# INDEXING CAPITAL GAINS THE ELIMINATION OF THE TAXATION OF CAPITAL

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**Abstract:** Economists cannot agree on the appropriate taxation of capital gains. Some believe that lowering the capital gains tax rate will increase government revenues. Others believe only the wealthy will gain from a special tax rate. This paper describes the history of capital gains taxation and presents the arguments for and against a special capital gains taxation rate. A proposal is made for indexing capital gains which would reduce the complexity of the Internal Revenue Code.

## INTRODUCTION

The special tax treatment of capital gains began with the 1921 Revenue Act which placed an upper limit on capital gains at 12.5 percent at a time when the rates on ordinary income went up to 70 percent. The holding period for treatment as a long-term capital gain was more than two years. Special treatment for long-term capital gains for corporations was introduced in the Revenue Act of 1942, at which time the holding period for long-term capital gains and losses was reduced to more than six months. Through the years the holding period to receive long-term treatment, the tax rates on capital gains, the introduction of Section 1231 assets as a bifurcation of capital gain treatment, and the definition of a capital asset have caused many changes in the Code and to this date, politicians continue to attempt to modify the treatment of capital assets.

Economists cannot agree on the appropriate taxation of capital gains. In the U.S. those economists who are considered supply siders believe that if taxes on capital gains were reduced more capital would be available and invested and this would result in a healthier economy. Those who are not supply sider advocates believe that capital will be available when demand occurs. As Eisner wrote:

> The prime determinant of business investment is demand. Investments in plant an equipment falls off when the economy is sluggish and excess capacity makes additional plant and equipment unnecessary. In such a situation, moderate annual tax benefits to business would appear to have little effect, particularly in the short run. Well-run firms will not be led to invest by tax reductions which increase after-tax earnings but do not make additional equipment profitable in the fact of existing idle capacity. Where demand is brisk, firms will invest without a special subsidy.[1]

This paper will first consider the criteria of equity as it is the most basic criterion in evaluating a tax system. Various arguments which have been made in asserting that capital gains should received preferential tax treatment will be analyzed and the indexing of capital gains as an alternative approach will be presented.

## EQUITY

In a review of various countries' taxation of capital gains the most frequent reason given for their approach is "fiscal equity" or "fiscal justice." Adam Smith in *The Wealth of Nations* set out his first cannon of taxation, which was, "the subject of every state ought to contribute towards the support of the government as nearly as possible in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state."[2] From the writing of Adam Smith and other economists, the notion of equity has come to be expressed in terms of horizontal and vertical equity. Based upon the progressive rate structure in out tax system, Congress has at least given tacit approval to vertical equity.

Since 1922, when capital gains first received preferential treatment, the taxation of capital gains has undermined both horizontal and vertical equity. For example, when two persons, one receiving $100,000 of salary and another receiving $100,000 from the sale of preferentially treated capital assets, pay different taxes on the same amount of income, the principle of horizontal equity has been violated. Likewise, if only 40 percent of a capital gain is taxed, as was the case after June 24, 1984, but before January 1, 1987, then a taxpayer with $100,000 of capital gains would be taxed at a lesser rate than a taxpayer with $50,000 of salary. This latter example is a violation of vertical equity.

From an equity standpoint, then, capital gains should be taxed the same as other income. However, since capital gains are often earned over a relatively long period of time, the effect of inflation on "gains" becomes a very real problem. When nominal gains are less than inflationary gains, a resulting transaction is actually a tax on capital and not on capital gains.

## ARGUMENTS IN SUPPORT OF PREFERENTIAL TAX TREATMENT FOR CAPITAL GAINS

### Capital Gains Taxation is a Tax on Wealth, Not Income

Some assert that a tax on capital gains is a tax on wealth and not a tax on income. However, this does not follow if one accepts either the Haig or Simon definition of income. According to Haig ("Income is the money value of the net accretion of one's economic power between two points of time."[3]) or Simon (income "...is merely the results obtained by adding consumption during the period to 'wealth' at the end of the period then subtracting 'wealth' at the beginning"[4]), capital gains is clearly "income" in an inflation-free environment.

