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Issues in the Indexation of Capital Gains

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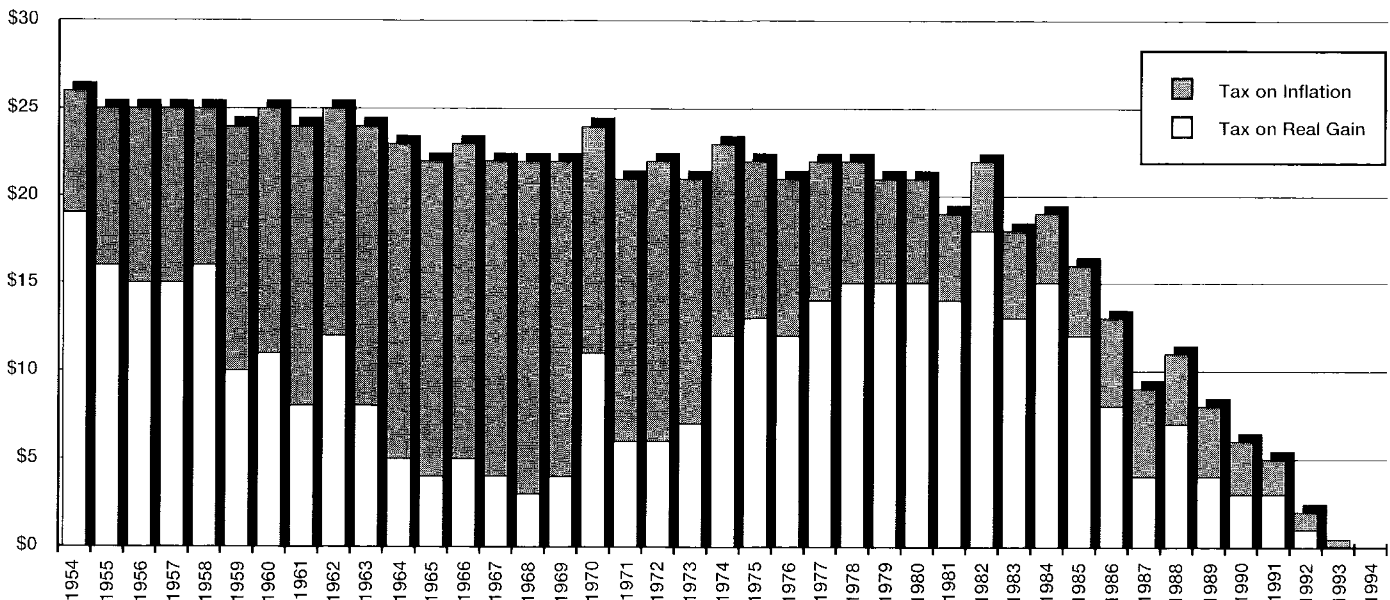
A capital gain occurs, in general, when a taxpayer sells an asset for a price that exceeds the purchase price. Indexing capital gains means adjusting the dollar value of an asset's purchase price (usually upward) for inflation. This procedure reduces the amount of a capital gain subject to taxation.

Historically, U.S. taxpayers have had to pay taxes on capital gains that result solely from inflation. This practice has led, in many instances, to effective tax rates on inflation-adjusted capital gains that substantially exceed 100 percent.

Figure 1 illustrates, for an average stock purchased in June of different years and sold in June of 1994, how much of the current capital gains tax results from real versus inflation-induced gains. The average stock, as *Table 1* describes, is represented by the value of the Standard and Poor's Index of 500 stocks in June of each year from 1954 to 1994. Therefore, the fraction of the capital gains tax that is on real gains fluctuates, depending upon both the real and inflation-induced price of the stock at the time of purchase date and sale date.

Figure 1
The Tax on Real vs. Inflationary Capital Gains of an Average Stock (Stock Bought in June of Designated Year and Sold in June of 1994)



Source: Tax Foundation.

