no real gain and, in a perfect world, you would not have to pay any tax.

However, I want to emphasize today two very fundamental practical problems with indexing. These problems, we believe, far outweigh any theoretical perfection that might arise from indexing.

The first problem is complexity. The Internal Revenue Code today is already so complex it is near the breaking point. Much of the complexity arises from Congress, as well as the regulation writers, trying to achieve perfection.

We believe that down in the trenches where real people make honest efforts to comply with the tax laws, indexing will vastly increase the burden and complexity for everyone. This includes individuals, businesses of all sizes, and the IRS.

Activities that are relatively simple today will involve massive calculations under indexing: buying and improving a home, buying and selling stock, or buying an interest in a mutual fund. You could not invest in a simple dividend reinvestment plan without an accountant. I do not know what they do in the U.K.

Everyone who collects stamps or baseball cards will be required to keep permanent records, not only of each purchase price, but also of the calendar quarter in which each stamp or card was acquired. If you ever want to sell a stamp, you will need to consult your accountant. And, for most individuals, accountant's fees are not even deductible.

If this is not bad enough, a State might choose not to allow indexing for revenue reasons. Everyone in that State would then be required to keep two sets of books, even for the baseball cards. Individual taxpayers are likely to be dumbfounded at this prospect. I suppose Congress could require the States to permit indexing, although that would probably be an unfunded mandate.

I could go on, but I want to talk about tax shelters. Every experienced tax lawyer who reads the indexing provisions of H.R. 9 im-

mediately dreams up half a dozen ways to beat the system and create a tax shelter that eliminates tax on unrelated income.

Some of the most obvious opportunities arise from the fact that assets are indexed, while liabilities are not. Totally artificial tax deductions can be created with little or no out of pocket investment by borrowing and using the proceeds to buy indexed assets.

I used the simplest possible example which Mr. Reynolds does not like because of some of the assumptions, but I will claim that the same principle applies to any example that you might choose.

Suppose you borrow $100, buy a share of stock for $100, and then sell the stock after 2 years for $110 after there has been 10 percent inflation. Also assume the interest rate on the loan is 5 percent a year, or $10 for 2 years, and the stock does not pay dividends.

Then when you sell the stock for $110, you have just enough money to pay off the principal of the loan, which was $100, as well as 2 years' worth of interest, which was five dollars a year for 2 years, or $10.

So, you start off borrowing all your money, you buy the stock, you end up with $110, you pay the principal and interest on the loan, and that is the end of the deal.

So, you start with no cash investment, you break even, and you end with no cash. But, when you figure your taxes, your tax basis in the stock went from $100 to $110 because of inflation, so you have no taxable gain on the stock, but you still get to deduct $10 of interest on the loan.

So, you end up with a net tax deduction of $10 on an investment that broke even, and that $10 deduction can be used to completely shelter unrelated income. Now, that is just a classic tax shelter. There are many other ways that you could achieve similar results, but I do not really have time to get into all of them.

Now, we also believe that no matter how much effort is put into trying to prevent tax shelters from arising as a result of indexing, the effort is doomed to failure. All it will do is make life more difficult for the honest taxpayer trying to properly report income and create more work for lawyers, as well as accountants.

Now, the tax shelter problem is not the fault of the excellent and dedicated legislative tax staffs. Rather, the problem is inherent in indexing because of the system where you can sell an asset at a cash profit and not pay tax on the gain, or sell it at your original cost and realize a tax loss.

The problem is similar to the problem of the manager of a computer system trying to keep out the hackers. You spend a lot of time and effort and set up all your defenses, but once your defenses are in place you are essentially a sitting duck while hundreds or thousands of very smart hackers probe your defenses for weaknesses.

Eventually they will find your weak spot and exploit it to the fullest. The worst thing is, in many cases you will not know your system is compromised until the revenues mysteriously start declining.

I would like to, very briefly, mention a few other problems with indexing. If only certain types of assets are indexed—for example, H.R. 9 limits indexing to stock and tangible assets, but not intangi-

bles such as patents—then economic inefficiencies are created because returns on different assets are taxed at different rates.

Also, because indexing under H.R. 9 is based on the number of calendar quarters you hold an asset, buyers will want to buy assets before the end of a quarter and sellers will want to sell after the end of a quarter. What will happen to the stock market at the end of each quarter?

Finally, suppose indexing is adopted and after a few years most people want to repeal it, for whatever reason. At that point, the tax basis in all indexed assets has gone up by a few years' worth of indexing.

Do you take away that basis? Is that a retroactive tax increase? Or do you let people keep that basis, which means that 30 years from now someone selling an asset has to determine whether it was owned during 1995 and, if so, whether it met the 1995 requirements for indexing? This gives a flavor of the problems indexing will create.

I should also point out that, in testifying before the House Ways and Means Committee, the AICPA, which represents 300,000 some odd accountants who will actually be doing the tax returns, opposed indexing on the grounds that it will be incomprehensible to the average taxpayer, and they are the people who actually have to do all the calculations.

So what I really believe is that the tax law will never be perfect, and the whole Code is a compromise between accuracy and administrability. We believe that indexing is one situation where all attempts at theoretical accuracy should be sacrificed for administrability.

Thank you.

[The prepared statement of Mr. Schler appears in the appendix.]

The CHAIRMAN. Thank you very much.

Mr. Dent, I think I understood all of your words today.

Mr. DENT. Thank you.

The CHAIRMAN. Because my Chief of Staff is a woman who is English from Blackpool.

Mr. DENT. Oh, yes.

The CHAIRMAN. And she talks like you. So, when you use an expression like, "had to be put right later," I have heard her say the same thing.

Mr. DENT. Maybe that is because my own grandmother and mother come from Blackpool.

The CHAIRMAN. Is that right?

Mr. DENT. Yes. Yes.

The CHAIRMAN. Well, give me their names before you are done and I will see if they know each other.

The one thing that you did not conclude was, what would be your advice to us? We have not yet indexed the Tax Code. It seems to me you have made it somewhat simpler in the United Kingdom by exempting a fair number of items that are not covered at all, and so for the average person they probably never approach this problem.

Would your advice be to us to adopt indexing, assuming we can make it as simple as it can be made, realizing that it can never be made totally simple, or would you not advise us to do it?

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Mr. DENT. Well, that is very much a key question. I personally do not know enough about the U.S. system to advise as to whether it would easily be capable of being slotted into place on top of the existing system.

What I would say is, from the U.K.'s experience of it, particularly given that we do have a lot of exemptions for individuals, the system has worked really quite smoothly. There have been changes which have caused problems, but they have mainly affected complex shareholdings, which will include mutual funds, I agree, and also abuse.

But, in general terms, for the majority of transactions, like a simple purchase and sale of an asset, indexation really has not been that complex. Indexation tables are even published in the Saturday newspapers, for example. So, it has worked fairly smoothly in practice.

The CHAIRMAN. A second question. You said one of the reasons the system has probably not been abused is that you cannot deduct investment interest expense. You can here. If we do not change that—and Senator Bradley has posed this question several times—does it lend itself to abuse?

Mr. DENT. I certainly understand the arithmetic of the arbitrage opportunities which have been talked about. What I would say is, that these are all based on the assumption that the investment rises at least as much as inflation. If you have an investment which rises by less than inflation you run the risk of ending up with a real loss and no tax deduction to match.

The CHAIRMAN. I heard what you said, but does that answer the question about the possibility of abuse, in terms of setting up shelters, if we are going to allow the deduction of interest expense?

Mr. DENT. There would be the possibility of abuse, yes. Yes. I would have to concede that that is technically possible. Yes. Having said that, I do not believe that that particular abuse has gone on on a wide scale in the U.K.

The CHAIRMAN. Mr. Cohen, what do you think?

Mr. COHEN. Well, I join with my good friend, Mr. Schler, in opposing the enactment of indexing, at least as a part of our present income tax system. I think it would be terribly complex.

The CHAIRMAN. I want to know what would happen if we index capital gains but we do not index interest expense. Does it lend itself to shelters?

Mr. COHEN. Oh, yes. I think that the indexing proposal is so complicated it is likely to lend itself to abuse that we will not be able to cope with by changing the statute and by myriads of anti-abuse regulations. I do not think it makes any difference whether you deduct interest, it only affects the magnitude of the problems.

The CHAIRMAN. Mr. Schler, what do you think?

Mr. SCHLER. I would bet that in the U.K. the tax lawyers and investment bankers are not nearly as creative as they are in the U.S. in finding ways to abuse systems like this, where you can sell for the same price and get a tax loss, or sell for more and not recognize income. So I would think, yes, there is great opportunity for abuse.

Senator MOYNIHAN. Mr. Schler, there is no need to insult our British cousins.

Mr. SCHLER. It was a compliment.

The CHAIRMAN. I think what he said is they are not as devious as we are.

Mr. DENT. I think we can be pretty devious, actually.

The CHAIRMAN. Mr. Reynolds, if I understand your testimony correctly, you are not too much worried about the failure to index the interest expense because you think the rate will change on debt to accommodate to that. Do I correctly understand you?

Mr. REYNOLDS. Yes, that is right. If we assume that the interest rate does not accommodate to inflation—which no economist assumes, but apparently a lot of lawyers do—and if we assume that the interest rate cannot accommodate to the excessive taxation of savers, then you get the tax shelter opportunity.

Unfortunately, those two assumptions are empirically and theoretically false. I have yet to see an example of this "abuse" that makes any sense, not even a hypothetical example. That is why I went through three or four tax arbitrage situations to show that they do not involve interest abuse of that sort.

The CHAIRMAN. Thank you.

Senator Graham, and then Senator Simpson.

Senator GRAHAM. Thank you, Mr. Chairman.

The Joint Committee on Taxation has estimated the revenue loss of indexing a basis of certain assets for purposes of determining gain or loss. It is not clear as to just what assets were considered in this evaluation, but I assume they were the assets that are in this proposal.

They estimate the revenue loss at $11.2 billion between 1995 and 2000, and between 1995 and the year 2005 at $45.2 billion. Do those numbers strike you as being in the range of accuracy?

Mr. SCHLER. Not being an economist, I have no idea.

Senator GRAHAM. Mr. Cohen?

Mr. COHEN. Senator, I am no economist either. I majored in economics a long time ago, but they have repealed all the economics I was taught. [Laughter.]

Mr. COHEN. But I would say it depends on the rate of inflation in the next 5–10 years, and I do not know what rate of inflation the Joint Committee revenue estimators assumed. Obviously, the greater the rate of inflation the more indexing is going to cost in revenue. The figures seem to me to be low, but that depends upon whether inflation is high or low.

Senator GRAHAM. There has been a suggestion of an alternative which has other objectives but would also achieve some of the same consequences of indexation, and that is to have the rate of capital gains tax be a function of holding period, that is, you would get a greater benefit for longevity of holding.

Do you have any comments as to that as an alternative approach to recognize the likely effect of long holding periods and the inflation associated with those periods of time on taxation of capital assets?

Mr. SCHLER. That would be somewhat simpler, although trying to keep track of holding periods, depending on how many different cut-offs you have, may not be that much better than trying to index which is based on holding periods also.

Just one thought occurred to me in response to your last question on the revenue estimates. I do not know how much tax shelter potential the Joint Committee took into account when they did their estimates. If they did not assume a fair amount of tax shelter activity I would guess that the revenue loss would be larger.

Senator GRAHAM. Mr. Reynolds, I would be interested in your comment as to a variation in the rate of taxation based on holding period as an alternative to indexation.

Mr. REYNOLDS. Yes. Once again, I do not think any economist is in favor of it, or at least I have never found one. The reason is, we do not want to lock people into investments, we want the maximum mobility and agility of capital we can achieve.

This kind of thing bribes you to hold assets longer. But there is already a tax advantage to deferral; the longer you wait, you enjoy the time value of money not paid in taxes. There is no particular reason for enhancing that time advantage of postponing the tax. There is no reason in economics for giving anyone a tax incentive to hold an asset one minute longer than he finds optimal.

Senator GRAHAM. Well, this raises issues which are other than the questions of indexation, but there is a school of thought that says we should be encouraging people to think about the economic benefits of investment over a 10- or 20-year period as opposed to the next 60 days, and that one of the ways of getting that kind of inducement is to have the tax law provide additional benefits for those elongated holding periods.

Mr. REYNOLDS. I am aware of the argument, but the "patient capital" argument confuses who happens to own title of a piece of property with the investment horizon of the investor. To give me a tax advantage for holding a stock for 5 years is only going to make me pick the safest stock I can possibly find, because a risky stock will go up and down over that 5-year hold. I just think it is fundamentally misconceived, and, again, I think most economists would agree.

Mr. DENT. If I could comment with a general observation. The approach which you talked about, Senator Graham, is actually one which is followed quite a lot on continental Europe where personal investments tend to be free of all capital gains tax, real estate, stocks, et cetera, if you hold for a particular time. Clearly, that varies from country to country, but, as a general rule, that is the way it tends to be done.

Senator GRAHAM. I have suggested that as one alternative means of achieving the objective of an indexation system, but with possibly somewhat less complexity.

Are there any other alternatives that you might suggest that would move towards the goals that are sought to be accomplished, but in a less administratively complex manner? And my time expired as I was asking the question, so I will withhold that question until the next round.

The CHAIRMAN. I might suggest this. We have a vote that is just about half-way through now. Alan, you are welcome to stay and ask questions if you want to miss the vote. [Laughter.]

Senator SIMPSON. Well, I can take a few minutes.

The CHAIRMAN. You can take two minutes. And I have asked Senator Moynihan just to start the committee again when he gets

back. We will have further questions, so if you would wait while we vote, we would appreciate it.

It is all yours, Alan.

Senator SIMPSON. Thank you, Mr. Chairman.

A very impressive panel. I have enjoyed hearing your remarks. This is my initial venture on this committee. I have not served here before, I had no desire to serve here.

I served on the Bipartisan Commission on Entitlements and Tax Reform, and I felt it important to bring whatever we learned there and what the President did not even use in his budget report, not one shred thereof, to at least bring it here for the national debate because of the situation with regard to Social Security, Medicare, Medicaid, the interest from the national debt, and Federal retirement, which are just eating our lunch. Thus, my presence, because tax law was not my bag.

Although I think I would have enjoyed being a student with Mr. Cohen. I think that good humor of his would be a delight because tax law—the Professor E. George Rudolph, as he taught tax law, came to me at the end of the semester and he said, I am very disappointed in your work. I thought, uh-oh, here it comes, the big "F." [Laughter.]

We were scoring it in those days, "As," "Bs," "Cs," "Ds," "Es," and "F." So, I was shuddering. He said, I am going to have to give you a "C." I said, go ahead. [Laughter.]

I was never more delighted in my whole life in law school. So, it is obviously complex. All of you have talked about the complexity of indexing.

But my question is, in your opinion, which proposal, if either, will give us the most bang for our money in terms of increasing the national savings rate? And we have heard testimony yesterday that really nothing we would do may increase that.

For increasing the national savings rate, which might be best, the indexing proposal or a cut in the capital gains tax? Yes?

Mr. REYNOLDS. A cut in the capital gains tax. And also in terms of revenue effectiveness. Even though I am here defending indexing, your question is posed quite specifically. I think that a lower rate is probably more potent per dollar.

Indexing is particularly beneficial for very long-term assets like real estate, farmland. But, in terms of most people's time horizon, which does not tend to go to 30–40 years, I think you get quite a big of bang for the buck and little or no revenue loss with my proposal—a 15 percent flat tax on capital gains.

Mr. COHEN. If this is just a multiple choice with no comments——

Senator SIMPSON. That is right.

Mr. COHEN [continuing]. I would say reduce the capital gains tax, forget about indexing.

Senator SIMPSON. Do you have a thought on that, Mr. Dent and Mr. Schler?

Mr. DENT. In the U.K. we have tended to encourage personal investment by not only granting capital gains tax relief, but also relief on the income from personal investments, but, again, subject to caps.

Mr. SCHLER. We take no position on reducing the rate, but I think if we had to choose between the rate and the indexing we would certainly pick the rate.

Senator SIMPSON. As you know, the Senate did not adopt the so called Contract With America proposal. There are many things in there we are working on and will work on. But the House's version of that did not seem to benefit the more risk-averse taxpayers, those who investment in a more risk-averse way, who own investments such as savings bonds, some of you discussed that, or bank savings accounts.

While it does benefit the risk-takers who invest in stock and real estate, should we be ignoring those who are more involved in more risk-averse activity, and can anything be designed to take care of that difference? Yes. I have got to scram here in a minute.

Mr. REYNOLDS. Sure. Repeal the 1993 increases in marginal tax rates—all brackets above 28 or 32 percent.

Senator SIMPSON. Short answer. Just go right on down the table. Mr. Schler?

Mr. SCHLER. And if you are going to index debt when it is held as an asset, you are really getting into enormous complexities, because then you have to index all debt when it is held as a liability.

So, banks would lose part of their interest deduction and corporations, if they borrow, no matter what they do with the money, they lose part of their interest deduction. And all lenders, even people who buy Treasuries, would have less interest income. It becomes more like a municipal bond. Then you are really substantially changing the entire tax system if all debt is indexed on both sides.

Senator SIMPSON. I have about seven and a half minutes, so I must go.

Mr. DENT. We found in the U.K. that it was the indexation of debt that placed the greatest opportunities for abuse.

Mr. COHEN. The main dilemma, in my way of thinking about it, is the failure in the current proposals to index debt, either for the borrower or for the lender. If we do try to index debt, it is unbelievably complicated. That is why it has not been done in any of the proposals that are pending before you, and they are defective because of the failure to index debt to the borrower and the lender.

Senator SIMPSON. I thank you very much. We will have a recess now until either Senator Moynihan or Senator Packwood return. Thank you very much.

[Whereupon, at 10:44 a.m., the hearing was recessed.]

[AFTER RECESS—10:45 A.M.]

Senator MOYNIHAN. If it is convenient for our witnesses, I would like to keep the questioning going until there are other Senators who might have questions who have returned. We are having a vote on a cloture motion, and there will be another 10 minutes before we can make sure that everyone has returned who was meaning to do.

I would like to ask a question of Mr. Dent, prompted by the Chairman's remarks about our distinguished Chief of Staff. This has nothing to do with anything we are doing here.

I was in Britain after World War II and the British Labor Party was immensely impressed by the fact that they had imposed an in-

come tax of 19 shillings sixpence on the pound in income, and they had thought that was a sure route to social equality, but they had failed to tax capital gains. Is that the case; do you remember the history of things?

Mr. DENT. That is broadly correct, yes. Capital gains tax was then introduced in 1965.

Senator MOYNIHAN. Not until 1965.

Mr. DENT. That is correct, yes.

Senator MOYNIHAN. Twenty years after we——

Mr. DENT. That is correct. And there was still a significant difference between the capital gains tax rate of 30 percent and the highest rates of tax on investment income which were 98 pence in the pound at one point, which is about the same as 19 shillings and sixpence. It was really not until the Conservative government——

Senator MOYNIHAN. That was by the time you had a 100-pence pound.

Mr. DENT. Yes.

Senator MOYNIHAN. Yes.

Mr. DENT. It was really when the Conservative government came in in the 1980's that rates started to come down, and we now have a maximum rate of 40 percent, which is harmonized for capital gains and income.

Senator MOYNIHAN. It is harmonized.

Mr. DENT. It is now, yes.

Senator MOYNIHAN. Commissioner, did you want to say something?

Mr. COHEN. It has been my experience, Senator, that through most of Europe, down at least until 1965 when there was a change in the government in London, taxpayers and tax administrators alike thought that capital gains were capital and not subject to income tax.

Senator MOYNIHAN. That is a nice way to phrase it.

Mr. COHEN. It was simple. They were born to believe that. Then I think the political atmosphere changed and at the time I was asked, when I was practicing law in New York, to go to London and give two lectures about the capital gains system as it operated in the United States, because they were looking forward to the introduction of some form of capital gains taxation.

Senator MOYNIHAN. So you are the one who did in the British aristocracy. [Laughter.]

Mr. COHEN. Well, among those who were in attendance at this lecture was a person I did not know of at the time, one Margaret Thatcher.

Senator MOYNIHAN. It was regarded as capital, per se, not income.

Mr. DENT. That is correct, yes. And that is a view which is still followed, as I mentioned earlier in much of continental Europe, where only short-term speculative gains are taxable.

Mr. COHEN. I think it was also true in France until some 15-20 years ago when they found that one of the top figures in the French Government had made a very large amount of money out of a capital gain which went untaxed.

Mr. REYNOLDS. And even now the French rate is 16 percent at the top.

Senator MOYNIHAN. And that was what, Mr. Reynolds?
Mr. REYNOLDS. And even now the French capital gains tax rate is 16 percent. When they have tried to raise it the Communist Party of France raised very strenuous objections.
Senator MOYNIHAN. Which was because they had a vested interest in maintaining the class system.
Mr. REYNOLDS. Farmers and small shopkeepers.
Senator MOYNIHAN. Farmers and small shopkeepers. That is too simple. They had a vested interest in the class system.
Mr. REYNOLDS. And also probably they had a lot of stocks and bonds, too.
Senator MOYNIHAN. They had a lot of stocks and bonds.
Mr. Schler?
Mr. SCHLER. Yes. I would just point out that the lower the capital gains rate compared to the ordinary income rate, even aside from indexing, the more pressure there is on tax shelters and converting ordinary income into capital gain also, as we know from the past.
Senator MOYNIHAN. As the work that Donald Shapiro helped us understand in 1986, your predecessor.
Mr. SCHLER. That is right. That related to the passive loss rules. The kind of tax shelters we are talking about here really are not picked up by that because the passive loss rules relate to business income like leasing and real estate. The kind of tax shelters that would be created here are more investment income and expense type tax shelters, which are totally unaffected by the passive loss rules.
Senator MOYNIHAN. Yes. But that is an interesting thing. It has always seemed to me that the absence of capital gains, not that I understood it particularly well—but the British thought that they would equalize the society by equalizing income, which they, in a certain senses, had at 19 shillings sixpence a pound. But the Duke of Westminster still owned the Mayfair.
Mr. DENT. That is true.
Senator MOYNIHAN. And, in the end, things were not that much different.
Mr. COHEN. But there are some major differences in the British system from our own, particularly with respect to capital gains. As Mr. Dent said earlier, if I understand it, the British exempt the first $9,000 in American dollars of capital gains. I believe that when the system was put into effect in the early 1980's they forgave all appreciation in assets that had occurred down till that time.
Senator MOYNIHAN. Until that point. Yes.
Mr. COHEN. They adopted what we did in March 1, 1913 when we instituted the Federal income tax. Everything was revalued as of March 1, 1913. Well, I am sure that the Congress is not going to revalue everything and start afresh on January 1, 1995 or 1996 and forgive all the capital gains taxes based on gains that had accrued prior to that date.
Senator MOYNIHAN. That is a fascinating point, but I would beg you not to be sure of anything this Congress might do.
Mr. COHEN. Senator, I stand corrected.
Senator MOYNIHAN. Thank you, Commissioner.

Mr. Chairman, I was just mentioning that in 1945 the British Labor Party came into power and imposed a 19 shillings sixpence income tax. The highest rate was 19 shillings sixpence on the pound, but there was no capital gains tax.

So, the Duke of Westminster, poor man, had to watch his fences, but he still owned the Mayfair. And Mr. Cohen says he was invited to lecture in London on the capital gains tax. Little did he know, but a lady in the audience was Margaret Thatcher. It is only very recently that Europeans have begun taxing capital gains, and always with a certain forgiveness to begin with.

Could I just ask, and then I will turn it back over to the Chairman, do you notice a change in savings rates that you might attribute to that behavior, that regime?

Mr. DENT. I would not say there has been any direct impact as a result of the tax hedges you have talked about, but in the last few years the U.K. has made significant efforts to encourage personal savings through a whole host of different incentive arrangements, many of which do have tax benefits in them.

Senator MOYNIHAN. Secretary Cohen, you are an internationalist in these regards.

Mr. COHEN. Well, I am no expert on whether capital gains taxes cause a reduction in the savings rate. One of the questions asked earlier was, if we had a choice between indexing or a reduction in the capital gains rate, which would be better for the economy.

I think that certainly Mr. Schler and I, the two lawyers on the panel, would unhesitatingly go for the simplified manner of simply reducing the capital gains tax rate rather than to go into the complexities of indexing.

Senator MOYNIHAN. Thank you very much, sir, Mr. Secretary, gentlemen. Thank you, Mr. Chairman.

The CHAIRMAN. Professor Cohen, Treasury 1, had indexing in it for both debt and equity, and then Treasury 2 dropped it. Were you at all privy to their thinking or what was going on back then?

Mr. COHEN. I do not know, Senator. This is the dilemma, whether you should index debt or not index debt. And it affects both the borrower and the lender. If you do not index debt, you have the problems that I indicated today.

The borrower is going to get the benefit of his inflation adjustment not only on his own money that he puts out, but the money he borrowed, although he can pay that money back at maturity without any inflation adjustment at all.

The person who loses because of inflation is the lender. The lender, under what is currently proposed, is not getting an inflation adjustment; his inflation adjustment redounds to the benefit of the borrower. I think that is just simply cockeyed. You should not do this or you will find that people will be back on your doorstep saying, this is just wrong, you have got to change it.

If you do index the debt, as the Treasury attempted to do in the Treasury proposal—I mentioned this to my class at Virginia of 100 bright students and they had so many questions about how this would work, we spent four days on it.

I paced up and down for two afternoons and dictated a 35-page memorandum of problems with indexing debt and I sent it around to a small number of people in and out of government. The Treas-

ury withdrew the proposal to index debt in its final recommendation, and I do not know whether or not my memorandum had any effect on it or whether, as I think is more likely, they realized the problem themselves.

The CHAIRMAN. Mr. Dent, what was it you said is printed in the papers on Saturday, an index?

Mr. DENT. Yes. Each month our indexation factor is updated, whereas the U.S. proposal has a quarterly index. We have a different factor each month and it is published in the Saturday newspapers. A lot of individuals readily understand how to do it.

The CHAIRMAN. You can look at it like the lottery numbers.

Mr. DENT. Yes. It is based on the Retail Price Index.

The CHAIRMAN. All right.

Mr. DENT. But the Revenue produce a simple table which just has the months of acquisition and disposal, so you just look the factor up rather than have to work it out from the indices themselves.

Mr. COHEN. In my written statement, Mr. Chairman, I suggest to you that you ask the IRS to give you a mock-up of what the income tax form would look like in the year 2000, and the year 2005, and so on, if you adopted indexing and if they gave instructions to the individuals about all the inflation adjustments.

I think you would find that there are so many inflation adjustments that this would be a constantly expanding book. I think you ought to see yourself what the taxpayers would be confronted with if they had to live under that system.

The CHAIRMAN. Senator D'Amato, any questions for this panel?

Senator D'AMATO. Mr. Chairman, I have no questions.

The CHAIRMAN. Do you have any more, Pat?

Senator MOYNIHAN. No, sir.

The CHAIRMAN. Gentlemen, I think we are done. Mr. Dent, why do you not give me the names of your grandparents and I will check and see if my chief of staff knows them.

Thank you very much for coming. We appreciate it.

[Whereupon, at 10:59 a.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED

PREPARED STATEMENT OF EDWIN S. COHEN

My name is Edwin S. Cohen. I am Joseph M. Hartfield Professor Emeritus at the University of Virginia Law School. Last semester I was brought back to teach again at Virginia, and currently I am a visiting professor at the University of Miami Law School. I am also Senior Counsel to the law firm of Covington & Burling, Washington, D.C.[1] From 1969 to 1972 I was Assistant Secretary of the Treasury for Tax Policy and from 1972 to 1973 Under Secretary of the Treasury.

My concerns about the feasibility of indexing for inflation were kindled when in late 1984 the Treasury incorporated such a proposal in its tentative tax reform recommendations to President Reagan. Shortly afterwards I mentioned the indexing proposal to my class of some 100 students at Virginia, and, as bright student will do, they raised so many interesting questions that we spent four classes discussing it. Subsequently I paced up and down in my office for two afternoons dictating a long memorandum summarizing unanswered problems about the Treasury's tentative indexing proposal. I sent the memorandum to several persons in and out of government. The Treasury on its own recognized there were serious problems and substantially revised its final recommendations.

Some five years later, when in the Bush administration the treatment of capital gains again became a prominent issue, the indexing proposal resurfaced. About that time I was invited to give a luncheon speech to the New York State Bar Association Section of Taxation. In that speech I noted some of the major problems with fitting indexing into our income tax system and urged the Section to study the matter and issue a report. The following year they did so in considerable depth, pointing out numerous complexities, inconsistencies and vagueness in the pending indexing legislation and strongly opposing its enactment.

Earlier this year, the New York State Bar Association Section of Taxation, of which my good friend, Mr. Schler, was the Chairman until his term expired last month, again opposed the enactment of indexing and renewed its objections. With the conclusions in those two reports I concur, as I stated recently in a lecture before the American College of Tax Counsel in Los Angeles.

The Dilemma About Indexing Debt. I think a major quandary with respect to indexing for inflation is whether or not to make an inflation adjustment with respect to indebtedness, such as savings accounts in banks or money market mutual funds, U.S. government obligations, and real estate mortgages. Most of the proposals for indexing would make inflation adjustment to the cost of common stock, real estate and some other assets, but not to indebtedness. That would mean that a person who puts her money in U.S. government bonds or in a bank savings account or a money market mutual fund would get no adjustment for inflation, but her neighbor who invests in real estate or common stocks would get the inflation adjustment and the resultant tax saving.

Inflation affects all of us as it occurs. If we are going to make an adjustment for the rising cost of meat and potatoes in determining investment profits and losses, we should do so alike for those who hold government bonds, real estate mortgages or savings accounts as well as for those who own real estate or common stocks. If this were not done, the holders of government bonds, mortgages and savings accounts would surely be back on your doorstep clamoring for similar relief.

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[1] To the best of my knowledge and recollection, I have not represented any client regarding inflation indexing for the past decade.

Why do most of the proposals ignore fixed investments in U.S. bonds, mortgages and savings accounts? Simply because, at least to date, no one has been able to overcome the complexities involved in designing for income tax purposes an acceptable method of applying inflation adjustments to indebtedness.

