REPORT #710

TAX SECTION

New York State Bar Association

Memorandum in Opposition to Proposal to Index Capital Gains for Inflation by Regulation

February 13, 1992

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TAX SECTION
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President George Bush
The White House
Washington, D.C.

Dear Mr. President:

On behalf of the Executive Committee of the Tax Section of the New York State Bar Association, I am writing to express our strong opposition to a proposal, reportedly being considered within the Administration, to index capital gains for inflation by amending the tax regulations rather than the Internal Revenue Code.

We believe that adoption of inflation indexation by regulation is a terrible idea. Whether or not inflation indexation is desirable, it raises complex policy, technical and revenue issues that are much too important to be decided unilaterally by a single branch of the government. Further, we believe such a regulation would be an invalid usurpation of the exclusive power of Congress to legislate a sweeping change in a basic income tax principle that has remained unaltered *i* since the earliest days of the federal income tax.

Attached is a memorandum that details our position.

Very truly yours,

John A. Corry
Chair

TAX SECTION
New York State Bar Association

February 13, 1992

Memorandum in Opposition to Proposal to Index Capital Gains for Inflation by Regulation

This memorandum, submitted on behalf of the Executive Committee of the Tax Section of the New York State Bar Association, details the reasons for our strong opposition to a proposal, reportedly being considered within the Administration, to index capital gains for inflation by amending the tax regulations rather than the Internal Revenue Code.*

Section 1012** provides generally that the basis of property "shall be the cost of such property." As we understand it, the contemplated regulation would define "cost" as permitting indexation on the basis that inflation causes the economic "cost" of property to increase.

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* This initiative was reported in an editorial in the January 28, 1992 Wall Street Journal and has been supported by the U.S. Chamber of Commerce.

** Section references are to sections of the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

Two years ago, the Tax Section prepared and submitted a report urging that Congress reject any proposal to index the basis of capital assets for inflation because an indexation regime would create intolerable administrative burdens for taxpayers and tax administrators and would offer numerous tax arbitrage and avoidance opportunities for aggressive tax planners. A copy of that report is attached. Although we continue to oppose indexation, we do not discuss the merits of indexation in this memorandum, but address only the reasons why it should not be adopted by regulation.

Inflation Indexation by Regulation Would Be Terrible Tax Policy

The impact of indexation upon both taxpayers and fiscal policy would be far too broad to be adopted unilaterally by a single branch of the government. A revised definition of "cost" would affect every taxpayer that has purchased or constructed property or has acquired it for services. No economic background is required to recognize the substantial negative effect that this would have on government revenues, particularly as a result of increases in the basis for depreciation. Wholly apart from a legitimate concern as to whether indexation by regulation would violate the constitutional authority of Congress to impose taxes,[*] these budgetary considerations require legislative involvement.

In addition, as reported in the press, the contemplated basis adjustment would apply only for purposes of computing gain and depreciation. Clearly, however, unlike

[*] Article 1, Section 8

a statutory amendment, any such interpretation also would have to affect the basis for computing loss, since as an economic matter, a taxpayer's cost of property is the same whether he sells the property at a gain or at a loss. Also, unlike the capital gains rate reduction proposed last month by the Administration, there would be no valid basis for distinguishing between capital gains and losses of individuals and gains and losses of corporations.** Inflation does not differentiate between the two. These distinctions can be made only by legislation.

Further, as the Tax Section's 1990 report makes clear, any indexation provision “conceals an array of troublesome administrative, computational and substantive issues.” This is especially true where indexation applies only to the definition of “cost”. For example, a failure to index liabilities as well as assets would permit tax payers that borrow money to purchase property to deduct the component of interest payments that reflects anticipated inflation and subsequently sell the property at a gain reduced by indexation. Further, in the case of pass-through entities such as partnerships, s corporations, mutual funds and trusts, entity level and interest holder level adjustments must be carefully coordinated so that all basis adjustments are reflected, but only once. As another example, although under existing law the precise time that an asset is acquired or sold in a taxable year seldom is of

** For the same reason, indexation would have to apply to all assets the basis of which is “cost”, including some, such as collectibles, that the proponents of this plan may not wish to cover.

any significance, indexing basis would change all of this in a way that a mere redefinition of “cost” cannot easily address.

