Eliminating the Capital Gains Preference. Part I: The Problems of Inflation, Bunching and Lock-In

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ELIMINATING THE CAPITAL GAINS PREFERENCE. PART I: THE PROBLEMS OF INFLATION, BUNCHING AND LOCK-IN*

MICHAEL J. WAGGONER**

All income in the form of wages, interest, dividends and rent is, in general, subject to the federal income tax, but only half of capital gains are taxed. It has been estimated that over half of the benefits of this preferential tax treatment accrue to individuals with adjusted gross income in excess of $100,000,† enabling high-income individuals to reduce their tax rates from the theoretical 70% top marginal rate

* This is the first of a two part article. Part II, dealing with corporate income tax, will be published at a later date. Sections 101 and 102 of the Tax Reduction And Simplification Act of 1977, P.L. 95-30, changed the definition of taxable income and some computations. Because these changes are not substantive and were enacted shortly before the article was published, they have not been incorporated into this discussion.

** Associate Professor of Law, University of Colorado Law School. A.B., (1964) Stanford University; L.L.B., (1967) Harvard University. I want to thank my colleagues, Norton L. Steuben and Stephen F. Williams, and Prof. Alan D. Freeman of the University of Minnesota Law School for their suggestions in preparing this article.

† People & Taxes 6-10 (June 1975), using data prepared by the Treasury for then-Senator Mondale, estimated that in Fiscal Year 1974, the benefits of long-term capital gains were distributed as follows:

<table>
<thead>
<tr>
<th>Adjusted Gross Income Class</th>
<th>Total Capital Gain Benefit to Class (in millions)</th>
<th>Average Individual Capital Gain Benefit Within Class</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 to $3,000</td>
<td>$ 76</td>
<td>18.73</td>
</tr>
<tr>
<td>$3,000 to $5,000</td>
<td>34</td>
<td>4.49</td>
</tr>
<tr>
<td>$5,000 to $7,000</td>
<td>81</td>
<td>9.79</td>
</tr>
<tr>
<td>$7,000 to $10,000</td>
<td>158</td>
<td>13.83</td>
</tr>
<tr>
<td>$10,000 to $15,000</td>
<td>304</td>
<td>19.06</td>
</tr>
<tr>
<td>$15,000 to $20,000</td>
<td>282</td>
<td>28.61</td>
</tr>
<tr>
<td>$20,000 to $50,000</td>
<td>1,137</td>
<td>126.25</td>
</tr>
<tr>
<td>$50,000 to $100,000</td>
<td>969</td>
<td>1,479.39</td>
</tr>
<tr>
<td>$100,000 and over</td>
<td>3,109</td>
<td>19,431.25</td>
</tr>
</tbody>
</table>
### Table 1


<table>
<thead>
<tr>
<th>Effective rates (percent)</th>
<th>Expanded adjusted gross income (thousands of dollars, ratio scale)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2</td>
</tr>
<tr>
<td>Tax exempt and other preference income</td>
<td>0</td>
</tr>
<tr>
<td>Transfer payments</td>
<td>10</td>
</tr>
<tr>
<td>Income splitting</td>
<td>20</td>
</tr>
<tr>
<td>Capital gains</td>
<td>30</td>
</tr>
<tr>
<td>Comprehensive tax</td>
<td>40</td>
</tr>
<tr>
<td>Personal deductions</td>
<td>50</td>
</tr>
</tbody>
</table>

**Notes:**

- **a** Rates, exemptions, and other provisions of the Revenue Act of 1971 scheduled to apply to calendar year 1972 incomes.
- **b** Includes effect of removing maximum tax.
- **c** Includes effect of full taxation and constructive realization of capital gains.
- **d** Includes effect of taxing of interest on state-local bonds and life insurance policies; taxing net imputed rent (including effect of disallowing personal deductions for mortgage interest and real estate taxes); disallowing excess of percentage over cost depletion; disallowing excess of accelerated over straight-line depreciation; and removing dividend exclusion.
- **e** Includes effect of removing additional exemptions for age and blindness and retirement income credit.

to the 30-35% effective rate that, on the average, such persons pay.\(^2\)

This special tax treatment is expected to cost the U.S. Treasury more
than $6.2 billion in lost tax revenue this year.\(^3\)

Thus, the preferential treatment which the present tax system
provides for capital gains sounds like the sort of "loop-hole" which
should be eliminated. Yet, merely to eliminate the capital gains
preference would accentuate four major inequities in our present fed-
eral income tax system—inflation, bunching, lock-in, and double tax-
ation of corporate earnings.

Much of the apparent gain on the sale of property may be due
to inflation, or decrease in the value of the dollar, rather than being
due to appreciation, or increase in the value of the property. For
example, if property were purchased for $100 and then, after the value
of the dollar had been halved by inflation, sold for $250, the apparent
gain of $150 would represent only $50 of appreciation plus $100 of
inflation. It seems unfair to tax the inflation.

Income which is "bunched" into one year will be taxed more
heavily due to our progressive income tax than would the same total
income spread over several years. Because gain is taxed only when
the property is sold or the gain is otherwise realized, a person may
be required to pay more taxes in the year of sale than would have
been due had the gain been taxed as the property appreciated. For
example, a property holder might have had only a 20% marginal tax
rate for the years the appreciating property was held, but the large
gain recognized in the year of sale might push him up to a marginal
tax rate over 50%. It may seem unfair that this person should pay
substantially more taxes than another person who had the same
total income during those years but whose income was evenly distrib-
uted among those years.

A person owning appreciated property may be "locked-in" be-
cause of the large tax which will be due upon the sale of that property.
This is another effect of not taxing appreciation when it occurs, but
rather only when the property is sold or the gain otherwise realized:
sales may be discouraged, locking a person into his investments. For
example, a person currently earning 8% on property would normally
sell that property in order to purchase property earning 10%, but such
sales may be discouraged or even precluded if that sale would create

\(^2\) See Table I at page 314 supra. The disparity between theoretical and actual tax rates
has long been criticized: "It is about time for Congress to quit this ludicrous business of dipping
deeply into great incomes with a sieve." H. SIMONS, PERSONAL INCOME TAXATION 219 (1938).

a tax liability equal to a substantial part of the worth of the original property.

A final inequity concerns corporate taxation. Currently corporate earnings on equity are doubly taxed, once to the corporation when earned, and again to the shareholder when those earnings are distributed as dividends, or when the shareholder sells his stock and the gain in part represents retained earnings already taxed once to the corporation. For example, a person in a 50% tax bracket might form a corporation with $100; then, after the corporation has earned $10 and paid $5 in corporate income taxes, he may either have the corporation pay a $5 dividend or sell the corporation for $105, its book value, and be taxed $2.50 on this dividend or gain of $5. This would net only $2.50 on earnings of $10—in effect a 75 percent tax.

To some extent the present system of taxing net long-term capital gains ameliorates each of these problems by excluding one-half of certain gains from income. While that amelioration is very crude, elimination of the capital gains preference should be accompanied by mechanisms to alleviate these problems.

Some of these problems also are troublesome outside the capital gains area—for example, much as inflation exaggerates gain on the sale of a capital asset, depreciation deductions may be eroded by inflation so that net income is over-stated—so they should be solved generally. Moreover, with these problems generally solved, particular solutions to them—for example, accelerated depreciation may be justified in part as easing the distortion of inflation—might be eliminated. The purpose of this article is not merely to recommend the elimination of the preferential treatment our present tax system provides for capital gains. The purpose includes also proposing general solutions to problems to which the capital gains preference provides an inadequate response.

This approach, unfortunately, requires exploring some apparently tangential areas, but it seems necessary for a thorough treatment of these problems. A suggestion to solve certain problems in our tax system should include consideration of whether the solution should be extended to similar problems in other areas. How far to carry this process is a difficult matter of judgement: stopping too soon may appear simple-minded; going too far may lose the reader in complexity. But these areas are important, and they are not long explored before the discussion returns to the main topic: outlining a tax system without preferential treatment for capital gains but with improved solutions to problems of inflation, bunching, lock-in, and corporate taxation. While this article is intended to contain enough technical detail to be worth the while of tax specialists or economists,
it is hoped that through plain-language explanation of current law and numerous examples, it may also be useful to the lay reader.