As an illustration, if one owns a U.S. bond or a savings account, an inflation adjustment to the cost of the bond would merely produce a loss at its maturity or earlier sale. The proper answer should be an adjustment to the amount of interest income the individual receives during her period of ownership. The difficulty of designing that adjustment was one of the chief reasons for the Treasury's withdrawal of its proposal a decade ago. And a House committee report in 1989 confessed that the complexity involved in indexing debt was responsible for confining indexing to common stocks and real estate.

Investing Borrowed Money. One of the puzzling matters in the indexing proposal stems from the fact that a half century ago the Supreme Court decided that a person who owns real estate that is encumbered by a mortgage includes in his cost for the property not only the money he puts up out of his own funds but also the amount of any mortgage on the property. And this is true even though the owner of the property has no personal liability to pay off the mortgage debt—a so-called non-recourse debt that caused so much trouble for the S & L's.

As a simple illustration, suppose Mr. Green undertakes to buy Greenacres for $100,000 and puts up $20,000 in cash. The $80,000 remaining balance of the $100,000 purchase price is financed by a mortgage. For income tax purposes Mr. Green's cost for Greenacres is $100,000. If inflation for the next five years amounts to 20 percent, the indexing proposal would increase his cost to $120,000, and he would have no tax to pay if he then sold Greenacres for $120,000. But look at the result: after paying off the $80,000 mortgage, Mr. Green would have $40,000 left in cash, which is twice the $20,000 he invested—a 100 percent profit but no tax to pay because of the 20 percent inflation adjustment.

What's wrong with' this result? While inflation is damaging to the owners of property, because the price of meat and potatoes has risen, debtors actually gain from inflation because they can pay off the debt at maturity with dollars that have less purchasing power than at the time the money was borrowed. The inflation adjustment for the cost of Greenacres should be offset by Mr. Green's gain from inflation with respect to his mortgage debt. Mr. Green should have a 20 percent inflation adjustment applied only to the excess of the $100,000 cost of Greenacres over the $80,000 mortgage debt. If this were done, the 20 percent indexing adjustment, applied only to a net of $20,000, would amount to $4,000, leaving him with a taxable gain of $16,000.

But if one were to index Mr. Green's mortgage debt as well as his $100,000 cost for Greenacres, there would be host of other problems. The principal amount of the mortgage debt might be reduced periodically or even increased before he sold the property, or might be replaced by other debt. There would be further, seemingly endless, complex issues in the income tax treatment of the mortgage lender, who suffered from inflation.

For example, should we somehow reduce the income tax burden of the mortgage lender when the mortgage is paid off in the year 2000, because the payment is worth less in view of inflation? Or if Mr. Green paid $6400 annual interest at 8% on the $80,000 mortgage between 1995 and the year 2000, and inflation amounted to 4 percent a year, should the mortgage lender have been taxed on only half of the interest he received because the rest was offset by inflation? And if so, should Mr. Green's income tax deductions for his interest payments of $6400 have been cut in half? Homeowners with mortgage obligations might well be concerned if their income tax deductions for home mortgage interest payments were reduced because of indexing for inflation.

Potential Manipulations or "Arbitrage." The amount of inflation adjustment generally is said to be measured by the extent of inflation from the start to the close of what is known as the "holding period" for the asset. Generally under existing law the length of the holding period is immaterial after it passes one year. But with indexing one would have to know the holding period for as long as ten, twenty or fifty years, creating problems that do not now exist. As the Bar Association notes, the holding period could be easily manipulated by taxpayers and their advisors according to the terms of the contract between buyer and seller. In truth, indexing should be allocated between buyer and seller by asking who is bearing the risk of inflation, and for what length of time, not by reference to technical provisions of the contract. But with so many different types of possible contractual arrangements, it would be extremely difficult to draw and administer the appropriate rules as to who is really bearing the risk of inflation, and how long. I think you should be aware of the opportunities for manipulation, and the likelihood that books would be written about

techniques for minimizing taxes by taking advantage of the indexing provisions. The New York bar report calls attention to a number of those potential issues.

Difficulties of Administration. I think indexing under any of the current proposals of which I am aware would be complicated and costly both for taxpayers and the IRS. Consider the simple case of a person who buys a small amount of stock in a listed company and joins one of the popular dividend reinvestment programs offered by such companies in which quarterly dividends are applied four times a year to purchase for the shareholder additional shares or fractions of shares. After 10 years the investor sells all the shares owned by her or him in the Company. There will be 37 different inflation adjustments to be applied to the 37 different purchases to determine the gain or loss on the sale of all the shares.

I suggest that if you seriously consider the possibility of enactment, you should ask the IRS to prepare for you mock-ups of federal income tax returns as they would exist after ten years in the year 2005 and after 20 years in 2015, together with the instructions to accompany the returns and the data by which taxpayers could ascertain the inflation percentage for each holding period over the intervening years. I think you would find it quite complex, and especially so if we indexed debt. Perhaps the increasing use of computers would in time lessen the difficulties, but for those who have been unable to master VCR's this might well be a daunting task.

In short, Mr. Chairman, I think that taking inflation into account in calculating a taxpayer's net taxable income is so fraught with complexities and ramifications that no feasible plan for doing so has yet been developed, if ever it could be done without major structural revision of our income tax system.

THE PENDING PROPOSAL TO INDEX CAPITAL GAINS

by Edwin S. Cohen

Set forth below are the remarks of Edwin S. Cohen at a September 23, 1989 luncheon meeting of the New York State Bar Association Section of Taxation in Hamilton, Bermuda.

Cohen suggests that the indexing provisions of the pending capital gains tax legislation present practical problems that have not been sufficiently discussed. He provides illustrations of some of these problems and calls on the tax bar to express concern and work toward solutions.

Edwin S. Cohen is senior counsel at the firm of Covington & Burling, Washington, D.C. He taught tax law at the University of Virginia law school for many years and served as Assistant Secretary of the Treasury for Tax Policy from 1969 to 1972 and as Under Secretary of the Treasury from 1972 to 1973.

I am honored to have the opportunity to speak with you today on this beautiful island. This marks the third time I have had the pleasure of speaking before you. I am grateful, for even my family protests my speaking a third time.

On the first occasion that I appeared before you, when I was at Treasury almost a score of years ago, I was cautioned to complete my remarks by a specified time, but your then-chairman, whose identity I fortunately do not recall, consumed most of the time allotted to me by reading verbatim his annual report to the Section. Too little time remained for me to put my foot in my mouth.

The second occasion was in 1981 when President Reagan had just taken office and had named Don Regan, previously the head of Merrill Lynch, as Secretary of the Treasury. I remember noting that Merrill Lynch had been featuring a TV commercial in which a bull wended his way carefully through a china shop, and I suggested that the commercial would stand him in good stead at Treasury. Unfortunately, commercials have a short life, and when he later moved to the White House, a lot of china was broken.

Your chairman, Bill Burke, I am happy to say, is a former student of mine, as was Roger Mentz, one of his predecessors. Bill has cautioned me to be brief, doubtless because he knows that, despite valiant efforts, I have never managed to finish a law course. But neither he nor Roger may be aware that after they graduated I called on a student one day to explain to the class a case that I had assigned for reading, only to have the student reply, "Mr. Cohen, you may not believe this, but I have fallen further behind in this course than you have." I fully expect that student to become President of the United States, or at least chairman of the Section of Taxation.

Now I would like to ask you to peer with me today into the muddy waters currently swirling around the capital gains tax struggle in Congress. I have no crystal ball to foretell the outcome, but I would like to call to the attention of this distinguished group of lawyers the serious problems that I think you would be grappling with if the pending proposal to index capital assets were to go into effect.

Indexing would apply generally to sales of stock in C corporations, to sales of timber, and to sales of real property (both land and buildings) and tangible personal property which are capital assets or which are property used in a trade or business.

As you well know, the Ways and Means Committee a week ago adopted by a narrow margin a compromise proposal put forward by Congressman Jenkins, of Georgia, to permit a deduction of 30 percent of net long-term capital gains realized between September 14, 1989, and December 31, 1991, and eliminate the five percent "bubble" tax on such gains, thus ensuring that the net effective tax rate on long-term capital gains realized during that limited period would be no more than 19.6 percent (i.e., 70 percent of 28 percent).

In addition, starting January 1, 1992, the basis of many capital assets or property used in a trade or business, held for more than one year, would be indexed for inflation occurring after 1991 in calculating gains, but not in calculating losses on sales.

Indexing would be available to all taxpayers except C corporations. Thus, it would apply to sales by individuals, estates and trusts, and also to partnerships and S corporations in determining gain to be taken into account by partners or S corporation shareholders that are eligible to use indexing.

Indexing would apply generally to sales of stock in C corporations, to sales of timber, and to sales of real prop-

erty (both land and buildings) and tangible personal property which are capital assets or which are property used in a trade or business. It would not apply to an interest in a partnership or stock in an S corporation. Nor would it apply to debt instruments.

Indexing would not apply to assets acquired before January 1, 1992, a restriction that would seem unfair to many, and may lead to many transactions designed to achieve a post-1991 acquisition date in order to make an asset eligible for indexing, if the transaction itself produces little tax. There would obviously be a tendency in 1991 to defer long-term investments until after the end of the year, while sellers would want to complete their sale before the close of 1991, when the lower 19.6 percent rate would expire. Midnight on New Year's Eve in 1991 could be quite eventful. Cinderella would applaud. Everyone would want to make the glass slipper fit.

I realize that this is a compromise proposal and that it may well be changed or eliminated before the 1989 tax bill is enacted, but I thought it worthwhile to call to your attention some of the complexities that would await us if the indexing proposal should ever go into effect. I do so particularly because one possible outcome of the congressional battle is to put indexing into effect immediately, as Chairman Rostenkowski recently proposed, instead of deferring it until 1992, and in any event once it is on the books it may be difficult to remove or revise it. Moreover, I do so because I believe that largely because of political and tactical concerns the administrative complexities and difficulties involved in the indexing proposal have not been publicly discussed.

Midnight on New Year's Eve in 1991 could be quite eventful. Cinderella would applaud. Everyone would want to make the glass slipper fit.

Let me say that I much prefer having a positive and optimistic view of the world, and I dislike being critical of proposals that so many able people have worked to produce. Indexing has been strongly supported by many economists and by some lawyers, journalists, and legislators as a solution to the long-pending capital gains tax controversy. But I am concerned that revenue and political considerations have produced thus far a proposal that may be quite complex and at times unfair. I should add that while I have seen the text of the committee report, I have not yet seen the bill itself.

Indexing bills that have been pending in Congress for more than a decade have measured the inflation adjustment to the basis of assets by the rise in the Consumer Price Index between the calendar quarter in which the asset is acquired and the calendar quarter in which it is sold. The 1984 Treasury indexing proposal, which was not sent to Congress, would have operated similarly. Indexing in this fashion would mean that although there would be no inflation relief for assets sold during the first year of ownership, the inflation adjustment would vary thereafter from quarter to quarter until the asset is sold. Presumably, the percentage adjustment would rise regularly as the calendar quarters come and go and as inflation continues.

Under the capital gains system we have had since 1942, all the shares of stock held by a taxpayer for more than a year (at times this period has been six months) have been treated alike. Under a regime of quarterly indexing however, once the first year of ownership is passed, the cost of shares bought in one calendar quarter will be subject to a different inflation adjustment from those acquired in a different quarter. If quarterly indexing were to go into effect on January 1, 1982, then by 1997 there would be 20 different inflation adjustments and by 2002 there would be 40, mounting by four each year. Each of these percentage adjustments would have to be applied separately to each asset sold, depending upon the calendar quarter in which it were bought and the calendar quarter in which it were sold.

I am concerned that revenue and political considerations have produced thus far a proposal that may be quite complex and at times unfair.

As an illustration, this would mean that, unless some shortcut is devised, a person who participates in a quarterly dividend reinvestment plan, maintained by most large corporations, from the beginning of 1992 to the end of 1997, and then sells all the stock in the company, would have 20 different inflation adjustments to make to the basis of his shares. This number would double by 2002 and quadruple by 2012, a worry, however, that will not concern my generation.

It is possible to reduce these numbers if the indexing adjustment were made on an annual basis instead of quarterly. The new bill, I understand, calls only for annual inflation adjustments. But annual adjustments create larger and more abrupt steps in the indexing percentages, making controversies over the date of the beginning or end of the holding period more significant when the asset is eventually sold. And even with annual adjustments, a person who had participated in a dividend reinvestment plan for a decade would have 10 different inflation adjustments to use when he sold out.

Moreover, if I understand the annual method described in the committee report, it operates on the basis of whole years of 365 days. Thus, if one buys stock on June 15, 1992, and sells it on June 14, 1997, he would compare the C.P.I. for 1992 with that for 1996; but if he sold the stock on June 16, 1997, he would compare the C.P.I. for 1991 with that for 1996. The inflation adjustment would differ depending upon whether the date of sale preceded or followed the anniversary of the date of purchase, even if the asset were held 20 or 30 years. A person in a quarterly dividend reinvestment plan who sells out on July 1 would have inflation adjustments for stock acquired from reinvesting dividends in the first half of each prior year that would be different from the adjustments for dividends reinvested in the last half of that year.

Computer programs can be developed in time to handle such complexities, but calculations by individual taxpayers are likely to be difficult and subject to errors. Individuals doubtless will expect that the inflation adjustments will be calculated for them by brokerage firms, banks, insurance companies, mutual funds, and others who handle their investments. Indeed, it may be that the

professionals, including executors and trustees, who make monthly, quarterly, or annual reports to investors would soon have to reflect not only the original cost, but also the indexed cost in order that the investor could judge his tax position if one or more of the investments were to be sold.

Recordkeeping and calculation are not the only problems. One set of issues arises from the decision to permit indexing only for the purpose of computing gains, but not for purposes of computing losses. Let me illustrate.

If I invest $10,000 in a stock and hold it for five years, during which time inflation amounts to 30 percent, and then sell it for $15,000, my original basis of $10,000 will be indexed up to $13,000, and my nominal gain of $5,000 will be reduced to a taxable gain of $2,000.

However, if you invest $10,000 at the same time in two stocks, each for $5,000, hold them for the same time and also sell them for a total of $15,000, but on one of your stocks there is a gain and on the other there is a loss, your inflation adjustment will be limited to $1,500 while mine will amount to $3,000. This flows from the decision to forbid indexing on assets sold at a loss.

The same problem would exist if either you or I buy blocks of the same stock at different prices, and when we sell we find that on some blocks there is a gain and on some there is a loss. Apparently, the indexing adjustment would apply only to the blocks that produce a gain and not to those that produce a loss.

There are other results that cause one to ponder. For example, let us assume that Mr. A invests $20,000 in cash to buy Blackacre, on which there is a mortgage for $80,000. Five years later, when inflation has amounted to 30 percent, he sells Blackacre for $130,000, pays off the $80,000 mortgage, and has $50,000 left in cash. I understand that his original tax basis of $100,000 for Blackacre would be indexed up to $130,000 (the sales price) and he would have no taxable gain, although his $20,000 cash investment has grown to $50,000, an increase far greater than inflation.

Rules would be necessary to ensure that buyer and seller act consistently in determining when the seller's holding period ends and the buyer's begins.

Contrast Mr. A's case with that of Mr. B, who forms a high tech corporation by investing $20,000 to subscribe for all its stock, and the corporation borrows $80,000 from others. If the corporation is a C corporation, Mr. A would be allowed to index only his $20,000 basis for his stock and the corporation would not be eligible for indexing. It would take a lot of inflation to make Mr. B think that indexing has encouraged him to be an entrepreneur. He might look with envy at Mr. A.

Perhaps Mr. B would be well advised to use subchapter S, if it is available to him. Then the corporation could index its indexible assets if and when they are sold, and pass through to him the benefit of the inflation adjustment, but he could not index his stock. Some rules would be needed when corporations move from C to S status or vice versa, or when section 351 transfers occur on incorporation.

And before we leave Mr. A and Mr. B, let us not forget Mr. C, who simply puts his $20,000 into a savings account for five years, during which time inflation is 30 percent. If the interest accumulation makes the account grow to $26,000, he would still be taxed on the $6,000 interest, though inflation has eaten it up. The 1954 Treasury preliminary proposals for tax reform included indexing for interest income and expense, but that suggestion was never sent to Congress, in part at least because of the complexities and problems it would create. And the committee report concludes that indexing of debt would involve too many complications.

If one reads the indexing bills that have been pending in Congress for more than a decade, one is bound to notice the vagueness of some of the language. . . .

Under our present capital gains system, the determination of the beginning and end of the holding period generally becomes immaterial once it passes one year. With indexing, the determination of the dates on which the asset is bought and sold would be material however long the asset is held by the taxpayer. Moreover, rules would be necessary to ensure that buyer and seller act consistently in determining when the seller's holding period ends and the buyer's begins. This would be particularly true where there is an installment sale, a conditional contract of sale, or a long-term lease that may be in substance a sale. Logically, the governing factor should be the time when the risk of inflation passes from seller to buyer, a moment in time which may be difficult to fix, and not the time when technically the holding period begins or ends under existing law.

Since corporations would not be allowed to index, but individuals could do so, one can envisage problems stemming from transactions between corporations and individuals, since the individuals would benefit from having holding periods begin early and end late, and the corporations could be expected to cooperate in structuring the transactions.

If one reads the indexing bills that have been pending in Congress for more than a decade, one is bound to notice the vagueness of some of the language, followed by a directive to the Secretary of the Treasury to "prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section." Among the generalized provisions is one which treats as a separate asset with its own inflation adjustment each "substantial improvement to property." Thus, each "substantial" improvement to a building or equipment would have its own indexing starting date and its own inflation adjustment. I am amused about another provision in those prior bills treating as a separate asset with its own inflation adjustment "any other portion of an asset to the extent that separate treatment of such portion is appropriate to carry out the purposes of this section." These phrases indicate the difficulties that lawyers in government and in private practice would face in interpreting and applying indexing.

(Continued on next page)

SPECIAL REPORTS

You will be relieved to know that I shall resist the temptation to mention other problems that are apparent to lawyers from a casual reading of the indexing materials that have been released thus far. I am sure they have occurred to the government attorneys who have recently been engaged in the drafting of the current proposal.

The difficulty is that the public debate about the capital gains provisions has been carried on primarily by economists, journalists, and political figures, and the indexing compromise has emerged without full input from the bar. For many years the New York State Bar Association has been in the forefront of those who have made helpful and meaningful comments on tax legislation and regulations. I am confident you will again be leaders in this work if the indexing proposal moves forward. The Association has stood strongly for simplification of the tax law. Indexing of basis would surely move in the opposite direction, and I submit that you should express your concern.

I am grateful to you for inviting me to be with you today. Though it has been almost a quarter century since I last practiced law in New York, I am still one of your dues-paying members and I still teach from time to time in New York as a visitor at Cardozo Law School. But my continuing devotion to New York was never more in evidence than it was Monday night a week ago when I was one of the few voices in jam-packed R F K Stadium in Washington cheering on the Giants to that thrilling last-second victory. And there I was, screaming to those New York Giants in my best Virginia drawl, "Go, y'all!"

PREPARED STATEMENT OF CHRISTOPHER H. DENT

I am Christopher Dent and I am a British Chartered Accountant. I have been employed by Price Waterhouse in London since 1981, and since April 1994. I have headed up Price Waterhouse LLP's UK tax group, based in New York. It is a great honor for me to have been asked to summarize the United Kingdom's experience with the indexation of capital gains.

This testimony begins with a general summary of capital gains taxation in the UK, and then moves on to the treatment of indexation. I then address two particular aspects of indexation which I know are of concern in relation to the proposals for indexation included in HR 9. These are (1) the complexity and administrative burden attached to indexation, and (2) the opportunities indexation affords for tax avoidance or "arbitrage," and in particular the opportunities which may arise if liabilities are not indexed.

Throughout the report I shall make observations on the US proposals, although these should not be taken as exhaustive, and finally in my conclusion I shall seek to draw together those aspects of the UK experience which seem to me most worthy of consideration in relation to the HR 9 proposals. Price Waterhouse, as a firm, has not taken any position with respect to the indexation proposals.

GENERAL SUMMARY OF UK CAPITAL GAINS TAXATION AND THE INTRODUCTION OF INDEXATION IN THE UK

The taxation of gains recorded on the disposal of capital assets was introduced into the UK, on a comprehensive basis, in 1965. The rate of tax was fixed at 30% for both individuals and companies, and this remained the case until 1987 (for companies) and 1988 (for individuals) when capital gains tax rates were harmonized with corporation and income tax rates so that capital gains are taxed as the top slice of total income.

For individuals Capital Gains Tax has always been, and remains, a separate tax from income tax, but for companies taxable gains (known as "chargeable gains") are now included in the corporation tax assessment. The principles used to determine taxable gains are almost identical, and the term Capital Gains Tax (CGT) is often used, loosely, to include corporation tax on chargeable gains. This convenience will be followed in this testimony.

During the period 1965 through to 1988 the 30% CGT rate was usually lower than the basic rate of individual income tax, and for most of that time it was very much lower than the progressive rates of tax that applied on higher income levels. The 30% rate applied to corporate chargeable gains was also less than the normal rate of corporation tax applied to other profits and income, which for much of the period was 52%.

There was no provision for indexation in the 1965 capital gains tax regime, but in a crude way the lower CGT rate compensated for the fact that in reality tax was being charged on inflationary gains. UK inflation was generally high throughout the later 1960s and 1970s, and reached a level of about 25% in the late 1970s. The Conservative Government, elected in 1979, promised indexation in its electoral pledges, and legislation followed in 1982. There was some opposition to it from the Labour

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party, but it would be true to say that since its introduction it has, amongst the general public, been a relatively uncontroversial feature of the British tax system. The overall concept is readily understood and regarded as fair in the UK.

It is difficult to say how much indexation costs in overall fiscal terms because, for a variety of reasons, accurate figures are unavailable. A tentative estimate is that the 1994 yield from CGT, charged on individuals and trusts but not companies, would have increased from approximately £1bn (about $1.5bn) to £1.9bn (about $2.9bn) in the absence of indexation, which has therefore halved, approximately, the yield from personal CGT. Indexation would also have reduced the amount raised in corporation tax (£18bn, about $27.6bn, in 1994), but not, it is believed, significantly inasmuch as the majority of corporation tax liabilities would be based on trading and investment income.

THE CURRENT SCOPE OF THE TAXATION OF CAPITAL GAINS

Before moving on to a more detailed review of indexation, it is worth pausing for a moment to summarize the scope of UK taxation on capital gains generally, as this naturally circumscribes the application of indexation.

The assets covered are virtually identical for both individual and corporate taxpayers. In the first instance all capital assets (but no liabilities) are included, but then many are excluded through other provisions.

The most common capital assets on which individual taxpayers pay CGT are corporate stocks, investments in authorized unit trusts and investment companies (equivalent to mutual funds), foreign currency securities (most UK government and corporate bonds are excluded for reasons set out later), land and buildings other than a private home, and works of art or antiques. Any assets in a business conducted on an individual or partnership basis will also be included, such as business premises, plant and machinery, and intangibles such as goodwill.

A company will be liable to tax on similar assets, i.e., equity investments in subsidiaries (subject to various reorganization reliefs), other stocks, certain limited types of Sterling debts, foreign currency debts (although these will very shortly be taken out of the scope of the CGT principles and be dealt with under an entirely separate foreign exchange regime), goodwill, patents and other intangibles, land and buildings, plant and machinery and certain other miscellaneous capital assets. A company which is trading in any of these assets, for example a financial institution, will of course fall within the normal trading regime and not the CGT rules.

As mentioned above, liabilities are wholly outside the scope of CGT and thus movements are non-taxable or non-deductible. The most common reason for a liability to change its Sterling value, however, is if it is denominated in a foreign currency, and such instruments are shortly to be dealt with under a new set of provisions which will bring movements on foreign currency liabilities into tax for the first time.

A SUMMARY OF THE INDEXATION ALLOWANCE IN THE UK

An indexation allowance is available on all assets, with very few exceptions, which fall within the CGT net. The allowance is calculated on an asset by asset basis, by multiplying an indexation (inflation) factor by the base cost of the asset being sold, in much the same way as is proposed in the US. The allowance is then deducted from the gross, or unindexed gain, but cannot create a tax loss. (This has not always been the case; between 1985 and 1994 indexation could create a loss, and the implications of this are discussed further below.) Any excess allowance over and above the gross gain is forfeited.

There is no minimum holding period for the allowance to be available (although the original 1982 legislation included a one-year holding requirement, which was removed in 1985). Consequently the allowance is available even where an asset is only held for a few weeks. The UK capital gains rules draw no distinction between short-term and long-term holdings, provided the asset is capital in nature. A person who frequently deals in a particular type of asset may be held to be trading for tax purposes, in which case no allowance would apply inasmuch as the profits would be subject to normal taxation as income.

The allowance is based on the movement of the UK's Retail Price Index (RPI), equivalent broadly to the US CPI, between the months of acquisition and disposal. This index is recomputed monthly, and is readily available; additionally, the Inland Revenue publishes a table each month which shows the indexation factor for the period of ownership concerned. In those very rare instances where the RPI falls the indexation factor is nil, because indexation is not permitted to increase a gross gain.

One particular feature of the UK indexation allowance is the way in which it deals with assets held on the day indexation was introduced, April 6, 1982 (April

1 for companies). The UK's initial approach was very similar to that proposed in the US, namely, indexation of historic cost for post-effective date inflation; however, since 1985, the UK system has allowed a market value election in relation to assets held in April 1982 for the purposes of calculating indexation. The intention of this election was to allow all inflationary growth after 1982 to fall out of tax, as the historical cost might be much lower than the 1982 value.

Similarly the UK indexation legislation, when it was introduced, shared with the US proposals the feature that pre-introduction inflation gains remained taxable. To a degree this is a policy decision.

From a technical perspective, however, it is more complex to have a system which combines a market value rule (for indexation) with a historic cost rule for calculating the gross gain. Furthermore, as the years pass the non-inflation protected part of a gain, realized several years after the introduction of indexation, can seem anomalous in its own right. For these reasons the UK changed the CGT system again in 1988 by rebasing all base costs to the 1982 market value. The harmonization of base costs and market values for general CGT and indexation purposes simplified the computational regime considerably, but not as much as if this approach had been implemented from the outset.

Example 1 in the footnote to this page will illustrate how a system which does *not* include a market value provision on introduction only provides partial protection from inflation.

The dates of acquisition and disposal are the same for indexation purposes as they are for capital gains purposes generally. The determining factor is the point at which an unconditional contract is concluded, even if the actual flow of funds is later (or earlier). The fact that the consideration may be settled in installments is disregarded. The US proposals are consistent with this approach.

Example 1:

Asset historic cost (1970)	1,000
Asset value (1994)	5,000
Disposal proceeds (1998)	8,000
Inflation: 1970–1994 300%; 1994–1998 40%.	
Gross gain (8,000–1,000)	7,000
Indexation (1994 to 1998) 40% of 1,000	(400)
Taxable gain	6,600
Gross Gain made up of:	
Real Gain:	
Pre 1994: 5,000–(1,000 X 400%)	1,000
Post 1994· 8,000–(5,000 X 140%)	1,000
	2,000
Inflation gain:	
Pre 1994: (1,000 X 300%)	3,000
Post 1994: (5,000 X 40%), of which 400 is tax-free	2,000
Total Monetary Gain	7,000

The difference between the taxable gain of 6,600 and the real gain of 2,000 is partly the pre-introduction inflationary gain of 3,000, and partly a post-introduction inflation gain of 1,600, which represents the 40% inflation factor applied to the difference between the 1994 value and the historic cost (4,000). This 1,600 post-introduction inflation gain remains taxable because the indexation allowance is based on the historic cost, and not the market value of the asset when indexation is introduced As drafted, the legislation thus would not provide full protection against inflation after 1994. If the proposal is only intended to provide partial protection, then its application would depend on how long ago the asset was acquired.

Unlike the U.S. proposal, indexation is in the UK available on options. For general CGT purposes the treatment of options is complex, in some circumstances they are treated together with the property acquired on exercise as a single integrated asset, but for other purposes they are treated as separate assets. For indexation purposes, however, the allowance is computed separately on the option consideration and the exercise consideration. This means that indexation will accrue on the amount paid for the option from the point at which the option is acquired, and indexation will accrue separately on the amount subsequently paid on exercise, from the exercise date, so that the entire consideration is fully indexed. This aspect of the allowance has not given rise to any particular difficulty in the UK.

The above represents only a brief summary of a complex area. Indexation and capital gains tax generally have undergone frequent and complex legislative revisions in the UK; to give a more comprehensive and detailed history of these is beyond the scope of this testimony. Some of the reasons why these revisions were nec-

essary will, however, emerge in the remainder of this paper. I now go on to describe the UK experience of the administrative requirements of indexation.

ADMINISTRATION OF INDEXATION

Indexation has not, *in itself* created any particularly onerous administrative burdens for the majority of UK taxpayers. There are several reasons for this.

Firstly, individual taxpayers are largely unaffected by CGT. This is mainly because *there are a number of exemptions from CGT which eliminate the need for most individual taxpayers to prepare CGT calculations. These exemptions include:*

- a person's principal residence tangible wasting assets (i.e., any non-business asset which would be expected to have a useful life of 50 years or less). This will exempt most ordinary possessions.
- private motor vehicles government securities and most corporate bonds
- sales of chattels not otherwise excluded, such as works of art, where the proceeds are £6,000 (about $9,000) or less, with taper relief for higher sums
- an annual allowance of £6,000 (about $9,000) per individual for any chargeable gains not already exempted.

These exemptions simplify considerably the administration of CGT and obviate the need for detailed indexation calculations for the vast majority of individuals. Those individuals who do have sufficient assets to incur capital gains liabilities may be sufficiently sophisticated to cope with the indexation calculation, which ordinarily is not a complicated calculation, or will employ professionals to look after their financial affairs. The situation may be more complex in the US as individuals tend to make more frequent investments in mutual funds, the gains on which would fall into tax.