Inflation indexation reached through a definition of “cost” would result in unprincipled distinctions by granting indexation to certain assets and denying it to other assets that are equally affected by inflation. Under Section 1012(a) the basis of property is cost only where enumerated subchapters of the Internal Revenue Code do not provide otherwise. Those exceptions cover a large number of situations in which the basis of property is determined with reference to something other than its cost. Thus, the basis of property acquired from a decedent is its fair market value at the time of the decedent's death,[*] and the basis of property acquired by gift, which has no cost to the donee, is its basis to the donor or the last preceding owner who had not acquired it by gift.[*] Under Sections 301(d) and 334(a) the basis of property received in corporate distributions is its fair market value at the time of the distribution. Further, although the cost of property acquired by a corporation as a stockholder contribution and in a tax free reorganization is its fair market value at the time of acquisition,[**] under Section 362 its basis is the same as it would be in the hands of the transferor increased by any gain recognized by the transferor on the transfer.

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[*] Section 1014.

[*] Section 1015

[**] Niagara Mohawk Power Corp. v. United States, 525 F.2d 1380 (Ct. Cl. 1975); Maltine Co. v. Commissioner. 5 T.C. 1265 (1945); I. Lewis Corp. v. Commissioner. 22 T.C.M. 35 (1963).

Other examples abound.[***] Thus, a regulation that would link indexation to "cost" would provide a tax basis hodgepodge where the assets of some taxpayers are indexed and others are not, although the inflation effect on all of them is exactly the same. Only by legislation can indexation be made applicable to all assets that are similarly affected by inflation.

[***] See, e.g., Sections 1031(d) (like kind exchanges); 1033(b) (involuntary conversions) and 723 (assets contributed to partnerships).

An Attempt to Index for Inflation By Regulation Would be Invalid

An attempt to adopt indexation by regulation would be invalid as contrary to the meaning of "cost" in Section 1012. Since 1957, Treasury Regulation § 1.1012-l(a) has provided that the cost of property "is the amount paid for such property in cash or other property." It is clear, however, that although no similar regulation appeared in the 1939 Code or prior revenue acts, the 1954 Code regulation merely adopted the definition of cost that already was widely accepted.

As long ago as 1934, a subcommittee of the House Ways and Means Committee assumed that the "cost" of property was the amount paid for it when it listed as a defect in the then existing treatment of capital gains that

> In many instances the capital-gains tax is imposed on the mere increase in monetary value resulting from the depreciation of the dollar instead of on a real increase in value.*

The courts also recognized that the cost of property under the 1939 Code was the amount paid for it. Thus, in Vandenberge v. Commissioner, 147 F.2d 167, 168 (1945), cert, denied. 325 U.S. 875 (1945), the Fifth Circuit stated:

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* Hearings before the Committee on Ways and Means, 73d Cong., 2d Sess. 41.

> Section 113(a) of the Revenue Act of 1938 provides that the unadjusted basis of property shall be the cost of such property. The solution to the question raised is as simple and clear as the language of the pivotal statute. The cost of the property was the price paid to acquire it.

And in Hawke v. Commissioner. 35 B.T.A. 784, 789 (1937), the Board of Tax Appeals stated:

> We must assume that Congress used the term "cost" in its commonly understood meaning as the amount of money which a man pays out in the acquisition of property.*

It is therefore nonsense to suggest, as has the Chamber of Commerce, that the definition of cost "is regulatory, not statutory." To the contrary, the existing regulation merely confirms the definition of cost that had already existed for many years.