The first section of this article describes and analyzes current treatment of capital gains. It indicates how that current treatment fails to adequately deal with the four problems noted above—
inflation, bunching, lock-in, and double corporate taxation—sometimes providing too much relief, sometimes too little. The next four sections explore mechanisms to alleviate these four problems. Briefly, those mechanisms are: an inflation correction applied not only to basis for determining gain or loss on sale but also to depreciation, loans, and other transactions spread over a significant period of time; a liberalization of the present rules for averaging income; increased recognition of unrealized appreciation and depreciation; and, integrating the personal and corporate income taxes. As to some of the mechanisms, in addition to proposing a theoretically appropriate yet hopefully feasible version—both administratively and politically—additional versions of decreasing theoretical appropriateness and increasing administrative and political feasibility are also outlined. Three of those sections are included in this issue; the fourth, dealing with integrating the personal and corporate income taxes, will appear as Part II of this article, to be published at a later date.

I. THE CURRENT TREATMENT OF CAPITAL GAINS

Generally, only one-half of net capital gain is included in an individual's adjusted gross income.4 Thus, the normal tax on such gain is at most half the tax on other income, and the tax may be substantially less.5 For example, (omitting for purposes of simplicity

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4. I.R.C. § 1202 (1954). Unless otherwise indicated, all sections referred to are from the Internal Revenue Code of 1954, as amended, Title 26 of the United States Code, and will be cited in the form "Section XXXX." Under Section 1201(b), the first $50,000 of an individual's net capital gain will be fully included in income, but taxed at a rate of 25% rather than at normal progressive rates, if this produces a lesser tax than would result from application of Section 1202.

5. Two departures from normal taxation qualify this statement. Although normal individual tax rates under Section 1 go as high as 70%, Section 1348 generally limits the marginal tax rate on personal service income to no more than 50%. Section 1348 will be referred to as the maximum tax. Second, Section 56, in general, imposes a minimum tax of 15% on items of tax preference (one of which is the excluded half of capital gains) in excess of the greater of $10,000 or one-half an individual's normal tax liability. In combination, these two provisions may result in capital gains being taxed at more than one-half the rate applicable to personal service income. For example, disregarding personal exemptions and personal or business deductions, a couple with personal service income of $200,000 would have a normal tax liability of $110,980, reduced by the maximum tax to $92,060, while a couple with $200,000 in long-term capital gains would have a normal tax liability of $45,180, increased by the minimum tax to $56,791.50.

Also, it may be noted that the amount of personal service income to which the maximum
the minimum and maximum tax, personal exemptions and credits, and the standard and other personal or business deductions) a couple with $40,000 in ordinary income will pay $12,140 in federal income tax, but would pay only $4,380 if their income consisted of $40,000 in net long-term capital gain. Thus, the couple with capital gains pays barely 36%, not one-half, of the tax paid by the couple with ordinary income. This is so because, due to our progressive tax structure, the tax which would be owed on the excluded half of capital gains would be higher than the tax owed on the included half. In the example, the first $20,000 of taxable income is taxed at rates of 14% to 28% creating a tax liability of $4,380 or an average of 22%, while the second $20,000 is taxed at rates between 32% and 45%, creating a tax liability of $7,760 or an average rate of 39%.

There are several possible justifications for current treatment of capital gains. The following subsections critically analyze the more substantial justifications, then discuss some of the problems created by having largely separate systems for taxation of ordinary income or loss and capital gain or loss.

A. Inflation

Capital gains taxation is to some extent an inflation correction. That property produces more dollars when sold than were required to purchase it may be due to dollars becoming less valuable, that is, inflation, rather than to the property becoming more valuable, that is, appreciation. It seems unfair to tax that part of the gain which is due to inflation. Excluding half of the gain from income, as the current system does, compensates in some measure for the declining value of dollars.

But the compensation provided for inflation by the present treatment of capital gains is very crude. It does not apply to many other...
items involved in determining tax liability which also are sensitive to inflation: depreciation, inventories, interest, the rate structure, etc. Moreover, since the holding period required for capital gains treatment is only "more than six months [or nine months, or a year]," normally too short a period for significant inflation, present capital gains treatment will in some cases over-compensate for inflation. If an individual purchased stock for $100 and sold it thirteen months later for $150, he would have a gain of $50, reduced under current law to $25 because it is a long-term capital gain. If 7% inflation occurred between purchase and sale, his purchase price, if restated in dollars having the same value as the dollar at time of sale, would be $107. Thus he has a real gain of $43, but is taxed on a gain of only $25. Yet, for assets held for longer periods, or on which there is little or no dollar gain or even a loss, capital gains will not adequately compensate for inflation. Thus, if an individual purchased stock in 1960 for $100, the value of the dollar might have been halved by inflation by 1977, so that if the 1960 purchase price were restated in 1977 dollars his corrected basis would be $200. If in 1977 the stock were sold for $180, under current law he would have a gain of $80, of which $40 would be taxable, where the individual has suffered a real (that is, adjusted for inflation) loss of $20. If in 1977 the stock were sold for $240, he would have $70 taxable gain under current law, but a real gain of only $40.

This problem with the present system of capital gains taxation could not be solved by extending the holding period, because time does not equal inflation. Even if the period were made as long as ten years, in some decades there is little inflation (the 1920's and the decade between the Korean and Vietnamese Wars) or even deflation (during the Great Depression of the early 1930's), while in other decades inflation is substantial (from World War II through the Korean War, and since the Vietnamese War).  

B. Bunching

Capital gains might be considered a remedy for the inequity created under our present tax system when income is bunched: it is unfair to tax in one year at progressive rates a gain which has accrued

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7. The 1976 Tax Reform Act increased the holding period for long-term capital gains treatment from six months before 1977 to nine months in 1977 and one year after 1977. See Section 1222 (1-4). This article will use one year to describe the holding period for long-term capital gains or losses.

over a number of years. For example, an asset which appreciated $10,000 each year for five years would (excluding, for simplicity, other income, personal exemptions and credits, and business, standard, and personal deductions) produce a tax at ordinary income rates of $17,060 on a joint return, if sold at the end of the fifth year, but a total tax of only $9,100 if one-fifth of the gain were taxed each year.

It will be noted, however, that the present treatment of capital gains (omitting for simplicity the minimum tax) would overcompensate in this example—the tax would be only $6,020. Yet in a few cases, the capital gains averaging mechanism may be inadequate. For example, $100,000 in gain would be taxed $45,180 at ordinary rates, $17,060 as capital gain, and $16,200 if spread over twenty years.

Moreover, capital gains has several conceptual defects in dealing with this problem. Since the required holding period is only "more than . . . 1 year," the special benefit is available where this form of averaging is unnecessary. This problem could, of course, be solved with a longer holding period and a graduated exclusion. But even under such a system, or under the current system, it seems inappropriate to permit this form of "averaging"—to the extent that it is justified by the bunching created when several years appreciation is taxed in the year of sale—to a taxpayer who realizes similar capital gains each year. This problem might be illuminated by a table. Suppose a taxpayer buys an asset each year, holds each asset for five years, then sells it at a gain of $50,000. The table shows the amount of appreciation each year:

9. See note 7 supra.
Thus, the taxpayer after the fifth year has annual appreciation equal to the amount realized, yet he still obtains the benefit of capital gains "averaging." Also, it would seem that an averaging mechanism should consider all income, not only capital gains. An individual might have income from an investment of $50,000 per year, then at the start of one year sell the investment at a gain of $50,000, and have no other income that year. Although his income is constant, so that the gain does not push him into a higher bracket, he still receives the benefit of capital gains "averaging." In addition, such "averaging" is available even to the taxpayer who has spread the gain over a number of years under I.R.C. § 453 (Section 453), thus reducing or eliminating the problem of many years' appreciation being taxed in one or a few years. Under certain circumstances, that section allows a taxpayer, rather than recognizing all the gain in the year of sale, to recognize the gain only as payments are received over a number of years. Thus, an individual who realizes a gain of $50,000 on the sale of property could agree to receive the sale price in five equal annual installments, and then recognize only $10,000 of the gain each year.
Finally, the averaging argument for capital gains overlooks the importance of tax deferral. If unrealized appreciation may be considered income, a question addressed in section IV below, by not paying tax on appreciation as it occurs, the holder of property may be considered to be receiving an interest-free loan from the Treasury equal to the amount of tax he would owe on the appreciation. Thus, of two individuals becoming wealthier, the first because of appreciation in property already owned and the second by saving out of current income, the first pays no current tax on his increase in wealth while the second can only save from after-tax dollars. If each is in the 50% bracket, $1000 of appreciation makes the first $1000 wealthier, while $2000 in income, cut in half by the income tax, is required for the second to become $1000 wealthier. The first can “invest” $1000—that is, increase the value of his investments by $1000—out of $1000 in income in the form of appreciation, because no tax is collected currently on this income. In effect, the government has made the first individual an interest-free loan of the $500 in taxes that would be due on income other than appreciation. The first individual can choose when to repay the loan by deciding when to sell the asset, and, prior to 1977, could have avoided ever repaying the loan by holding the asset until his death. In addition, all the earnings from the investment made possible by the interest-free loan (after taxes, which are imposed whether or not an interest-free loan is involved) accrue to the first individual.

The interest saved may exceed the increase in tax due to having several years’ appreciation taxed in one year on realization. The easiest example is a taxpayer who would be in the top bracket from other income whether or not the appreciation was included in income as it occurred: for such a taxpayer, there is no increased tax cost in bunching income, so the benefit of deferral is not offset by higher taxes in the future. For other taxpayers also, the tradeoff between deferral benefits and future higher taxes may be advantageous, depending on the holding period, the interest rate, and the increase in tax rates on realization.

C. Encouraging Investment

Current patterns of capital gains taxation might be justified because they stimulate investment. But, if the exclusion of one-half of capital gains is intended as a subsidy, it suffers from the defect, noted

10. The 1976 Tax Reform Act eliminated the step-up in basis at death, instead providing a carryover basis, for post-1976 appreciation. Section 1023. See discussion in section IV A. infra.
by Surrey\textsuperscript{11} of all deduction-exclusion subsidies, it subsidizes most those with high incomes. A deduction or exclusion is worth the taxpayer's marginal tax rate; one dollar of deduction is worth seventy cents to those in the seventy percent bracket but only twenty-two cents to those in the twenty-two percent bracket (a couple with two children and $18,000 income using the standard deduction). Whatever the tax code may be trying to subsidize, it seems inequitable and irrational to pay that couple less than one-third as much as we pay the highest income persons for doing the same thing. It does not seem necessary to focus the subsidy on those with high incomes. While a person with a high income can of course save or invest more than can a person with a more modest income, such middle income people are more numerous, so in the aggregate they can potentially generate substantial savings or investment.

Moreover, it is not clear that the subsidy is appropriately targeted. One might seek to stimulate investment by increasing the rate of return. A person evaluating a possible investment may be expected to consider total return, both current income and appreciation, each after allowance for taxes. Capital gains, by increasing the portion of appreciation that an investor may retain after taxes, thus may increase the total after-tax return on investment and thereby stimulate investment. However, this stimulus is available primarily for that part of an investment's return which is appreciation, rather than current income, so it provides more encouragement to appreciating investments than to current-income investments. Appreciating investments are already substantially subsidized, as indicated above, because appreciation is not taxed as it accrues but only when, perhaps years later, the appreciated property is sold, in the interim in effect giving the taxpayer an interest-free loan. It is not clear that we want to subsidize preferentially investments whose return is primarily in appreciation rather than in current income. A prime example would be speculating in unimproved and unused land, realizing no current income but expecting appreciation as the expanding economy and population increase demand for, and hence the price of, land. Since land is a commodity whose supply is for practical purposes largely fixed, the higher price does not bring forth any additional supply. Thus, the effect of increasing investment in land, through increasing the after-tax return on such investment, may be largely just to increase the price that those who might put the land to productive use.

must pay. Although such land speculation may be an extreme though not unusual case, a similar problem may appear in other real estate investments such as farms or buildings when, though the investment does produce some current income, a major part of the anticipated return is appreciation. There is another problem in stimulating investment through increasing the after-tax return through appreciation. The subsidy may be available to each successive owner, not just the first owner who creates the property (of course, as to unimproved and unused land, the Creator is not taxable). While there is an argument to be made for encouraging a market for productive property, thus encouraging initial creation of productive property by providing an advantageous forum in which the creator may sell his creation, it should be noted that each successive sale of the property may be entitled to capital gain treatment. As the subsidized sale becomes more remote from the initial creation of the property, the effect of the subsidy in encouraging the creation of additional productive capacity decreases.

Putting aside the possible distortions in types of investment which might be caused by a tax subsidy to appreciation but not to current investment income (and also for the moment disregarding the tax benefits of deferring the recognition of appreciation until the appreciated property is sold, which tend to reduce the impact of the point about to be made), the different taxation of current income and appreciation may aggravate certain social problems. Current income from an investment may now be subject to uniquely high tax rates up to the maximum rate of 70% imposed by Section 1, whereas the tax on investment liquidation is reduced by capital gains to no more than 35% (plus the minimum tax of up to 7.5%), and the tax on personal service income is generally limited by Section 1348 to no more than 50%. A system of taxation which makes it relatively more advantageous to terminate than to continue a business or investment encourages entrepreneurs to sell. Because it is primarily wealthy individuals and large corporations who can afford to buy, such a system may promote concentration of property ownership. This would threaten—beyond what technology demands—the Jeffersonian ideal of a society which includes many small businessmen and farmers, and

12. See Survey of Current Business (Commerce Dep't, Nov. 1974), reporting that the top 0.2% of the families own 30% of the individually held stock in this country, the top 1% own 51%, and the top 10% own 74%. Another estimate is that in the early 1950's the top 5% received 20% of the income, but the top 1% owned 27% of all privately held wealth. R. Lampman, Taxation and the Size Distribution of Income, 2 Tax Revision Compendium of the House Ways and Means Comm., 85th Cong., 1st Sess. 2236-37.
would risk turning us into a nation of clerks.  

Capital gains, alternatively, might be intended to promote flexibility in investment, by removing the disincentive to change investments which a tax at ordinary rates on realization of appreciation might impose. Certainly it is desirable not to obstruct investors' decisions as to the most productive form for their investments to take. It should be noted, however, that capital gains treatment is available whether or not the proceeds are re-invested, so capital gains may as effectively subsidize disinvestment as investment. Other non-recognition provisions such as Sections 1031-34, in contrast, require both that the proceeds be reinvested and that the basis of the acquired property be reduced by the amount of gain not recognized. Still, it may be in the public interest to shift investments into more productive hands, even though no new investment occurs. Much of the lock-in of investments, however, has been due to the possibility which existed before 1977 of complete escape from taxation on appreciation due to the step-up in basis at death provided by Section 1014. Weighed against the reductions in lock-in which have been and may further be achieved through modification of Sections 1014 and 1023 and through other changes suggested below, it is difficult to justify on this basis the substantial inequity and loss of tax revenue created by the present provisions for taxation of capital gains.

D. Double Taxation of Corporate Earnings

Corporate earnings are taxed once to the corporation at a rate of 48%, once the surtax exemption of $50,000 is exceeded. Those earnings may be taxed a second time to the stockholder, either when the corporation pays dividends, or when the stockholder sells his stock if it has appreciated due to retained earnings. However, if the stockholder retains the stock until his death, the pre-1977 appreciation may never be taxed, due to the step-up in basis at death provided by Sections 1014 and 1023. To the extent that earnings are retained, the capital gains treatment for gain from sale of stock (or, in general,

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15. See note 10 supra.
16. Section 11(b) imposes a tax of 20% on the first $25,000 of corporate earnings and 22% on the remainder, and Sections 11(c) and (d) impose a surtax of 26% on earnings in excess of $50,000, so that the total tax on corporate earnings in excess of $50,000 is 48%. In the interests of simplicity, the discussion will ignore for the time being the surtax exemption, and treat all corporate earnings as being taxed at 48%.
gain on liquidation of the corporation) may be viewed as an amelioration of the double taxation of corporate earnings. Yet this justification for capital gains, even if limited to sales of stock—and some stock sales don't qualify because the stock was not held for more than one year or was held for sale to customers—has two major defects.