The exemptions apply equally to corporate taxpayers, except that the annual £6,000 allowance is unavailable, and tangible wasting assets, such as plant and machinery, will not be exempt if they have qualified for tax depreciation. Such assets do not usually record a gain on disposal. Corporate tax returns are often prepared by experienced tax accountants and the calculation of indexation relief is not generally difficult. There are however two particular areas where problems can arise.

SECURITIES

The calculation of capital gains on securities, including indexation relief, can be very complex. The problem is mainly in relation to stocks nowadays, as most bonds have been taken out of the scope of CGT altogether. The difficulty lies in identifying those stocks being sold where a taxpayer has made a series of acquisitions and part disposals of a particular security over a number of years, and it is at its most acute where the holding in the security concerned commenced several years earlier, during the evolution of the present CGT system. The complexity of dealing with these transactions has been exacerbated by the number of changes to the CGT and indexation rules over the period 1982 to 1994. It may be useful briefly to review the reasons for those changes.

When first introduced in 1982, the UK indexation legislation provided for a one-year holding period before indexation accrued. Partly in order to prevent taxpayers from circumventing this restriction, and partly to minimize the availability of the relief generally, a new method for identifying the securities to be sold was also introduced. The pooling method used before 1982 was frozen and superseded by a last in first out (LIFO) method based on individual acquisitions, rather than pools. There were also complex rules to catch "bed and breakfast" type transactions, i.e., a sale followed shortly by a repurchase of similar stock (referred to as wash sales in the U.S.).

These rules proved very difficult for institutional investors with complex holdings, and in 1983 a system of parallel pooling was introduced.

In 1985 the one-year holding period was removed, which permitted the reintroduction of pooling. At the same time, it now became possible to use indexation to create a capital loss, and to make a 1982 market value election for indexation, but not the gain calculation generally. The specific "bed and breakfast" matching provisions also changed. Coupled with the transitional 1982 to 1985 system, the new arrangements were even more complex than before.

In 1988 all CGT calculations were rebased, and it became possible to elect for a 1982 market value for both basic gain calculations as well as indexation. This meant that all pre-1982 gains, inflationary and real, fell out of the CGT net altogether. Whilst this should have simplified the position considerably, the cumulative impact of these changes, and the various elections necessarily involved in making the system equitable, rendered the position very complex.

At the same time key changes were taking place to other aspects of CGT, including the gradual elimination of bonds and debts from the scope of the tax, and various anti-abuse provisions were introduced.

Since the late 1980s many institutional investors, such as pension funds and insurance companies, have had a very serious compliance problem on their hands. The creation of computer systems to cope with these amendments, coupled with all the usual stock reorganizations, rights and bonus issues etc., proved virtually impossible, and there is no doubt that serious administrative burdens were placed on both taxpayers and the Inland Revenue inspectors responsible for these cases as a result.

The critical questions are to what extent these problems were avoidable and whether the US could introduce indexation without similar difficulties. I think there are two points to be made:

1. The UK's problems were exacerbated by the frequency of the changes to the system, and the fact that certain key decisions were not addressed at the outset. In particular it is necessary to make long term decisions on such issues as:

- whether there need to be any rules linking acquisitions with near contemporaneous disposals, such as "bed and breakfast" (wash sale) rules, or whether the normal identification rules can prevail;
- whether there needs to be a waiting period before indexation accrues. The 1982 LIFO system, withdrawn again in 1985, was primarily necessitated by the need to prevent avoidance of this waiting period;
- whether indexation can create a loss. This is discussed in more detail below;
- whether indexation should be based on market value when it is introduced. The UK waited three years before introducing this election, which greatly complicated the administration; and
- whether pre-introduction gains should be exempted in any way, either for historical inflation, or by total rebasing on the effective date of introduction (as in the UK). The maintenance of parallel historical and market value records, required in the UK between 1985 and 1988, was a major complication. Equally the belated rebasing to 1982 values, which was not effected until 1988, was very difficult to work with.

The US should address these problems thoroughly at the outset, inasmuch as the UK experience amply demonstrates that piecemeal changes are unsatisfactory.

2. The US system differs from the UK system in that it is already possible in the US, to a large extent, to select specified shares to be sold from a particular stockholding. The existing long-term gains rules necessitate the maintenance of accurate base cost records in relation to the accumulation of a specified class of stock. In contrast, the UK started from a point where stocks were pooled, but in order to defer or minimize the benefits of indexation the UK grafted a LIFO system onto the pooling system.

In my view, the US system would lend itself much more to the introduction of indexation in relation to securities if the option to select the shares to be sold were continued, as is proposed. In that scenario the system could accommodate a one-year waiting period, providing there are no new rules to prevent taxpayers from selecting stocks for disposal so as to minimize its impact. It might be possible, even, to introduce a market value election or a complete rebasing, now or later, provided the fundamental principle that the taxpayer can select the stock to be sold is retained, thereby avoiding the pooling concept. It is the pooling concept which was at the heart of the difficulties experienced in the UK.

These difficulties should not, however, be exaggerated; in the UK, they affect a fairly small number of taxpayers, mainly institutional investors. The majority of business taxpayers and individuals only old relatively simple shareholdings in the UK. I do, however, recognize that in the US it is more common for individuals to make multiple investments in mutual funds and keeping track of these could be complex, a problem not replicated in the UK because investments in unit trusts tend not to be made on a periodic basis, and many profits are covered by the annual exemption.

1982 VALUATIONS

The 1982 market value elections for indexation and, later, gain calculation, are an obvious administrative difficulty. Such valuations will be needed for many years to come. They are fairly straightforward for quoted securities, although even then there are complications where there have been reorganizations. The position is much more difficult in relation to unquoted securities, intangibles such as goodwill etc., and to land and buildings, including leases. These valuations are frequently required, and necessitate professional opinions followed by negotiation with the Inland Revenue. The Inland Revenue also employs specialists in this field.

This is a costly and burdensome administrative task, but one which appears unavoidable if full relief from the taxation of inflation gains is to be granted going forward. The alternative is a partial indexation system, as has been proposed in the U.S.

THE ABUSE OF INDEXATION

There is no doubt that well-informed taxpayers will seek to maximize the benefits from any relief. I am aware also that the ability to take advantage of so called arbitrage opportunities is of major concern in relation to these proposals.

LEVERAGED INVESTMENT AND THE EXCLUSION OF LIABILITIES FROM INDEXATION

In particular I know that some commentators are concerned about investors borrowing so as to leverage up their investments and record tax free gains through indexation as the investments increase in value. Example 2 below illustrates the idea at its simplest.

The general experience in the UK is that this type of transaction has not been particularly common.

Individuals have not tended to enter into such transactions, partly through a natural disinclination to borrow in order to make speculative investments, and partly because the UK does not permit an individual to deduct interest charges in relation to private investments in stocks against either the income generated from the stock, the eventual gain on disposal of the stock or any other income.

This means that in a case such as Example 2, below, where inflation is less than the cost of borrowing, a tax-free indexation allowance will not compensate for the absence of interest relief. If the investment fails to increase in value in real terms, then there is an even larger adverse disparity between the tax result and the commercial result. Consequently, it is only possible to even achieve tax neutrality where the asset increases with inflation, which itself has a rate at least as high as the interest rate. Since this is rarely certain to happen, indexation has not really been capable of widespread exploitation.

In the US the position is of course different in so far as it is often possible to deduct the interest, which means that even where the indexation relief were to be denied, because it would create a loss, the tax result would be no worse than the commercial result, and where the investment did increase in value then part of the gain would be tax-free (subject to the "anti-conversion" rules enacted in 1993). This relief cannot, in a sense, be regarded as compensation for inflation because the reality is that no net asset existed at the start of the year which could be eroded in real terms.

Corporate taxpayers in the UK have been in a rather different position, because they have, in general, been able to deduct interest paid against other income, including investment income from the securities acquired. Nevertheless there has not, in our experience, been widespread tax planning, through gearing up, on the back of indexation. Corporate borrowers are frequently restrained from borrowing due to commercial pressures, and in general have borrowed to purchase assets required in the business in the long term, and not in order to record speculative profits to be sheltered by indexation. There are of course exceptions, especially in the financial services field, and financing products have been devised, to our knowledge, by banks who seek to utilize indexation themselves. Such strategies are by their very nature rare, aggressive, and complex and run the risk of falling foul of various anti-abuse rules.

Example 2:

Cost of stock investment		1,000
Borrowings		1,000
Interest cost		10%
Dividend yield		5%
Inflation		5%
Sale proceeds at end of one year	1,200	1,000
Less Cost	(1,000)	(1,000)
Less indexation	(50)	nil
Taxable gain	150	nil
Deduction for excess of interest over yield	50	50
Monetary Result	+$150	−$50
Tax Result (US)	+$100	−$50
Tax Result (UK) (interest not deductible)	+$200	+$50

Notwithstanding the above comments, there is clearly some substance in the claim that indexation is capable of exploitation through the failure to index liabilities.

THE INDEXATION OF DEBT

The UK has never indexed debt *liabilities*, because they have been outside the scope of CGT, and the implications of this were discussed above.

Many types of debt *assets* were included in the capital gains net, in the past, but have gradually been removed in the last few years. This has, at least in part, been due to the exploitation of indexation. Three particular examples of the type of exploitation concerned are as follows:

1. Once it became possible to use indexation to create a loss, then indexation could create a capital loss on ordinary loans and deposits, even where there was no commercial risk. For example, an investment in a Government security or quoted corporate bond could have created a capital loss, even though the interest rate already included an inflation element as well as a reward for the use of money. Many debt instruments were removed from the CGT net altogether at approximately the same time that the rule permitting indexation to create a capital loss was introduced in 1985, but attempts were still made to obtain the benefit of indexation losses for those loans not excluded by the new provisions.

2. It also became possible for groups to set up internal financing arrangements with little commercial rationale other than to accrue indexation relief to create a capital loss or relieve a capital gain. For example, it was possible to subscribe for stock in a company and borrow all the funds back, leaving an empty shell company to clock up indexation on the base cost of the stock ready to secure a capital loss for later use. Anti-avoidance rules to prevent this type of transaction were introduced in 1988, and this scheme would never have worked had it not been possible to use indexation to create a loss.

3. It was possible to set up loans where the principal sum was indexed, so that it would increase over time, and the interest coupon was set at a low level to compensate. The increase in the principal would be treated as capital and relieved by indexation. For that reason legislation was introduced in 1988 to deny indexation on a wide range of linked company equity and debt financing, and in 1989 and 1993 these provisions were bolstered by new rules which sought to tax the uplift in value as income. Simultaneously these securities were, in stages, removed from the CGT net, which in itself took them out of the scope of indexation.

In 1994 the government abolished the availability of indexation to create a loss altogether, commenting that the ability to use indexation to create a loss still created major opportunities for abuse and that further specific anti-avoidance legislation was no longer feasible.

One conclusion to be drawn from the UK experience is that the indexation of fixed-interest securities does give far more opportunities for misuse than the indexation of stocks and tangible assets.

CONCLUSIONS

On the basis of the above discussion, I would draw the following conclusions on the UK experience of indexation and its possible relevance in consideration of the HR 9 proposals. My personal observations are not intended to reflect positions of Price Waterhouse on these issues.

(1) Although there was some Parliamentary opposition to indexation when it was introduced in 1982, it has since been regarded as a relatively noncontroversial aspect of the UK tax system, and is generally regarded as fair in the UK.

(2) Indexation has not caused widespread administrative problems, either for taxpayers or Inland Revenue officials in the field. This is partly because most individuals are unaffected by CGT as there are exemptions which cover most regular personal transactions. There are, however, serious difficulties in calculating capital gains in relation to complex shareholdings.

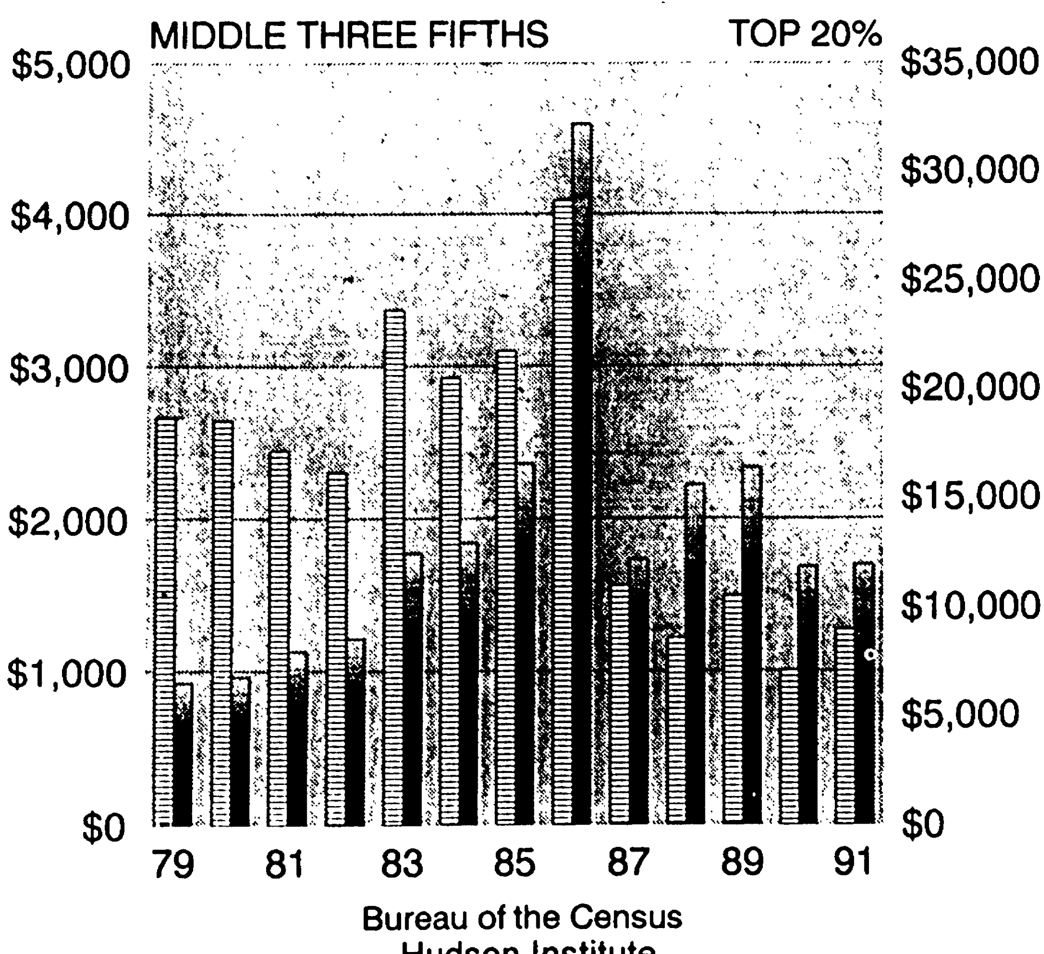
(3) The system currently proposed for the US has two features which the UK experience suggests could be concerns. Similar problems arose in the original UK system, and had to be put right later, at great cost to simplicity. These are, firstly, that the historical base cost is used to calculate future inflation relief, which will therefore not fully reflect current values, and, secondly, that pre-introduction inflation gains are not relieved at all. There are no simple solutions to these issues, but they should be fully debated now as subsequent solutions were difficult to implement in the UK.

(4) The UK system of indexation has not been abused on a widespread scale. Neither individuals nor companies have geared up on any significant scale to exploit indexation, although this may partly be due to the fact that individuals cannot deduct investment interest expenses as they can in the US.

(5) Such abuse as has taken place has necessitated relatively sophisticated tax planning, but has almost entirely exploited two particular features of the UK system which have now been eliminated. First, it used to be possible to use indexation to create a loss and, secondly, debt assets were previously chargeable assets within the scope of CGT and, therefore, indexation. The UK government reacted initially by introducing specific anti-abuse rules restricting indexation, and later by disallowing indexation losses and by taking such debt securities out of the scope of CGT altogether.

To summarize in a single sentence, indexation has, broadly, been a success in the UK, but the concept and the UK experience of it would need very careful analysis before indexation were introduced in the US in order to get it right the first time.

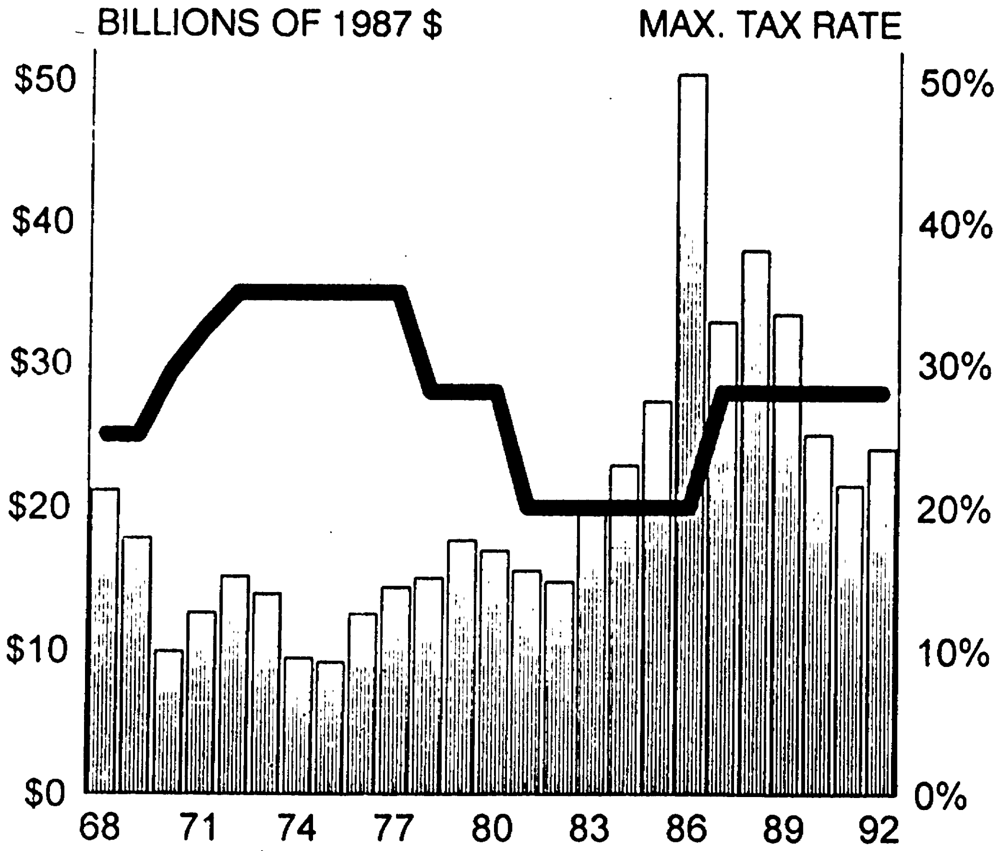
AVERAGE REALIZED CAPITAL GAINS FELL MOST SHARPLY AT MIDDLE INCOMES



Bureau of the Census
Hudson Institute

REAL CAPITAL GAINS TAX RECEIPTS FELL WHEN TAX RATES ROSE, AND ROSE WHEN TAX RATES FELL

REAL REVENUES
MAXIMUM TAX RATE



Office of Tax Analysis, U.S. Treasury. Adjusted for inflation by the deflator for federal purchases. The alternative minimum tax could push the rate to 49% in 1972-76, and the "bubble" could result in a 33% tax in 1988-90. Hudson Institute.

PREPARED STATEMENT OF ALAN REYNOLDS

The seemingly endless controversy over the optimal tax policy concerning capital gains is rooted in quite different views about the nature of capital gains, the incidence of a capital gains tax, and the impact of this tax on total revenues from all sources. Is a capital gain really no different from any other sort of income? Does the tax fall mainly on owners of capital or on labor? Does the capital gains tax raise any revenue, over time, when the impact on the economy and on other taxes is taken into account? Whether they realize it or not, practical men who hold strong opinions about these topics are embracing economic theories. And theories, unlike mere opinions, are subject to examination by the use of logic and evidence.

Proponents of the recent U.S. convention of imposing high marginal tax rates on transactions that yield nominal capital gains claim to believe that capital gains are no different from any other sort of income and should therefore be taxed the same. They claim the tax falls on capital, which is mainly owned by people with high incomes. And they claim the tax raises significant amounts of revenue. All of these opinions merit close scrutiny.

The familiar concept of zero-based budgeting can be applied to tax policy as well as spending programs. Rather than starting with a presumption that every existing tax is the "baseline," from which only incremental changes can be considered, it would be more constructive to begin by asking whether we would impose each particular tax at all, if starting with a blank slate.

Why does the U.S. tax capital gains at all? Many successful economies do not bother with this nuisance tax (Hong Kong, Singapore, Malaysia, Chile, Germany, Austria, Netherlands, Peru, Mauritius, Poland, Cyprus, New Zealand, etc.). Indeed, a few countries that used to impose taxes on capital gains have abolished the tax in recent years (Argentina, Bolivia, Kenya, Papua New Guinea). Many others now *exempt stockholders* from the capital gains tax (Mexico, Italy, Thailand and South Korea). Most of the remaining countries tax capital gains at a much lower rate than the U.S. does (Japan, China, France), or *exempt a* sizable amount of gains annually (the U.K.) or over a lifetime (Canada). A few index the basis of the tax (Australia, U.K., India, Malawi). The U.S. is the only significant economy in the world that taxes single-year capital gains at the same rate as salaries, for most taxpayers, without even providing any adjustment for inflation. The very few other countries that have even tried to tax nominal gains at the same rates as income—notably, Iran, Congo, Venezuela and Nicaragua—have not experienced enviable economic performance.[1]

The relatively unique fixation on capital gains taxes in the largest English-speaking countries may be traceable to a pair of U.S. professors who taught in the twenties and thirties. The conventional rationale for a capital gains tax is still the ancient Haig (1921) and Simons (1938) definition of income, which arbitrarily lumped capital gains in with income or consumption. It is easy to test how sincerely this definition is actually believed: Anyone who really believed that capital gains are no different from other income should be perfectly willing to give up a monthly salary, and to accept in its place the possibility of an uncertain amount of money (or a bill for losses) at some unknown future date. (Government economists should not be excused from this exam).

If unpredictable capital gains were really the same as routine income, then all capital losses should be fully deductible against income from any source. There may be sound practical reasons for the asymmetric "heads I win, tails you lose" treatment of capital losses. But failure to allow capital losses to be offset against income nonetheless requires abandoning all pretense that capital gains are the same as income, or that apologists for the capital gains ever had any intention of treating capital gains the same as other income.

Once we abandon the quaint habit of defining capital gains as no different from a weekly paycheck, economics offers no other clear justification for taxing capital gains at all. No economist has ever dared to suggest that a capital gains tax does no damage to the economy. The most that anyone has claimed is that the damage may not be so awful. The custom of taxing capital gains is sometimes defended on "equity" grounds (where equity is defined as preventing American families from becoming too wealthy). As we will later show, however, this redistributionist impulse incorrectly assumes that taxes on capital are not shifted to labor.

The only remaining rationale for the capital gains tax is that the IRS wants the money. But the capital gains tax is an extremely inefficient method of raising revenue. Reporting and monitoring costs are a heavy burden, yet avoidance and evasion are easy. Since only realized gains are taxed, it is mainly a voluntary tax. We will later offer several reasons and evidence for doubting that the capital gains tax

raises any revenue at all, particularly once its harm to savings and capital mobility are taken into account.

The case against taxing capital gains at all is well understood outside the United States. Suppose, Mr. Saler spends every dollar he earns, so he is taxed only once. Ms. Frugal, on the other hand, manages to save a portion of whatever is left of her income after taxes, so she will be taxed again—on any interest, dividends or rent that her investment produces. Income saved and the income from the savings are both taxed. This double taxation of savings was greatly aggravated by the phase-out of deductions in 1990 and the more explicit increase in marginal tax rates in 1993, because earnings from savings are *marginal income*, taxed at the taxpayer's highest bracket. A neutral tax system would either *exempt all savings* from taxation (as with an IRA) or *exempt all income from savings* (as with municipal bonds). This leaves no room for a capital gains tax, for good reason.

Capital gains taxes introduce yet another layer of taxes on saving—triple taxation—which is most apparent in the case of stockholders. Corporations pay a tax on profits, then double-taxed savers pay another tax on the same profits. This triple tax occurs whether taxes are paid out as dividends or reinvested in ways that raise the value of the firm and therefore result in a potentially taxable capital gain (or estate). The stock price reflects the discounted present value of the company's expected future income. Since those earnings will be double-taxed at either or both the corporate and personal levels in the future, there is no justification for a triple tax on the appreciation in the stocks' value. All that such a capital gains tax can possibly accomplish is to keep the market value of shares lower than otherwise, raising the cost of equity capital and raising the debt-equity ratio of firms to a precarious level (thus reducing taxable profits in the process).[2]

The 1986 increase in the capital gains tax (which raised the tax rate from 11% to 28% for many middle-income taxpayers), has greatly reduced federal and state revenues, fostered a precarious increase in corporate leverage which eroded the corporate tax base, and put younger and smaller U.S. firms at a distinct disadvantage in the global competition for capital.

If the objective of good tax policy is to maximize economic growth—and the rising real incomes and real tax receipts that only economic growth can produce—then the most efficient tax rate on capital gains is zero. If the objective is to raise the ratio of capital to labor, and thus raise labor's share of national income, the most efficient tax rate on capital gains is also zero. A zero tax on capital gains is the benchmark by which lesser reforms must be judged. Objections to reducing or indexing the capital gains tax make little sense when evaluated by the criterion of maximizing economic growth and real wages, rather than by the criterion of defending an unquestioned status quo. Any real or imagined difficulties with indexing capital gains for inflation, for example, would never arise if, as in most successful economies, there was no U.S. tax on capital gains.

INDEXING

In 1980, Alan Blinder demonstrated that up until that time, "most capital gains are not gains of real purchasing power, but simply represent maintenance (or rather partial maintenance) of principal in an inflationary world."[3] Many savers finally did experience real gains on stocks and bonds from 1982 to 1992, but also losses in real estate. Of $8 trillion in unrealized gains at the present time, Polyconomics Inc. estimates that "only" $1 trillion represents real gains.

The inequity of taxing illusory, inflated gains can be illustrated by considering the plight of farmers. The average farmer is 53 years old, and the average period of ownership of farmland is 29 years. Farmers usually have almost all of their wealth tied up in the farm, and no employer to provide them with pensions. As they reach retirement, it often becomes necessary to sell all or part of the farm. Because the basis of real property has not been indexed, however, years of compounded inflation can easily result in an enormous tax liability on a totally illusory gain. And unlike the gains on many other assets, such as collectibles, it is not easy to conceal the sale of a farm from tax collectors.

In nominal terms, the value of farm land today is nearly five times what it was thirty years ago, but that is also true of the consumer price index. To round the figures, for illustration: suppose the price of a farm and the CPI were both exactly five times what they were in 1965. A farm bought for $200,000 three decades ago might be sold today for a million dollars. That leaves a taxable gain of $800,000, and that one-time gain would put the farmer into the highest tax bracket regardless of his or her normal income. With a 28% rate on that nominal capital gain, the tax bill in this example would amount to $224,000, plus state taxes. Yet this farmer has experienced no real gain at all. Taxing the nominal gain would confiscate large

share of the principal of the original investment. It requires considerable ingenuity to make excuses for such a blatantly confiscatory tax.

Joseph Minarik once wrote that, "Advocates of a capital gains preference always say that inflation is a problem but always decline to accept indexation as a precise and equitable solution." In the same essay, however, Mr. Minarik himself declined to accept indexing as a "precise and equitable solution," and instead claimed this equitable solution was, in his view, inequitable:

> Indexing capital gains in a world in which interest income and expense is not indexed would be inequitable between recipients of capital gains and recipients of interest income . . .[4]

It is true that those who realize that the optimal capital gains tax is zero cannot be satisfied with indexing alone, but also want the tax rate as close to zero as is politically possible. It is an pedagogical fable that capital gains tax rates have been much lower than income tax rates for all but a few of the last 74 years only as a crude adjustment for inflation. Congress had other good reasons for keeping the capital gains tax down, as do all successful foreign economies.

Inflation does present major problems for a non-zero capital gains tax, but inflation is only one problem among many. Assistant Treasury Secretary Samuels says the best solution to the taxation of unreal gains is to keep inflation down. That is not a satisfactory solution, because there is no way that investors can be sure that high inflation will not come back. The cumulative effect of inflation as low as 3–4% a year will greatly erode an asset's real value over a decade or two. The best solution to this problem, and others, is to abolish the capital gains tax. Indexing is second-best. Boasting about last year's low inflation is no help at all—it tells us nothing about inflation next year, much less over decades.

The high tax rate on capital gains presents different problems, regardless of inflation. The tax discourages savings, particularly in the form of equity investments in emerging enterprises that are not yet able to pay regular dividends (such as growth stocks and venture capital). The tax on exchanging titles to property also reduces the liquidity and mobility of assets subject to this tax, discouraging the timely and efficient reallocation of capital to its most efficient managers and uses. Indexing alone, essential as it is, will not fix these problems.

Minarik wrote that indexing the basis of capital gains would be "inequitable between recipients of capital gains and recipients of interest income." If inflation pushed interest rates up, those receiving income in this form would supposedly have to pay taxes on income that is not "real," while those receiving gains would appear to be treated more fairly. Minarik implies that it would be fairer to be equally unfair to both types of investors. That is a questionable ethical philosophy, but also careless economics.

Arbitrage ensures that there can be no "inequity" of this sort. *Before-tax returns would adjust to equalize expected after-tax returns.* This is why *all* varieties of capital are hurt by any sort of tax on capital (e.g., property taxes also reduce returns to stockholders), and that is why all savers and investors will benefit from a lower, indexed capital gains tax, whether they hold appreciating assets or not.[5]

It is illuminating to contrast Minarik's concern about the alleged inequity of failure to index interest income with Mr. Samuels' concern about alleged revenue losses from failing to index interest expenses. A plausible case can be made for not taxing interest income and also not allowing interest deductions, or for adjusting both for inflation.[6] Yet Mr. Samuels does not advocate such a change, which leaves the impression that this is merely a flimsy debating tactic.