Other opponents of taxing capital gains contend that current financial accounting treats material capital gains as extraordinary items and not as a part of operating income. Also, other opponents of taxing capital gains point out that some believe that capital gains should be reflected directly on the balance sheet, bypassing the income statement altogether. In considering these approaches one need to remember that the purpose of separating extraordinary items on the income statement is to provide an income statement that is consistent and comparable from year to year. If sales of assets other than inventory were included in the operating statement, managers could time sales of such property to conceal problems with operations. Opponents of reporting capital gains contend that capital assets are the basis for a company being in business, and gains and losses should not be recognized on the income statements since these assets are the engine that keeps a company operating. In evaluating these positions, it should be remembered that accountants are not attempting to define operating income, but to present reliable and comparable financial statements over different time periods.

The Supreme Court in 1921 clearly

refuted the idea that gains from capital is not income, for in Eisner v. Macomber the court stated, "...Income may be defined as the gain derived from capital, from labor, or from both combined...."[5] There are numerous examples in our tax system where income is not taxed; for example, the receipt of a gift is income, but it is not taxed. Thus, the issue is not whether capital gains is income, but rather, should these gains be taxed, and if so, at what rate?

**Lowering Capital Gains Taxes Increases Tax Receipts**

For the period 1982 through 1985 when the maximum tax on capital gains was 20 percent, the tax receipts from capital gains was $79.533 billion. For the years 1987 through 1990 when the maximum tax on capital gains was 28 percent the receipts from capital gains was $134.869 billion. While inflation has not been factored into these receipts, the Treasury figures do not support the contention that federal revenues would increase if the rate on capital gains were reduced.

Those who maintain that federal tax receipts increase when capital gains rates are lowered suggest that taxpayers who have substantial capital gains are locked into holding their assets when rates are too high and those persons would sell if capital gains rates were lowered. The numerous studies on the effects of various changes in the taxation of capital gains show different results as to whether revenues move in the same or opposite direction as the change in the capital gains rate. Using cross sectional data to look at the reductions in 1978 and 1981, the Treasury concluded that the reductions raised revenue for both periods. However, using time series data, they found that the 1978 reduction raised revenue, while the 1981 reduction lost revenue.

A report issued by the Congressional Budget Office in 1988 stated that the increase in capital gains rates in the 1986 act "...most likely will increase revenue from capital gains taxes, while a reduction of the top rate to 15 percent would most likely reduce revenue." A further reading of this report leads one to question the validity of any of these studies. The report states, "...that considerable uncertainty must be attached to the results of all statistical studies on the realizations of capital gains, including this one..., relatively modest percentage changes in the realizations response translate into much larger percentage changes in the net revenue effect of a tax change. As a result, standard statistical tests do not permit rejection the possibility that the 1986 act reduced revenued from capital gains taxes or that a 15 percent rate would raise revenue...."[6]

A persistent problem in estimating the effect of a tax change on capital assets is what is known as the portfolio effect. If the tax rates on capital gains are reduced, how will taxpayers change their portfolios to take advantage of the new law? If investors withdraw savings that are earning taxable interest and invest them in capital assets, what will be the impact of the loss of revenue due to a decline in taxable interest income? Also, if lower capital gains rates were enacted, corporations could be expected to lower dividend payouts, which would decrease dividend income. Estimates of these changes increase the "educated guesses" used to determine the effect of a tax reduction on capital gains. A study done by Treasury's Office of Tax Analysis (OTA) showed the 1978 capital gains cuts increased revenues, while a later study by OTA showed that the increase in the capital gains tax in the 1986 act would raise revenue. Does this suggest the government decides the results and then changes the parameters until the desired result is achieved? As Gene Steuerly, former director of OTA, told a meeting of the National Tax Association, "If anyone tells you they know what the revenue consequences of a capital gains cut will be, don't believe him."[7]

