REPORT #662

TAX SECTION

New York State Bar Association

AD HOC COMMITTEE ON INDEXATION OF BASIS

REPORT ON INFLATION ADJUSTMENTS
TO THE BASIS OF CAPITAL ASSETS

June 27, 1990

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TAX SECTION

New York State Bar Association

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 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

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Identical letters with enclosure to:

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Tax Report #662

NEW YORK STATE BAR ASSOCIATION, TAX SECTION

AD HOC COMMITTEE ON INDEXATION OF BASIS

REPORT ON INFLATION ADJUSTMENTS TO THE BASIS OF CAPITAL ASSETS

June 27, 1990

New York State Bar Association, Tax Section

Ad Hoc Committee on Indexation of Basis[1]

Report on Inflation Adjustments to the Basis of Capital Assets[2]

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.[3] 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.

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1 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 Blattmacher, Guy C.H. Brannan, Harvey Dale, Stanley Rubenfeld, Vic Zonana, Eugene Vogel, Jim Peaslee, Ken Anderson and Gavin Leckie.

2 Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code"), and to the Treasury regulations thereunder.

3 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; H.R.4105.

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 deduction 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 deferred or shifted to tax-exempt or non-taxable taxpayers. As we explore in some detail below, an indexation system which only selectively attempts to index the tax system would create numerous opportunities for such tax arbitrage.[4] 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

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

thoughtfully developed elsewhere.[5] 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 basic 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[6] (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

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5 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”).

6 H.R. 3299, 101st Cong., 1st Sess., §§ 11951 et seq. (hereinafter, the “1989 Bill”); H.R. Rep. No. 247, 101st Cong., 1st Sess., pp. 1474-1480 (hereinafter, the “House Report”).

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. ADDITIONAL 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.

Thus, even in an ideal system of indexing[7], the complexity of the Code would be increased, taxpayers' compliance burdens would be augmented and disputes concerning a variety of legal issues would proliferate.[8] This will undoubtedly 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

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7 Moreover, the theoretical soundness of any indexation system is itself questionable, as discussed in Part V, *infra*.

8 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").

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 miles 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.[9] For example,

[9] 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.

although an indexation system might include in indexable basis from the time of acquisition the amount of a purchase money note,[10] 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 would necessarily 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.[11]

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.[12]

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[10] But see discussion of “debt arbitrage” in Part III.B.l., infra.

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

[12] See Part III.C.6., infra.

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.[13] 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.[14] Indexing basis changes all of this and will inevitably lead to a meaningful

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[13] See Part III.B.2., infra.

[14] See Part IV.B., infra.

increase in disputes over these issues.[15]

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,[16] stock acquired pursuant to the exercise of rights acquired in a tax-free distribution,[17] and the treatment of property acquired from a decedent may be needed.[18] At the same time, consideration would

[15] 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.

[16] 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 § 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. 62, infra.

[17] 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.

[18] 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.

need be given to modifying the “tolling” rules that apply in connection with short sales,[19] straddles,[20] and commodity futures transactions.[21]

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.[22] Finally, a detailed set of special holding period tacking and tolling rules would need to be adopted for transition purposes.

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19 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.

20 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.

21 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.

22 These rules are discussed in further detail in Part III.B.3.C., infra.

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.[23]

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

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

relatively ordinary products.[24]

F. The Problem of "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,[25] (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.

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[24] 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 uponI 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.

[25] 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.l.d.i., infra.

Taxpayers are adept at electing against the fiscal authority and will structure their affairs to receive favored tax treatment.[26] 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[27] 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 an 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.

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 Pass-Through Entities.

Any indexation system will create significant additional complexity in the treatment of pass-through entities, specifically partnerships, S corporations, mutual funds (RICs), real estate investment trusts (REITs), trusts, subchapter T

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

[27] 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.

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 pass through 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 pass-through 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 to specific pass through entities follows is presented below in the discussion of the provisions of the 1989 Bill.[28]

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

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

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 under taxes 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 under measurement of the real income of a taxpayer who borrows to finance the purchase of an indexed asset.[29] Assume that Mr. A invests $20,000 in cash to buy Blackacre, a non-income producing real estate asset subject to an $80,000 mortgage. Five years later, when cumulative inflation has amounted to 30 percent[30] 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.[31]

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 deductions 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,

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29 See, e.g., Durst, pp. 1251-1256.

30 For simplicity, inflation and interest percentage rates in this Report will be stated on a cumulative basis, including compounding.

31 This example has been borrowed from Cohen, p. 105.

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,[32] 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.

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32 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 Reg. § 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).

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 non-indexed 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 5 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.

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 5 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.[33] 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 stock X losing investment and the indexation benefit from his profitable stock Y investment, 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 miles would

[33] Cohen, p. 105.

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 that 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.[34]

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.[35]

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[34] 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).

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

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.[36] 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.

36 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.

Assume A purchases an option for $50 which gives him the right to purchase 1 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% 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 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.[37] Similarly, holders of warrants and options should also be able to index their basis with respect to

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[37] See Shuldiner, p. 10.

gains upon disposition of a warrant or option.[38]

Further, the denial of indexation benefits to intangible assets except for stock raises significant problems. First, this arbitary distinction will cause taxpayers in identical economic circumstances to be taxed differently based on their choice of investment vehicle. For example, payments made with repect 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 his 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.

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38 Cf. § 1234 (granting sale or exchange treatment to the expiration of options, in effect providing preferential capital gains treatment).

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 more represents a haphazard form of corporate tax integration 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 taxation 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.[39] While this result is undesirable in its own

[39] 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.