Table 1
Unindexed vs. Indexed Capital Gains Taxation: An Example Using an Average Stock

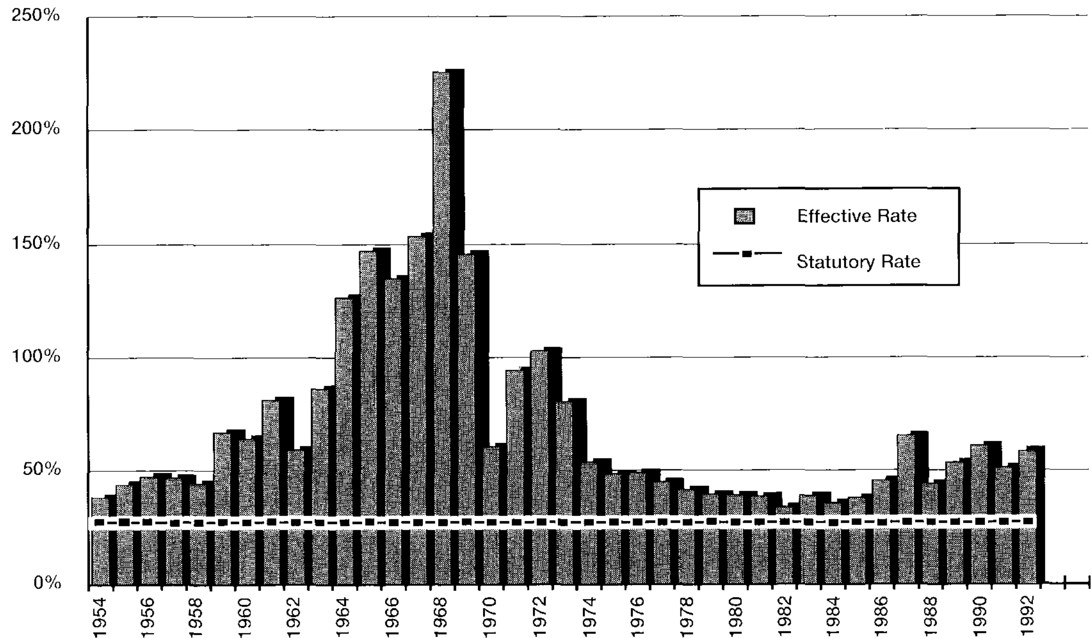
	Nominal (Current Law)				Inflation-Adjusted (Proposed Law)			
June of (Year):	Value of Avg. Stock: S&P 500 Index (1994=100) (A)	Capital Gain: Bought in June of Designated Year, Sold in June of 1994 (B)	Capital Gains Tax Owed Without Indexing (28% Rate) (C)	Applicable Inflation Ratio (D)	Value of Avg. Stock: S&P 500 Index (1994=100) (A x D)	Capital Gain: Bought in June of Designated Year, Sold in June of 1994 (E)	Capital Gains Tax Owed With Indexing (28% Rate) (F)	Effective Tax Rate on Real Capital Gains Without Indexing (C ÷ E)
1954	6.37	93.63	26.22	4.948	31.50	68.50	19.18	38.27%
1955	8.75	91.25	25.55	4.762	41.65	58.35	16.34	43.79%
1956	10.17	89.83	25.15	4.610	46.90	53.10	14.87	47.36%
1957	10.45	89.55	25.07	4.451	46.54	53.46	14.97	46.90%
1958	9.84	90.16	25.25	4.362	42.91	57.09	15.98	44.22%
1959	12.63	87.37	24.46	5.020	63.42	36.58	10.24	66.87%
1960	12.59	87.41	24.47	4.904	61.74	38.26	10.71	63.96%
1961	14.43	85.57	23.96	4.885	70.48	29.52	8.27	81.16%
1962	12.23	87.77	24.58	4.775	58.41	41.59	11.65	59.08%
1963	15.41	84.59	23.68	4.705	72.52	27.48	7.69	86.19%
1964	17.64	82.36	23.06	4.636	81.79	18.21	5.10	126.66%
1965	18.70	81.30	22.76	4.521	84.53	15.47	4.33	147.20%
1966	18.92	81.08	22.70	4.397	83.19	16.81	4.71	135.04%
1967	20.10	79.90	22.37	4.250	85.43	14.57	4.08	153.58%
1968	22.10	77.90	21.81	4.087	90.32	9.68	2.71	225.41%
1969	21.80	78.20	21.90	3.899	84.99	15.01	4.20	145.87%
1970	16.62	83.38	23.35	3.696	61.42	38.58	10.80	60.51%
1971	21.92	78.08	21.86	3.503	76.80	23.20	6.50	94.22%
1972	23.75	76.25	21.35	3.338	79.26	20.74	5.81	102.95%
1973	23.03	76.97	21.55	3.180	73.23	26.77	7.50	80.50%
1974	19.74	80.26	22.47	2.945	58.13	41.87	11.72	53.67%
1975	20.32	79.68	22.31	2.656	53.96	46.04	12.89	48.46%
1976	22.38	77.62	21.73	2.490	55.72	44.28	12.40	49.09%
1977	21.83	78.17	21.89	2.348	51.26	48.74	13.65	44.91%
1978	21.47	78.53	21.99	2.191	47.04	52.96	14.83	41.52%
1979	22.37	77.63	21.74	2.008	44.91	55.09	15.43	39.46%
1980	25.19	74.81	20.95	1.842	46.40	53.60	15.01	39.08%
1981	29.08	70.92	19.86	1.667	48.47	51.53	14.43	38.54%
1982	24.12	75.88	21.25	1.549	37.37	62.63	17.54	33.92%
1983	36.58	63.42	17.76	1.483	54.24	45.76	12.81	38.80%
1984	33.67	66.33	18.57	1.421	47.85	52.15	14.60	35.62%
1985	41.53	58.47	16.37	1.367	56.75	43.25	12.11	37.86%
1986	53.93	46.07	12.90	1.328	71.63	28.37	7.94	45.46%
1987	66.26	33.74	9.45	1.290	85.51	14.49	4.06	65.20%
1988	59.51	40.49	11.34	1.249	74.32	25.68	7.19	44.14%
1989	71.18	28.82	8.07	1.193	84.89	15.11	4.23	53.42%
1990	79.24	20.76	5.81	1.141	90.44	9.56	2.68	60.84%
1991	83.17	16.83	4.71	1.092	90.79	9.21	2.58	51.17%
1992	89.76	10.24	2.87	1.058	94.98	5.02	1.41	57.07%
1993	98.51	1.49	0.42	1.025	100.97	-0.97	0.00	NA
1994	100.00	0.00	0.00	1.000	100.00	0.00	0.00	NA