First, the adjustment is very crude. Corporations differ widely in the percentages of after-tax earnings distributed and retained; stockholders differ widely in the time they hold their stock; stock prices are influenced by many factors other than retained earnings.

Even in the ideal world required by the theory of this justification for capital gains, in which corporations retained all after-tax earnings and in which stock prices were determined solely by retained earnings, this system of 48% corporate tax, plus one-half the individual tax rate on the remainder, produces the same tax as the individual tax applied to corporate income only at a tax rate of approximately 65%. For a stockholder with higher marginal personal income tax rates this system would produce a lower tax rate than would be applied if that stockholder's share of corporate earnings had been earned directly without interposition of a corporation, whereas for stockholders with lower marginal personal income tax rates this system produces above normal rates.

Moreover, this computation assumes that the stock is sold at the end of the year. If, as is more realistic, it is assumed that the stock will be held a number of years, deferral changes the tax picture. If the stock is held until the shareholder dies, the pre-1977 appreciation may never be taxed, due to the step-up in basis at death. For such stock, the only tax is the 48% corporate income tax, leaving shareholders in brackets below 48% overtaxed and those in higher brackets undertaxed. If the stock is held for a number of years but sold prior


18. To compute the tax bracket for which $1 of ordinary income would pay the same tax as $1 of corporate earnings where the corporation paid no dividends and the stock appreciated the amount of the retained earnings, the following equation must be solved for Y: $1 x Y = .48 + (.52 x Y/2). Y = 64.86. This highly simplified equation ignores the Section 1201 alternative tax and any possible change in tax brackets. If the alternative tax of 25% were used, the cross-over point would be at a tax rate of 61%.

to the shareholder's death, the tax on the retained earnings will be deferred until sale, even though the shareholder is benefiting from those retained earnings by having them generate additional earnings within the corporation, and even though the shareholder can obtain a cash benefit without incurring tax liability by borrowing money secured by those earnings, to the extent they are reflected in an increase in the value of the stock. In effect, the shareholder has received an interest-free loan from the government of the amount of tax which would be due had the appreciation attributable to retained earnings been currently taxable. If a normal interest rate is 8%, the value of an interest-free loan would in effect cut the tax in half in nine years. While the value of deferral will of course depend on both the period of deferral and the interest rate, for this example the crossover point would occur at a tax rate of approximately 55%, with shareholders with a higher marginal tax rate being under-taxed and those in lower tax brackets being over-taxed.

Second, various studies suggest that it is doubtful that corporate earnings fully bear the corporate income tax. Rather than the corporate income tax solely serving to reduce after-tax earnings of the corporation and hence of the shareholders, it appears that part of the tax may be shifted to others. The tax may be shifted forward: the tax may be added to the costs of goods or services produced so that it is ultimately paid by customers and, thus, is in effect a form of sales tax. Or the tax may be shifted backwards: the presence of the tax may reduce the prices paid to the corporation's suppliers, in large part wage or salary earners, so that the tax is in effect another employment tax similar to the Social Security tax. Finally, the tax may be

20. This computation is based on the rule of thumb that 72 divided by the interest rate produces the number of years required for an amount invested to double. See Andrews, A Consumption-Type or Cash-Flow Personal Income Tax, 87 Harv. L. Rev. 1113, 1125 n.20 (1974). Thus in this case, 72 divided by an 8% interest rate yields 9 years for an amount invested to double, or, to put it another way, deferring the tax for 9 years effectively halves the tax.

21. Modifying the equation in note 18 supra: \( S_1 \times Y = .48 + (.52 \times Y/4) \), \( Y = 55.172 \).

shifted horizontally to owners of other capital, such as corporate debt or businesses not conducted in a corporate form. Some elaboration of horizontal shifting might be helpful. Before the corporate income tax is imposed, rates of return on corporate equity and other capital (e.g., corporate bonds, businesses operating in non-corporate forms such as partnerships or sole proprietorships) should be approximately the same, after allowing for such factors as risk and liquidity. For example, both corporate equity and other capital might earn a return of 10%. Imposing a 50% corporate income tax would lower the after-tax rate of return on corporate equity to 5%, while leaving the after-tax rate of return on other capital at 10%. With the after-tax rate of return on other capital now twice the return on corporate equity, people may be expected to shift their investments from corporate equity to other capital. By reducing the supply of corporate equity this should increase the return to remaining corporate equity, and by increasing the supply of other capital this should reduce the rate of return to other capital. A new equilibrium should be reached: in the preceding example, a possible equilibrium might be a 16% return on corporate equity, reduced to 8% by the corporate income tax, and an 8% return on other capital. Under the new equilibrium, after-tax rates of return in both corporate equity and other sectors are likely to be lower, so that in effect both sectors may bear the tax. Although the direction—forward, backward, or horizontal—and degree of shifting is unclear, that significant shifting occurs seems likely. To the extent such shifting occurs, corporate earnings not only are not being doubly taxed, they are relieved of normal tax to the degree that they are retained and taxed at capital gains rates upon ultimate disposition of the stock.

This concludes, for the present, criticism of various possible justifications for capital gains. The discussion now turns to some other problems created by the separate tax system for ordinary income and loss and capital gain and loss.

E. Inconsistent Treatment of Losses

Thus far we have considered only the tax treatment of long-term capital gains. The Code provides apparently symmetrical treatment of long-term capital losses, only half of which may be deducted from ordinary income.23 None of the justifications discussed above for the present treatment of long-term capital gains supports this treatment of capital losses, thus indicating further that those justifications can-

not adequately explain the present treatment of both capital gains and losses. If capital gains are to allow for inflation, then capital losses should be larger, not smaller, than comparing dollars would indicate. If property was purchased for $100 in 1960 and sold for $50 in 1977, the dollar loss is $50. But if the dollar has been halved by inflation between 1960 and 1977, the purchase price restated in 1977 dollars would be $200 and the loss $150, but the Code allows recognition of only a $25 loss.

If capital gains are a crude averaging device to prevent bunching of income, losses should be fully allowed or even exaggerated. Had a loss which occurred gradually over several years been recognized as it occurred, it would have offset income taxed in the highest bracket each year; whereas if recognized all in one year, much of the loss will be used against income taxed in relatively low brackets. Moreover, here the taxpayer will have been making interest-free loans to the government, by paying more taxes than he would if the loss had been recognized as it occurred, the reverse of the situation for gains.

If capital gains treatment is an investment subsidy, deduction of losses should not be restricted. Although investors hope for gains, if they are realistic they must anticipate the possibility of losses. Restrictions on deduction of losses will increase the portion of the losses they will be required to bear, thus discouraging investment. 24

If capital gains are an adjustment for the tax imposed on the corporation on retained earnings, the loss deduction should be allowed in full. For example, a corporation might be created with $100 capital, earn $20 its first year and pay $10 in taxes (for simplicity, treating the corporate tax rate as 50% and ignoring the surtax exemption), break even the next three years (so we may ignore the net operating loss provisions of Section 172), then lose $30 and be liquidated, its shareholder receiving $80 for his stock. Although the corporation during its life had a net loss from operations of $20 - $30 = -$10, the shareholder sustained a loss of $20, because in addition to losing $10 on its operations the corporation paid $10 in taxes. The shareholder has a fair claim that his entire loss, due in part to the corporation’s tax payment, should be deductible; he has some claim, although this is a departure from the annual accounting concept generally followed in our tax system, that he should receive a refund of taxes paid by the corporation plus a deduction for any remaining

24. Special provisions may alleviate this problem. Losses on stock issued in accordance with Section 1244 will be ordinary, and a net loss for the year on property described in Section 1231 will be ordinary, even though in both cases gains or net gains, respectively, would be capital.
loss. Of course, so long as marginal tax rates are below 100%, the refund of taxes is more valuable than a deduction of the same amount.