The Supreme Court has ruled that where the words of a statute are "plain", they "should be accorded their usual significance in the absence of some dominant reason to the contrary." Old Colony Trust Co v. Commissioner, 301 U.S. 379, 383 (1937). In the case of property acquired for cash, the "plain meaning" of the word "cost" is the cash purchase price. Thus, Webster's New International Dictionary (Second Edition (1959)) defines "cost" as "the amount or equivalent paid, or given, or charged, or engaged to be paid or charged for anything bought or taken in barter or for services rendered; charge; price."* In Silverstein v. United States,

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* On appeal, Hawke was reversed and remanded on the basis that the taxpayer's "cost" of stock would have included the bargain element of stock received for services. Hawke v. Commissioner. 109 F.2d 946 (9th Cir. 1940), cert. denied. 311 U.S. 657.

* The Random House Dictionary of the English Language, Second Edition (1987) defines cost as "the price paid to acquire produce, accomplish or maintain anything.1*

349 F. Supp. 527, 530 (E.D. La. 1972), the court adopted this plain meaning approach, stating:

> The word “cost” is not defined in a technical sense in the Internal Revenue Code, although it is widely used. Wherever used, it appears to denote the dictionary meaning, “the amount or equivalent paid or charged for something,” “the outlay in expenditure (as of effort or sacrifice) made to achieve an object,” or “the loss or penalty incurred in gaining something.” [Ibid]. Webster's Third International treats “cost” more broadly as meaning “the amount or equivalent paid or given or charged or engaged to be paid or given for anything bought or taken in barter or for service rendered.”

Indeed, the Tax Court has relied upon this “doctrine of common interpretation” in rejecting a taxpayer's argument that that portion of gain from the sale of property which is attributable solely to inflation is not “income” within the meaning of the Sixteenth Amendment to the United States Constitution. Without referring to Treasury Regulation S 1.1012-1(a), the Court stated in Hellermann v. Commissioner. 77 T.C. 1361, 1366 (1981):

> As was stated by Judge Learned Hand, “[the] meaning of [income] is * * * to be gathered from the implicit assumptions of its use in common speech.” United States v. Oregon-Washington R.& Nav. Co., 251 F. 211, 212 (2d Cir. 1918).Thus, the meaning of income is not to be con-strued as an economist might, but as a layperson might. Petitioners received many more dollars for the buildings than they had paid for them. The extra dollars they received are well within the common perception of income, even though each 1976 dollar received represents less purchasing power than each 1964 dollar paid. Petitioners' nominal gain may or may not equal their real gain in an economic sense. Nonetheless, neither the Constitution nor tax laws “embody perfect economic theory.” See Weiss v. Wiener, 279 U.S. 333, 335 (1929).

These authorities demonstrate that it has been as well-established as anything could be in the income tax law that the “cost” of property purchased by the taxpayer is the acquisition price without any adjustments other than those specifically provided for by Congress. That the word “cost” has been used as the measure of basis throughout this period

of time demonstrates the Congressional acceptance of that position. When an adjustment has been necessary, Congress has amended the Code to provide it. Thus, Section 1016(a) contains 24 enumerated adjustments to the Section 1012(a) definition of basis, none of which, apart perhaps for the adjustment for depreciation,* would be as wide-sweeping as an inflation indexation adjustment to the cost of property. After referring to the enumerated exceptions to the general definition of basis in the similar provision of the 1938 Code, the Tax Court in Maltine Company v. Commissioner, supra, stated:

> These exceptions, which do not apply here, are examined because they indicate the degree of precision with which the statute provides for the varying situations for which Congress intended to make special exceptions. The inevitable conclusion is that it meant exactly what it said when it said that the basis, except for the several special situations thereafter specifically set forth, should be cost. To hold petitioner's basis for determining loss to be other than cost would be to create another exception, which we conceive to be properly the task of Congress if it is to be done. 5 T.C. at 1272.