Source: Tax Foundation.

For example, as shown in column A of *Table 1*, an average stock that commanded a real price of $100 in June 1994 commanded a market price of $23.03 in 1973. Under current law, a taxpayer that bought an average stock in June 1973 and sold it in June 1994 would pay tax on a $76.97 capital gain, as shown in column B. The tax liability shown in column C amounts to $21.55 (28 percent of $76.97).

However, adjusting for inflation in terms of 1994 dollars reveals that only 35 percent of the $76.97 capital gain shown in column B resulted from the stock's real value. The remaining 65 percent of the gain represented inflation (the reduced purchasing power of a dollar). To determine the inflation-adjusted capital gain, one simply multiplies the 1973 purchase price of $23.03 (column A) by the applicable inflation ratio of 3.180 (column D). The inflation-adjusted purchase price equals $73.23, which yields the inflation-adjusted capital gain of $26.77 reported in column E ($100-

Figure 2
Effective Tax Rate on Real Capital Gain with a 28% Tax on Nominal Gains (Stock Bought in June of Designated Year and Sold in June of 1994)



Source: Tax Foundation.

$73.23). And the real gain of $26.77 is approximately 35 percent of the $76.97 nominal gain.

Figure 2 reveals the effective tax rate imposed on taxpayers when they are taxed on the inflation component of a capital gain. The inflation-adjusted tax liability (shown in column F of *Table 1*) for a taxpayer that bought an average stock in June 1973 and sold it in June 1994 amounts to $7.50 (28 percent of $26.77). The current law (unindexed) tax liability of $21.55, therefore, imposed on the taxpayer an effective tax rate of 80.5 percent ($21.55 in tax divided by the $26.77 inflation-adjusted capital gain). As *Figure 2* shows, no matter what year the average stock was purchased, upon selling it the taxpayer faced effective tax rates substantially greater than the 28 percent statutory rate, and in many instances the effective rate exceeded 100 percent.

How Indexing Would Work in Practice

The Job Creation and Wage Enhancement Act of 1995 (JCA'95) includes a proposal to index capital gains for inflation. The proposal generally follows the indexing method used in other countries that belong to the Organization for Economic Co-operation and Development and that also levy a tax on capital gains: Australia, Greece, Ireland, Luxembourg, and the United Kingdom.

The Act provides that the purchase price of qualifying capital assets held for longer than one year shall be adjusted for inflation for purposes of calculating capital gains (but not capital losses). Qualifying assets (or "indexed assets" as the legislation terms them) include "stock in a corporation, and tangible property (or any interest therein), which is a capital asset or property used in a trade or business." Assets that do not qualify include creditor's interest, options, net lease property, certain preferred stock, stock in S corporations, and stock in foreign corporations (unless such stock is listed on at least one of the major U.S. stock exchanges or traded on any other U.S. regional exchange such that price quotations are regularly published).