To say that the current tax on capital gains is too high ignores the past. For most of the period since 1954 the marginal rates on capital gains has varied from 25 to 39.9 percent. It is also interesting to note that while the 1978 Act increased the long-term capital gains deduction from 50 to 60 percent and removed the capital gains preference from the base of the add-on minimum tax, the top marginal rate on capital gains was still 28 percent which is currently the top marginal rate on capital gains. Since the current top marginal rates for all income are much lower than in periods when capital gains changes were made, drawing conclusions form prior code changes may be entirely irrelevant.

**The Lock-In Effect**

Some argue that by reducing the capital gains, holders of assets which are under-performing may sell and reinvest the funds in more promising ventures. Such an exchange, it is asserted, would increase economic efficiency. Since another investor has to purchase the asset sold, all that happens is that the portfolio make-up of two or more taxpayers has changed. Additional investment hasn't occurred, but rather, the amount available for investment has been reduced by transaction costs and the amount of taxes imposed. Also, if sellers use are or all of their after-tax receipts for consumption, a further reduction is capital investment occurs.

Other, perhaps more important issues, suggest that reducing the capital gains tax rate may not solve the locked-in problem. For example, the change in capital gains rates would not effect a taxpayer with property that has been depreciated and is subject to various recapture provisions, such as IRC §§1245, 1250, and 291, which convert much or all of the gain on a sale of a depreciated asset to ordinary income. Therefore, if a taxpayer cannot take advantage of the lower rate due to other overriding provisions of the law, such a change in the capital gains tax rate would have no effect on the holders of these assets.

Another problem in attempting to motivate taxpayers to sell properties is the stepped up basis heirs receive with inherited property (§2031). A study by the Congressional Budget Office notes that, "...a large fraction of capital gains is realized by taxpayers in the very highest income groups--those who can be expected to leave the largest bequests--a big differential between the rate on gains realized during a taxpayer's lifetime and the rate on gains passed at death (currently zero) can have a significant, negative effect on the permanent level of realizations."[8] The Tax Reform Act of 1976 introduced a carryover basis for inherited property, which would have partially addressed this problem, but his was repealed in 1980.

In a study using the Internal Revenue Service Seven-Year Panel of Taxpayers over the period 1967-73, Minarik found that taxpayers at all income levels timed their capital gains "...to coincide with years in which their ordinary income is below average and their deductions are higher than normal."[9] Minarik also found that for many investors with large portfolios, who are the dominant holders of capital gain property, "...the potential for realization of larger amounts of capital gains in response to reduced tax rates on gains is limited."[10] Minarik noted that studies, such as that done by Feldstein, Slemrod, and Yitzhaki,[11] which show that a decrease in tax rates would increase sales sufficiently to produce an increase in tax revenue may be flawed because they are based on a proportional increase in realized gains based on changes in effective tax rates. Minarik's study states than many of the returns in his sample may have limited additional gains to realize and therefore, a decrease in rates would have limited impact. It should be noted that during the time period covered by both studies the top marginal rates were significantly higher than under current law. Hence, studies which show an increased level of sales of capital assets due to a lower tax rate may not be applicable in the current environment.