It should be emphasized that it is not the purpose of the preceding paragraphs to advocate an exaggerated deduction for capital losses. The purpose is only to show that the various justifications for the current favorable treatment of long-term capital gains—justifications found to be inadequate in prior sections of this article—would justify exaggerated rather than restricted deductions for capital losses. That the losses are restricted under current law is further evidence that those justifications, while important matters with which the tax system should deal, cannot adequately explain the current system. Treatment of capital losses more consistent with those justifications is discussed below, as part of a proposed revision of capital gains taxation.

There are a few other quirks in capital gains taxation. Losses must be netted against gains, with only a net loss deductible from ordinary income. But a long-term loss, only half of which could be deducted from ordinary income, can offset dollar-for-dollar a short-term gain, all of which would be included in income; a long term gain, only half of which would be included in income, will offset dollar-for-dollar a short-term loss, which could have been deducted in full from ordinary income. In the first case, netting benefits the taxpayer; in the second, the tax collector. Moreover, capital losses can be deducted only against capital gains, plus $3000 of ordinary income, although any excess loss may be carried forward indefinitely to offset future capital gains, plus up to $3000 of ordinary income each year. Limiting deduction of capital losses against ordinary income may impose a substantial hardship on the small investor whose major investment produces large losses, and who has few other investments likely to produce capital gains. Many years of taking the loss against $3000 of ordinary income may be required to recoup the loss, and until then the small investor has been making an interest-free loan to the government.

There is a purpose to these provisions. The netting seems generally reasonable, given the philosophy of symmetry between gains and losses. Until 1950, $1 of short-term capital loss would offset $2 of long-term capital gain, but this was believed by Congress to be an

25. The 1976 Tax Reform Act increased the amount of ordinary income against which capital losses may be deducted from $1,000 before 1977 to $2,000 in 1977 and $3,000 thereafter. Section 1211(b). This article will hereinafter use $3000 as the amount of ordinary income which may be offset by capital gains.
abuse, so the current netting was introduced. The abuse, it may be noted, was largely a matter of appearance, as the effect of full deduction of short-term capital losses (up to the limits provided) and only half inclusion of long-term capital gains can still be achieved by having the loss recognized in a year different from the year of the gain. Limiting the deduction of capital losses against ordinary income prevents an investor with a large portfolio, which is likely at any time to include a certain amount of stock which has declined in price, from timing recognition of losses so as to eliminate taxation of his ordinary income such as dividends and interest. But these provisions do not follow from the general justifications for capital gains taxation discussed above, and they can produce erratic and inequitable results.

F. Problems Created by the Existence of Capital Gains Taxation

Thus far consideration has focused on problems of and possible justifications for capital gains in the abstract. The reality of what currently is and is not a capital gain luxuriates in complexity and uncertainty:

—Patents easily produce capital gains for the inventor under Section 1235, but copyrights will rarely produce capital gains to the author due to Section 1221(3). While one may argue that our society has a greater need for new technology than for art, the line between patents and copyrights is not a line between the necessary and the frivolous. Patents are issued on leisure products as well as for new weapons and pollution-abatement equipment; those scientists and engineers are taught from copyrighted textbooks, and are kept current by reading copyrighted periodicals.

—Relatively minor differences in how a corporation is formed, merged, operated, divided, or liquidated may change gain or loss from ordinary to capital or vice versa. (This will be discussed in Part II of this article, to be published at a later date.)

—Cases struggling with whether “property [is] held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business,” so as to be denied capital gains treatment, fill the Reports.

—In *Corn Products Refining Co. v. Commissioner*, the Supreme Court created a common law of capital gains to make certain types of gain, which might under a literal reading of Section 1221 appear to be capital, taxable instead as ordinary income. This common law

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26. 350 U.S. 46 (1955). Section 1221 (and its predecessors) defines “capital assets” as all property, then lists certain exceptions. *Corn Products* held that the “corn futures” which taxpayer bought and sold as an integral part of its manufacturing operation were not capital assets, though they were property and not within any of the listed exceptions.
has had its greatest use in transforming what might appear to be
capital loss into ordinary loss, and has failed to produce a clear line
of demarcation.\textsuperscript{27}
—The question of whether a payment is made for property, and hence
entitled to capital gains treatment, or whether it is a substitute for
ordinary income continues to be only vaguely answerable despite the
efforts of the Congress and the courts.\textsuperscript{28}
—It may be possible, in effect, to convert ordinary income to capital
gains, by taking deductions from ordinary income while the property
is owned, then having capital gains treatment when the property is
sold. Legislative and judicial efforts to restrict such conversion, either
by denying the deductions or by making part of the gain ordinary,
are very complex and only partially effective.\textsuperscript{29}
These and other factors related to capital gains add significantly
to the length and complexity of the Internal Revenue Code, which
would seem already to be excessively long and complex. It has been
estimated that half the language in the Code deals with capital
gains.\textsuperscript{30} The costs of this complexity are substantial, both for the
administration of the tax laws and for the political process, which
from time to time revises the Code.

\textsuperscript{27} See, e.g., Schlumberger Technology Corp. v. United States, 443 F.2d 1115 (5th Cir.
1971); Waterman, Lorgen & Co. v. United States, 419 F.2d 845 (Ct. Cl. 1969) (both permitting
ordinary loss on stock purchased in a corporation related to taxpayer's business). See also
Commissioner v. Bagley & Sewall Co., 221 F.2d 944 (2d Cir. 1955) (decided before Corn
Products) (permitting ordinary loss on government bonds purchased to secure performance of
a contract).

\textsuperscript{28} See Section 1241. Compare Judge Friendly's opinion in Sirbo Holdings, Inc. v.
Commissioner, 476 F.2d 981 (2d Cir. 1973), on remand 61 T.C. 723 (1974), aff'd, 509 F.2d
1220 (2d Cir. 1975) with Bill Rose's Diamond Horseshoe, Inc. v. United States, 448 F.2d 549
(2d Cir. 1971).

\textsuperscript{29} See Section 163(d) (restricting interest deductions) and Sections 1245 and 1250 (pro-
viding certain gain will be ordinary rather than capital). See also United States v. Regan, 410
F.2d 744 (9th Cir.), cert. denied, 396 U.S. 834 (1969); Schultz v. Commissioner, 50 T.C. 694,
aff'd per curiam, 420 F.2d 490 (3d Cir. 1970), both requiring certain expenses be added to basis
rather than deducted.

\textsuperscript{30} C. SHOUP, PUBLIC FINANCE 324 n.2 (1969). See also Bittker, Tax Reform and Tax
subject to a lower tax rate than other types of income is perhaps the single most complicating
aspect of existing law."

Addressing the general problem of complexity in the tax laws, Learned Hand wrote:
In my own case the words of such an act as the Income Tax, for example, merely
dance before my eyes in a meaningless procession: cross-reference to cross-reference,
exception upon exception—couched in abstract terms that offer no handle to seize
hold of—leave in my mind only a confused sense of some vitally important, but
successfully concealed, purport, which it is my duty to extract, but which is within
my power, if at all, only after the most inordinate expenditure of time.

The administration of the tax laws is not merely a matter for 
the Internal Revenue Service. It begins with persons making business 
and other economic and social plans with an eye on tax effects. 
Transactions anywhere near one of the many boundaries between 
ordinary income and capital gains must be carefully examined and 
perhaps drastically altered to come on the desired side of the line. 
Those dry and dusty few who master the labyrinth exact substantial 
tribute as guides, as the particular position of often arbitrary lines is 
alternatively fixed and shifted by the efforts of Congress, the IRS, 
and the courts. Next, when the taxpayer must fill out his tax return, 
beyond the problems of confusion that this complexity creates, there 
are the problems rising from the taxpayer feeling that the system is 
unfair or inequitable, that his ordinary income transaction may seem 
no different in substance from another's capital gain transaction. 
Such perceived inequities weaken the ethics of self-assessment upon 
which our tax system depends. The IRS must then audit, using its 
scarce resources to redirect the confused and to corral those whose 
ethics bend. Not only are there problems of scarce audit resources, 
but also there are likely to be problems of confused IRS agents, as 
the lines to be first understood and then policed become more nu-
merous and intricate. Then the matter may go to court, with each 
line providing additional issues which the taxpayer or the IRS may 
consider worth litigating, additional issues which each court may 
misunderstand or at least understand differently than other court 
understood them. And the United States Supreme Court, the only 
court which can rule with authority to bind all taxpayers, has much 
to do besides refining the intricacies of capital gains.