Minarik tries to focus our attention only on the lender; Samuels on the borrower, yet it is the interaction between lenders and borrowers that ensures that the imaginary difficulties they concoct (inequity in Minarik's example, revenue loss in Samuels') could never actually exist.

Mr. Samuels recently offered the following illustration in testimony to the House Ways and Means Committee:

> Assume that a taxpayer purchases undeveloped land for $100,000, giving a $20,000 cash down payment and borrowing $80,000. If the land were sold several years later for $130,000, *with the $30,000 representing an inflationary increase* in the value of the property, the taxpayer could repay the $80,000 mortgage and retain $50,000 in cash without being subject to taxation [emphasis added].

Note that the $30,000 gain in this example is not a gain at all. In constant dollars, the property is worth no more at the time of sale than it was when originally purchased. The fact that the government collects no revenue on nominal gains that merely keep pace with inflation is not a flaw of indexing—it is the reason for indexing. No "tax arbitrage" is possible unless the after-tax real return exceeds the after-tax real cost of borrowing.[7] Yet in Mr. Samuels example, the real capital gain is

zero, before and after taxes. The mortgage interest expense, on the other hand, is well above zero. In periods of inflation, the Fed usually pushes "real" rates quite high, and deductibility merely lessens the cost a bit. Interest ·· deductible because it really is a cost borrowers, not income.

Deductibility of (nominal) interest certainly does not deprive the government of revenue, as Mr. Samuels implies, because *that interest is received by a lender who has to pay taxes on the interest income.* Mr. Samuels' concern about revenue losses ostensibly arising from failure to index interest costs arises from not looking at both sides of the transaction. For every borrower there is a lender. If the borrower has a larger interest deduction because inflation pushes interest rates up, then the lender likewise has a larger taxable income for the same reason. The borrower does not really gain from the fact that higher interest rates bring larger deductions, because interest rates rise to adjust for taxes just as they rise to adjust for inflation. If lending does not pay a competitive return, after taxes, then prospective borrowers bid the interest rates up until it does. The yield on taxable bonds and mortgages contains a "tax premium" as well as an "inflation premium." There is no "inequity" from failing to indexing interest income (as Minarik suggests), and no revenue loss from failing to index interest deductions (as Samuels suggests).

In a more recent essay, Minarik explained, quite correctly, that, "the markets can offer higher interest rates to compensate lenders (and penalize borrowers) for the inexact taxation of the interest income (and deductions of business interest expense)."[8] If the combination of inflation and nonindexation of interest really gave an advantage to borrowers and penalized lenders, then borrowers would be eager to borrow and lenders reluctant to lend. Interest rates are then bid up to the point where there is no advantage to borrowers. Markets are quite capable of adjusting interest rates to compensate for both inflation and taxes. Because that happens, most hypothetical tax arbitrage possibilities (such as deducting interest expenses on money used to buy tax-free bonds) turn out to be unprofitable in the real world (e.g., using actual interest rates rather than those used in hypothetical examples).

A more serious revenue threat is that inflation provides many opportunities to evade the capital gains tax by investing in tangible assets and collectibles that are expected to appreciate at a rate that exceeds the interest rate. In the late seventies, oriental rugs and vases, stamps, coins, art, jewelry, antique furniture and cars were being bought and sold with untaxed capital gains. Without a tax agent for every taxpayer, the IRS could not possibly capture a tax on such transactions, many of which took place in flea markets and garage sales.

Far from being "too generous," as Mr. Samuels suggests, the proposed indexing plan is not generous enough. Only the *original* basis is to be indexed; retained earnings during the period between the asset's purchase and sale should also be adjusted for inflation.[9] In Mexico, for example, "historical costs may be increased by factors . . . to adjust them for inflation and, in the case of shares of capital stocks, also *by amounts intended to partially cover net retained earnings* [emphasis added]"[10] By not incorporating even such a rough adjustment in the U.S., indexing only the *original* basis of assets is only a partial solution. It would, however, be a major improvement.

TAX ARBITRAGE: ANOTHER GOOD REASON FOR LOW TAX RATES

Inflation aside, most possibilities of "tax arbitrage" would become less attractive, not *more* attractive, with the lowest possible tax on real capital gains. The clearest illustration of tax arbitrage is for a taxpayer in a high tax bracket to borrow money, deduct the interest cost, and use the money to buy tax-free municipal bonds. This has nothing to do with the tax treatment of transfers of property. Indeed, a lower capital gains tax would make this arbitrage scheme less attractive, by making capital appreciation more attractive (e.g., a lower capital gains tax would make growth stocks relatively more attractive than tax-free bonds, which are mainly held for income).

Another commonly cited example of tax arbitrage does involve capital gains, but has nothing to do with whether interest expense and/or capital gains are indexed for inflation. "An investor can take long and short positions in similar assets," notes Auerbach, "and realize immediately whichever investment goes down in value."[11] Investors, unlike academics, rarely go to such trouble just to discover investments that will go down in value. But note that this scheme too has nothing to do with whether interest or gains are indexed. It would work just as well (or just as poorly) with cash.

The only significant form of tax arbitrage in which interest deductions and capital gains are involved is the mortgage on taxpayer's primary residences. That is because mortgages, unlike other loans, often carry fixed long-term interest rates that

may later turn out to have been too low to compensate lenders for inflation and taxes. Also, the capital gain resulting from inflating housing prices can be rolled over into another home, with a $125,000 exemption at age 55, which is quite unlike the tax treatment of any other asset. A lower tax on capital gains for other assets would reduce the arbitrage involved in leveraged home buying. The relatively sensible taxation of capital gains on homes would no longer appear so advantageous when compared with investments in U.S. businesses and farms if sales of the latter assets were not so severely punished by the capital gains tax.

The incentive to engage in tax arbitrage would be *diminished,* not increased, by reducing and indexing capital gains on assets which (unlike homes and municipal bonds) do not currently escape the onerous capital gains tax.

Accountants' concerns about tax arbitrage certainly do not justify the status quo for tax policy. On the contrary, opportunities for tax arbitrage enhance the case for "dynamic" revenue estimates, and lend support to much lower marginal tax rates, particularly on globally mobile capital. As Eugene Steuerle points out, "it does not cost much to reduce statutory tax rates on income that, for the most part, is not recognized in the first place."[12] Indeed, a study by two of the toughest critics of tax arbitrage, Roger Gordon and Joel Slemrod, came to the rather startling conclusion that "abandoning entirely any attempt to tax capital income while leaving the tax law otherwise unchanged would have resulted in a slight rise in government revenue."[13] That is, the Gordon-Slemrod study estimated that a zero tax rate on capital gains, dividends, interest income, corporate profits and estates would probably not cost the Treasury a single dollar.

CONVERTING INCOME INTO CAPITAL GAINS?

Another common objection to reducing the capital gains tax rate is that it would supposedly encourage taxpayers to "convert ordinary income into capital gains." This conjures up visions of people somehow moving their incomes off the W2 and 1099 forms and onto Schedule D. That is easier said than done. Complex and rare abuses of the past, involving such devices as commodity straddles, were tightly curbed by the 1981 and 1986 tax laws. Those who still talk about converting income into capital gains are usually and understandably vague. Yet Eric Toder, a former economist with the Treasury and CBO, once offered the following examples:

> Corporations may reduce taxable dividends and increase retentions; high bracket individuals may increase the shares of their portfolios held in growth stocks relative to dividend-paying stocks and bonds. . . .[14]

What is notably missing from Toder's story is *debt.* The current tax system encourages corporations to convert what would otherwise be capital gains into *income*—interest payments to banks and bondholders. Financing plant and equipment with debt results in deductible interest expenses, while financing investment with equity results in both the company and its shareholders paying taxes twice. A prophetic 1987 study by Randall Pozdena of the San Francisco Fed thus came to the following conclusion:

> An increase in the corporate marginal tax rate or the tax on capital gains increase the use of debt generally and low-grade (risky or "junk") debt specifically [emphasis added].[15]

The otherwise admirable 1986 tax reform increased effective tax rates on corporate profits and capital gains (and real estate), and thus provided a powerful incentive for companies to add to debt and retire equity (leveraged buyouts, going private, stock buybacks, etc.). This incentive to become highly leveraged is a major reason why receipts from the supposedly increased taxes on corporate profits came in far below static estimates (as did receipts from the increased capital gains tax).[16] This was quite predictable, but static revenue estimates do not incorporate even the most obvious reactions to higher tax rates.

Receipts from the greatly reduced personal tax rates on "the rich," on the other hand, soared far above the initial estimate. A larger percentage of families reported higher incomes because of more incentive to work (spouses of high-income taxpayers joined the work force in record numbers until 1990), more incentive to take a large share of income in cash rather than perks and leisure, and less incentive to engage in tax avoidance, arbitrage and evasion.[17] The share of income tax paid by the most affluent 1% of taxpayers jumped from 17.9% in 1981 to 27.6% in 1988. This was a major source of the dramatic increase in real federal tax receipts, which jumped by an unusually large 26%—from $728.1 billion in *1980* to $916.2 billion in 1989, in constant 1987 dollars.[18] If the capital gains tax had not been increased after 1986, however, the dramatic surge in revenues after 1986 would have been even more impressive.

The distinction between how stockholders are rewarded for putting their capital at risk is trivial, compared with the tax bias against equity in general and in favor of debt. Raising the tax on capital gains and lowering it on dividends from 1987 to 1992 did not make dividends increase significantly. The wider gap between taxes on dividends and capital gains in 1993-94 also did not have much visible impact on payouts. Investors probably just bid-up the relative prices of dividend-paying blue chip stocks relative to stocks of newer firms that cannot possibly pay dividends, regardless of the tax code. But the high tax on capital gains after 1986 did make a lot of equity disappear, as public companies were taken private by issuing "junk bonds" and/or borrowing from banks.

Toder's story is backwards. It is not that a lower capital gains tax would unduly favor corporate savings (retained earnings), nor that it would bias investors toward stocks in young "gazelles" rather than stodgy blue chip companies. In reality, the existing capital gains tax artificially *discourages* corporate savings, and *discourages* taxable investors from providing venture capital or buying shares in promising young companies. A tax climate more favorable to "growth stocks relative to dividend-paying stocks and bonds" would be extremely beneficial to entrepreneurial expansion.

Toder's last example of converting income into capital gains is that "individuals may increase the rate of turnover of buildings, thereby producing more capital gain income for sellers, but more ordinary income deductions (for depreciation) for buyers." Prior to 1986, frequent turnover of buildings was due to accelerated depreciation that assumed more inflation than there was, which ended up being more generous than neutral cost recovery or expensing. However, depreciation periods for buildings were greatly lengthened in 1986 and again in 1993. The capital gains tax by itself, even at a zero rate, does not provide any incentive to exchange buildings more frequently. Selling buildings every year certainly does not assure anyone, much less everyone, of real capital gains. It is not that easy to become wealthy.

LIFETIME INCIDENCE AND INCOME DISTRIBUTION

In 1939, Nobel Laureate John Hicks once wrote that "if measures making for efficiency are to have a fair chance, it is extremely desirable that they should be freed from distributive complications as much as possible."[19] In the debates over capital gains taxation, distributive complications have received almost all the attention, and economic efficiency practically none.[20]

Past efforts to reduce and/or index the capital gains tax have been hampered by the belief that most of the benefits from such a change would accrue to those in, say, the top 1% or 5% of the income distribution. This is good arithmetic but incompetent economics. There are two errors involved. The first is that the incidence of any tax should at least be examined over lifetimes, not individual years. Young people usually have low incomes and no net worth. Middle-aged people have higher incomes, and have at least begun to accumulate assets for retirement. If we look only at one year, it looks as though reducing any tax on savings must benefit only "the rich," meaning those who are at the peak of their age-earnings profile. But young people too get older, and they will have higher incomes and assets when they do.

It must be true by definition that large capital gains in any one year are realized by people with high incomes, since the gains are counted as income. That makes it quite impossible to realize a $200,000 gain without also having at least a $200,000 income. Some have argued that such bunching of one-time gains into single years (e.g., selling a farm or small business) is not a serious problem. Business Week reported that concern about bunching was "blown apart" by Joel Slemrod's research, showing that "from 1981 through 1984. . . more than half of all capital gains were claimed by investors who took profits in each of the four years."[21] Straw men are easy to blow apart. Nobody ever claimed that those with big gains in one year typically had no gains at all in other years. Anyone with any investments could hardly avoid having some gains from 1982 to 1984, because prices of stocks and real estate were soaring. What Business Week neglected to mention was that Slemrod found that the share of gains received by those with incomes above $200,000 (including gains) fell from 39.6% to 22% when looked at over those four years, rather than just a single year.[22] This relates to the earlier discussion about "lifetime" incidence, though four years is still very far from a lifetime. The more years that are included, the smaller the share of gains going to "the rich."

Don Fullerton and Diane Lim Rogers find that "if we label the bottom 30 percent of the population the 'poor' and the top 30 percent the 'rich,' we find that 13.8 percent of the annually poor are lifetime rich." They also found that "owners of capital are not just 'the rich' but are people whose earnings peak relatively early and who must therefore save more . . . *The lowest income groups and the highest income*

groups have earlier peaks, saving more during life, and bear more of the burden of capital taxation [emphasis added]."[23]

The second misunderstanding about incidence—who *really* pays the capital gains tax—is far more important, and surprisingly misunderstood. In an essay on estate taxes, Joseph Stiglitz once explained how taxes on capital accumulation (which certainly includes the capital gains tax) must ultimately be shifted to labor, through lower productivity and real wages:

> The reductions in savings and capital accumulation will, in the long run, lead to a lower capital-labor ratio; and the lower capital-labor ratio will . . . lead to an increase in the share of capital. Since income from capital is more unequally distributed than is labor income, the increase in the proportion of income accruing to capital may increase the total inequality of income.[24]

Because the return on capital invested in the U.S. has to be globally competitive, taxes that make capital artificially scarce must increase the before-tax return to capital to compensate for the taxes, yet labor nonetheless ends up with less capital, lower productivity and lower real wages. "The pre-tax return to capital rises and the wage falls."[25] With the increasing integration of global capital markets, this adjustment happens much more quickly than it did in the past. Two economists from the Canadian Tax Foundation recently observed that "with capital mobile, the before-tax rate of return to capital will simply have to rise to compensate for the tax, lowering the amount of capital accumulation in the economy and placing the burden of the tax on the immobile sources of income like labor. . . "[26]

The capital gains tax does not hurt those who already own capital, but entrepreneurs and emerging enterprises that are attempting to *acquire* capital, and workers who depend on more and better capital to enhance their productivity. The capital gains tax, like the estate tax, is a "soak the poor" tax in disguise.

Any country that attempts to tax capital more harshly than others will not be able to attract foreign capital, and is likely to be plagued by "capital flight" by its own taxpayers. Given the huge size of the U.S. current account deficit, this could easily result in a "hard landing"—a falling dollar and rising interest rates. Indeed, this has been happening to a considerable extent ever since the passage of OBRA 93.

"TARGETED" CENTRAL PLANNING, WINDFALLS, AND SIMPLICITY

Assistant Secretary Samuels says "additional incentives for new investment. . . [should] be targeted and consistent with the tax policy principles of fairness, efficiency and simplicity." The main purpose of reducing and indexing the tax on capital gains is *not* to create "incentives for new investment," but to remove disincentives to saving, risk and the transfer of assets. This is why comparisons between capital gains tax relief and an investment tax credit, made by Minarik and others, are completely misconceived. The widening gap between investment and savings is the current account deficit. Given the huge size of that gap ($140 billion) it would be foolhardy to offer revenue-losing tax credits in order to whip-up additional business demand for financing of new equipment—at a time when U.S. capital goods industries are already operating near peak capacity—while forgoing revenue-enhancing reform of the capital gains tax which would make it feasible to finance such investment with new equity, rather than relying on a precarious inflow of (mostly official) foreign capital.

OBRA 93 provided relief from capital gains taxes for investors making large investments in very small firms in certain highly restricted industries (e.g., not services), if those investments are locked-in for at least five years. Economics can offer no justification for any of this central planning. The notion that capital gains tax rates should be lower the longer that assets are held is particularly indefensible. Deferral of taxation already reduces effective tax rates the longer an asset is held. There is absolutely no reason why investors should be bribed to hold securities one minute longer than they otherwise would. The fallacy of "patient capital" arises from confusing the availability and cost of equity capital with the name of the person who happens to hold title to the shares. Enticing people to hold shares for many years does not improve the value of those shares and, if anything, favors safer investments over risk. Providing a lower tax rate to immobilize the ownership of capital simply makes shares of the supposedly "targeted" companies less liquid, and less attractive on secondary markets (where capital gains, if any, will be determined). If Congress did nothing else about capital gains taxation, it would be a meaningful improvement to repeal the "targeted" capital gains provisions enacted in 1993, which can only misallocate scarce capital.

Mr. Samuels worries about providing "a windfall benefit to existing investments." There was no comparable concern about inflicting windfall losses when the capital

gains tax was increased. When it comes to indexing, the concept of "windfall" is quite inappropriate, if not offensive. There is no way that those making investments in the past could have anticipated the amount or timing of inflation. In many cases, the waves of inflation inflicted real losses (e.g., to holders of stocks and bonds), which may nonetheless result in taxable "gains" if the assets are sold. Indexing the basis of capital gains surely passes any normal citizen's concept of "fairness," even if Treasury experts somehow regard it as some sort of "windfall."

Perhaps because of concerns about "windfalls" (as well as undue respect for static revenue estimates), the House Republican contract only proposes prospective indexing for future inflation. This is unfortunate, because failure to adjust for past inflation would limit the potential benefits to the economy and to Treasury revenues from ending the lock-in effect (though lower tax rates would unlock many of these unrealized gains). Retrospective indexing might cause a one-time bunching of gains (and huge revenues) in the early years—particularly if taxpayers were not convinced that this provision would be permanent. This is not a bad thing, from the government's point of view, because of the time value of money—each additional billion received in 1996 means less debt to service ten years later.

It is not correct to assume (as Treasury revenue estimates appear to) that the gains unlocked as a result of indexing for past inflation would otherwise be realized later without indexing, thus resulting in larger future revenues. If nominal capital gains from the inflationary seventies remain subject to confiscatory taxation, if realized, trillions of dollars of such phony gains will never be realized at all. "More than half of all capital gains are never taxed. Either they are held until the owner dies, after which they are exempt from tax to subsequent owners. Or they accrue to tax-exempt U.S. entities, such as pension funds [and tax-exempt institutions], or to foreign owners not subject to U.S. tax."[27] The tax on many other gains are simply evaded, which not difficult to do with collectibles and small real estate holdings. It is no solution to repeal the step-up provision at death, because that would aggravate powerful incentives to engage in "estate planning" that already greatly reduce revenues from the individual income tax (due to gifts and donations).

Mr. Samuels feigns sympathy for the added taxpayer paperwork burden that might result from adjusting capital gains for inflation. We should not, he says, "start requiring people to keep new detailed records." This is an empty argument against indexing. Nobody is proposing that indexing must be mandatory. If taxpayers prefer the "simplicity" of paying taxes on nominal gains, they would be quite free to keep doing that.

A FLAT TAX ON GAINS WOULD BE MORE COST-EFFECTIVE

With OBRA 93, the federal system of earned income tax credits, phased-out deductions, and rising marginal tax rates became as steeply graduated as it was back in 1977, according to the CBO. Aside from discouraging labor force participation and saving at a time when both are quite weak, steeply graduated tax rates inevitably require cumbersome piecemeal reforms, such as two-earner tax credits and income averaging. Tax rates of 36% and higher should be repealed, effective January 1995.[28]

Until the 1993 tax rate increases are rolled back, the proposed exclusion of 50% of the gain means the tax rate on capital gains also becomes steeply graduated, rising from 7.5% to 19.8%. There is no coherent argument for applying a system of graduated tax rates to capital gains, and there are some very good reasons to switch to a simple flat rate.

Many of those currently subject to income tax brackets of 36% or more have highly variable incomes from year to year. Top-bracket taxpayers include many small businesses, investors, salesmen, farmers, and self-employed professionals whose income falls in the higher brackets in some years, lower brackets in others. High-bracket taxpayers and their spouses have considerable discretion about when to work and when to get paid, and can thus shift income from one year to the next. The experience of December 1992, when reported income soared in anticipation of the 1993 tax increase, is persuasive proof.

Because an exclusion applies graduated tax rates to capital gains, it provides *a perverse incentive to realize net gains during years in which taxable income is low,* and shift losses and other deductions into years in which income is high. Minarik's study of bunching "suggests that some taxpayers . . . may time their gains to coincide with years in which their ordinary income is below average and their deductions are higher than normal."[29] If accrued but unrealized gains were large enough, there would even be an incentive to deliberately minimize income-earning activities in some years (including work) in order to realize the gains at a lower rate.

Intertemporal income-shifting, to minimize taxes, impairs economic efficiency and reduces revenues. This could easily be avoided by simply taking the current 28% cap on the tax down to 15%, so that all taxpayers would pay the same 15% rate on gains of equivalent size. If Smith had twice as large a gain as Jones, then Smith would pay twice as much in taxes on that gain. This is, after all, supposed to be a tax on capital gains, not on salaries. There are more than enough other taxes applied to salaries. Why 15%? Because that rate would not be higher than current rates for any taxpayer.

It is difficult to imagine any "fairness" argument for raising or lowering the tax on capital gains depending on the amount of other income that taxpayers happen to have during the years in which they choose to realize gains. If taxpayers who would otherwise be in the 15% bracket happened to have a large gain, then that gain alone would push them into the 28% bracket where the proposed exclusion would tax the gain at 14% anyway. If taxpayers in a 15% bracket had a small gain, they would not need a tax rate of 7.5% to encourage them to realize it.

A 50% exclusion would be a major improvement over current law, but it would be more cost-effective to simply impose a 15% flat rate. If taxpayers must continue to be plagued with this inefficient tax, and all the burdensome reporting that goes with it, then numerous problems associated with bunching, averaging, estate planning, and intertemporal income shifting can all be prevented by imposing one, simple flat tax of 15% on all gains.

"STATIC" REVENUE ESTIMATES AND SAVINGS

It is a common mistake to judge the economic impact of any proposed "tax cut" by the amount of revenue it is estimated to lose. In 1976, James Tobin of Yale observed that, "There is a point beyond which higher surtax rates collect less—not more—revenue."[30] Certain types of taxes do maximum damage to the economy in exchange for minimum revenue, if any. In such cases, it may well be possible to reduce the tax rate substantially with little or no revenue loss, particularly if we take into account the effect of reducing one tax (such as the estate tax) in raising receipts from other taxes (such as personal income tax).

The problem with static revenue estimates is not simply that they grossly overstate the revenue losses from lower tax rates but that they grossly overstate the revenue gains from higher tax rates. This sort of misinformation has led federal and state legislators to take undue comfort in the belief they had fixed budget problems, on paper, though actual revenues later declined. This was the experience with income and sales tax increases in New Jersey and California in recent years, as well as other nations, such as Canada. It was also the experience with the federal increase in capital gains tax in 1986.

Ever since the tax rate on capital gains went up in 1987, actual realization of gains have been about half as large as the CBO forecast at the time of the 1986 tax bill—an error of roughly $100 billion every year. As Figure 1 shows, real receipts from the capital gains tax itself clearly rose for a sustained period whenever the tax rate declined, and real receipts fell whenever the tax rate was increased (e.g., revenues were substantially lower in 1992 than in 1985). As a result, in 1993 the CBO finally reduced its estimated future revenues from the individual income tax by as much as 1% of GDP, "with revisions to the forecast of realizations of capital gains accounting for about half of the reduction."[31] In a $7 trillion economy, a half percent of GDP implies a revenue exaggeration of around $35 billion a year, and larger in later years.

Using the same sorts of bookkeeping techniques that led the CBO astray, the Treasury now estimates that a 50% exclusion and prospective indexing "would reduce tax receipts by $60.9 billion over the six-year FY 1995–2000 period, and by $183.1 billion over the FY 1995–FY 2005 period." There is no reason to take these estimates any more seriously than the wildly inaccurate 1986 CBO estimates. Good policy should take precedence over bad estimates.

There are numerous reasons for expecting that reducing or even eliminating the capital gains tax would, on balance, increase tax receipts from a wide variety of sources, not simply the capital gains tax itself. This is not, however, the reason for reducing and indexing the capital gains tax. The purpose of a more reasonable tax rate on realized, real gains is to reduce the tax system's powerful bias against savings, and to improve the mobility of capital and the efficiency with which assets are allocated to their most efficient uses. The fact that all this can so easily be accomplished with little or no revenue loss is simply a welcome bonus.

In recent years, the debate over the revenue impact of reducing, indexing or eliminating the capital gains tax has focused exclusively on only one issue—the incentive to realize gains by exchanging property more frequently, rather than becoming

locked-in to past investments.[32] Although this is indeed an important issue, there are many others, some of which have been neglected since the debate over the 1978 Steiger Amendment.[33] At that time, for example, Data Resources Inc. (DRI) estimated that *eliminating* the capital gains tax would *raise* federal revenues by $38 billion over five years (serious money in those days).[34]

Unlike most recent studies, DRI estimated the impact of the capital gains tax on the market value of taxed assets. If a prospective future gain will be subject to a lower marginal tax, this will be discounted into the present value of U.S. assets, raising national wealth. This is not just a one-time event, but would be endlessly repeated, because a stronger economy, armed with a larger and more agile supply of capital, would continue to generate newer and bigger investment opportunities. The ratio of stock prices to current earnings would remain higher than otherwise, and arbitrage ensures that long-term interest rates would be *lower* than otherwise (bonds have to compete with stocks, and part of the return from bonds is also subject to the capital gains tax). Lower interest rates would reduce federal spending on debt service.

Most governmental research on how the capital gains tax affects realizations has serious flaws. Alan Auerbach, former chief economist with the Joint Committee on Taxation, measured capital gains revenues as a ratio to an index of stock prices.[35] If both tax receipts and the stock market rise as the capital gains tax is cut, as they invariably do, then both the numerator and denominator of the ratio of receipts to stock prices may rise by similar amounts, leaving the ratio unchanged. Ratios of receipts to GNP suffer the same defect. To the extent that a lower capital gains tax rate increases real GNP, then revenues and GNP would both rise, so that revenues "as a percentage of GNP" must understate the impact.

Auerbach points out that "estimates by the JCT (or OTA) take the aggregate output, employment and prices forecast by CBO (or OMB) as given." Static revenue estimates from the Treasury, CBO and JCT assume that reduced tax rates on capital would have literally no favorable effect whatsoever on wealth, savings, net foreign investment, or anything else affecting actual or potential economic growth. Since the performance of the economy is "given" by CBO or OMB projections, there is no scope for growth-oriented tax policy. Double the worst tax rates or cut them in half, and nothing can change but revenues.

Static revenue estimates also assume that taxpayers make literally no effort to avoid or evade steeper tax rates. James Poterba estimated that "a 1 percent change in the marginal tax rate leads to a 1 percent change in reported income, so that even without any change in the true tax base . . . capital gains tax cuts would be essentially self-financing."[36] Because "compliance is much lower for sales of real assets such as business property and personal residences than on corporate stocks and bonds," the lower the capital gains tax, the smaller the actual tax bias against investing in U.S. business.

Government economists waste much of the time they could be using to come up with realistic revenue estimates to explaining why they habitually assume that taxes have no effect on saving, economic growth or tax compliance. Mr. Samuels cites three older studies by federal agencies to the effect that "any effects on saving, investment and economic growth [as a result of lower tax rates on capital] are likely to be quite small . . . [The] responsiveness of saving to changes in the after-tax return is uncertain, and only a fraction of the additional savings will be used to finance new investment in domestic plant and equipment." Revenue estimates do not assume "quite small" effects; they assume zero effects.

The standard appeal to ignorance—claiming that the effect of taxes on savings is "uncertain"—is based on "studies" that do not even ask the right questions. The 1994 *Economic Report of the President* asserts that "saving rates seem to be little affected by movements in after-tax interest rates."[37] This is quite misleading on three counts. First of all, periods in which interest rates are going up are periods in which the value of stocks and bonds are going down. It should not surprise anyone that people are less eager to save when bear markets are producing widespread capital losses.[38]

Second, the "saving rate" is the ratio of personal savings to *after-tax* income. If savings were unchanged and after-tax income were reduced by higher income taxes (or a tax-induced recession), then the "saving rate" would appear to rise. Yet the flow of savings would be unchanged, and the real after-tax value of accumulated past savings (wealth) would be reduced by the tax increase. The relationship between rising interest rates (i.e., capital losses) and saving rates is *irrelevant* to the question of whether or not lower tax rates on capital gains would increase America's real net worth.

Third, corporate saving is also personal saving, because people own the corporations. As James Poterba points out, "raising the tax burden on capital gains . . .

will encourage firms to raise their [dividend] payout rates, compounding the negative corporate saving effect of higher corporate taxes."[39] A lower capital gains tax, by contrast, would increase *corporate* saving. A 1988 CBO study at least mentioned this point, yet somehow twisted it around:

> A reduction in capital gains tax rates that encouraged realizations could also encourage corporations to increase retained earnings at the expense of lower dividend payouts and less debt financing. Both of these changes would lower individual income tax revenues because dividend and interest income is taxable, while unrealized appreciation is not. (Less debt financing would, however, raise corporate revenues).[40]

The seemingly unimportant parenthetical remark at the end—about reduced corporate leverage—is one more thing excluded from revenue estimates. Corporate debt financing (unlike nearly all household financing) often involves selling bonds and commercial paper to tax-exempt pension funds. The corporation deducts the interest expense but the government collects no taxes on the resulting interest income. Added corporate savings is not a bad result either—it would raise the size of future corporate earnings, and thus raise the base of that tax. Moreover, the CBO's concern about "unrealized appreciation" not being taxed seems odd, since the starting point of the whole argument is "a reduction in capital gains tax rates that *encouraged* realizations." That logic implies that encouraging realizations would discourage realizations.[41]

What about personal savings? It is commonly said that tax policy must not have much effect, because the reduction of marginal tax rates after 1986 was not accompanied by higher personal saving. On the contrary, the drop in savings since 1986 is quite consistent with a strong effect from tax policy. Jonathan Skinner and Daniel Feenberg found that "the decline in marginal tax rates and the increase in the capital gains tax largely offset each other, leaving the effective tax rate on household investment largely unchanged."[42] If that was all that happened, it might have been a wash, aside from shifting household portfolios away from assets that pay off in capital gains (NASDAQ stocks) into assets that paid off in interest income (junk bonds). But IRAs and other pensions were also severely curtailed, and effective corporate tax rates were increased. Once marginal tax rates were also pushed back up in 1990–93, that reduced (1) the incentive to earn more in the first place, (2) the after-tax income left to save, (3) the incentive to save, and (4) the incentive to invest whatever saving was left in the U.S.—rather than in foreign countries or tangible assets (commodities, houses and cars).