**Taxing Capital Gains Reduces Business Investment**

Perhaps the strongest argument for preferential treatment for capital gains is that it promotes additional investments in business assets. The argument here is that if taxpayers' earnings are shielded from tax, they will save more, which will support a greater total real investment by business. While this may be true, it is not clear that a reduced cost of capital, which would result, would be worth the cost to society. Other costs, such as labor, may overwhelm the capital costs, and firms may still choose to operate their production facilities in foreign countries. Tax revenues would be given up without accomplishing the objective of increasing our productive capacity. Business investment will only be made if a firm expects regular profits, rents, or royalties, which are all taxed at ordinary rates. Additionally, some taxpayers may be more interested in their ability to deduct capital losses than in a preference on capital gains. While §1244 gives some protection for an investment in small firms, an increase in the ordinary loss treatment afforded under §1244 may do more to promote small business investment than any change on the gain side of the equation. Taxes which impinge on savings impact the rate at which capital is accumulated, but this applies to all types of savings. If it is the intent to accumulate capital at a high rate, the taxation of interest income, dividends, and other forms of savings should be addressed, since each represent income derived from capital. The holding of capital assets is merely one form of savings, and it is not clear why a special preference should be given to this form of savings over other forms.

While taxing any activity restricts that activity, the argument that taxing capital gains reduces business investment does not address the preferential treatment afforded capital assets which result in additional consumption rather than production. For example, rental residential property is currently depreciated over 27.5 years while other depreciable real property is depreciated over 39 years. Therefore we would expect more construction of apartments than would otherwise take place. While such provisions may lower the costs of rents, they clearly distract from business investment. If the goal of the Congress is to increase capital investment in business, then the tax laws need to be consistent in their application.

Backers of a cut in the capital gains tax suggest that it will promote an investment in more risky ventures, which will lead to increased productivity. However, Blum suggest the opposite result would occur, and makes the following observation:

> ...a reduction in the capital gains tax rate is likely to discourage the riskiest investment--highly leveraged acquisitions. The ability of the buyer to finance the acquisition depends on large part on the ability of acquired assets to general operating cash sufficient to service the debt. If the capital gains tax is reduced, the assets will become more expensive without any increase in operating cash flow. Therefore, a tax cut will increase the purchase price but not

the financeable amount. Higher equity investment becomes necessary, thus making the acquisition more difficult.[12]

A significant part of the capital gain from venture capital operations may actually be compensation for the founder's labor income, as it is common in such ventures for the founders to draw relatively small salaries and plow earnings back into the business. Given that this compensation is tax-favored by deferral relative to wage and salary income, it is not clear that giving this deferred income an additional benefit by reducing the tax on capital gains is necessary or desirable.

If a reduction in the taxation of capital gains occurs, corporations will reduce their dividend payouts and increase their retention of earnings, with the intent of increasing share prices because of the higher level of reinvestment. Since this would cause a greater lock-in of capital than would a stream of dividends, new ventures would have a more difficult time in raising capital. This may lead to a distorted allocation of capital among users, for firms with high levels of retained earnings may not be able to employ these assets as efficiently as new entrants.

An additional issue seldom considered, is why a preference should be given to business capital versus human capital. Developing skills and educating the work force may be more important than the rate at which plant and equipment are replaced. Massel looks at capital formation and found that 90 percent of the growth in output per man hour of labor from 1919 to 1955 was accounted for by technological, information, organization, and similar factors, while only 10 percent was accounted for by increases in capital per worker.[13] If tax revenues are reduced and this causes less to be spent in educating the work force, then reducing the tax rates on capital gains may do harm to out productive capacity.

## Is a New Direction in Tax Policy Needed?

Given the flaws in the arguments for granting capital gains a tax preference and the current economic problems such as the federal budget and balance of payments deficits, it would appear that a new approach should be considered rather than reverting back to the old preferential treatment for capital assets. While only Congress can control the spending side of the equation, a new direction in tax policy may provide a more equitable taxing system while at the same time making it simpler.

## The Treatment of Inflationary Gains

The tax-free recovery of capital is a basic presupposition of the federal income tax law that has been permitted by administrative practice or judicial decision in a variety of situations, even where there is not explicit statutory authorization to do so. In the past various methods have been used to mollify the inflation effect, such as only taxing a portion of capital gains, but each of these have been crude attempts at dealing with the inflationary problem. For example, when the holding period for a long-term capital gain was more than one year, one taxpayer might have held a capital asset for 366 days and another for 3,666 days, yet each of them would be taxed on 40 percent of their gain. To have this type of adjustment and contend that one of its benefits is it helps to address the inflation effect clearly misses the mark. The argument that preferential treatment for capital gains is necessary to reduce the effect of inflation appears even more inappropriate when the holding period for capital gains is relatively short, as when the holding period for a long-term capital gain was more than six months from 1942 to 1977, and after June 24, 1984, but before January 1, 1987.