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.l.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 only be able to index $20,000 of 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.[40]

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,[41] and partnerships may not provide adequate liability protection.

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

[41] 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.

Thus, the already asymmetrical system of taxing incorporation and dissolution of corporations that was created by the 1986 Act[42] will now further penalize the uninformed or those who must use the Subchapter C mode.

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.[43]

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[42] 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.

[43] A "principal purpose" standard has been notably difficult to apply under Code § 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.

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, he 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.[44] 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

[44] 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.

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.

C. Pass-Through Entities.

1. In general.

The 1989 Bill's provisions for pass-through 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 pass-through 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 benefit. The proper allocation of indexing benefits among partners is not as pimple 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 first $100 of proceeds are paid to A, the remainder split 50% 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% 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 would still 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 the 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."[45] 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

[45] House Report, p. 1479 (emphasis added).

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.[46] 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.[47]

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[46] Id.

[47] 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.

On the other hand, if example (3) contains the correct rule under the 1989 Bill, then 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 would thus 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.

Furthermore, if the ABD partnership subsequently sold the asset for $240, partner D would receive flow-through 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 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 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.[48]

Section 754 will therefore assume even greater importance. However, there will 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.[49] 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 6 years, regulations governing the mandatory section 704(c) provisions have not been forthcoming, with consequent difficult problems for legitimate business transactions.

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48 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.

49 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.

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 analog 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 labor contract or a no assignable 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,[50] 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 I REIT stock. Corporate shareholders were, however, 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 RIC's. The following example demonstrates that shareholders of RIC's will be able to blend gain and loss positions in the RIC's securities in calculating individual gains or losses.

Assume that a RIC acquires three indexable securities, each for $1,000.[51] 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,

50 House Report, p. 1479.

51 For simplicity, diversification rules are ignored.

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%. 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 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.

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 non-fungible.

5. Other pass-through 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 pass-through 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 dispositions 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.

It should be noted that the 1989 Bill effectively denies 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 cooperatives over smaller taxpayers who must conduct significant aspects of their affairs through cooperatives.

6. *Recordkeeping, computational and other problems with the 1989 Bill flow-through provisions: an illustrative example*.

The provisions of the 1989 Bill relating to pass-through entities significantly increase recordkeeping 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 ten 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.

Assume that X's property has a tax basis of zero upon contribution. Assume that at the beginning of year 6, 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:

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		Book Gain	
Sale Price	600	Sale Price	600
Adjusted Tax Basis	(60)	Adjusted Book Value	(300)
	540		300

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% to X (240) and 20% 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 480 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 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 120 tax basis),[52] Thus:

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[52] 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 (Siam of $60 basis before recapture plus $60 recapture), and applying a 50 percent indexation adjustment.

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

At this point, numerous issues arise. First, how 1 is the section 704(c) allocation to X to be determined? In 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 flow-through 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 in [sic] 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.[53] Yet, as the above example 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.

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[53] 53 House Report, p. 1479.

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.

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.[54] 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, or 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

[54] Cohen, p. 104.

law already is widely perceived as overly complex.[55]

B. Increased Recordkeeping.

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 its the precise period for which it has been held.[56] 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

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[55] See, e.g., H. Stout, Codified Confusion. Tax Law Is Growing Evermore Complex, Outcry Even Louder. Wall St. J., Apr. 12, 1990, p. Al, 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, certainty 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.").

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

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 particularly 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.[57] 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 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 of 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.

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

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, non-compliance, 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 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 face 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.[58]

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 over-taxation attributable to inflation, then 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.[59]

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

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[58] Bravenec & Curatola, Indexing the Federal Tax System for Inflation, 28 Tax Notes 457 (July 22, 1985).

[59] Steuerle & Halperin, pp. 3 66-3 68.

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.[60] Ironically, the benefit of basis indexing is greater for property that does not generate current income and that as a result already enjoys the benefit of tax deferral.[61]

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.

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60 This result is most easily understood in the context of an investment in non-participating preferred stock. For example, individual Investor A pays $1,000 for $1,000 face amount of XYZ Corp. preferred stock, which has a 10% annual dividend. Inflation of 5% 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 un-indexed dividend payment represents economically a return of capital in part. Cf. § 1059(f). The same phenomenon occurs with respect to depreciable property if basis is indexed only on disposition and depreciation deductions are not indexed.

61 <u>See</u> Part V.B., <u>infra</u>.

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 each year is 10%. 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.[62] 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.

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[62] This result is even more pronounced where assets depreciate initially and then appreciate.

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.[63] 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

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[63] See Steuerle & Halperin, pp. 353-356.

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.

Appendix 1: Indexing in the United Kingdom.

In 1982, following the high inflation of the 1970's and after several years of discussion[1], the U.K. indexed of 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]

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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 §§86 and 87 of the U.K. Finance Act of 1982 and §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% 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%. Corporate capital gains are taxed at the full corporate rate of 35% (25% in the case of "small companies").

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]

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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 twelve months of ownership, thus excluding relief whether the asset was disposed of within those twelve months or not; and (iii) the indexing adjustment could only reduce (or eliminate) a gain.

A continuing problem with the U.K. indexing provisions has been the complexity of identifying the assets that have been sold to determine their eligibility for the 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

[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 (un-indexed) into capital gains (indexed). In the U.K., this has led to a series of anti-avoidance legislation.

example, the Finance Act of 1988 contains provisions[8] preventing linked companies from manufacturing an artificial loss through the sale of certain inter-company 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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[8] § 114 and Sched. 11, Finance Act 1988.