Beyond these problems of administering our capital gains-
ordinary income tax system lie political problems. First, the existence 
of the more advantageous capital gains taxation has provided a han-
dle for those seeking tax relief. Where if we had only one system of 
taxation it would be very difficult to lobby successfully for a special 
rate on behalf of one individual or industry, the lobbying task is eased 
considerably under the existing dual systems of ordinary income and 
capital gains whose irregular and ill-defined borders invite shifts 
based on an appealing case.\textsuperscript{31} So those involved with lump-sum pen-
sion distributions,\textsuperscript{32} iron ore,\textsuperscript{33} and even Christmas trees\textsuperscript{34} have

\begin{itemize}
  \item \textsuperscript{31} Surrey, \textit{The Congress and the Tax Lobbyist—How Special Tax Provisions Get En-
  \item \textsuperscript{32} Section 402(a)(2) (only applies in regard to distributions attributable to pre-1974 
employer contributions).
  \item \textsuperscript{33} Section 631(c).
  \item \textsuperscript{34} \textit{See} Section 631(a), last sentence.
\end{itemize}
been granted this benefit; others have sought and will seek it. The
game can of course be played the other way, so that losses, which
would seem to be capital, are treated as ordinary. Each new extension
of capital gains, and each new conversion of capital loss to ordinary
loss, adds further to the complexity of the tax system. Second, the
complexity of the Internal Revenue Code, due in significant part to
the dual system of capital gains and/or ordinary income, may constitute
a barrier to the effective operation of the political process. The
current complexity of the Code is normally well understood by its
beneficiaries (or at least their representatives), who will by personal
contacts, skilled representation and campaign contributions seek to
maintain those favorable complexities.35 The complexity of these
provisions for practical purposes may make them invisible to the
public and the political process. Also, the political process of reform
may be dampened or drowned in intricacy. The relatively simple
reform proposal of eliminating preferential treatment for capital
gains—not an unreasonable suggestion—is likely to be met by refer-
ences to problems of inflation, the need to stimulate investment, or
double taxation of corporations. This may not be an unreasonable
response, but it may so complicate the question as to prevent any
action being taken. What is needed is an analysis, perhaps quite
complex, which will show that problems such as inflation do not
justify the present treatment of capital gains, and that those problems
should and can be solved in a relatively simple fashion. With such
problems solved the capital gains preference may be eliminated.

This is not to suggest that the Code can be made short and
simple. Given the variety in our economy and society, a certain length
and complexity in the Code will be required if it is to provide the
precise guidance necessary for the tax system to be uniformly applied
by the many taxpayers, IRS agents, and courts involved in its admin-
istration. But, for the reasons discussed above, length and complexity
are costly, and should be avoided where possible. If the present treat-
ment of capital gains were necessary to further some social goal, a
certain consequent complexity might be acceptable. But, as suggested
above, the present treatment of capital gains fails to deal adequately
with the major problems which might justify that treatment. If more

35. "Our forefathers sacrificed much to achieve legislative control over taxation. This
was in considerable part motivated by the desire to avoid arbitrary exercise of the taxing power.
They reckoned perhaps without a full understanding of what organized special interests can do
a tax system under representative government." H. Groves, Taxation of Capital Gains, 2
Tax Revision Compendium, House Ways and Means Comm. 85th Cong., 1st Sess. 1193
(1959).
effective solutions to these problems can be developed, the capital gains preference may then be unnecessary. While various arguments for the capital gains preference other than those discussed here exist, those arguments would have to be very substantial to justify continuing the great complexity created by the existence of separate systems of taxing ordinary income and capital gains, once the problems discussed above have been generally solved.

The alternative proposed here to the present treatment of capital gains represents a substantial simplification, though the simplification may be lost to the reader in the elaborate exposition. The alternative would draw fewer lines than are required by the current treatment of capital gains; what conceals the simplification is that the lines which remain will require more extensive computations. It is hoped that the reader will suppress the fear of computations so common in our society in considering the proposals made in the remainder of this article. The costs of computational complexity are much lower in terms of economic distortion, taxpayer confusion and frustration, strain on IRS audit resources, and risk of judicial differences or misunderstandings, than are the costs of conceptual complexity to which we are subjected by the present treatment of capital gains.

II. Inflation

Inflation creates two basic problems for our tax system. First, it will cause a misstatement of income whenever a substantial period of time elapses between expenditures and receipts. This is the problem which should be corrected generally if capital gains are to be taxed like other income. Second, inflation affects the value of any amount fixed in dollar terms in the Code, such as the personal exemption, the low income allowance, and the rate structure. Although, as indicated below in subsection II. B., this second effect of inflation is different from the first or accurate-statement-of-income-inflation problem—and hence is not directly related to capital gains—it might be corrected as part of a general solution to the problems posed to our tax system by inflation.

A. Accurate Statement of Income

1. Aspects of the Problem. A person who buys property for

37. For other discussions of these problems, see McDonald, Inflation: Concepts of Income, Tax Reform, 28 TAX LAWYER 533 (1975); Comment, The Feasibility of Adjusting for Inflation in Computing Taxable Income, 49 Wash. L. Rev. 873 (1974); Note, Inflation and the Federal Income Tax, 82 Yale L.J. 716 (1973), and, in the United Kingdom, see Inflation Accounting Committee, Inflation Accounting (1975).
$100 and then, after inflation has cut the value of the dollar in half, sells the property for $200 has no gain in any real economic sense, but is treated under the Internal Revenue Code as having a gain of $100.

His problem, however, is not unique. A similar problem would be presented if instead of selling the property he had used it in his trade or business and taken depreciation deductions against the income the property produced. Here too the dollars which he would receive free of tax as a return of his initial investment would be worth less than the dollars with which he made that initial investment.

On the other hand, this same person may benefit from our present tax system's failure to take inflation into account. If he had purchased the property with borrowed money, he would be repaying that loan with dollars worth less than those he borrowed. The tax system in certain circumstances treats a release of indebtedness, such as occurs when fewer dollars are repaid than were borrowed, as income, and it may provide similar treatment when a foreign currency loan is repaid after that currency has been devalued, but the release of indebtedness which occurs due to inflation is not at present considered income for tax purposes. This tax benefit to the borrower—ignoring inflation's release of indebtedness—is paralleled by a tax detriment to the lender. The latter under present law is not permitted to recognize, for tax purposes, the loss he sustains when

38. United States v. Kirby Lumber Co., 284 U.S. 1 (1931); Treas. Reg. § 1.61-12. Under certain circumstances Section 108 permits the taxpayer to elect not to recognize this gain, if he consents to a basis adjustment under Section 1017.

39. I.T. 3810, 1946-2 C.B. 55. See generally Ravenscroft, Taxation of Income Arising from Changes in Value of Foreign Currency, 82 Harv. L. Rev. 772 (1969). The Commissioner, in 1943 C.B. 10, announced his acquiescence in B.F. Goodrich Co. v. Commissioner, 1 T.C. 1098 (1943), a case holding that repayment of a foreign currency loan with devalued currency did not produce income, but that acquiescence was withdrawn and nonacquiescence substituted in 1974-2 C.B. 5. The Commissioner's present position on this issue is supported by more recent cases such as J.A. Gillin v. United States, 423 F.2d 309 (Cl. Cir. 1970), and W. Helbrun, Inc. v. Commissioner, 214 F.2d 815 (1st Cir. 1954).