The rest of Mr. Samuels' remark, about only "a fraction" of savings going into "domestic plant and equipment" raises questions. How large a fraction? And where else could savings possibly go? Under the mattress? Does money deposited in a bank or mutual fund just sit idle?

Perhaps the worry is that some "fraction" of added savings would go into constructing and financing homes. Although housing, like farming and services, does not get much respect from economists, it is the single most important investment that real people ever make. If Mr. Samuels is worried that U.S. savers might invest in *foreign* assets, a lower capital gains tax would repatriate domestic capital and attract a net inflow of foreign capital, because it would be quite favorable for the appreciation of U.S. stocks, bonds and real estate.

In reality, the lower the tax rate on real capital gains, the more corporations and households will save. Even in the *extremely* unlikely event that tax collections from the capital gains tax itself might briefly decline if the tax rate were cut, the net revenue effect of even a zero tax would still be positive. As Martin Feldstein remarked in a different context (IRAs), "an increase in private saving increases the capital stock and the return on this additional capital increases corporate tax payments that offset the loss of personal income tax revenue."[43]

Minarik raised yet another familiar complaint. He wrote that "over 85 percent of formal venture capital . . . comes from institutions not subject to the capital gains tax."[44] This is a common yet bizarre objection to a lower capital gains tax rate. It is, in fact, another reason why a lower tax rate on gains must *increase* revenues—by giving taxable individuals an incentive to supply seed money to the sorts of promising new ventures that only tax-exempt organizations would dare to invest in today. Instead of collecting *zero* tax on most venture capital gains, as the government now does, it could be collecting 15% on a much larger pool of venture capital.

Unless those making revenue estimates become far more candid about what is and is not included in their figures, it would be reckless to base tax policy decisions on revenue estimates. This is particularly true in cases where a large body of nongovernmental research indicates a robust and unambiguous behavioral response to taxes—such as labor force participation of spouses, "estate planning" effects on in-

come taxes, tax avoidance and arbitrage, and the myriad distortions caused by a high tax rate on nominal capital gains.

Reducing the capital gains tax to no more than 15%, and indexing the basis is clearly "Pareto Optimal." It would make many people better off (particularly workers) without making anyone worse off (not even the tax collectors). This is as close to a free lunch as economics can offer. It would be tragic to delay such an opportunity.

APPENDIX:

CAPITAL GAINS INDEXING IN THE U.K.[45]

The U.K. began taxing capital gains in 1965, at a flat rate of 30%. However, an annual exemption introduced in 1968 was subsequently increased several times, rising to five thousand pounds in 1982 and indexed to keep pace with inflation (e.g., the exemption rose to 5900 by 1985/86). Limited, prospective indexing was introduced in March 1982, which later became the base period for full indexing. In 1985, losses were also indexed.

In 1988, the top tax rate on personal income was reduced from 60% to 40% (marginal rates at lower incomes are 20% and 25%), and real capital gains above the exempt amount became taxable at the same rates as income. Gains were fully indexed for retail price inflation back to March 1982. The annual exemption was rolled back to five thousand pounds, but couples can exempt ten thousand pounds.

Because small gain are tax-exempt, the tax normally applies only to large realizations in any single year—which would usually push the taxpayer into the highest tax bracket regardless of regular income. Corporate capital gains are taxed at the slightly lower corporate tax rates.

The combination of a fairly generous exemption with a high 40% marginal tax above the exempt amount creates a strong incentive to realize small gains frequently and to defer large gains for the longest possible period. In the absence of indexing, the incentive to delay realizations of large gains indefinitely would be greatly aggravated.

Anecdotal information from the London Stock Exchange suggests that the complicated British capital gains tax generates very little revenue. The problem is neither indexing nor the exemption, both of which are roundabout techniques for preventing the punitive tax rate from utterly suffocating equity finance and driving it offshore.

ENDNOTES

[1] Price Waterhouse, *Individual Taxes,* 1994.

[2] The present value of real estate likewise reflects the discounted present after-tax value of future income (e.g., rent). The increased capital gains tax after 1986 reduced the incentive to maintain and improve distressed properties in the hope of future gains, thus contributing to the costly S&L crisis.

[3] Alan S. Blinder, "The Level and Distribution of Economic Well-Being," in M. Feldstein, ed., *The American Economy in Transition,* University of Chicago, 1980, p. 447.

[4] Joseph J. Minarik, "Capital Gains Taxation, Growth, and Fairness," *Contemporary Policy Issues,* July 1992, pp. 17 & 23.

[5] The main reason for emphasizing capital gains, rather than such alternatives as cutting tax rates on profits and/or dividends, is that the cost to the Treasury from taxing realized gain at a rate of 0–15% is obviously negligible. There would be more controversy about the revenue impact in most other cases, though that is debatable too (see footnote 13, above). By forcing gifts and contributions, the estate tax reduces *income* tax receipts, for decades, by much more than it collects at death. That makes it another prime candidate for revenue-enhancing repeal. See Alan Reynolds' testimony before the Senate Committee on Agriculture, Nutrition and Forestry, February 7, 1995.

[6] Vito Tanzi, ed., *Taxation, Inflation and Interest Rates, International Monetary Fund,* 1984, p. 26.

[7] "As long as the after-tax rate of return on the preferred asset is greater than the after-tax rate of payment on the borrowing, the taxpayer will find this arbitrage profitable." C. Eugene Steuerle, *Taxes, Loans & Inflation,* Brookings Institution, 1985, p. 60.

[8] Joseph J. Minarik, "Taxation, A Preface, " in David R. Henderson, ed., *The Fortune Encyclopedia of Economics,* Time Warner 1993, p. 315. See also Alan Reynolds on marginal tax rates in the same volume.

[9] Stephen J. Entin, "Proposed Trade-Off of Step-up Basis at Death for Adjustment of Capital Gains for Inflation: A Bad Bargain," Institute for Research in the Economics of Taxation, September 7, 1993.
[10] Price Waterhouse, *op. cit.*, p. 243.
[11] Alan J. Auerbach, "On The Design and Reform of Capital Gains Taxation," National Bureau of Economic Research *Working Paper* No. 3967, January, 1992.
[12] Steuerle, *op. cit.*, p. 153.
[13] Roger H. Gordon & Joel Slemrod, "Do We Collect Any Revenue From Taxing Capital Income?" in Lawrence H. Summers, ed., *Tax Policy and The Economy,* NBER, MIT Press, 1988, p. 120.
[14] Eric J. Toder, "Revenue Effects of Capital Gains Taxes," New Zealand Treasury Dept., December 20, 1988.
[15] Randall J. Pozdena, "Tax Policy and Corporate Tax Structure," Federal Reserve Bank of San Francisco *Economic Review,* Fall 1987, p. 49.
[16] "Corporate interest payments were significantly higher. . . in the late 1980s than in the years leading up to the Tax Reform Act." James Poterba, "Why Didn't The Tax Reform Act of 1986 Raise Corporate Taxes?" National Bureau of Economic Research *Working Paper* No. 3940, Dec. 1991.
[17] Alan Reynolds, "Workforce 2005: The Future of Jobs in the United States and Europe" in *OECD Societies in Transition,* Paris, 1994.
[18] *Budget of the United States Government: Historical Tables,* Fiscal 1995, Table 1.3, p. 17.
[19] Dieter Helm, ed., *The Economics of John Hicks,* Basil Blackwell, 1984, p. 142.
[20] Richard Schmalbeck of Duke University, using revenue estimating procedures of the JCT, estimated that the deadweight welfare loss to the private sector from the capital gains tax is five and a half times as large as the revenue this tax purports to collect. "The Uneasy Case For A Lower Capital Gains Tax," *Tax Notes,* July 9, 1990.
[21] Howard Gleckman, "Capital Gains," *Business Week,* March 5, 1990, p. 26.
[22] Joel Slemrod, "Who Realizes Capital Gains?" *Tax Notes,* October 23, 1989, p. 494.
[23] Don Fullerton & Diane Lim Rogers, *Who Bears The Lifetime Tax Burden?,* Brookings Institution, 1993, pp. 26 & 37.
[24] Joseph Stiglitz, "Notes on Estate Taxes," *Journal of Political Economy,* April 1978.
[25] Laurence Kotlikoff and Lawrence Summers, "Tax Incidence," National Bureau of Economic Research *Working Paper* No. 1864, p. 47.
[26] Michael Ruston, review of John B. Shoven & John Whalley, eds., *Canada-U.S. Tax Comparisons,* University of Chicago, 1992, in *National Tax Journal,* March 1994, p. 230.
[27] "The Capital Gains Tax Cut," *The Brookings Review,* Summer 1992, p. 28.
[28] Alan Reynolds, testimony before the House Ways & Means Committee, January 17, 1995.
[29] Joseph J. Minarik, "Capital Gains," in Henry J. Aaron & Joseph A. Pechman, eds., *How Taxes Affect Economic Behavior,* Brookings Institution, 1981, p. 248.
[30] James Tobin, "Considerations Regarding Taxation and Inequality," in Colin D. Campbell, ed., Income Redistribution, American Enterprise Institute, 1976, p. 132.
[31] Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1994–98,* Jan. 1993, p. 64.
[32] "The estimated magnitude of the realization response is large enough to substantially mitigate the revenue loss that a tax reduction would otherwise cause and may. . . be large enough to generate an increase in revenues." Joel Slemrod & William Shobe, "The Tax Elasticity of Capital Gains Realizations," National Bureau of Economic Research *Working Paper* No. 3237, January 1990.
[33] Alan Reynolds, "Half-Dozen Ways Less Means More In Capital Gains," *Wall Street Journal,* July 25, 1989.
[34] Robert L. Bartley, *The Seven Fat Years,* Free Press, 1992, p. 68.
[35] Alan J. Auerbach, "Capital Gains Taxation in the United States" *Brookings Papers on Economic Activity* 1988:2, p. 598.
[36] James Poterba, "Tax Evasion and Capital Gains Taxation," *American Economic Review,* May 1987, p. 237.
[37] *Economic Report of the President,* February 1994, p. 88.
[38] "Measured real interest rates probably do not accurately reflect the expected returns on most of the assets in consumers' portfolios." Lawrence Summer &

Chris Carroll, "Why Is U.S. National Savings So Low?" *Brookings Papers on Economic Activity,* 1987:2, p. 624.

[39] James M. Poterba, "Tax Policy and Corporate Saving," *Brookings Papers on Economic Activity,* 1987:2, p.487.

[40] Congressional Budget Office, *How Capital Gains Tax Rates Affect Revenues,* March 1988, p. 68.

[41] Alan Reynolds, "Time To Cut The Capital Gains Tax," Polyconomics Inc., March 15, 1989.

[42] Jonathan Skinner & Daniel Feenberg, "The Impact of the 1986 Tax Reform on Personal Saving," in Joel Slemrod, ed., Do Taxes Matter?, MIT Press, 1990, p. 50.

[43] Martin Feldstein, "The Effects of Tax-Based Saving Incentives On Government Revenue And National Saving," National Bureau of Economic Research *Working Paper* No. 4021, March 1992, p.7.

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[45] Mervyn A. King & Mark H. Robson, "United Kingdom" in Dale W. Jorgenson & Ralph Landau, eds, *Tax Reform and the Cost of Capital,* Brookings Institution, 1993, p. 307. Nick Morris, "United Kingdom" in Joseph A. Pechman, ed., *Comparative Tax Systems,* Tax Analysts, 1987, pp. 300–301. Price Waterhouse, *Individual Taxes,* 1994, p. 398.

PREPARED STATEMENT OF MICHAEL L. SCHLER

My name is Michael Schler. I am here on behalf of the Tax Section of the New York State Bar Association. I was the Chair of the Tax Section until my term expired last month, and I continue to be a member of our Executive Committee. The Tax Section is dedicated to furthering the public interest in a fair and equitable tax system and to the development of sound tax policy. I am a tax partner at the New York law firm of Cravath, Swaine & Moore and have practiced tax law for over 20 years.

We are very grateful for the opportunity to present our views today on indexing the tax basis of assets for inflation. The bottom line is that we strongly oppose indexing, because it will vastly increase the complexity of the tax system and it will lead to the return of the tax shelter days of the 1980's.

But before expanding on these reasons, I would like to emphasize several points. First, we are a completely nonpartisan organization, and the members of our Executive Committee are of all political persuasions. Nevertheless, our strong opposition to indexing is essentially the unanimous view of all of these members, Republican as well as Democrat.

Second, our strong opposition to indexing is long-standing. We wrote to Chairman Rostenkowski in 1990 strongly opposing an indexing provision very similar to that now in H.R. 9, and we submitted at that time an extensive report describing our concerns about indexing. Included with my statement today are copies of our 1990 materials, as well as a letter to the same effect we recently sent to Chairman Archer of the House Ways and Means Committee.

Third, we take no position on whether the capital gains rate should be reduced. Our position on indexing is based solely on our technical expertise as tax lawyers. The arguments for and against a lower rate involve policy issues far beyond our particular expertise. We leave that debate to others.

Finally, yes we recognize the theoretical correctness of indexing. If you buy an asset with your own money for $100 and later sell it for $150 after there has been 50% inflation, you have no real gain. In a perfect world you would not have to pay any tax.

On the other hand, capital gains receive other benefits today that even as a theoretical matter offset the failure to index. The maximum rate is 28% (and H.R. 9 reduces the rate to half the ordinary income rate), and no tax has to be paid until you decide to sell the asset.

However, I want to emphasize today two very fundamental *practical* problems with indexing. These problems far outweigh any theoretical perfection that may arise from indexing. The first problem of course is complexity.

The Internal Revenue Code today is already so complex it is near the breaking point. Much of this complexity arises from Congress (as well as the regulation writers) trying to achieve perfection. We believe that down in the trenches, where real people make honest efforts to comply with the tax laws, indexing will vastly increase the burden and complexity for everyone. This includes individuals, businesses of all sizes, and the IRS.

Activities that are relatively simple today will involve massive calculations under indexing—buying and improving a home, buying and selling stock, or buying an interest in a mutual fund. You could not invest in a simple dividend reinvestment plan without an accountant. Everyone who collects stamps or baseball cards will be required to keep permanent records not only of each purchase price, but also of the calendar quarter in which each stamp or card was acquired. If you ever want to sell a stamp, you'll also need to consult your accountant. (I should point out that for most individuals, accountants' fees are not deductible.)

If this is not bad enough, consider the fact that most states impose their own income tax. If a state chooses not to allow indexing for revenue reasons, everyone in that state will be required to keep two sets of books (even for the baseball cards). Individual taxpayers are likely to be dumbfounded at this prospect.

Finally, suppose indexing is adopted and it turns out to be so complicated that after a few years most people want to repeal it. What do you do about the assets that already have a basis indexed for a few years' inflation? Do you take away that basis that taxpayers are already relying on? Is that a retroactive tax increase?

Or do you let taxpayers keep their indexed basis as of the repeal date, and only disallow future indexing? If you let people keep the indexed basis, you have created a permanent complexity in the Code. Someone selling an asset thirty years from now would have to figure out whether it was owned in 1995, and if so, whether it was eligible for indexing this year.

I could go on, but that is enough on complexity. The other major problem we have with indexing is that it will inevitably result in the return of the tax shelter days of the 1980's. Every experienced tax lawyer who reads the indexing provisions of H.R. 9 immediately dreams up a half dozen ways to "beat the system" and create a tax shelter that eliminates tax on unrelated income. It is inevitable that many of these tax shelter schemes will be mass marketed through ads in the newspapers.

Some of the most obvious opportunities arise from the fact that assets are indexed while liabilities are not. Even the theoretical justification for indexing falls apart at this point. Totally artificial tax deductions can be created with little or no out-of-pocket investment, by borrowing and using the proceeds to buy an indexed asset.

Take the simplest possible example. Suppose you borrow $100, buy a share of stock for $100, and sell the stock after two years for $110, after there has been 10% inflation. Also assume the interest rate on the loan is 5% a year, or $10 for two years, and the stock doesn't pay dividends. When you sell the stock for $110 you just have enough money to pay off the principal of the loan ($100) and two years' interest ($10).

You started with no net cash investment, you exactly break even, and you end with no cash. You have no taxable gain on the stock because of the indexed basis. But you get to deduct $10 of interest. You end up with a net tax deduction of $10 on a break-even investment, and you can use that deduction to shelter $10 of other completely unrelated income.

There is no theoretical or other justification for this result. It is a classic tax shelter. I should add that the passive loss rules adopted in 1986 would have no effect on this. Those rules apply to losses on real estate, leasing and other businesses, but not investment losses. There are other rules limiting interest deductions for debt used to make investments. However, at the very least a taxpayer could use the completely artificial deductions arising from indexing to shelter all of his or her other unrelated interest and dividend income.

I also want to emphasize that there would be many ways besides borrowing to create a tax shelter out of indexing. Keep in mind that the world of financial products is extraordinarily creative, and very motivated to develop tax favored investments.

Just as one example, H.R. 9 indexes only stock and tangible assets that you own, but not bonds. It is not clear why intangibles such as patents are excluded, but that's another story. The reason for excluding bonds is that if you buy a bond for its face amount you get back exactly what you paid. If you were allowed to index the principal amount of the bond you would be guaranteed a tax loss at maturity (even on a Treasury obligation) even though you got back your full principal amount.

But today a taxpayer can convert almost any asset into the economic equivalent of a bond by using equity swaps and other creative techniques. Under H.R. 9, such an asset would still be indexed, because it is not *literally* a bond. The result is a guaranteed tax loss and not much else.

Another area filled with opportunities for creativity arises from the fact that H.R. 9 indexes all corporate stock regardless of the nature of the assets held by the corporation. For example, if a corporation holds an asset not eligible for indexing, all

it has to do is transfer the asset to another corporation. It then gets to index the stock of the second corporation, which may be almost as good.

So much for fun and games. Of course, it would be possible to write a statute to try to prevent all the unintended abuses of the indexing provisions. This would bring us back to theoretical purity (which is where we started). However, the complexity would become truly overwhelming in trying to distinguish "good" from "bad" transactions. Even those ordinary taxpayers intended to be the beneficiaries of indexing would need lawyers to interpret the rules, as well as accountants.

Furthermore, no matter how much effort is put into trying to prevent tax shelters from arising as a result of indexing, with all due respect I believe the effort is doomed to failure. This is not the fault of the excellent and dedicated legislative tax staffs.

The problem is similar to the problem of the manager of a computer system trying to keep out the hackers. You spend a lot of time and effort and set up all your defenses. But once your defenses are in place, you are essentially a sitting duck while hundreds or thousands of very smart hackers probe your defenses for weaknesses. Eventually they will find your weak spot and exploit it to the fullest. And the worst thing is that in many cases you won't know your system is compromised until the revenues mysteriously start declining.

There are other problems with indexing that I haven't had time to discuss. If only certain types of assets are indexed (for example, H.R. 9 limits indexing to stock and tangible assets), economic inefficiencies are created because returns on different assets are taxed at different rates. Even aside from the fact that intangible assets such as patents are not indexed, why is the cost of stock indexed but not the cost of a stock option?

Similarly, the amount of indexing you are entitled to is necessarily based on exactly when you buy and sell an asset. H.R. 9 compares price levels for the calendar quarter in which you buy and the calendar quarter in which you sell. There is then an incentive to buy stock and other indexed assets at the end of one quarter rather than the beginning of the next quarter, and not to sell an asset at the end of a quarter but rather to hold until the beginning of the next quarter. Each of these techniques will give you an extra 3 months of indexing benefits. Legislation could of course go to monthly or even daily indexing calculations, but you obviously pay the price in increased record keeping and complexity. There are no easy solutions to these problems.

Finally, I have been asked to address how other developed countries tax inflationary gains. We have not studied this matter at any length. However, we understand that the U.K. and some other countries do index the tax basis of assets for inflation (although the U.K. does not also have a reduced rate for capital gains). We also understand, however, that a series of anti-abuse amendments has been necessary in the U.K.

Even more importantly, we do not know whether taxpayers in the U.K. and other countries have the deep-seated American urge to exploit loopholes in their tax systems. We also doubt that the financial markets outside the U.S. are as creative in developing tax-advantaged products. Recent history in the United States indicates that taxpayers will take full advantage of the rule that no one needs to pay more taxes than are legally due. We would therefore urge extreme caution in applying the lessons of other countries to the United States.

To close with my original theme, the tax law will never be perfect. The whole Code is a compromise between accuracy and administrability. A "simple" indexing system such as that in H.R. 9 is neither accurate (because liabilities are not indexed) nor administrable. An accurate indexing system would give rise to even more overwhelming complexity and yet would still give rise to tax shelters. We strongly believe that indexing is one situation where all attempts at theoretical accuracy should be sacrificed for administrability.

Attachments.

SUPPLEMENTAL MATERIAL

January 19, 1995.

Hon. BILL ARCHER
House of Representatives
Washington, DC

Re: Tax Basis Indexing provisions of H.R. 9

Dear Chairman Archer: I am writing on behalf of the Tax Section of the New York State Bar Association to strongly oppose any proposals to index the tax basis of assets for inflation.

It is our judgment as tax lawyers that the indexation proposals currently before Congress are fundamentally flawed. The proposals would:

- permit unwarranted tax avoidance and revenue loss;
- potentially result in the mass marketing of tax shelters to well advised and high income taxpayers, as in the 1980's; and
- vastly increase the burden and complexity of the tax system for all taxpayers (individual, small business and large business) as well as the IRS, at a time when many believe that its complexity has already brought it near the breaking point.

Moreover, even if a theoretically sound system of indexation could be developed, the additional complexities that would be necessary to do so would completely overwhelm taxpayers and the IRS.

Our position on indexation is based on our particular experience and expertise as tax lawyers rather than on broader policy judgments. We take no position on the policy issues of the appropriate tax rate that should apply to capital gains in general, or the appropriate depreciation rate that should apply to depreciable assets.

We refer specifically to two provisions of H.R. 9, the Job Creation and Wage Enhancement Act of 1995. The first is Section 1002, which (with certain exceptions) indexes the basis of corporate stock and tangible assets that are capital assets or used in a trade or business. The second is Section 2001, which indexes the basis of depreciable property.

Section 1002

Section 1002 is based almost entirely on a similar provision in H.R. 3299 introduced in the 101st Congress in 1989 and approved by the Ways and Means Committee in that year (the "1989 Bill"). In 1990 the Tax Section submitted a letter and report discussing that provision (the "1990 Report"), in which we strongly urged Congress to reject indexation.

We enclose a copy of the 1990 Report, as well as a newly prepared Appendix that details the variations between the indexing provisions of the 1989 Bill and H.R. 9. As noted in the Appendix, if anything H.R. 9 provides even greater opportunities for improper tax avoidance than did the 1989 Bill. As a result, almost all the serious issues raised in the 1990 Report are equally valid today.

Much of the tax avoidance potential of indexing in Section 1002 arises from the fact that indexing is not consistently applied:

- *assets* are indexed to reflect the fact that appreciation in value in dollar terms is illusory to the extent it is offset by a decline in the real value of the dollar, but
- *liabilities* are not indexed even though the real value of the obligation to repay the debt is equally reduced by a decline in real value of the dollar.

This is best illustrated by an extreme but simple example of a "no money down" tax shelter, where the taxpayer starts with no cash, exactly breaks even on a cash flow basis, but ends up with a tax deduction:

> On January 1, 1996, X takes out a recourse loan of $100 and buys a share of common stock for $100. Inflation during 1996 is 3%. The interest rate on the loan is 6%. The stock pays dividends of 6%, just enough to pay the interest on the loan. On January 2, 1997, X sells the stock for $100 and uses the proceeds to pay off the loan.

X made no out-of-pocket investment that lost value due to inflation. There is thus no possible justification for applying indexation to X. Nevertheless, under the indexing proposals X's tax basis in the stock increases from $100 to $103 because of the 1996 inflation of 3%. X can therefore claim a taxable loss of $3 on the sale of stock. Thus, *on a transaction which was totally break-even to X under any interpretation, X has created a capital loss that permits X to avoid all tax on $3 of other unrelated capital gain.*

This result is perfectly legal under H.R. 9, and any tax lawyer would give an unconditional tax opinion that it worked. Moreover, while the example involves the creation of a capital loss that could only offset capital gains, a slight variation in the example would result in the creation of an ordinary loss that could offset unrelated ordinary investment income of an individual, and any unrelated ordinary income of a corporation.[1]

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[1] Suppose that the stock paid no dividends and was sold for $106 instead of $100. There would still be just enough cash to pay interest and principal on the debt, but X would have $3 of capital gain (taking into account the indexed basis of $103) and a $6 interest deduction. The result would be that at least $3 of unrelated ordinary investment income would be sheltered from tax. Taking into account the 50% capital gains deduction also in H.R. 9, there would be only $1.50

Continued

Moreover, individuals could use home equity loans to purchase indexed assets. Since interest deductions on such loans are not subject to the "investment interest" limitations of the Code, the reduced capital gain on the sale of an asset due to indexing would "free up" interest deductions that could be used to shelter salary and other noninvestment income.[2] It is from examples like this, however, that tax shelters are made and marketed.

To be sure, in the example, X bore the risk that the stock would decline in value and that a real economic loss would result. A tax shelter would not be attractive on this basis. However, there are numerous opportunities under the statutory provision to substantially reduce or eliminate risk of loss, thereby creating a pure "tax loss generator" that requires little or no investment, and that involves little or no risk of loss.

It would be possible in theory to avoid results such as these that are based on leverage by:

(1) disallowing indexing on debt-financed property,

(2) indexing liabilities the proceeds of which were used to acquire indexed assets, so that a borrower would have income on the repayment of principal on Such a loan to reflect the economic gain arising from the fact that the loan was repaid with dollars that were worth less than the borrowed dollars because of inflation; or

(3) similar to (2), disallowing each year a portion of the deduction for otherwise deductible interest on debt used to acquire indexed assets, based on that year's inflation rate.

However, we believe the resulting complexity of any of these approaches would be so overwhelming that any such attempt would fail.[3] Very significantly, there would need to be complex rules "tracing" liabilities to indexed assets, so that one of the foregoing consequences would arise only to the extent the debt "relates" in some fashion to indexed assets.[4]

Moreover, debt financing is not the only technique that could be used to create unwarranted tax benefits from indexing. Indexing could be used to generate artificial tax losses, with no significant risk to the taxpayer, through financial transactions such as (i) net leasing that did not come within the net leasing exclusion in the bill, (ii) preferred stock with small upside potential that did not come within the preferred stock exclusion in the bill, and (iii) equity swaps, forward sales, and other financial products, none of which come within the short sale rule in the bill.

Of course, attempts could be made to preclude all unintended results of indexing. However, this would create further complexity and would likely prove ineffective in any event.[5] In addition, a large amount of otherwise productive economic resources would be shifted into tax planning schemes.

As a result, we strongly oppose the provisions of Section 1002 of H.R. 9.

Section 2001

We turn now to Section 2001 of H.R. 9, relating to "Neutral Cost Recovery." That provision in effect indexes the basis of depreciable property for inflation, and, in the

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of income on the sale, and the $6 interest deduction would permit $4.50 of other ordinary investment income (or $9 of other capital gain) to be sheltered from tax. In the case of a corporation, the Section 163(d) investment interest limitations do not apply, and the unrelated income could be sheltered even if were not investment income.

[2] Interest on business loans is also exempt from the investment interest limitations. The result in the text could therefore also be achieved if—a self-employed individual were permitted to take out a business loan and indirectly use the proceeds of the loan to purchase an indexed investment (through the technique of using the loan proceeds in the business and withdrawing "different" cash from the business to make the investment). This technique raises the "tracing" issue discussed below.

[3] For example, under approaches (2) and (3), if a home mortgage were used to acquire an indexed asset (including the home itself or a car, both of which are indexed assets), either a portion of each monthly interest payment would be nondeductible or else income would arise on each monthly principal payment.

[4] The interest tracing rules are already among the most complex tax provisions applicable to individuals, and new tracing rules for indexing would simply be overwhelming. Moreover, taxpayers would make great efforts to "separate" their debts from their indexed assets. To illustrate part of the problem, suppose an individual-simultaneously (1) used money in the bank to buy indexed stock and (2) borrowed money to buy a bond that is not eligible for indexing. Would one of the adverse consequences apply to the loan or the stock, as would be the case if (1) the cash was used to buy the bond and (2) the loan was used to buy the stock?

[5] Moreover, if indexing is adopted and turns out to be undesirable for these or other reasons, even if it were repealed its complexities might linger for decades. Taxpayers would likely expect to retain the full indexed basis of assets as of the repeal date, even if future indexing of all assets was prohibited. Thus, records concerning the brief application of indexing would have to be maintained for as long as those assets were held.

case of property with a depreciable life of 10 years or less, an additional 3.5% per year. We understand that the latter adjustment is intended to be the financial equivalent of immediately expensing the asset, and that immediate expensing is in turn financially equivalent to the expected return on an asset being completely free of tax.