The inflation adjustment is straightforward and was used to generate the inflation adjustments in *Table 1*. Rather than the current method of subtracting the sale price of an asset from its purchase price, the taxpayer will first multiply the purchase price of the asset by the "applicable inflation ratio" (if the ratio is greater than one). Presumably, the Internal Revenue Service will publish tables of the "applicable inflation ratio" (similar to the one

presented in *Table 1*) along with the normally published materials that accompany every income tax form. The IRS will calculate the applicable inflation ratio by dividing the gross domestic product deflator for the last calendar quarter ending before the asset sale takes place by the value of the deflator for the last calendar quarter ending before the asset was originally purchased (or, in the case of inheritance, when the taxpayer acquired the asset). The gross domestic product deflator is a government-calculated price index similar to the consumer price index.

Under the proposed legislation, indexing would apply to "indexed assets" acquired after December 31, 1994. For any "indexed asset" held on January 1, 1995, the taxpayer would have the option of selling that asset at its existing market value and re-acquiring it, for tax purposes, at the same value.

Indexing and Tax Code Complexity

The body of federal tax law relating to capital gains is voluminous and complex. For most taxpayers, the complexity of the proposed indexing provision will be trivial in comparison to the existing complexity.

Over the past four decades — since Congress passed the landmark Internal Revenue Code of 1954 — the number of tax code sections dealing with capital gains has grown 1,200 percent. Virtually the entire body of this law and its accompanying regulations deals with properly defining a capital gain or loss under the many possible combinations of types of capital assets and capital asset transactions. First and foremost, the law seeks to establish a method for calculating the correct purchase price ("basis") of an asset and the correct sales price of the asset.

The indexation of capital gains will add one multiplication calculation to each capital gain transaction reported by a taxpayer, once the existing body of rules and regulations are used to calculate the proper basis and sale price of an asset. One could argue that this additional multiplication step will add to the complexity faced by a taxpayer. However, the complexity associated with this additional calculation is essentially identical to that associated with a single exclusion, against which few complaints of complexity are lodged.

Many commentators have argued incorrectly that indexing capital gains will add substantially to taxpayers' income tax compliance costs because it will require taxpayers to update their investment records annually to account for inflation. In virtually all cases, taxpayers subject themselves to capital gains taxation only if they choose to realize a capital gain. Indexation would, therefore, remain an inert tax code provision until a taxpayer made the choice to realize a gain. Only at this time would the taxpayer need to multiply the asset's purchase price by the "applicable inflation ratio" provided by the Internal Revenue Service in a published table. Furthermore, unlike other tax code provisions, like the parallel tax system known as the alternative minimum tax, indexing capital gains is an optional calculation for the taxpayer.

Capital Gains and the Incentive for Tax Gamesmanship

For the entire history of the U.S. income tax system, capital gains have received special tax treatment. First and foremost, taxpayers must pay taxes on capital gains only when they choose to realize capital gains. Such (potentially indefinite) deferral of taxation creates an incentive for taxpayers to categorize other types of income as capital gains—tax gamesmanship.

In addition to tax deferral (even at death), capital gains have historically received two other types of special tax treatment. First, when a taxpayer inherits capital assets, the value of those assets are readjusted (usually upward) to their current market value, thereby reducing the inheritor's exposure to potential capital gains tax liability. Second, realized nominal capital gains have traditionally been taxed at a lower rate than other forms of income. Between 1922 and 1987, this difference was accomplished by excluding some fraction (usually one-half or more) of long-term capital gains from taxation. The Tax Reform Act of 1986 eliminated the exclusion of capital gains, but the top tax rate on capital gains has remained at 28 percent despite the tax rate increases of 1990 and 1993. (A select group of taxpayers faced a 33 percent rate in the 1988 through 1990 tax years.)

The indexing of capital gains for inflation, like the 50 percent exclusion also included in the JCA'95, is consistent with the U.S. tradition of providing special tax treatment to capital gains. Indexation, along with all of the special tax provisions for capital gains, creates an incentive for taxpayers to "game" the tax system — that is, make economic and financial decisions that are driven solely by tax considerations. Although the addition of capital gains indexation to the tax law will enhance the existing incentives, it will not fundamentally alter the incentive for tax gamesmanship that has existed for decades.

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