40. To be more precise, a release of indebtedness is normally treated as though the taxpayer had received cash equal to the amount of indebtedness released, up to the taxpayer's net worth after the release. Treas. Reg. § 1.61-12. Whether such an equivalent hypothetical cash receipt is income depends on the circumstances. For example, a debtor's repurchase of his own obligations at a discount was held to constitute income in Commissioner v. Jacobson, 336 U.S. 28 (1949), but in other circumstances the release has been held to be a gift, Bosse v. Commissioner, 29 T.C.M. 1772 (1970). Also, when the indebtedness was incurred to purchase property, a release has been treated as a reduction in the purchase price, Hirsch v. Commissioner, 115 F.2d 656 (7th Cir. 1940), and, when the release occurs because property subject to a non-personal-liability mortgage is transferred, the release has been treated as part of the amount realized, producing income or gain only to the extent, if any, that the amount realized exceeds the taxpayer's adjusted basis in the property. Crane v. Commissioner, 331 U.S. 1 (1947).
the loan is repaid in dollars which are worth less, because of inflation, than the dollars lent.

Any solution to the problems posed by inflation should not be limited to the problem of accurately measuring gain outlined in the first paragraph of this section, but should be generalized to deal also with problems such as those involving depreciation and borrowing posed in the two following paragraphs. The remainder of this subsection will outline possible solutions to such problems. Discussion of one key element of any solution—the choice of an appropriate index to measure inflation—will be deferred.

2. Sales. A correction for inflation may perhaps be most easily made and understood in the case of a sale of property. Take as an example property purchased for $100 when the appropriate price index was 1.20 and sold for $210 when that index was 1.50. Under current law, this transaction would produce a gain of $110. Under the proposed revision, taxpayer's basis of $100 would be multiplied by the ratio of 1.50 to 1.20, or 1.25, so that his basis would be $125 and the gain only $85. Had the purchase price been $200 rather than $100, where currently the taxpayer would have a basis of $200 and gain of $10, under the revision he would have a basis of $250 and loss of $40.

This principle would be applied whether the property sold is of the type now qualifying for capital gains treatment or is inventory or other ordinary income property. This inflation correction would be an alternative to that already crudely provided by the Last In, First Out or LIFO system. Under the LIFO system, inventory is treated for tax and accounting purposes as though that which was most recently acquired was used first. At times this convention will correspond to the taxpayer's practice, for example, where coal is poured into a storage bin and then removed for use from the top, but the more normal business practice is to use the oldest materials in stock first to avoid spoilage, that is, the First In, First Out or FIFO system. LIFO corrects for inflation by matching current raw material or wholesale prices to current sales prices. LIFO has two weaknesses as an inflation remedy, however. First, while much of the gain which it avoids recognizing is due to inflation, a significant part of the gain which LIFO avoids recognizing may be real gain if the rise in raw material or wholesale prices exceeds the inflation rate. Such gain is being realized through sales of the old, appreciated inventory, yet the

41. See Section 472 and Treasury Regulations promulgated under that section.
LIFO system permits deferral of recognition of this realized gain. Second, although the LIFO convention will decrease apparent gain in a period of rising or steady inventory, when inventories fall due to changes in industry practice or business conditions, the basis in the inventory sold may be determined by relatively old acquisition prices, which may have been paid when the inflation index was substantially lower. This substantial taxable gain may interfere with implementation of improved inventory control practices. The proposed inflation correction would avoid both of these problems, separating inflation gain from appreciation, and applying regardless of increases or decreases in inventory. With an inflation correction, the tax system might eliminate the LIFO convention, or perhaps restrict LIFO to those situations where it approximates actual practice.

The inflation correction proposed here should be distinguished from replacement cost accounting. Replacement cost accounting seeks to determine how many dollars it would take to replace existing inventory and depreciable property; inflation correction seeks to determine how many dollars it would take to replace the dollars used to purchase existing inventory or depreciable property. While both systems eliminate income attributable to inflation, replacement cost accounting would also eliminate income attributable to appreciation. For example, when the value of all oil increased dramatically because of the 1973 Arab oil embargo and price increase, owners of oil had a real increase in value in the oil owned. When oil purchased for $3 per barrel was shortly thereafter sold for $12 per barrel, its owners had realized a real (inflation-corrected) gain of $9 per barrel. That this gain would be non-recurring or even a windfall would not exempt it from the income tax. After the oil price increase, more working capital would be required to maintain the same oil inventory, but under Section 263 this (or any other) increase in required capital would not be deductible: thus, the fact that all the proceeds from the sale of old oil will be required to purchase new oil would not justify failing to recognize the realized real gain on the old oil.

For tax purposes, inflation correction is the proper approach. Financial statements, on the other hand, are intended to show results of operations, to indicate how well the business has been managed and to provide a basis for projecting future earnings, among other

43. The SEC recently began requiring that financial statements be footnoted to show the effects of using replacement cost for inventory and depreciable property. Accounting Series Release 190. See Schorr, New Accounting Rule Ordered by the SEC Upsets Many Concerns, WALL ST. J. Sept. 23, 1976, at 1, col. 6.

purposes. Non-recurrent items have traditionally been separately treated. To include in financial-statement income, without explanation, the gain on oil in inventory when the price increase occurred could be misleading, as this gain is not likely to be recurrent. Accordingly, it may be appropriate to indicate on financial statements how results would differ under replacement cost accounting.

The financial impact of these related changes in the tax system—permitting a correction for inflation but eliminating the preferential treatment for capital gains and eliminating or restricting the LIFO convention—will be in certain cases to decrease tax revenues, by increasing basis to allow for inflation, and in certain cases to increase revenues, by eliminating the capital gains preference and by taxing inventory appreciation which the LIFO system now permits deferring. Determining the relative magnitude of these offsetting effects would require extensive econometric studies which are beyond the capabilities of this author.

3. Depreciation. Before discussing how depreciation deductions might be corrected for inflation, and how with such an inflation correction depreciation practices might be changed, it may be useful to outline the purpose of depreciation deductions. Depreciation may be viewed as a system of matching expenses to the income they earn. A business may have many expenses in connection with property it uses: maintenance, insurance, interest on money borrowed to buy the property, etc. Another such expense is the property wearing out or becoming obsolete, so that when it is eventually sold or scrapped it will yield less than the amount originally spent to acquire it. The purchase price will normally be the property's basis; what it will yield when the business sells it is its salvage value; the difference between basis and salvage value is an expense of producing income during the property's useful life, that is, the period it is in use. Allocating that expense to that income must of course be based on estimates, because at the time the property is acquired it is seldom possible to predict with certainty either how long the property's useful life will be, or how much its salvage value will be at the end of that useful life. Depreciation is the system for allocating that expense. There are many ways to compute depreciation under Section 167; take, for example, property purchased for $1200, with an estimated useful life of ten years, and an estimated salvage value of $200, so that the total

45. The discussion in the text is based on traditional concepts of depreciation which are generally accepted in our present tax system. For consideration of alternative concepts of depreciation, see W. Baxter, Depreciation (1971).
expense of using that property over ten years is $1000, which might be allocated at $100 per year. In a period of inflation, the dollars used to measure those successive $100 annual deductions will in real terms be worth a decreasing fraction of the worth of the dollars used to purchase the property. Without an inflation correction, the deductions allowed will not equal in real terms the total expense of using the property, resulting in an overstatement of income. This section explores methods of correcting for inflation, together with other changes in methods of determining depreciation which will then be appropriate.

Computing the inflation correction for depreciation or amortization deductions is probably best done by computing depreciation for the year using the original basis, reducing the basis by the amount of depreciation, then correcting the amount of the year’s depreciation deduction for the inflation which has occurred since the property was purchased. To correct the basis for inflation each year seems needlessly complex, and makes it more difficult to keep track of adjustments to the basis for past depreciation. When it becomes necessary to compute adjusted basis, for example, to determine gain or loss on a sale, the adjusted basis may be multiplied by the ratio between the appropriate price indexes for the year of sale and year of purchase. (Sample computations under both methods are set out in the footnote.) Except for mathematical inaccuracies, there should be no

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46. Annual adjustments to basis for inflation are proposed in Note, Inflation and the Federal Income Tax, 82 YALE L.J. 716, 720-24 (1973). Sample computations, id. at 722 n.29, show that in a few years the number of digits—which may either be used at increased computational cost or dropped with a possible decrease in accuracy—increases substantially.