Each of our objections to capital gains indexing applies equally to basis indexing for depreciation purposes, and to an even greater extent to indexing in excess of the inflation rate. We believe the effect will be a vastly more complicated Tax Code, greatly increased opportunities for tax avoidance, and a great shifting of economic resources into tax planning schemes.[6]

For example, short-lived equipment will be similar to a municipal bond in that expected earnings will in effect be tax-free. Such equipment will actually be a far better investment than a municipal bond, however, because interest on debt to purchase the equipment will be fully tax-deductible while interest on debt incurred to purchase a municipal bond is not deductible. This result has the potential for reduction of the corporate income tax far beyond that apparently contemplated by the drafters of the statute. For these reasons, we also strongly oppose Section 2001.

Conclusion

We would be pleased to assist in any way possible in trying to make these or other indexing proposals more workable. However, for the reasons stated above we believe such efforts would be overwhelmingly complex and are not likely to succeed. We therefore strongly oppose the indexing proposals and believe their adoption would be a serious error.

We also wish to point out an additional very significant issue relating to *state* taxes. The indexing provisions in H.R. 9, if applicable for state tax purposes, would cause a significant loss of state revenue. As a result, some states may not be willing to allow indexing of some or all assets. Enormous additional complexity would result if individuals or corporations, or both, were required to maintain separate tax basis and other related records for Federal and state tax purposes.

Finally, we understand that the United Kingdom and several other countries have forms of basis indexing. As indicated in our 1990 Report, however, we understand that a series of anti-abuse amendments has been necessary in the U.K. Moreover, we understand that some countries (such as the U.K.) do not also have the reduced capital gains rate provided in H.R. 9, and others (such as Israel) have experienced severe inflation necessitating indexing despite its drawbacks.

Most importantly, we are not aware of the extent to which discontinuities in the tax systems of those other countries are exploited by taxpayers in order to achieve unintended tax benefits. We believe, however, that recent history in the U.S. indicates that such results here are extremely likely.

Very truly yours,

MICHAEL L. SCHLER, *Chair, Tax Section.*

1995 APPENDIX: THE 1995 BILL

The 1995 Bill differs from the 1989 Bill in several respects. Many of the changes address concerns which were discussed in the 1990 Report. However, in responding to these concerns, the 1995 Bill creates additional serious problems. This merely demonstrates our belief that any indexation system is inherently unworkable. Many of the modifications which are contained in the 1995 Bill are relatively minor and have little impact from a technical point of view. The following changes could have significant technical implications and are therefore worthy of discussion.

The 1995 Bill Eliminates Even the Inadequate Measures for Mitigating Debt Arbitrage Provided in the 1989 Bill

The 1990 Report commented on the arbitrage opportunities brought about by the 1989 Bill's failure to index liabilities. The 1995 Bill does not correct this problem. In fact, the 1995 Bill even eliminates the 1989 Bill's limited solution to the debt arbitrage problem. Although the solution contained in the 1989 Bill was problematic, its elimination gives rise to significant concern that the magnitude of the debt arbitrage problem is not fully recognized.

The 1989 Bill attempted to mitigate the potential for debt arbitrage by disallowing basis adjustments that would create or increase a loss. Under the 1989 Bill, the basis of assets could be indexed solely for purposes of determining gain. In contrast, the 1995 Bill allows indexation to create or increase capital, but not ordinary, loss.

[6] We may provide additional technical comments on this provision in the future.

All ordinary losses generated or increased though indexation will be treated as long term capital losses.

The 1990 Report stated that the loss limitation solution to the debt arbitrage problem was problematic because of its failure to treat similarly situated taxpayers comparably. However, allowing indexation to create losses is highly questionable since it exaggerates the potential for tax arbitrage, thereby sanctioning potentially serious tax avoidance schemes.

In addition, allowing losses to be created through indexation while still failing to index liabilities will create an even greater revenue risk than what would have existed under the 1989 Bill. This further highlights our concern regarding the intrinsic problems with indexation. The 1990 Report provides examples which illustrate this point. See section III(B)(1) of the 1990 Report.

Corporations may Index Assets Under the 1995 Bill

Corporations would be permitted to index their assets under the 1995 Bill, whereas they could not do so under the 1989 Bill. The 1990 Report noted that not allowing corporations to index assets would tend to increase the tax penalty associated with operating through a C corporation and therefore increase the existing bias against operating in C corporation form. Although the 1995 Bill avoids this situation by allowing corporations to index basis, the inclusion of corporations nonetheless introduces several new areas of significantly heightened complexity to the tax law.

One of the principal areas of concern is the consolidated return rules. To implement appropriate basis adjustment rules, coordinated indexing adjustments would have to be made at each tier of a consolidated group. This coordination would have to reflect differences that might exist by reason of variances between the basis of a subsidiary's stock and the basis of its assets, the mix of indexable and non-indexable assets at the subsidiary level, and the timing of the sale of stock or assets. For example, because parent corporation P may sell the stock of subsidiary S, which holds indexable assets, before S realized gain on those assets, a mere pass-through of realized indexing adjustments would be inadequate for P. Thus, rather than a single adjustment at the time of disposition, annual basis adjustments with the associated complexity would have to be made and passed through up the chain of stock ownership. Moreover, complex rules would be necessary to deal with cross-ownership of stock among members of a consolidated group to avoid multiplication of indexing adjustments. Special rules also would be required to deal with inter.company transactions. Finally, we note that because the rules that would apply for consolidated returns presumably would reflect the fact that not all assets are indexable, there may be vast differences in the indexing adjustment available to a corporation with respect to stock in otherwise identical corporations where one is consolidated and one is not.

The 1995 Bill Creates Distortions for Holders of Partnership Interests by Eliminating the Special Rule for Section 754 Elections

Both the 1989 Bill and the 1995 Bill would provide for indexation of partnership assets at the partnership level and a pass-through of the adjustment to the partners. Partnership interests themselves are not indexable assets under either bill. The 1989 Bill, however, contained a special provision applicable to the transfer of a partnership interest if the partnership had made a section 754 election which was in effect at the time of the transfer. Under this provision, the transferor partner would treat the adjustment under section 743(b) (1) as a sale of the partnership assets for purposes of indexation. This provision effectively allowed the transferor partner to index his partnership interest.

The 1990 Report explored some of the substantial problems which would result from the special rule pertaining to section 754 elections. Rather than developing a substantive solution to these problems, however, the 1995 Bill merely eliminates the special provision entirely. In doing so, it has merely replaced the prior difficulties with new problems.

For example, the 1995 Bill now creates an unprincipled distinction between joint ownership of assets and holding assets in partnership form. Consider individual taxpayers A and B who hold an asset jointly. Each has a 50% interest in the asset, which has a cost basis of $100 and a fair market value of $200. In a later year, when A disposes of A's share of the asset, the indexed basis of the asset is $150. Therefore, A's gain upon disposition is $25. Alternatively, if A and B hold the same asset through a partnership, upon a sale of A's partnership interest to C for $100, A would have a $50 gain. Therefore, A's effectively penalized for using the partnership form.

On the other hand, if the value of the asset has declined, there would be a loss on the sale of A's interest to C. If a section 75.4. election is made, the basis of the

partnership assets with respect to C is written down. However, if no election is made, it remains possible for C to get the benefit of buying an interest in an indexable asset at less than original cost where the indexable basis of the asset at the partnership level is significantly higher. In doing so C would gain the benefit of indexation adjustments upon the partnership's ultimate disposition of the asset that may be greatly overstated relative to the actual effect of inflation on the asset during C's holding period. These overstated adjustments could effectively shelter significant real gains. We can anticipate an active market for such tax sheltering opportunities.

1995 Bill uses a GNP Deflator Rather than the Consumer Price Index

A minor change has been made which relates to how assets will be indexed. The 1989 Bill used an index which was based on the consumer price index while the 1995 Bill uses a GNP deflator. As the 1990 Report indicated, we believe that any indexation factor is destined to produce imprecise results. As it will be pure chance if a basis adjustment actually matches inflation, we believe that which factor is ultimately chosen should an indexation system be put in place is a matter of little consequence as a technical matter.

TAX SECTION

Tax Report #662

New York State Bar Association

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June 28, 1990

The Honorable Dan Rostenkowski
Chairman
House Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Rostenkowski:

I write to express the strongly held view of the Executive Committee of the Tax Section that Congress should reject any proposal to adjust or "index" the basis of capital assets for inflation. As described in the enclosed Report, an indexation regime would create intolerable administrative burdens for taxpayers and tax administrators as well as offer numerous tax arbitrage and avoidance opportunities for aggressive tax planners. As tax practitioners, we are seriously concerned that any indexation system will permit the use of its inherent complexities, distortions and tax avoidance opportunities to severely erode the revenue base. An indexed tax system will also place a great deal of additional strain on an audit system already stretched beyond the limits of its real capacity.

Adoption of indexation in even the most limited manner would make the tax law significantly more complex. We view this incremental complexity as particularly insidious because the implementing legislation may be deceptively simple. The indexation provisions adopted by the Ways and Means Committee in the course of considering the Omnibus Budget Reconciliation Act of 1989, discussed in some detail in our Report, represent just this type of

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deceptive simplicity. In effect, simplicity is achieved by simply ignoring the many difficult problems inherent in the statute.

Although we express our grave concern about the desirability of implementing an indexation regime, we wish to make clear that we are not at this time expressing any position regarding the desirability of enacting any form of preferential taxation of capital gains including the adoption of a preferential rate.

Very truly yours,

Arthur A. Feder
Chair

Enclosure

REPORT ON INFLATION ADJUSTMENTS TO THE BASIS OF CAPITAL ASSETS

by the
New York State Bar Association
Tax Section Ad Hoc Committee
on Indexation of Basis

In this article, the authors argue strongly that indexation would create administrative burdens for taxpayers and administrators, as well as offer numerous tax arbitrage and avoidance opportunities for aggressive tax planners. They also believe that the complexities, distortions, and tax avoidance opportunities will severely erode the revenue base. Further strain would be placed on the audit system, which already is stretched beyond its capacity.

Adoption of indexation in even the most limited manner would make the tax law significantly more complex. This incremental complexity is particularly insidious because the implementing legislation may be deceptively simple. The indexation provisions adopted by the Ways and Means Committee in the course of considering the Omnibus Budget Reconciliation Act of 1989, discussed in some detail in this article, represent just this type of deceptive simplicity. In effect, simplicity is achieved simply by ignoring the many difficult problems inherent in the concept.

The committee is chaired by Harold R. Handler and Bruce Kayle, who were the principal authors of this report, ably assisted by Dan Chung. Helpful comments were received from Arthur Feder, John Corry, Michael Schler, Steve Millman, Dennis Ross, Jonathan Blattmachr, Guy C.H. Brannan, Harvey Dale, Stanley Rubenfeld, Vic Zonana, Eugene Vogel, Jim Peaslee, Ken Anderson, and Gavin Leckie.

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I. INTRODUCTION

In the ongoing debate regarding the implementation of some form of preferential taxation of capital gain income, many legislative alternatives will be considered. One such alternative is adjusting or "indexing" the basis of certain capital assets to reflect general price level inflation, thereby attempting to tax only "real" as opposed to inflationary gains.[1] This Report discusses the issues, problems, and other considerations raised by the indexing of the basis of capital assets.

The principal argument in favor of indexing basis is that the tax system would be more equitable if only "real" as opposed to inflationary gains are taxed. Nevertheless, it is our view that the implementation of any indexing regime would necessarily introduce far reaching new complexities and distortions into the tax system, without necessarily resulting in the taxation of only "real" gains. We believe the tax law would be ill served if Congress were to enact any such system.

In addition to increased complexity, any indexation system would by its nature provide taxpayers with additional deductions or basis adjustments which would diminish income, and thus tax revenues. Any system of indexation must also be designed with great care to avoid creating "abusive" opportunities for tax arbitrage, that is, providing deductions or reduction of taxable income for high-bracket taxpayers while allowing income to be or shifted to tax-exempt or nontaxable entities. As we ex-

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[1] Several Bills currently are pending before Congress that would provide for some form of basis indexing. See S 171, S 182, S 645, S 664, S 1311, S 1286, S 1771, H R 57, H R 232, H R 449, H R 504, H R 719, H R 1242, H R 2370, H R 3628 and H R 4105.

plore in some detail below, an indexation system which only selectively attempts to index the tax system would create numerous opportunities for such tax arbitrage.[2] As tax practitioners, we cannot stress more strongly our concern that the tax arbitrage opportunities presented by an indexation system and, in particular, any selective indexation proposal, will have a corrosive effect on the revenue base.

This Report is not intended to present an exhaustive analysis of the issues raised by basis indexing or to develop what inevitably would be complex solutions to the various problems raised. Many of these issues and problems have been thoughtfully developed elsewhere.[3] Rather, the Report is intended (1) to demonstrate the sheer enormity of any attempt to develop an administrable system of indexing that does not create distortions as bad or worse than those intended to be avoided, (2) to indicate the pervasive transactional complexities that basis indexing would introduce into the tax system, and (3) to describe some of the tax arbitrage opportunities inherent in any indexation system.

The discussion below is directed at what we see as the basis elements of any indexation system. As an example of the problems and issues created by an indexation system, the Report offers some specific comments regarding those provisions of the Omnibus Budget Reconciliation Act of 1989 as passed by the House of Representatives[4] (although not contained in the final version of the legislation) that would have implemented a form of basis indexing. The Report also discusses the tax arbitrage opportunities presented by the selective indexation proposal contained in the 1989 Bill, and the 1989 bill's failure to provide effective limits on arbitrage opportunities.

In summary, it is the position of the Tax Section that implementing any indexation system would be inadvisable. We wish to make clear, moreover, that this Report is not intended to express any position regarding the desirability of enacting any form of preferential taxation of capital gains, or in particular to support the adoption of a preferential rate for capital gains.

II. STATUTORY AND TRANSACTIONAL COMPLEXITY

A. In General

The single most important issue regarding any indexation system is the potentially pervasive if not overwhelming complexity that would be introduced into the tax system. Basis indexing has the potential to touch every area of the tax law from depreciation to excise taxes to employee benefits. This fact cannot be avoided with limited or simple indexing proposals. To the extent that Congress addresses all the implications of basis indexing, the complexity of the statute will grow directly. If Congress chooses to ignore those implications, the code will grow over time as "fix" after "fix" is added to eliminate revenue losing oversights and tax arbitrage opportunities.

No taxpayer . . . will be able to prepare a tax return that includes the sale of a . . . home or a business, without professional help.

Thus, even in an ideal system of indexing,[5] the complexity of the code would be increased, taxpayers' compliance burdens would be augmented, and disputes concerning a variety of legal issues would proliferate.[6] This undoubtedly will result in a system in which no taxpayer (particularly individuals and small businesses) will be able to prepare a tax return that includes the sale of a major asset, such as a home or a business, without professional help. Moreover the administrative burden imposed on the Internal Revenue Service by any indexation system is likely to exceed its present capacity to respond. The auditing process alone may be severely compromised. But, in addition, a far more serious burden of dealing with scores of interpretive and legislative regulations will exacerbate the serious existing problem of the Internal Revenue Service's inability to promulgate regulations on a timely basis.

On the other hand, attempts to "simplify" any regime of indexing, perhaps by adopting partial indexing measures, will introduce new distortions and opportunities for tax arbitrage. Taxpayers inevitably will devise techniques to exploit any discontinuities created in the process of simplifying an indexation system. Such exploitation could be prevented only by adopting rules that are equally, if not more complex, than the rules that "simplified indexation" tried to avoid. There is no such thing as a simple indexation system.

B. Indexing Complex Transactions

While indexing calculations for the simple sale of property for a simultaneous cash payment may be relatively straightforward, property often is acquired or disposed of pursuant to options, forward contracts, section 1256 contracts, installment sales, and contracts requiring contingent payments. In addition, property can be deemed disposed of pursuant to corporate or partnership distributions. Any rational system of indexing would need to develop rules to provide for indexing calculations to be made in these circumstances.[7] For example, although an

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[2]See Part II F. and Part III B., *infra*

[3]See Durst, *Inflation and the Tax Code: Guidelines for Policymaking*, 73 Minn. L. Rev. 1217 (1989) (hereinafter "Durst"), Hickman, *Interest, Depreciation and Indexing*, 5 Va. Tax Rev. 773 (1986), Halperin & Steuerle, *Indexing the Tax System for Inflation*, in *Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax* (H. Aaron, H. Galper & J. Pechman, eds., Brookings 1988), Note, *Inflation and the Federal Income Tax*, 82 Yale L.J. 716 (1973), Shuldiner, *Indexing the Federal Income Tax*, unpublished paper presented at NYU School of Law Tax Seminar for Government (March 1990) (cited with the author's permission) (hereinafter "Shuldiner")

[4]H.R. 3299, 101st Cong., 1st Sess., sections 11951 *et seq.* (hereinafter, the "1989 Bill"), H.R. Rep. No. 147, 101st Cong., 1st Sess., pp. 1474-1480 (hereinafter, the "House Report")

[5]Moreover, the theoretical soundness of *any* indexation system is itself questionable, as discussed in Part V, *infra*

[6]An excellent description of the generic problems associated with indexation is provided in Cohen, *The Pending Proposal to Index Capital Gains*, 45 *Tax Notes* 103, 105 (Oct. 2, 1989) (hereinafter "Cohen")

[7]For an excellent description of the theoretical methodology for indexing property acquired pursuant to options, forward contracts, and section 1256 contracts, see Shuldiner at pp. 16-19

indexation system might include in indexable basis from the time of acquisition the amount of a purchase money note,[8] it is less clear that indexable basis should include basis attributable to contingent payments for any period before contingent payments are made.

Every rule or solution addressing such transactions, however, would impose additional computational burdens of a magnitude far greater than the single basis calculation now required upon disposition of an asset. Moreover, these solutions necessarily would be detailed and complex, and one can expect Congress to avoid difficult and inherently complex problems by relying on "regulations to be provided." The 1989 Bill, to quote just a single example, uses such an escape hatch for RICs and REITs:

> [I]n order to deny the benefit of indexing to corporate shareholders of the RIC or REIT, the bill provides that, *under regulations*, (i) the determination of whether a distribution to a corporate shareholder is a dividend will be made without regard to this provision, (ii) the amount treated as a capital gain dividend will be increased to take into account that the amount distributed was reduced by reason of the indexing adjustment, and (iii) such other adjustments as are necessary shall be made to ensure that the benefits of indexing are not allowed to corporate shareholders.[9]

The temptation to avoid addressing such significant and complex issues will be a major concern. Personal and business decisions regarding a wide variety of transactions cannot reasonably be expected to wait out the delays, which have become increasingly common, in promulgating regulations governing a system that could affect virtually every area of the code.[10]

Simplifying conventions . . . will arbitrarily deny indexation benefits or offer planning opportunities.

Although certain simplifying conventions can be adopted, those simplifications will arbitrarily deny indexation benefits or offer planning opportunities. For example, the 1989 Bill denied indexation benefits to options.[11] This denial would inappropriately deny inflation relief to purchasers under options and extend overly generous benefits to sellers under options. Moreover, for taxpayers who are deemed to sell property by reason of corporate or partnership distributions, simple mechanical rules comparing basis and selling price can operate to deny indexation benefits entirely.

C. Disputes Regarding Timing of Asset Transfers

Because indexing basis would amplify the degree to which a taxpayer's holding period affects tax liability when an asset is disposed of, any indexation system will produce numerous new legal disputes relating to the precise time tax ownership is treated as having passed. Assets may be transferred in a variety of ways, such as installment sales, conditional sales, sales pursuant to options, and long term leases, that obscure the proper acquisition or disposition date for tax purposes. Although determining when an asset is acquired or sold is necessary under present law for determining the taxable year to Report gain, the taxable year to begin depreciating property and several other purposes, the precise time that an asset is acquired or sold in a taxable year seldom is of any significance.[12] Indexing basis changes all of this and inevitably will lead to a meaningful increase in disputes over these issues.[13]

Careful consideration must be given to the already complex rules governing the tacking and tolling of holding periods.

D. Holding Period Rules

In any indexation system, careful consideration must be given to the already complex rules governing the tacking and tolling of holding periods. Although the present rules could be used for many situations, special rules modifying the present law "tacking" rules applicable to wash sales,[14] stock acquired pursuant to the exercise of rights acquired in a tax-free distribution,[15] and the treatment of property acquired from a decedent may be needed.[16] At the same time, consideration would need to

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[8] *But see* discussion of "debt arbitrage" in Part III B 1, *infra*.

[9] House Report, pp. 1478-1479 (emphasis added).

[10] *See* Part III C 6, *infra*.

[11] *See* Part III B 2, *infra*.

[12] *See* Part IV B, *infra*.

[13] Furthermore, the theoretically proper time for indexing to begin or end is at the time that the "risk of inflation" with respect to the property passes and not at the time that the technical tax holding period commences or ends. *See* Cohen, p. 105. Implementing this theoretically correct solution would be difficult at best and would give rise in at least some cases to the obviously undesirable result of taxpayers having two different holding periods for the property. However, failure to address this issue will result in taxpayers receiving inflation relief in cases where they have no risk of inflation. For example, assume that individual A contracts to sell stock or other indexable assets to tax-exempt entity B at a fixed price, the closing to occur two years after the date of the contract. Where does A's entitlement to inflation adjustment end? Moreover, the risk of inflation would be a new element of ownership to be considered in the already murky area of holding period determination.

[14] Under present law, the holding period and basis of property acquired in a wash sale includes the holding period and loss realized on the sale of the substantially identical property, code section 1223(4). This form of tacking generally places the wash seller in the same position as if he had not sold the property. Nevertheless, where holding periods are tacked and the deferred loss is added to basis, the "compounding" effect of allowing indexing based on an amount that exceeds fair market value arguably confers an inappropriate benefit on the short seller. *See* text accompanying fn. 60, *infra*.

[15] Unless modified for purposes of the indexing calculation, sections 1223(5) and 1223(6) would deny the benefits of indexing for that portion of the basis of stock allocable to the basis of the pre-exercise holding period of the rights.

[16] It would be inappropriate to apply for purposes of any indexing calculations, section 1223(11), which provides a minimum one-year holding period for property acquired from a decedent where the basis of the property is determined under section 1014.

be given to modifying the "tolling" rules that apply in connection with short sales,[17] straddles,[18] and commodity futures transactions.[19]

Furthermore, the number of necessary exceptions and special rules would increase significantly if a system of "partial indexing" is adopted. For example, if the benefits of indexing were granted to individuals but not corporations, virtually all the holding period and basis rules relating to transactions between corporations and shareholders would have to be modified in a manner that undoubtedly would enhance their complexity.[20] Finally, a detailed set of special holding period tacking and tolling rules would need to be adopted for transition purposes.

E. Other Statutory Complexity

The code already provides for indexing of various items (tax brackets in particular), and these indexing provisions must be coordinated with any basis indexing provisions to prevent the granting of double benefits. Consideration would need to be given to the extent that the benefits of basis indexing should be preserved where basis is to be reduced under section 1017. Modification of computations under section 1231 may be necessary. If corporations are included in an indexation system, consideration must be given to the treatment of earnings and profits, consolidated returns, section 304, and many other aspects of corporate transactions.[21]

Rules must be created to address the treatment of common individual investments such as insurance policies, variable annuity contracts, and voluntary contributions to pension plans. Computation of a taxpayer's income in each of these cases requires more than merely determining basis, holding period, and amount realized. Rather, the withdrawal of assets and recovery of basis over time will require the development of special indexing rules that will further complicate the treatment of these relatively ordinary products.[22]

F. 'Selective' Indexing and Tax Arbitrage

Another major concern with respect to any indexation system is whether indexation is to be comprehensive or selective. Obviously, it is more difficult to draft a statute if all assets and liabilities are to be indexed. Moreover, such a statute would be far more complex. However, if (i) provision is made for indexing the basis of assets without provision for indexation of liabilities,[23] (ii) holding period requirements deny the benefit of indexing to assets held for a short duration, (iii) only certain taxpayers are eligible for the benefits of indexing, or (iv) only certain assets are eligible for the benefits of indexing, the problems associated with tax arbitrage become enormous.

Taxpayers are adept at electing against the fiscal authority and will structure their affairs to receive favored tax treatment.

Taxpayers are adept at electing against the fiscal authority and will structure their affairs to receive favored tax treatment.[24] Accordingly, any system which is selective rather than comprehensive will create opportunities for financial engineering adverse to the revenue base, in effect allowing the law of adverse selection to operate against the fisc. A straightforward example of the type of planning that will be possible is for investor A, who is entitled to indexation benefits to purchase indexable property and give a participating mortgage [25] to investor B, who is not entitled to indexation benefits, effectively allowing the latter to share in the property's appreciation. Nevertheless, this arrangement will allow investor A to benefit from indexation of the entire basis on the property, while deducting as interest the amount of capital appreciation enjoyed by investor B, truly a windfall at the government's expense.

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[17]The simplest approach to short sales would be to treat the short and long positions as separate transactions and toll their respective holding periods for the period that the taxpayer holds both positions. The 1989 Bill adopted this approach. However, this simple rule can lead to anomalous results, most often favoring the taxpayer. *See* Shuldiner, p. 15.

[18]The tolling rules of Temporary Regulation section 1.1092(b)-2T will produce anomalous results similar to those under the "simple" approach to short sales. Moreover, unlike the pro-taxpayer effect of these anomalies generally, these rules would particularly favor the government with respect to the treatment of "qualified covered call options" (within the meaning of section 1092(c)(4)). It is unclear that the same policies that underlay the tolling of holding period for qualified covered calls should be applied to exclude the benefits of indexing for the stock with respect to which the call option is written.

[19]The special rules contained in section 1223(8) must also be coordinated with the option rules described in further detail in Part III.B.2., *infra*.

[20]These rules are discussed in further detail in Part III.B.3.c., *infra*.

[21]For the equally troubling prospect of excluding corporations from an indexation system, *see* Part II.F. and Part III.B.3., *infra*.

[22]Annuity payments generally are included in the annuitant's gross income. *See* section 72(a). However, a proportion of each annuity payment is excluded from gross income to the extent it represents a return of the annuitant's investment in the insurance or annuity contract. *See* section 72(b)(1). Similarly, section 72(e) generally provides that the amount received upon surrender, redemption, or maturity of an annuity contract should be included in income only to the extent such amount exceeds the annuitant's investment in the contract. Under section 72(c)(1), an annuitant's "investment in the contract" is defined as the aggregate amount of premiums and other consideration paid for the contract, less amounts previously received under the contract that were excluded from the annuitant's gross income. This amount should correspond to the annuitant's basis in the contract.

Under any comprehensive indexation system, an annuitant's "investment in the [annuity or insurance] contract" (*viz.*, the annuitant's basis) logically should be indexed for inflation. To the extent an annuity payment or receipt of cash upon surrender, redemption, or maturity of an annuity contract represents a return of the annuitant's basis, the annuitant will be overtaxed upon receipt of an annuity payment if the annuitant's basis is not indexed for inflation.

[23]This results in augmented basis or expenses without a corresponding increase in income or reduction in interest deductions to reflect the borrower's gain from the decrease in the real value of the principal amount of his liability attributable to inflation. *See* Part III.B.1.d.i., *infra*.

[24]For an example of the experience in the United Kingdom with selectively indexing certain assets, *see* Appendix 1, fn. 7 and accompanying text.

[25]For example, the lender receives stated interest plus additional interest based on appreciation in the value of the property, subject to a ceiling on the aggregate interest rate.

The problems associated with each possible selective approach to indexing are well illustrated by the 1989 Bill. As discussed in Part III.B., below, this causes innumerable problems.

G. The Treatment of Passthrough Entities

Any indexation system will create significant additional complexity in the treatment of passthrough entities, specifically partnerships, S corporations, mutual funds (RICs), real estate investment trusts (REITs), trusts, subchapter T cooperatives, common trust funds, and conceivably real estate mortgage investment conduits (REMICs). This complexity arises in several ways.

First, entity level and interest holder level adjustments must be coordinated so that all adjustments are reflected, but only once. Second, appropriate allocations of the indexing adjustments among the interest holders must be provided for. Third, new rules would be required for application of the holding period tolling rules to passthrough entities and their beneficial holders. Fourth, extremely difficult problems would be presented by a publicly traded partnership, especially the need to deal with continuous section 754 adjustments and other aspects of indexation adjustments attributable to partnership assets or interests. All of these complexities may become particularly acute where there are tiered passthrough entities (e.g., partnerships or REITs owning partnership interests), and the complexities are further compounded where the benefits of indexing are extended only to certain assets or certain taxpayers. More detailed discussion of the application of an indexing regime is presented below in the discussion of the provisions of the 1989 Bill.[26]

Any indexation system will create significant additional complexity in the treatment of passthrough entities ....

H. Cross-Border Investment

Additional complexity will exist for foreign taxpayers that conduct their U.S. activities in a manner that causes them to be subject to U.S. withholding on expatriated payments, instead of the federal income tax regime imposed on domestic U.S. corporations or other domestic entities. Although these foreign persons may avoid some of the problems associated with indexation applied to transactions of domestic entities, an indexation system will create difficulties for any payments that are subject to withholding based on the foreign person's capital gain. In particular, withholding pursuant to section 1446 will be considerably more difficult.

In addition, for outbound investment, the interplay of the capital gains rules and the foreign currency rules can operate to limit inappropriately the indexation benefit to which an investor should be entitled or to offer too generous an indexation benefit. If, for example, a U.S. investor purchased an investment in a "strong" currency and earned an overall (i.e., combined currency gain and property appreciation) return exactly equal to the rate of inflation, it would seem appropriate under an indexation system to impose no tax. Nevertheless, to achieve this apparently simple result, foreign currency would need to be treated as an indexable asset, at least to the extent of the amount invested in the indexable capital asset. On the other hand, if the investment were in a "weak" currency, and the overall gain were less than the inflation rate, gain realized on the asset could be completely eliminated by indexing, while the taxpayer would still be entitled to deduct the currency loss. This result would be inappropriate in a system that did not otherwise permit indexing to result in a loss.

III. THE 1989 BILL: A REVIEW

A. In General

Many of the general and specific concerns expressed above are well illustrated by the 1989 Bill. Without doubt, the simplicity of the 1989 Bill is attractive. A few pages of seemingly clear statutory provisions index the tax system for inflation with respect to certain capital assets. This deceptive simplicity, however, conceals an array of troublesome administrative, computational, and substantive issues. In particular, the 1989 Bill would have provided sharp-sighted taxpayers with ample arbitrage possibilities. One can only imagine the series of technical correction acts and omnibus reconciliation act "revenue raising" proposals which would follow adoption of a proposal comparable to the 1989 Bill. This part focuses on some of these issues.