The effect of inflation on the taxation of an asset can be demonstrated by the following example. Assume a taxpayer purchases a security with an 8 percent return, 4 percent of which is due to inflation. If a taxpayer purchases this security for $10,000, and no dividends are paid, and sells the security at the end of ten years for $21,910, he has a $11,910 taxable gain. If his tax rate is 28 percent, then he pays a $3,335 tax on the gain. After paying the tax the investor retains $18,575. If the investor's purchase price is adjusted for the inflation effects, his purchase price or basis increases to $14,800, which reduces his after tax gain to $3,775, which over the holding period amounts to an annual return of approximately 2.3 percent. Compared with a before-tax rate of return of 4 percent, an after-tax rate of return of 2.3 percent reflects an effective tax rate of 43 percent, which is much higher than the statutory rate of 28 percent. As the inflation rate increases, the effective tax rate also increases. For example, if the inflation rate were 12 percent, the effective tax rate increases to 64 percent.

Deferral offsets more of the inflation tax the longer a capital gain, growth asset is held. Using a 4 percent real return and a 4 percent inflation rate the effective tax rate for one year is 55 percent, 43 percent if held for 10 years, and 25 percent if held for 30 years. With a bond which pays interest but is redeemed for its face value, the effective tax rate on the bond with 4 percent inflation and a 4 percent interest payment would be 55 percent, regardless of how long the bond is held.

The effective tax rate when an exclusion is given for capital gains benefits a growth stock over a dividend paying stock. This is also true when indexing occurs, but the difference is much less in the indexing case. This would suggest that adopting a different treatment of capital gains may shift more firms to increase dividends if indexing were instituted rather than allowing a deduction of 40 or 50 percent of the gain. Such a shift may improve the allocation of capital, for if firms couldn't effectively utilize their excess capital they would be more likely to increase their dividend payouts.

**Indexing Depreciation**

If the treatment of capital gains is to eliminate inflationary gains from the sale of assets, then it would follow that depreciation also should be indexed. If, for example, an asset were purchased for $10,000 which has a ten-year expected life, then annual depreciation of 10 percent each year could be taken, assuming residual value is ignored. After one year if the inflation rate were 5 percent, then the remaining basis of $9,000 would be multiplied by 1.05 to yield the inflation adjusted basis of $9,450, which would then be divided by the remaining nine years to yield a depreciation deduction of $1,090. For the third year if the inflation rate were 6 percent, the remaining basis of $8,360 would be multiplied by the inflation rate to yield an adjusted basis of $8,862, which would be divided by the remaining 8 years to yield a depreciation of $1,108.

Current depreciation methods create a higher cost for depreciable assets than would depreciation indexed for inflation. The current system may promote manufacturing firms moving their capacity to other countries or replacing their equipment at a slower rate. If depreciation were indexed the real rate of return would increase and the cost of capital would decrease, which would be a positive factor for U.S. firms.

If the asset were sold in any year the gain or loss would be the difference between the sale price and the inflation adjusted basis used to compute the indexed depreciation deductions. Any gain would be ordinary gain, and any loss would be an ordinary loss. Such a treatment would eliminate the section 1231 issues and would simplify the treatment of depreciable assets. Many are confused when discussing the "recapture" rules of sections such as 1245 and 1250, and this approach would obviate the necessity for such rules.