It is an equally fundamental tax principle that a basis adjustment does not occur in the absence of income recognition or some other taxable event involving the property in question. The date of death basis for property acquired by death provided in Section 1014 is a striking exception to that rule, but even there there has been a transfer of property. As the Tax Court stated in Borg v. Commissioner, 50 T.C. 257, 263 (1968):

> Where a taxpayer has not previously reported, recognized, or even realized income, it cannot be said that he has a basis for a note evidencing his right to receive such income at some time in the future.

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* Section 1016(a)(2).

Our belief that the Executive Branch of the governaent has no lawful authority to make such a wide-sweeping change by regulation is heightened by the fact that Congress has already addressed the effects of inflation on individual taxpayers. Beginning with the Economic Recovery Tax Act of 1981, the Internal Revenue Code has provided for adjustments in individual tax bracket amounts, the standard deduction and the personal exemption in order that personal income tax rates will not increase purely by reason of inflation. See Sections 1(f), 63(c)(4) and 151(d)(4). Moreover, the Omnibus Budget Reconciliation Act of 1989 as passed by the House* contained indexation provisions which were not adopted by the Senate and were rejected in conference.** Thus, a regulatory attempt to adopt inflation indexation would be an impermissible intrusion into an area in which Congress has already asserted its legislative authority.

A strong pillar of judicial deference to regulations is the legislative re-enactment doctrine. See Helvering v. Winmill, 305 U.S. 79 (1938). It is a two- edged sword, however. If Congress has focused on a legislative change — which it certainly has with respect to the many legislative calls for indexing of capital gains over the last few years — but rejected the change (as it did in 1989), to adopt the change by regulation would be an invalid usurpation of the Congressional legislative power. This is the teaching of Fribourg Navigation Co. v. Commissioner, 383

* H.R. 3299, 101st Cong., 1st Sess. §§ 11951 et seq.. discussed in H.R. Rep. No. 247, 101st Cong., 1st Sess. 1476-1490. In describing present law the Ways and Means Committee stated, “The taxpayer's basis reflects his actual cost in the asset adjusted for depreciation, depletion and certain other amounts. No adjustment is allowed for inflationary increases in the value of the asset.”

** H.R. Rep. No. 386, 101st Cong., 1st Sess. 664.

U.S. 272 (1966) and Commissioner, v. Brown, 380 U.S. 563, (1965). As stated in Fribourg:

> "The Commissioner's position represents a sudden and unwarranted volte-face from a consistent administrative and judicial practice followed prior to 1962."
>
> "Compounding congressional activity in this area with repeated re-enactment of the depreciation provision in the face of the prior consistent administrative practice, we find the Commissioner's position untenable."*

In concluding that an attempt to adopt indexation by regulation would be invalid, we are cognizant of the great weight to be given interpretative regulations. We recognize that "if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute." Chevron U.S.A. v. Natural Resources Defense Council, 467 U.S. 837, 843 (1984). This is not that case. Far from writing on a clean slate, any new regulation would contradict the existing regulation, which has been in effect for more than thirty years and reflects general principles followed by the Internal Revenue Service and the courts since the earliest days of the income tax laws. As the courts have held, the meaning of "cost" in the context of Section 1012 and its predecessors is clear and unambiguous. In such a case, there is no power to alter it by regulation.

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* 383 U.S. at 279 and 286.

Koshland v. Helvering. 298 U.S. 441, 446-47 (1936).*

John A. Corry

Chair, Tax Section

* The situation here is entirely different from that in Bob Jones University v. United States, 461 U.S. 574 (1983), relied upon in the Wall Street Journal editorial as authority for indexation by regulation. There the relevant statutory tern "charitable" was clearly ambiguous, whereas a regulation adopting indexing would involve a direct conflict with the plain meaning of the word "cost," which meaning has been reinforced by decades of judicial and administrative construction, including a long-standing explicit regulation. Moreover, in Bob Jones, the Supreme Court relied heavily upon the government's fundamental and overriding interest in eradicating racial discrimination in education. By contrast, Congress has already considered inflation indexation and to date has chosen not to adopt it.