B. Selective Indexing

1. Failure to index liabilities

a. In general. The 1989 Bill indexed the basis of capital assets without any indexing of debt. Nevertheless, inflation's effect on borrowers and lenders is just as profound as its effect on owners of assets. As is the case for owners of assets, the code presently does not account for inflation's effect on borrowers and lenders. By allowing borrowers generally to deduct the entire amount of their interest payments and requiring lenders to include all such interest in income without offsetting adjustments for the diminishing real value of the principal amount of the debt, the code as a general matter currently overtaxes lenders and undertaxes borrowers. The partial indexation system of the 1989 Bill would have exacerbated that situation.

b. Example. The failure to index debt results in a gross undermeasurement of the real income of a taxpayer who borrows to finance the purchase of an indexed asset.[27] Assume that Mr. A invests $20,000 in cash to buy Blackacre, a nonincome producing real estate asset subject to an $80,000 mortgage. Five years later, when cumulative inflation has amounted to 30 percent,[28] he sells Blackacre for $130,000, satisfies the $80,000 mortgage, and realizes $50,000 of cash. Under the 1989 Bill, the original tax basis of $100,000 for Blackacre would be adjusted to $130,000 and Mr. A would have no taxable gain. Nevertheless, Mr. A's $20,000 cash investment has grown to $50,000, an increase far in excess of inflation with respect to his actual investment.[29]

[26]See Part III.C., infra.

[27]See, e.g., Durst, pp. 1251-1256.

[28]For simplicity, inflation and interest percentage rates in this report will be stated on a cumulative basis, including compounding.

[29]This example has been borrowed from Cohen, p. 105.

If interest deductions are reflected, the income distortion is even greater. Assume Mr. A's mortgage bears 10 percent interest. Mr. A would have an annual interest deduction of $8,000, or $40,000 over the five-year holding period. Under the 1989 Bill, Mr. A presumably would have no taxable gain on Blackacre and $40,000 in interest deductions to be applied against other real estate income, i.e., his taxable income from Blackacre would have been an overall loss of $40,000. Without indexation, Mr. A would have a taxable gain of $30,000, interest deductions of $40,000 and a $10,000 net taxable loss.

c. **Tax arbitrage potential.** The distortion of income created by the failure to index debt will encourage taxpayers to enter into tax-motivated transactions. Transactions undoubtedly will be developed to allocate excess income (without indexation) to low-bracket or tax-exempt taxpayers and excess deductions or indexation adjustments to high-bracket taxpayers. It is likely, for example, in this type of environment for investment bankers to create investment pools in which tax-exempt investors will receive the income and in which taxable investors secure deductions and indexed basis advantages of the 1989 Bill system. Moreover, any indexation system, particularly one which selectively indexes the basis of assets, would encourage new attempts to create Americus Trust transactions. These transactions attempt to separate the income interest of an investment from capital appreciation and sell each interest to separate investors. As indicated by their history,[30] the propriety of such arrangements is questionable.

d. **1989 Bill solutions to 'debt arbitrage.'** The 1989 bill attempted to limit debt arbitrage opportunities in two ways. First, the 1989 bill would have amended section 163(d) to exclude gain from the sale or disposition of indexed assets from the definition of investment income. This limitation represents at best a very limited solution to restricting arbitrage transactions involving debt-financed purchases of indexed assets. Second, the 1989 Bill does not allow basis adjustments that would create or increase a loss. This loss limitation may create situations where similarly situated taxpayers will be treated differently and in many circumstances the limitations will be avoided.

i. **Investment interest limitation.** The 1989 Bill investment interest limitation solution is entirely ineffective with respect to taxpayers for whom interest expense is treated as a "business interest," or as "passive interest," provided that the taxpayer has sufficient passive income. Moreover, the solution is not even effective for taxpayers with sufficient investment income from nonindexed sources to offset their investment interest expense. For example, assume investor Y, who has $10 million a year of dividend income, borrows $100 million at 10 percent interest and purchases a $100 million capital asset that qualifies for indexation. The 10 percent interest expense on investor Y's $100 million loan matches her dividend income of $10 million. One year later, investor Y sells her capital asset for $105 million after having received $5 million in current income from the asset. If inflation is five percent, the indexed basis of the asset is $105 million, and investor Y recognizes no gain or loss on the sale of the asset. After repaying her loan, investor Y is left with $10 million, and has effectively transformed $5 million of her $10 million dividend income into tax-free income. This transformation arises from investor Y's ability to take interest deductions at their full nominal amount, while repaying her loan with inflated dollars.

Failure to allow indexing to generate losses will result in dissimilar treatment for taxpayers with identical economic incomes.

In a full indexation system, investor Y's nominal interest deduction would be decreased by the amount of inflationary gain she realizes as a borrower from the diminishing real value of the loan principal. If interest deductions were indexed in this manner, the 1989 Bill's investment interest limitation would be unnecessary. In the example above, investor Y's $10 million interest deduction would be decreased by $5 million, the amount by which the real value of the $100 million loan principal has declined in one year due to five percent inflation. As a result, in a fully indexed system, investor Y's net income would be $10 million, i.e., $15 million dividend and other income less $5 million indexed interest deduction. The exclusion from the computation of investment income of investor Y's indexed gain from the sale of her capital asset under the 1989 Bill is ineffective because she has sufficient investment income to offset her unindexed debt interest expense.

ii. **Loss limitation.** The 1989 Bill's loss limitation approach to debt arbitrage also is problematic. First, failure to allow indexing to generate losses will result in dissimilar treatment for taxpayers with identical economic incomes.[31] For example, A purchases stocks X and Y for $50 each and B purchases stock Z for $100. If stock Z appreciates to $200, stock Y to $200, and stock X depreciates to $0, A and B both have economic gain of $100. However, because of the loss limitation rule, A will receive no indexation benefit on his losing investment in stock X, and the indexation benefit from his profitable investment in stock Y, with an indexable cost basis of $50, will be only half of the benefit realized by B, who has an indexable cost basis of $100 for stock Z.

In addition, a loss disallowance rule will exacerbate the "lock-in" effect of the capital gains tax by encouraging the asset holder to hold the asset until the full indexation benefit can be used, i.e., until the asset's fair market value at least equals its indexed basis. This result can only be described as ironic in the context of a proposal intended generally to lessen the tax burden on capital gains.

e. **Other possible solutions.** The problem of debt-related arbitrage can be solved. Complex debt tracing

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[30] See T.D. 8080, 1986-1 C.B. 371. T.D. 8080 issued final regulations under section 7701 that denied trust classification to Americus investment trusts, effectively prohibiting such investment trusts. See Regulation section 7701-4. Moreover, T.D. 8080 stated that one of the major problems produced by such investment trusts was the "potential for complex allocations of trust income among investors with correspondingly difficult issues of how such income is to be allocated for tax purposes." For an excellent description of these transactions and their legislative and administrative history, see Walter and Strasen, *The Americus Trust Prime and Score Units*, 65 *Taxes* 221 (1987).

[31] Cohen, p. 105.

rules would prevent the avoidance of the investment interest limitation contained in the 1989 Bill. Similarly, such tracing could be used as a mechanism for providing indexing only to a taxpayer's net (i.e., equity) investment in property. Although tracing may be the most expedient method of addressing debt arbitrage, it is well understood that to the extent money can be considered fungible, tracing rules will be artificial and will tend to favor the most creditworthy taxpayers. For example, the rules disallowing interest incurred to carry tax-exempt obligations are largely meaningless to wealthy individuals who can borrow against portfolios of stocks or taxable bonds to invest in tax-exempt obligations. Moreover, we would not recommend a further complication of the already complex tracing rules associated with the different treatment of interest with respect to personal expenditures, personal residences, trades or businesses, passive activities, portfolio investments and other investments, not to mention source rules and foreign tax credit calculations. We are greatly concerned that creating any further reliance on debt tracing would only further entrench the current system and hinder legitimate simplification efforts.[32]

Further reliance on debt tracing would only further entrench the current system and hinder legitimate simplification efforts.

The debt arbitrage problem also could be solved by disallowing interest deductions attributable to the acquisition or holding of indexed assets. This type of solution would be highly dependent on problematic debt tracing rules, as discussed above, and undoubtedly would create major complexity.[33]

Still another means of solving the problem would be the "avoided cost" method now used for construction period interest. This would involve significant complexity in allocating debt to specific assets for purposes of denying inflation adjustments, particularly in situations where debt levels change frequently.

2. Exclusion of certain assets from indexation. The 1989 Bill makes unprincipled distinctions by granting indexation to certain capital assets and denying indexation to other assets that are equally affected by inflation. For example, the 1989 Bill does not allow indexation with respect to debt and certain debt-like assets, as well as all intangible assets other than stock, even though these assets are demonstrably affected by inflation as significantly as assets that are indexed under the 1989 Bill. Moreover, convertible debt, warrants, options, and other contracts with respect to stock are denied indexing despite economic attributes very similar to assets that are indexed under the 1989 Bill. In addition, the limitation of indexation benefits only to capital assets will deny indexing benefits to taxpayers who sell property constructed over a long period of time, such as a construction project, sophisticated equipment, or property described in section 1221(3), even though these taxpayers suffer the effects of inflation in much the same way as holders of capital assets. These exclusions are arbitrary and often illogical.

Under the 1989 Bill, stock received by the conversion of convertible debt, for example, is allowed an indexation adjustment only for the period after conversion; the holding period of the convertible debt before conversion is excluded. In contrast, convertible preferred stock apparently would qualify for indexation throughout a shareholder's holding period. Although the 1989 Bill excluded preferred stock from indexation, it defined preferred stock as stock with fixed dividends and no significant participation in corporate growth. Convertible preferred, by virtue of the conversion privilege, should be considered as participating in corporate growth, and therefore qualify for indexation. Even accepting the premise that debt assets should not be indexed if an indexation regime is adopted, a premise we believe faulty, it is truly impossible to rationalize this distinction, particularly in a tax system where convertible debt can be converted into stock without gain recognition and with a carryover basis and tacked holding period. Disparate treatment of convertible preferred and convertible debt would simply aggravate the already problematic distinction between debt and equity.

Warrants, options, and other contracts with respect to stock are also ineligible for indexation under the 1989 Bill.[34] The investment in or holding period of the warrant or option prior to exercise or disposition would thus not have the benefit of indexation. The reason for this exclusion is unclear, but it may reflect a limited attempt to prevent the tax arbitrage opportunity that might arise if the option writer (who in a properly structured system would be hurt by indexing) is a low bracket or tax-exempt taxpayer (e.g., a pension trust or foreign person) and the option holder (who would benefit from indexing) is a high bracket taxpayer. In any case, the exclusion is illogical, as the following example shows.

Assume A purchases an option for $50, which gives him the right to purchase one share of XYZ Corp. stock three years later for $100. Inflation over the three-year period amounts to 35 percent. If the fair market value of XYZ Corp. stock is $165 when A exercises the option, and A immediately sells the XYZ Corp. stock, what should be his taxable gain? Under the 1989 Bill, A would have a taxable gain of $15, since the sum of the option purchase price and the exercise price for the XYZ Corp. stock is $150, $15 less than the fair market value of the stock. In real economic terms, however, A has a loss on the option; the 35 percent inflation, when applied to his option purchase price of $50, would require XYZ Corp. shares to sell at a fair market price of $167.50 for A to break even ($50 plus 35 percent inflation plus $100 exercise price). Similar results occur if A sells the option instead of exercising it. Thus, if A sold the option for $60, he would

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[32] See letter from Arthur A. Feder, Chair of the New York State Bar Association Tax Section, to Chairman Rostenkowski, recommending among other things simplification of the interest allocation rules (April 23, 1990).

[33] See, e.g., New York State Bar Association Tax Section Report on section 163(j) (March 14, 1990).

[34] The 1989 Bill also excludes from indexation options, contracts, and other rights to acquire an interest in property. The problem described here with respect to stock options thus also would apply to an option to purchase real property.

suffer a real economic loss of $7.50, yet would have a taxable gain of $10 under the 1989 Bill.

Under current law, the exercise of an option or a warrant is not a taxable event, and the cost of the exercised option or warrant increases the property's sales price and cost basis. This treatment recognizes implicitly that amounts paid for an option properly are treated as a cost of acquiring or proceeds from the sale of an interest in the property. Accordingly, to reflect the actual economic cost of the property, the holder of a warrant or option should be allowed to index basis attributable to the purchase price of the warrant or option for the period before its exercise with respect to any property received upon exercise.[35] Similarly, holders of warrants and options also should be able to index their basis with respect to gains upon disposition of a warrant or option.[36]

The denial of indexation benefits to intangible assets except for stock raises significant problems.

Further, the denial of indexation benefits to intangible assets except for stock raises significant problems. First, this arbitrary distinction will cause taxpayers in identical economic circumstances to be taxed differently based on their choice of investment vehicle. For example, payments made with respect to stock market indexed debt instruments or stock market indexed annuities will reflect inflation in the same manner as stocks underlying the index, yet the 1989 Bill would provide no indexation.

Moreover, in practice the distinction between tangible and intangible property will lead to numerous disputes regarding allocation of purchase price where tangible and intangible assets are sold together. For example, where a lessee of real property sells the leasehold interest together with any self-constructed improvements, the 1989 Bill would make it mutually advantageous for the buyer and seller to allocate as much of the purchase price as possible to the improvements to maximize actual or potential indexation benefits. Such an allocation would be unlikely to have great significance under current law, since the buyer will depreciate both the leasehold and the improvements over the remaining term of the leasehold. Although current law places limitations on artificial allocations, the 1989 Bill would test the effectiveness of current law in new circumstances, with uncertain consequences.

Finally, it appears to us to be somewhat incongruous to allow indexation of corporate stock without regard to whether the corporation holds assets that would be indexable if the corporation itself were eligible for indexation. One might argue that by reason of this feature, the 1989 Bill represents a haphazard form of corporate tax integration more than a principled mechanism to provide inflation relief for deserving assets.

3. Benefits for only certain taxpayers. Limiting the benefit of any favorable method of capital gains indexation to specific taxpayers will create additional complexity and distortion of the tax system. In this regard, the 1989 Bill would create other arbitrage opportunities. The 1989 Bill does not allow C corporations to index assets, but allows shareholders to index their basis in C corporation common stock. In contrast, under the 1989 Bill, pass-through entities such as partnerships and S corporations would be allowed to index their assets, but individuals would not be allowed to index their S corporation shares or partnership interests.

a. Distorted incentives for holding assets. Making basis indexing available to some but not all taxpayers creates an artificial incentive for those taxpayers permitted to basis indexing to hold eligible assets relative to taxpayers denied the benefits of indexing. Moreover, the introduction of this tax-related incentive will tend to result, as would any uneconomic incentive, in an inefficient allocation of resources.[37] While this result is undesirable in its own right, the inevitable engineering of transactions designed to maximize the availability of the benefits of indexing will aggravate the distortion.

b. Exclusion of C corporations. The exclusion of C corporations from the indexing system under the 1989 Bill disproportionately taxes individuals who invest through C corporations. For example, in contrast to the illustration presented in Part III B 1 b, above, assume Ms B invests $20,000 in a C corporation, receiving all its stock. If the C corporation borrows $80,000 and purchases Whiteacre for $100,000, the corporation would not be able to index its basis in Whiteacre and Ms. B would be able to index only her $20,000 basis for the corporation's stock. The tax burden on Ms. B's investment in a C corporation would be significantly higher than Mr. A's similar investment as an individual.[38]

As a result, the bias against C corporations in our current system will be furthered. Consequently, well-advised taxpayers will be further encouraged to use partnerships or S corporations to avail themselves of the benefits of indexing. This bias against C corporations, already exaggerated by the "inversion" of individual and corporate tax rates and by the repeal of the *General Utilities* doctrine in 1986, undoubtedly has contributed to an erosion of the corporate revenue base. Nevertheless, not all taxpayers can use subchapter S,[39] and partnerships may not provide adequate liability protection. Thus, the already asymmetrical system of taxing incorporation and dissolution of corporations that was created by the 1986 Act[40] now will further penalize the uninformed or those who must use the subchapter C mode.

[35] See Shuldiner, p. 10.

[36] Cf. section 1234 (granting sale or exchange treatment to the expiration of options, in effect providing preferential capital gains treatment).

[37] Needless to say, providing tax incentives for holding certain assets in favor of others without clear policy justification is a major retreat from the "level playing field" policy of the Tax Reform Act of 1986.

[38] This example has been borrowed from Cohen, p. 105.

[39] A common example of inability to use subchapter S would be a start-up venture which incorporated to achieve limited liability and which has a corporation as a major equity funding source.

[40] I.e., the repeal of *General Utilities* permits the incorporation of appreciated assets tax-free, but imposes a tax upon the withdrawal of the same asset from corporate solution.

c. Enforcement of the limitation: additional statutory complexity. The 1989 Bill contains only broad and vague regulatory authority designed to assure that the benefits of basis indexing are limited to intended beneficiaries. Specifically, the 1989 Bill provides the IRS with the authority to disallow all or part of any indexing adjustment in the case of any transfer, the "principal purpose" of which is to secure or increase the indexing adjustment. The 1989 Bill also would deny the indexing adjustment for sales of depreciable property between certain related parties. These rules are likely to prove inadequate to limit the benefits of indexing only to the intended beneficiaries. In particular, the "principal purpose" standard is likely to prove difficult for the IRS to administer.[41]

The 1989 Bill would unfairly prevent the intended beneficiaries from receiving the benefits of indexing in certain circumstances.

At the same time, the 1989 Bill would unfairly prevent the intended beneficiaries from receiving the benefits of indexing in certain circumstances. For example, consider the sole individual shareholder of a C corporation who contributes to the corporation property that has appreciated, but whose fair market value and indexed basis are the same. The policy of the 1989 Bill would indicate that the precontribution gain in these circumstances should not result in any tax. This would require the corporation in the example to receive an increased basis for the indexation available to the individual before the transfer of the appreciated property to the corporation. Otherwise, the 1989 Bill would cause the shareholder to suffer from the possibility of corporate taxation upon a post-contribution sale of the corporation's assets without the benefit of inflation adjustments. Even though the potential tax could be avoided if the shareholder sold the property and contributed the proceeds, this will not always be a practical solution, particularly where the property is unique and necessary to the business.

These deficiencies in the 1989 Bill could be cured by ambitious statutory modifications, addressing a wide array of different possible transfers of assets from eligible to ineligible or ineligible to eligible taxpayers. Different rules would be required for transfers between related parties and transfers between unrelated parties. In addition, different rules will be appropriate for transfers in taxable and tax-free transactions.

Further, special rules will be needed to address basis and holding period problems of transferees, particularly for assets acquired in tax-free transactions. Other special rules will be needed for corporate partners as well as for conversions of C corporations to S corporations and vice versa. Finally, rules would be required for addressing situations where related eligible and ineligible holders of assets hold offsetting positions with respect to capital assets. Numerous disputes arising from the application of these special rules are easily foreseeable.

4. One-year holding period. Other provisions in the 1989 Bill raise recognition and timing issues. The 1989 Bill imposes a one-year minimum holding period before an eligible asset is indexed. Several problems immediately present themselves with respect to this seemingly innocuous requirement. First, taxpayers will be required to separate their securities portfolios, capital assets, and assets used in a trade or business between assets held less than one year and assets held more than one year.[42] With virtually no preferential treatment of long-term as opposed to short-term gains under present law, the extent to which this must be done currently is limited. Second, taxpayers will time their transactions so as to qualify or not for indexation, depending on the different tax outcomes. Third, with respect to the interaction of this provision with the 1989 Bill's separate indexation of any substantial improvement to an indexed property, taxpayers will be required to keep track of and make independent indexation calculations for an indexed property and each substantial improvement to it, and exclude entirely from indexation the basis attributable to any substantial improvements less than one year old.

The 1989 Bill's provisions for passthrough... will create great disparities between the direct ownership... and... ownership... through a passthrough entity.

C. Passthrough Entities

1. In general. The 1989 Bill's provisions for passthrough of indexation adjustments are problematic in many respects. As discussed below, these provisions will create great disparities between the direct ownership of property and the ownership of that property through a passthrough entity. Although these disparities in many cases will favor the government, in many situations the taxpayers will be favored with beneficial results and attractive planning opportunities.

2. Partnerships

a. Allocation of indexing benefits. The proper allocation of indexing benefits among partners is not as simple as it initially appears. A simple rule apportioning the indexation adjustment in proportion to the overall partnership income allocation would not be sufficient. For example, A and B form a partnership. A contributes property worth $100 and A and B both contribute services. The partnership agreement provides that on liquidation the

[41] A "principal purpose" standard has been notably difficult to apply under code section 269. *See* D. Watts, *Acquisitions Made to Avoid Taxes: Section 269*, 34 *Tax L. Rev.* 539, 549-552 (1979) (discussing complexities of "principal purpose" test). In fact, it was largely the ineffectiveness of section 269 that led to the enactment of section 382 in both its present and earlier versions.

[42] *See, e.g.*, Hoerner, *Indexing Capital Gains: The British Experience*, *Tax Notes*—News Analysis 988, 989 (Feb. 26, 1990). According to Philip Levi, personal tax manager for Grant Thornton, the one-year holding period created "a great deal of bother over the timing of transactions" and the separation of assets held less than one year and all other assets. *Id.* The one-year holding period was eliminated from the British indexation system by the 1985 reforms which allow indexing from the month of acquisition. *Ibid.*

first $100 of proceeds are paid to A, the remainder split 50 percent each. A receives the first $10 of annual partnership income and the remainder is divided equally between A and B.

In effect, A is being treated as the continuing economic "owner" of the $100 asset and is receiving payments (10 percent of income or $10 per year) for the partnership's use of the asset. How should the indexation adjustment be allocated if the property is sold after two years for $170 and A receives $45 and B receives $25? Since A supplied all the partnership capital, should B receive any part of the indexation adjustment? Presumably, A should be allocated the entire indexation adjustment upon disposition of the asset, rather than a simple allocation according to the partners' overall interests. Unless some mechanism were created to achieve this result, it is easy to see how indexation benefits can be transferred at a taxpayer's option. On the other hand, even if such rules were put into place, benefit shifting still would be possible to a significant extent by modifying slightly the form of the transaction, making the partner entitled to the preferred return as a lender.

The allocation problem becomes even greater if partners share income unequally, e.g., A receives 70 percent and B 30 percent of the partnership income until A receives $100 return and income is shared equally thereafter, or some other formula of shifting income allocations is used. It is unclear under the 1989 Bill how indexation adjustment allocations should be made in such situations. Rules will be needed to handle such allocation issues. Moreover, the formulation of rules governing such allocation issues should not be left to regulations because the allocation problem is immediate and widespread.

b. Timing of adjustments. Under the 1989 Bill, the basis of a partnership interest generally is indexed with respect to an indexable partnership asset only when the partnership disposes of the asset. In addition, if a section 754 election is in effect, a partner transferring his interest will receive a share of any indexation adjustment that has accrued at the partnership level at that time. Thus, for the first time section 754 will provide a positive benefit for the seller, as well as the buyer, of a partnership interest. As a result, transfers of partnership interests will raise issues regarding the allocation of indexation adjustments.

First, section 754 elections almost always are made on a tax-motivated basis. For example, suppose A, B, and C form the ABC partnership to purchase an indexable asset for $150. After 10 years, the asset has a fair market value of $180, but an indexed basis of $240. If partner A sold his partnership interest for $60, he would recognize a $10 gain, if no section 754 election is in effect.

At this point, the House Report on the 1989 Bill inexplicably fails to provide clear guidance with respect to the intended treatment of the indexation adjustment with respect to partner A's transferee, new partner D. The House Report states that the "transferee partner will be entitled to the benefits of indexing for inflation *occurring after the transfer*." This would suggest that the transferee partner does not receive, upon a subsequent disposition of the partnership asset, a proportionate share of the indexation adjustment that had accrued at the time of his acquisition of a partnership interest. In contrast, however, Example (3) of the House Report provides that transferee partner D would, if no section 754 election is in effect, receive a proportionate share of the partnership's indexation adjustment with respect to the asset, including the indexation benefit accruing before he joined the partnership. The failure of the 1989 Bill to provide a clear rule for such transactions is another example of the complexity involved in any indexation system.

The correct result in this situation is far from clear. If a transferee partner receives only indexation benefits accruing after his purchase of a partnership interest, the partnership will be required to track not only the indexation adjustment applicable to a particular asset, but also the amount of indexation accrued with respect to each partner at all times. Upon a partnership's sale of an asset, the partners would receive different indexation adjustments according to the exact date each partner joined the partnership, the amount of indexation adjustment accrued at that time with respect to that particular asset, and the amount of indexation adjustment occurring after the partner joined the partnership. This would clearly be an administrative and computational nightmare.

On the other hand, if Example (3) contains the correct rule under the 1989 Bill, partner A's sale of his partnership interest to new partner D would not result in the loss of accrued indexation benefits with respect to D's partnership interest, and the partnership's ability to utilize the full $240 indexed basis of the asset would continue. New partner D thus would receive the previously accrued indexation adjustment benefit from the partnership property if the property appreciates after his purchase. So long as the partnership is not dissolved and the proceeds of sale remain in partnership solution, no tax will be imposed on the potential permanent difference between "outside" and "inside" basis.

The exaggeration of any differential between outside and inside basis of the partnership may provide for abusive planning possibilities.

Furthermore, if the ABD partnership subsequently sold the asset for $240, partner D would receive flowthrough of the indexation benefits equal to $30 (one-third of the difference between the assets indexed and unindexed basis), increasing his basis in his partnership interest to $90. If the partnership distributed the sale proceeds to its partners, partner D would receive $80 tax free, although his investment has increased in value from $60 to $80 during a period in which no further inflation occurred. In sum, partner A in effect transferred to partner D the potential for $20 of tax-free future appreciation in the partnership's asset.

Second, the exaggeration of any differential between outside and inside basis of the partnership may provide for abusive planning possibilities. If original partner A were tax-exempt or otherwise able to offset the gain upon transfer of his partnership interest to D, the tax benefits

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House Report p. 1479 (emphasis added).

Id.

These problems are even more pronounced for partnerships such as law firms or accounting firms whose partners' interests frequently shift from year to year without any sale or exchange.

of such transactions would be further enhanced. For example, if partner D in Example 3 of the House Report is a foreign individual and ABD is a U.S. partnership doing business outside the U.S., and the partnership sold the indexed asset in a legitimate transaction and realized the gain offshore, there would be no U.S. tax. Nevertheless, the foreign individual would have the artificially high basis and may be able to transfer the asset to a U.S. corporation, which would then have the "built-in" loss.[46]

Section 754, therefore, will assume even greater importance. There will, however, be circumstances where the section 754 election is not available (e.g., because all partners do not consent) or the partnership inadvertently fails to elect, or the partnership is sufficiently large and complex that the cost of making section 754 calculations is simply too high. Moreover, if partnership assets have depreciated, it is unlikely that a section 754 election would be made.[47] This may lead to thoughts of making section 754 elections mandatory, similar to the treatment of section 704(c) by the Deficit Reduction Act of 1984. At this point, one should recall that, after six years, regulations governing the mandatory section 704(c) provisions have not been forthcoming, with consequent difficult problems for legitimate business transactions.

The rules are clearly not consistent for S corporations and partnerships.

3. S corporations. The provisions of the 1989 Bill relating to the treatment of S corporations and their shareholders raise several of the same issues as for partnerships discussed in Part VI.B.3.b., "Timing of Adjustments," above. Nevertheless, certain additional issues are raised. In particular, the rules are clearly not consistent for S corporations and partnerships. No analogy to section 754 exists for S corporations, with the consequence that a shareholder who sells his interest will be at a severe disadvantage to a comparably situated partner with a section 754 election in place. This situation will be encountered frequently where the S corporation has assets that are not freely transferable, such as a franchise, a lease contract, or a nonassignable lease. In these circumstances the S corporation stock can be sold, usually without any significant tax detriment to the sellers. In addition, even if the S corporation's assets are freely transferable, the seller of a minority interest in an S corporation will not be able to receive indexation benefits on the sale of his stock.

In addition, it is not clear under the 1989 Bill how indexing adjustments would be allocated where stock is sold during a taxable year. Although it may be reasonable to assume that indexing adjustments would track allocation of gain, it is possible that the 1989 Bill intended that the adjustments be made on the basis of the time of sale. Discontinuities in economic appreciation and basis adjustments will be created by either approach, particularly in light of the special rules for allocating gain in the case of transactions that terminate S corporation status, that terminate a particular shareholder's ownership, or that involve a transfer of more than 50 percent of the corporation's stock. Finally, the statement of the House Report that "indexing does not apply" for purposes of sections 1374 and 1375[48] leaves open the manner in which indexing computations will be made where sections 1374 or 1375 are applicable.

4. RICs and REITs.

a. In general. The 1989 Bill allowed RICs and REITs to index their taxable income and earnings and profits. In addition, to the extent that a RIC's or REIT's assets qualify for indexation, the 1989 Bill allowed its individual shareholders to index their bases for the RIC or REIT stock. Corporate shareholders, however, were denied these indexation benefits.

b. Avoidance of loss limitation provisions. The general rule that no losses may be created through indexing clearly will be violated by the rules relating to RICs. The following example demonstrates that shareholders of RICs will be able to blend gain and loss positions in the RICs securities in calculating individual gains or losses.

Assume that a RIC acquires three indexable securities, each for $1,000.[49] If indexation over three years is 20 percent, the aggregate indexed basis would become $3,600. Assume that asset 1 does not appreciate, asset 2 depreciates to $900, and asset 3 appreciates to $1,700. Under this scenario, a one-third owner of the entity would be entitled to sell his interest for $1,200, have an indexed basis of $1,200, and no taxable gain, while an individual owner of one-third of each of the three assets would have a net taxable gain of $133.34 (1/3 of $500 gain on asset 3 after $200 indexation adjustment minus $33.33 loss on asset 2). This will provide a RIC investor with a sizeable advantage over individual investors in stocks and securities.