**Distributional Effect of Indexing**

The latest IRS figures reveal that for 1993, taxpayers with income of over $200,000 reported 56 percent of the capital gains and over 70 percent was reported by taxpayers with incomes of $100,000 or more. In 1994, taxpayers with over $200,000 of income reported over 50 percent of the capital gains and over 74 percent of capital gains were reported by those with incomes of $100,000 or greater. (In 1981 only 32 percent of reported capital gains were claimed by taxpayers with incomes of over $200,000) Since taxpayers with these levels of income are taxed at the highest marginal rates, it is clear that a reduction in the taxation of capital gins will have the largest dollar impact on these taxpayers.

The Congressional Budget Office (CBO) has reported that tax reductions from indexation would have been less concentrated among higher income taxpayers than would an exclusion.[14] The CBO further reported that the real returns from assets other than stocks are hard to estimate because of incomplete information, but from the data reported real returns as compared to nominal returns were concentrated among high-income taxpayers. If the indexing of capital gains were instituted and a deduction for indexed losses were not permitted or were only partially permitted, such a limitation would lead to a higher concentration of wealth in the top income brackets.

Since most would agree that taxing inflationary gains is a tax on capital, it is recommended that all capital assets be indexed to reflect changes in the purchasing power of the dollar. Many components of our tax system already have been indexed, such as for exemptions and the standard deduction, so this would not be breaking new ground. Factors could be derived as of July 1 of each year and assets held for more than one year, counting from January 1 to December 31, would be eligible for indexing. For example, capital assets purchased in 1995 and sold in 1996 would not be eligible for indexing, but assets purchased in 1994 or earlier years and sold in 1996 would be eligible.

Capital and section 1231 assets held for businesses would be treated the same a capital assets held by individuals. This would allow those assets held by businesses to be treated as ordinary gains and losses and would simplify the law by eliminating the need for many provisions, such as sections 291, 1231, 1245, and 1250. Businesses would be allowed to deduct losses which would be realized because of changes in the purchasing power of the dollar.

**Losses Under Indexing**

Losses as well as gains should be recognized if equity is to be achieved. It is generally acknowledged that inflation is a hidden tax. If a government can pay off its debts with cheaper dollars, this permits the government to borrow more than it otherwise would. However, it is unfair to a taxpayer to tax him on nominal rather than real gains, and it is unfair to the purchaser of government debt to tax the interest received but not to allow the purchaser to reflect a loss due to the purchasing power loss experienced because of holding the security.

The indexing of capital assets would provide large revenue losses, so how to limit the revenue losses would be an important issue. An approach used in Australia is to apply indexing only to gains. Another approach would be to reduce the indexing factors. For example, if the price level had increased by 50 percent, only one-half or 25 percent would be used to adjust the asset's basis. Some advocate only permitted losses to offset gains, but for many taxpayers that experience few capital gains and losses, this approach would mostly benefit higher income taxpayers.

If losses were not permitted or limited when indexing were established, investments in risky assets would be discouraged. A safe asset would provide a higher after-tax return than would an investment in a risky asset. Also, the variability of after-tax returns for risky assets would be increased, which would mean that investors would expect a higher return.

Some contend that this process would be overly complex, but it could be relatively simple and would eliminate much of the complexity in the Code. Reducing complexity, along with making the tax system more equitable, should be two of the most important goals of policy makers.

## CONCLUSION

Any significant change in the Tax Code will result in winners and losers. If changes are to be made, an attempt should be made to increase equity and reduce the complexity of the tax law. Since excluding a portion of a capital gain would provide the most benefit to high income taxpayers, indexing would provide a more equitable approach. Also, if losses were permitted under indexing, even if only partial deductions were allowed, lower and middle income taxpayers would benefit relatively more than high income taxpayers.

If indexing were utilized, numerous Code sections could be eliminated, such as sections 291, 1231, 1239, 1245, and 1250. Additionally, other sections could be simplified. Clearly such a change would reduce, rather than add, complexity to our taxing system. For both of these reasons, serious consideration should be given to this approach.

## ENDNOTES

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[8] Note 6 at 67.

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[14] Note 6 at 91.