Aside from the ability to avoid the loss limitation provisions, RIC shareholders receive additional benefits from indexing by reason of continued indexing of their RIC stock in the absence of any corresponding inflationary gains on the RIC's assets. For example, assume that a RIC purchases two blocks of stock for $1,000 each. Within one year, one block becomes worthless, while the other block triples in value. Inflation for the year is 10 percent. If the RIC sold the appreciated shares, it would recognize a $1,900 gain (i.e., $3,000 minus indexed basis of $1,100). After offsetting the capital loss, the RIC would have a net capital gain of $900 which it distributes as a

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[46] Even without engineered abuses, the ability to transfer interests in partnerships, the fair market value of whose assets is below the partnership's indexed basis, creates an inherently tax-advantaged investment. The advantage lies in the fact that inflation adjustments at the partnership level will continue to be based on the high basis while any appreciation in the asset will occur based on the asset's fair market value. While this type of phenomenon occurs upon the transfer of any partnership interest where the partnership has depreciated assets, indexing will greatly compound this effect in a potentially limitless way.

[47] It should be noted that the absence of a section 754 election at the partnership level can be mitigated where the partners' basis in their partnership interests exceeds the partnership's bases in its assets when the partnership is deemed to liquidate under section 708, since the rules under section 732(b) provide partners with a step-up in the basis of partnership property to their basis in their partnership interests upon such a distribution of the partnership's assets.

[48] House Report, p. 1479.

[49] For simplicity, diversification rules are ignored.

capital gain dividend. After the distribution, the RIC shares would be worth $2,100, yet the aggregate indexed shareholder basis would be $2,200. The excess basis at the shareholder level is attributable to the indexing of a "nonexistent" asset at the RIC level (the worthless shares). This excess basis either would allow its shareholders to recognize a loss upon disposition of the RIC stock, or if losses are not allowed, would allow the shareholders to avoid recognition of gain if they sold their stock after the RIC's assets had further real appreciation of $100. Only an unthinkably complex regime of passing through realized and unrealized losses to RIC shareholders for purposes of indexing calculations would prevent this result.

c. Indexing of less than all of the entity's assets. The 1989 Bill would require a valuation of the RIC's or REIT's indexable and nonindexable assets on a regular basis. For RICs, the 1989 Bill required monthly asset valuations, but for REITs, due to the difficulty and cost, those valuations were required only every three years. While requiring REIT trustees to make "good faith" monthly judgments regarding a REIT's indexable to nonindexable asset ratio, the 1989 Bill's three-year valuation requirement provides ample opportunities for tax avoidance and arbitrage.

Further complexity is introduced where the benefits of indexing basis are intended to be provided to only certain taxpayers.

d. Indexing for not all taxpayers. Further complexity is introduced where the benefits of indexing basis are intended to be provided to only certain taxpayers. The rules to effect this limitation which will be issued under regulations, are certain to be complex. Moreover, to properly limit the benefits of indexing, it is likely that tracing share ownership will be necessary. Doing so, however, will have the undesirable if not disastrous consequence of rendering shares in a publicly traded mutual fund nonfungible.

5. Other passthrough entities. The 1989 Bill would create major additional complexity and opportunities for arbitrage with respect to trusts. In many respects, the complexities and arbitrage opportunities will be similar in nature to those arising in connection with the types of passthrough entities previously discussed. Nevertheless, many additional issues arise.

In particular, the taxation of trusts will be burdened with difficult computational issues arising under the throwback rules, the treatment of disposition of qualified real property under section 2032A, and the treatment of split interests in property. Moreover, the technical basis and holding period rules for property held by or acquired through a trust will provide numerous planning opportunities, particularly in circumstances involving transfers of interests in the trust as opposed to its corpus. We consider it highly unlikely that the *in terrorem* "principal purpose" rule will eliminate the perceived opportunities.

Partnerships and S corporations would have to maintain records...to determine indexation adjustments to partners' or shareholders' interests upon the sale of an indexed asset.

It should be noted that the 1989 Bill effectively denied the benefits of basis indexing to holders of interests in subchapter T cooperatives. We assume that this denial represents a conscious choice favoring the simplicity of denying the benefit over the difficult task of crafting rules to preserve the benefit of indexing in this context. Nevertheless, it must be recognized that this choice favors the interests of taxpayers large enough to conduct operations without dealing with cooperative over smaller taxpayers who must conduct significant aspects of their affairs through cooperatives.

6. Other problems with the 1989 Bill flowthrough provisions. The provisions of the 1989 Bill relating to passthrough entities significantly increase record keeping and computational burdens on taxpayers. Under the 1989 Bill partnerships and S corporations would have to maintain records for each indexed asset to determine indexation adjustments to partners' or shareholders' interests upon the sale of an indexed asset. For partnerships, already complicated issues regarding the allocation of gain, loss, income, and deductions related to assets contributed to a partnership by a partner under section 704(c) would be further complicated by the additional layer of issues and computations regarding indexation adjustments to such assets. Similarly, as anyone who has had to work through the adjustments and the individual valuation of all partnership assets in a complex partnership will attest, section 754 is not a simplification measure.

An example should illustrate the magnitude of the problem. Assume X and Y form a partnership. X contributes property with a fair market value of $480. Y contributes property with a fair market value and tax basis of $120. The properties contributed by X and Y are depreciable over 10 years on a straight-line basis. The partnership has no items of income, gain, loss, or deduction other than depreciation and gain or loss with respect to the property

Partner Capital Accounts

	X		Y		Property	
	Book	Tax	Book	Tax	Book Value	Tax Basis
Contribution	480	0	120	120	600	120
Depreciation, Years 1-5	(240)	0	(60)	(60)	(300)	(60)
Balance Year 5	240	0	60	60	300	60

Tax Gain	
Sale Price	600
Adjusted Tax Basis	(60)
	540

Book Gain	
Sale Price	600
Adjusted Book Value	(300)
	300

Assume that X's property has a tax basis of zero upon contribution. Assume that at the beginning of year six, both properties are sold for $600 and that inflation is 50 percent for the five-year period. First, the treatment of the partners without indexation of the partnership's assets:

$240 of the tax gain is allocated entirely to X as section 704(c) gain. The section 704(c) gain is the remaining disparity attributable to the value/basis differential of X's property, computed as the difference between the property's adjusted book value (240) and adjusted tax basis (0).

The additional $300 of tax gain and the book gain of $300 is allocated 80 percent to X (240) and 20 percent to Y (60), so that the capital account balances are:

	X		Y	
	Book	Tax	Book	Tax
Balance, Year 5	240	0	60	60
Gain	240	480	60	60
Balance	480	480	120	120

Liquidation proceeds, which are distributed in accordance with the Book Capital Account balances, will be distributed 40 to X and 120 to Y, resulting in an 80%/20% distribution ratio. Neither party should recognize gain or loss upon liquidation, as the proceeds received will equal the tax basis in their partnership interests (i.e., their Tax Capital Accounts).

This already complex system of partnership allocations is further complicated by the addition of indexation adjustments and allocations issues.

This already complex system of partnership allocations is further complicated by the addition of indexation adjustments and allocations issues. With indexation, the tax basis of the partnership's property would be 180 (150% of a 120 tax basis).[50] Thus:

Tax Gain	
Sale Price	600
Indexed Tax Basis	180
	420
Recapture Gain	60
	480

At this point, numerous issues arise. First, how is the section 704(c) allocation to X to be determined? If the indexed tax basis is used, only 120 of the tax gain would be allocated to X as section 704(c) gain, the difference between the property's adjusted book value (300) and the indexed tax basis (180). On the other hand, the unindexed adjusted tax basis might be used, resulting in the same section 704(c) allocation as before; this, of course, would require taxpayers to keep track of and make yet another basis determination.

Second, how is the indexation adjustment of 60 to be allocated between X and Y? If in proportion to X and Y's partnership interests, X would receive an increase in his partnership interest basis of 48 (80%) and Y would receive 12 (20%) as their flowthrough indexation adjustments. Since the sale at $600 in an indexed system produces an overall loss, such an allocation effectively allows X and Y to blend their losses and gains on their respective property contributions to the partnership. X's property has a large built-in gain of 480, presumably unreduced by inflationary indexing since its basis is zero. Nevertheless, the partnership has experienced an economic loss on X's property. Y's property also experiences a significant loss in value due to inflation.

An allocation of indexation adjustments according to X and Y's respective partnership interests would give X indexation adjustments when, without a partnership with Y, X's property would not receive any indexation. Similarly, Y has transferred 80 percent of the indexation benefits attributable to Y's property to X through the partnership structure. Moreover, this transfer of indexation benefits has allowed Y to avoid the 1989 Bill's restriction on losses created by inflationary indexing; the partnership's indexation benefit of 60 is entirely produced by an inflationary loss of Y's property. Additional rules will be necessary to determine allocations on a property-by-property basis, if indexation, as the 1989 Bill provides, cannot create or increase a loss.

Moreover, the 1989 Bill provides that substantial improvements or additions to indexed property should be separately indexed. This will inevitably create serious problems regarding the netting of gains and losses between the indexed property itself and any substantial improvement to it, the allocation of indexation benefits between the property and the substantial improvement, and the allocation of such benefits between, for example, partners contributing different amounts of capital, appreciated property, built-in loss property, or services to the indexed property and to any substantial improvement.

While these problems may have solutions, solutions, whether complex or simple, will only be the result of in-depth study and considerable effort focused on each particular aspect of S corporation or partnership flow-through. The 1989 Bill, in contrast, naively assumes that solutions lie in ignoring the problem areas. Thus, the House Report on the 1989 Bill states that partnership interests and S corporation stock were not made indexed assets to avoid "the complexity which would result in determining the proper measure of the basis adjustment if indexing were to take into account the fluctuating basis of the S corporation or partnership interest" or the varying mix of indexed and unindexed assets held by an S corporation or partnership.[51] Yet, as the above example

[50] The 1989 Bill provides that for purposes of determining the amount of depreciation recapture, basis adjustments attributable to indexing are not taken into account. Thus, the partnership will have $60 of recapture gain. The remaining gain is determined by using the $120 basis (sum of $60 basis before recapture plus $60 recapture) and applying a 50 percent indexation adjustment.

[51] House Report, p. 1479.

illustrates, problems of asset mix and indexation, among others, would arise immediately upon the sale of any partnership interest or S corporation stock, and cannot, as the 1989 Bill presumes, be deferred until the partnership or S corporation disposes of a particular asset.

IV. COMPLIANCE BURDENS

As our review of the 1989 Bill indexing proposal reveals, the complexity of the substantive issues raised by any basis indexing proposal could hardly be understated. The effect of any indexing proposal on the current tax system's complexity, however, also must be measured in terms of increased compliance burdens on taxpayers. Moreover, these increased compliance burdens will further strain an already overburdened audit system. This part of the report briefly identifies some of the compliance burdens that would be created or increased by an indexing system.

In many common circumstances, the indexing calculation would be a complex one.

A. The Basic Indexing Calculation

The first additional compliance burden attributable to indexing is the need to adjust the basis of assets that otherwise would not be adjusted or to make an additional adjustment where adjustment already is required. The additional complexity would be lessened if adjustments were made only annually (as opposed to quarterly) although there would be some sacrifice in accuracy.[32] As a practical matter, because the adjustment would be made only when an asset is disposed of, the incremental burden of adjusting the basis of any particular asset would be fairly modest in the simplest cases. However, even the relatively modest incremental calculations can amount to a significant additional burden for taxpayers who have a great number of otherwise simple transactions, such as an active trader of securities or an investor who has regularly reinvested dividends in a mutual fund, or pursuant to a corporate dividend reinvestment plan (hereinafter referred to as "DRIP"). Moreover, as discussed above, in many common circumstances, the indexing calculation would be a complex one. We question the wisdom of introducing *any* incremental complexity where the tax law already is widely perceived as overly complex.[33]

B. Increased Record Keeping

Under present law, once the holding period of an asset exceeds the applicable holding period for long-term capital gain or loss treatment, there is no further need to ascertain the precise period for which it has been held.[34] If the basis of assets were to be indexed, however, it would be important to establish the precise holding period of any asset so that the indexing calculation can be made accurately. We anticipate that certain conventions would be adopted for making the relevant indexing computations. These conventions may serve to simplify somewhat the indexing computations where payment or payments for assets are made either before or after the acquisition of the asset. Although records generated in the ordinary course of business probably would contain most of the information relevant to the indexing computation and conventions, the degree of detail that taxpayers would need to develop from these records would be markedly enhanced.

This is particular true for long-term investments of individual taxpayers, such as homes (or home improvements) or investments in family businesses, precisely the area of tax law in which additional complexity is to be added with the greatest of trepidation. For example, if a taxpayer were to build a new addition to his home, records generated by the transaction may indicate multiple dates, reflecting the payments made and the delivery of various parts and labor. In performing the relevant indexing computation, either all or none of the dates reflected would be relevant. Under present law, none of the dates would be relevant so long as at least one year has passed from the time the addition was completed (which usually would be the case).

Under a regime of indexing, however, each periodic date will be a "cliff," the passing beyond of which will be to the taxpayer's advantage. Moreover, major concerns as to complexity arise when a taxpayer sells his principal residence and purchases a new principal residence within the period allowed by section 1034. Except in the fortuitous event that the cost of the new residence is exactly equal to the sale proceeds of the old residence, the basis for the new residence will be different from the basis of the old, and complex adjustments will be required. Similar complex adjustments would be required for reorganizations with boot or any tax-favored exchange with boot, e.g., section 1031, because the basis of the acquired asset is different from that of the transferred asset.

C. Possible Institutional Responses

Some commentators have suggested that much of the compliance burden inherent in an indexation system, particularly for taxpayers with multiple transactions, could be absorbed by financial institutions that have sophisticated computer capability.[35] Reliance on institutions to shield taxpayers from the additional burdens of complexity is fundamentally misguided.

First, the extent to which institutions can perform this role may be overstated. For example, some commentators have suggested that institutions will relieve the individual

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Cohen, p. 104.

See, e.g., H. Stout, *Codified Confusion: Tax Law Is Growing Evermore Complex, Outcry Even Louder,* Wall St. J., Apr. 12, 1990, p. A1, col. 6; *Rostenkowski Pushes Simplification As Hearings Begin on Tax Reform,* 46 *Tax Notes* 738 (Feb. 12, 1990) ("committee will make tax simplification a top priority"); F. Goldberg, Statement before the House Ways and Means Committee (Feb. 7, 1990) ("The cumulative impact of repeated law changes—coupled with a statutory, regulatory, and administrative focus on theoretical purity—have imposed a staggering burden of complexity, uncertainty, and administrative costs."); K. Gideon, Statement before the House Ways and Means Committee (Feb. 7, 1990) ("We must work together in an effort to identify ways to simplify the system in a manner consistent with maintaining both the reality and perception of fairness.").

[34] Moreover, even this information usually is unnecessary because the distinction between long-term and short-term capital gains is virtually irrelevant under present law.

[35] *See* Durst, p. 1274; Steuerle & Halperin, p. 359.

taxpayer of the burden of indexing computations for stock acquired under a DRIP. In many cases, however, an individual cannot participate in a DRIP if the stock is held through a brokerage account, eliminating the possibility that the brokerage firm can perform the required calculations.

Second, institutions will not necessarily have available all the information necessary to make the relevant indexing computations. For example, if an investor removes securities from an account at one brokerage firm and deposits those securities at another, information about acquisition dates will not necessarily be transferred at the same time.

Finally, it will be impossible for any particular institution attempting to calculate a taxpayer's indexation adjustment to take into account all the special rules relating to the indexing calculation, many of which will require information not available to it. One brokerage firm will not necessarily be aware of transactions that toll the holding period for particular assets if the taxpayer executed those transactions through another brokerage firm. For example, a taxpayer may own shares of stock through one brokerage firm and have sold put options with respect to the same stock through another brokerage firm. The combination of heavy reliance on institutions for computations with the inability of the institutions to take into account all relevant aspects of the indexing calculation is a recipe for widespread reporting errors, noncompliance, or gaming against the Treasury.

V. THE WEAK THEORETICAL BASIS FOR INDEXING

All the complexity and exposure to significant erosion of the revenue base would be problematic even under a perfect indexation system, because the primary theoretical bases supporting indexation of the tax system are themselves problematic.

A. Inexact Nature of Adjustments

The main premise underlying any indexing proposal, i.e., that indexing the basis of an asset will result in the taxation of not only real appreciation, is highly questionable. The four factors discussed below contribute to this conclusion. Given the reality that any inflation adjustment would be imprecise at best, we believe, in fact of the problems discussed in the preceding portion of this Report, that any form of indexation would be extremely bad tax policy.

First, the use of any particular inflation index will offer inexact relief to the owner of any particular asset. For example, if the consumer price index is used, exact relief will be given only to an owner who plans to use the income from the asset for consumption, as opposed to business or investment purposes, and then only if the composition of the owner's planned or actual consumption matches that of the basket of goods whose price level is measured in composing the index. Although it may be said that consumption is the ultimate goal or at least use for all income, it nevertheless is true that for certain periods, investment goals may predominate. This has caused some to question whether use of an index other than the consumer price index would be appropriate.[56]

Second, the price of an asset and the returns available from that asset already may be adjusted to account for inflation. For example, if a lessor charges higher rents to compensate for the overtaxation attributable to inflation, basis adjustments would provide the lessor with redundant relief. For this reason, it is unclear whether it would be preferable to index basis for actual or expected inflation.[57]

Third, deferring basis indexation adjustments until disposition creates arbitrary results where income-producing property generates periodic returns in excess of the "real" rate of return. For example, if the current income generated by property were sufficiently high, there would be relatively little real or nominal appreciation in that property. All the currently received income would be treated as ordinary income to the recipient, notwithstanding the fact that in an inflationary environment, a portion of that income in economic terms would represent a return of principal. Thus, indexing basis would be of limited usefulness to the holder of this type of property for whom property appreciation attributable to inflation would be recognized as ordinary income over the period the property is held, accompanied by a capital loss (if losses are allowed) or diminution of capital gain on disposition.[58] Ironically, the benefit of basis indexation is greater for property that does not generate current income and that as a result already enjoys the benefit of tax deferral.[59]

Basis adjustments will match inflationary increases only by happenstance.

Finally, even assuming that the proper measure of inflation in an asset can be determined with reasonable precision, it can be demonstrated that in most cases actual basis adjustments will match inflationary increases only by happenstance. This unfortunate result occurs because in the absence of gain realization, annual adjustments are made to the basis of the asset without regard to its fair market value. Nevertheless, inflation in any period by its nature will increase the nominal price of an asset relative to its *value* at the beginning of the measurement period.

For example, assume that Ms. A purchased an asset for $1,000. After one year the asset is still worth $1,000. After two years, Ms. A sells the asset for $1,300. Inflation in

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[56] Bravenec & Curatola, *Indexing the Federal Tax System for Inflation*, 28 *Tax Notes* 457 (July 22, 1985).

[57] Steuerle & Halperin, pp. 366-368.

[58] This result is most easily understood in the context of an investment in nonparticipating preferred stock. For example, individual investor A pays $1,000 for $1,000 face amount of XYZ Corp. preferred stock, which has a 10 percent annual dividend. Inflation of five percent is anticipated in determining the dividend rate and inflation actually occurs at that rate. A's stock is redeemed after 10 years for $1,000. At that time, A's indexed basis in the stock is $1,629, resulting in a capital (and economic) loss of $629. This loss occurs because each unindexed dividend payment represents economically a return of capital in part. *Cf.* section 1059(f). The same phenomenon occurs with respect to depreciable property if basis is indexed only on disposition and depreciation deductions are not indexed.

[59] *See* Part V.B., *infra*.

each year is 10 percent. Under an indexation system, Ms. A would have a basis in the asset at the time of sale of $1,210 (*i.e.*, $1,000 plus $100 for the first year and $110 for the second year). Although Ms. A's inflation adjustment of $100 for the first year is appropriate, her inflation adjustment for the second year should be limited to $100. Price level increases in the second year only inflated the actual value of her asset, not the asset's adjusted basis. Ms. A's taxable gain is $10 less than her "real" gain.[60] By comparison, Mr. B purchases an asset for $1,000. The asset is worth $1,200 after one year and is sold for $1,300 after two years. At the time of sale, Mr. B's basis also would be $1,210, but his inflation adjustment for the second year should have been $120 rather than $110, resulting in tax of $10 of gain in excess of real gain.

Accordingly, the basis adjustment for an asset will exactly equal the measure of its price inflation (assuming that the exact amount of price inflation can be measured in any event) only where the asset appreciates at exactly the rate of inflation. Basis adjustments will be inadequate to adjust for inflation where an asset appreciates faster than the rate of inflation, and basis adjustments will be excessive where an asset appreciates at a rate slower than inflation.

Thus, it must be recognized that the connection between the actual effects of inflation on any particular asset and the relief provided by any system of basis adjustments is quite tenuous.

B. Neutral Taxation of Capital Income

Another often-stated premise underlying indexation proposals is that indexation is needed to achieve neutral taxation of income from capital as compared to other sources, i.e., to prevent capital income from being taxed more heavily than other income by reason of including inflationary as well as real gains in the tax base. This premise too is false. It is well understood that the current system taxes income from capital more favorably than income from other sources because gain from the appreciation of capital is not taxed unless realized and avoids tax altogether if the asset is held at death. Other advantages include accelerated depreciation, the availability of interest deductions on related indebtedness, and LIFO inventories.[61] Thus, unless these other benefits are eliminated, indexing of basis will allow income from capital to enjoy an even more favored tax status relative to income from other sources than it now enjoys.

VI. CONCLUSION

It is our position that the implementation of any indexation system as a part of a modification of the present tax system would be highly inadvisable. While this Report is intended to discuss only some of the potential problems with any indexation system, we believe it clearly identifies the nature of the numerous distortion, complexity, and tax arbitrage issues that any indexation system would create.

This Report reflects our position as professional tax practitioners. We are seriously concerned that any indexation system will permit the use of these distortions and tax arbitrage opportunities to seriously erode the revenue base. This will clearly be counterproductive in the current budgetary environment.

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[60] This result is even more pronounced where assets depreciate initially and then appreciate.

[61] See Steuerle & Halperin, pp. 353-356.

APPENDIX 1

Indexing in the United Kingdom

In 1982, following the high inflation of the 1970s and after several years of discussion,[1] the U.K. indexed the basis of certain assets in an attempt to avoid the taxation of inflationary gain.[2] Announcing the measure, the Chancellor of the Exchequer said in his Budget speech:

> I come now to the incidence of capital gains tax on inflationary gains. This is a matter which has rightly given rise to a great deal of discontent. No one has yet succeeded in finding a solution to this problem. Innumerable proposals for full indexation, for tapering and other ingenious devices have been put forward. None, unfortunately, overcame all the practical difficulties. I cannot, however, allow this injustice to continue. It is intolerable for people to be permanently condemned to pay tax on gains that are apparent but not real—that exist only on paper.

Thus, acknowledged at the outset that the measure was imperfect, basis indexing was created in the U.K. Since its introduction, the basis indexing provisions have undergone two major revisions, the second of which, in 1988, was part of a larger revision of the capital gains tax ("CGT").[3]

The U.K. indexing rules provide for adjustment to the basis of an asset upon its disposal. On the disposal of an asset, an indexation allowance is given, equal to relevant allowable expenditure multiplied by a fraction, the denominator of which is the retail price index[4] ("RPI") for the month of disposal and the numerator of which is the RPI for the month of disposal less the RPI for the month of acquisition. The indexation allowance is treated as a deduction from the gain or loss computed under general CGT rules. It may reduce a gain, turn a gain into a loss, or increase a loss.

Where an asset acquired before April 1, 1982, is disposed of after April 5, 1988, the adjustment is calculated by reference to the market value on March 31, 1982 (rather than the taxpayer's cost basis before that date), if this gives a result favorable to the taxpayer. For dispositions of assets from April 1982 until April 1985, relief was given on a more restricted basis.[5]

A continuing problem with the U.K. indexing provisions has been the complexity of identifying the asses that have been sold to determine their eligibility for the

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[1] See, e.g., Nobes, *Capital Gains Tax and Inflation*, 1977 Brit. Tax Rev. 154; Watson & O'Reilly, *A Scheme for the Indexation of Capital Gains Tax*, 1978 Brit. Tax Rev. 4.

[2] See sections 86 and 87 of the U.K. Finance Act of 1982 and section 68 of the U.K. Finance Act of 1985.

[3] In the U.K., the CGT is a separate tax from the income tax. Until 1988, a flat rate of 30 percent was imposed on a taxpayer's capital gains; the rate is now linked with the income tax rate so that for individuals, capital gains are added as the top slice of income to determine the appropriate rate, of up to 40 percent. Corporate capital gains are taxed at the full corporate rate of 35 percent (25 percent in the case of "small companies").

[4] The RPI figure is released by the Inland Revenue each month.

[5] Specifically, (i) only changes due to inflation after March 1982 were taken into account; (ii) no relief was given for changes due to inflation occurring during the first 12 months of ownership, thus excluding relief whether the asset was disposed of within those 12 months or not; and (iii) the indexing adjustment could only reduce (or eliminate) a gain.

allowance, and the correct cost basis to be attributed to them, especially in the case of securities. Because of the relevant effective date provisions, assets had to be divided between those acquired before March 1982 and after. Another allocation had to be made initially for assets held for less than one year, which were not eligible for the allowance. In 1985, the one-year rule was abandoned, but the taxpayer was given the ability to choose whether to calculate the allowance for assets acquired before March 1982 using the base cost on acquisition before March 1982 or the fair market value of the asset in March 1982, requiring further allocations. Expenditure on property after March 1982 itself qualified for a separate calculation to determine the allowance due in respect of it. Part disposals also had their own rules. The effect has been to impose a considerable administrative burden on taxpayers who generally have been unable to compute their basis adjustments without professional help.[6] The shifting of basis of all assets to their value on March 1982 is expected to ease that burden somewhat, but carries with it obvious administrative problems of its own.

In 1985, the rules were revised to allow the allowance even when it created a capital loss. Attempts to take advantage of this have resulted in legislation to prevent abuses.[7] For example, the Finance Act of 1988 contains provisions[8] preventing linked companies from manufacturing an artificial loss through the sale of certain intercompany debts. Other problems include the failure to index gains or losses on debt, creating arbitrage possibilities, and resulting in frequent legislative action to stop it.

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[6] See Hoerner, *Indexing Capital Gains: The British Experience*, 46 *Tax Notes* 988 (Feb. 26, 1990).

[7] For example, the distortion caused by indexing gains on securities, while fully taxing interest as income, will result in transactions and devices designed to convert the return on securities from income (unindexed) into capital gains (indexed). In the U.K., this has led to a series of anti-avoidance legislation.

[8] Section 114 and Sched. 11, Finance Act 1988.

COMMUNICATIONS

STATEMENT OF THE NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®

(SUBMITTED BY MARK O. DECKER, PRESIDENT AND CEO)

We appreciate the opportunity to comment on capital gains reduction proposals such as S. 182 and H.R. 9. The National Association of Real Estate Investment Trusts® ("NAREIT") represents over 240 real estate investment trusts (known as "REITs"), about 200 of which trade on the New York Stock Exchange, the American Stock Exchange, or the National Market System of the NASDAQ. In addition, NAREIT represents over 1,600 lawyers, accountants, analysts, investment bankers, and others who provide services to the REIT industry.

Congress established REITs in 1960 to allow small investors to obtain the diversification and professional management of real estate that beforehand were only available to large, sophisticated investors. Capital formation has been essential to the growth and success of REITs ever since, and the promise of a large scale, widely held real estate capital market has begun to become a reality. The market capitalization of publicly held REITs has blossomed from under $9 billion at the beginning of 1991 to about $45 billion today. This success story is due in large part to the tax modernization reforms adopted by Congress over the years.

The maturation of the REIT industry would not have been possible without capital formation. Thus, NAREIT applauds the intent of legislation such as S. 182 and H.R. 9 to create further incentives for the public to invest in the stock market. Specifically, NAREIT wholeheartedly endorses the proposal to reward the entrepreneurial risks of investing in stock by reducing the capital gains tax.

In addition, NAREIT supports the intent of S. 182 and H.R. 9 to index the tax basis of investors' stock to avoid taxing the noneconomic increase of value attributable to inflation. However, there appears to be some provisions in S. 182 and H.R. 9 that could deny such indexing to investors in REIT stock. Such a result would be terrible for the REIT industry because investors would have an incentive to invest in other companies for which they could receive the benefits of indexation.

S. 182 and H.R. 9 would allow stock in a REIT to be fully indexed only if 90% of the REIT's assets are "indexed assets," that is, corporate stock or tangible property. I will briefly summarize the three major technical provisions in S. 182 and H.R. 9 that could disqualify REIT shares from full indexation.

First, S. 182 and H.R. 9 exclude as an "indexed asset" any "net lease property." The nature of the real estate business is such that this definition could easily prevent more than half of today's REITs from qualifying for indexation. For example, many of our shopping center, health care, industrial, hotel, and net lease REITs own and operate portfolios of properties that fall under the net lease definition in S. 182 and H.R. 9. These REITs are in the ongoing real estate business and are completely different from the single shot, financing vehicles that the original net lease definition was meant to encompass.

Second, many REIT investments are made through partnerships. However, S. 182 and H.R. 9 could be interpreted to exclude as "indexed assets" properties held through a partnership. Such an interpretation would be contrary to the tax Code's usual rule of treating a partnership as an aggregation of the partners rather than as a separate entity.

Third, the 90/10 safe harbor is a good idea because the administrative complexity of requiring REIT shareholders to adjust only a portion of their tax basis is not justified when most of the REIT's assets qualify as indexed assets. However, we recommend that the 90% threshold be reduced to provide REITs with greater flexibility in conformity with the REIT asset tests.

NAREIT urges the Committee to enact these capital formation incentives after making our suggested technical changes to allow REITs to raise capital on an even playing field. Thank you once again for the opportunity to comment on this important legislation.

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