47. Take, as an example, an asset purchased for $1000 when the appropriate price index was 1.2 and depreciated straight line over 10 years with no salvage value. Suppose further that the appropriate price index for each of the following years was 1.3, 1.4, 1.5, 1.7, etc., respectively. Each year the taxpayer would be entitled to an uncorrected depreciation deduction of 100, and would reduce his basis 100. The inflation adjustment would multiply the 100 depreciation by 1.2/1.2 = 1 the first year, 1.3/1.2 = 1.083 the second year, 1.4/1.2 = 1.167 the third year, 1.5/1.2 = 1.25 the fourth year, and 1.7/1.2 = 1.417 the fifth year. If the property were sold at the end of the fifth year, taxpayer’s uncorrected adjusted basis would be $1000 cost-$500 (uncorrected depreciation) = $500. Correcting for inflation, the $500 would be multiplied by 1.417.

Under the system proposed in the Note cited in the preceding footnote, computations for the first year would be the same, (1000 x 1.2/1.2)/10. For the second year, taxpayer’s $900 adjusted basis would be multiplied by 1.3./1.2 or 1.083 which would equal $974.70, then divided by 9 to determine depreciation which would yield 108.30. For the third year, taxpayer’s $866.40 adjusted basis would be multiplied by 1.4/1.3 = 1.077 to produce $933.11, then divided by 8 to determine depreciation of $116.64. Remaining computations are left to the reader.

Both sets of computations ignore inflation in the first year, for simplicity. Such within-the-year inflation would be handled either by using an average index for the year or by using the midyear index. The base index would be the index for the month the asset was acquired. Thus in this case, if the asset were purchased in January when the index was 1.15, 1.15 would
double benefit from this inflation correction. Of the total cost or basis of the property, a portion will have been deducted each year as depreciation, and each year's portion will have been corrected for the inflation which had occurred between the year of purchase and that year. The remainder of the cost or basis, which remainder has not earlier been used as depreciation, will be corrected for inflation between the year of purchase and the year of sale and set off against the amount realized to determine gain or loss. Thus, each portion of the basis is used once, whether as a depreciation deduction or as an offset to the amount realized, and each portion is corrected for the amount of inflation which occurred between the time of purchase and the time that portion is used. To deny the inflation correction either to sales or depreciation would result in a misstatement of that type of income or loss, and might cause distortion of normal business transactions as persons attempted to recast them so that more of the basis could be used in an inflation-corrected manner.

Depreciation provisions currently in effect seem intended to provide some relief from inflation. Although the most generous depreciation provisions are reserved for new property by Section 167(b) and (j), and thus seem in large part to be intended as subsidies, used personal property may be depreciated according to the 150% declining balance method under Treas. Reg. § 1.167(b)-0(b), and used residential real property according to the 125% declining balance method under Section 167(j)(5). Since these accelerated methods were introduced during the inflation of the 1940's, it would appear that infla-

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The two major accelerated depreciation methods are double declining balance (DDB) and sum of the years digits (SYD), authorized by ¶¶ (2) and (3) of Section 167(b). In comparison to the straight line method, which provides equal annual depreciation deductions, these two methods result in larger deductions in the early years but smaller deductions in later years. If property purchased for $10,000 had a useful life of five years and a salvage value of $2,000, 20% of the depreciable amount ($10,000 cost minus $2,000 salvage equals $8,000 depreciable amount), or $1,600, would be deducted each year under the straight line method.

Under DDB, 40% of the depreciable amount (in this case cost, not reduced by salvage value, but the property could not be depreciated below salvage) would be deducted the first year (40% of $10,000 = $4,000). The second year, 40% of the remaining depreciable amount ($10,000 - $4,000 = $6,000), or $2,400, would be deducted, etc. Rather than using double or 200% of the straight line rate, other multiples such as 150% or 125% could be used. See generally Treas. Reg. § 1.167(b)-(2).

Under SYD, each year's depreciation is based on a fraction: the denominator is the sum of the digits in the asset's useful life (here, 1 + 2 + 3 + 4 + 5 = 15); the numerator the first year is the useful life, and each year is reduced by one (here, 5 the first year, then 4, etc.). The fraction is multiplied by the asset's depreciable amount—which, like straight line and unlike double declining balance, is cost minus salvage value (here, $8,000). Thus, under SYD the depreciation the first year would be $8,000 x 5/15 = $3,333.33; the second year it would be $8,000 x 4/15 = $2,133.33, etc. See generally Treas. Reg. § 1.167(b)-3.
tion relief was a part of their purpose.

The inflation relief is indirect and imprecise, however. Part of the relief is that depreciation deductions under these accelerated methods are permitted in years earlier than they would otherwise be allowed, so that there will have been less opportunity for inflation to occur. That is, inflation's effects are reduced if depreciation deductions which would normally be allowable in the fifth year, after they have been eroded by five years' inflation relative to the income from which they are being deducted, are instead "accelerated" from the fifth year to the third, and are eroded by only three years' inflation. Probably more important, by giving the taxpayer depreciation deductions more rapidly than they should accrue, the taxpayer is in effect being given an interest-free loan of the amount of taxes which would otherwise be due on the income sheltered by the premature depreciation deductions. The value of this interest-free loan in some measure compensates for the fact that the real value of the depreciation deductions as reduced by inflation is less than the real value of the amount invested.

As an inflation correction, this procedure leaves much to be desired. It is available equally whether the value of the dollar is rising,

49. It seems clear that presently authorized methods of computing depreciation deductions are more generous than economic depreciation would indicate. As to real property, Taubman & Rasche, Economic and Tax Depreciation of Office Buildings, 22 NAT. TAX. J. 334 (1969), conclude on the basis of both theoretical and empirical studies that economic useful lives of office buildings are generally longer than the 1962 Guidelines suggest, and that straight line depreciation, let alone accelerated depreciation, is excessive. They later reached similar conclusions for apartment buildings, TAUBMAN & RASCHE, SUBSIDIES, TAX LAW, AND REAL ESTATE ECONOMICS, ECONOMICS OF FEDERAL SUBSIDY PROGRAMS, TAX SUBSIDIES, JOINT ECONOMIC COMM., 93rd Cong., 2nd Sess. 343 (1972). It has been suggested that depreciation deductions should be allocated so as to produce a constant rate of return on unamortized investment, in which case depreciation deductions would resemble the portion of a level-payment mortgage amortization allocable to principal, low at first and then rising. Kurtz, Real Estate Tax Shelter—A Postscript, 26 NAT. TAX. J. 341, 342-43 (1973). This approach is proper only if the net income before depreciation is constant, which might not be the case, as an older building might command lower rents or have higher maintenance costs.

Useful lives for depreciable personal property seem also to be generously short. The 1962 Guidelines, Rev. Proc. 62-21, 1962-2 C.B. 418, as amended, in assigning useful lives, used the 30th or lower percentile of what surveys indicated were actual industry practices, so that 70% or more of the assets were used longer than their guideline's "useful life." See 3 TAX REFORM HEARINGS, HOUSE WAYS AND MEANS COMM., 93rd Cong., 1st Sess. 412, 427 (1973) (appendix to statement by Martin David). These already short lives may be further shortened by 20% under the Asset Depreciation Range (ADR) system, authorized by Section 167(m) and Treas. Reg. § 1.167(a)-11. For example, a 1960 IRS survey found a mean life for assets in the textile industry of 17.9 years, the guideline life was set at 13.3 years, lowered by ADR to 10.6. A recent survey showed mean lives of 17.2 years, barely changed since 1960, but the guideline life was lowered to 10.3 years, further lowered by ADR to 8.2 years—less that half the mean life determined by survey. See Sunley, Treasury and ADR: Generous Treatment for Textiles, Tax NOTES 3 (16 Aug., 1976). Of course, past practice is not a certain guide for the future.
falling, or constant, and its value is dependent on the taxpayer's marginal tax rate. Existence of such accelerated depreciation provisions requires that property be priced in the market as two different assets—the physical or economic property, plus the tax shelter. Because the tax shelter is most valuable to those with high incomes, the system tends to push the price of property ownership above what the small investor or entrepreneur can afford, since to get the physical or economic property on which he might be able to earn a reasonable return he must also purchase the tax shelter which may have little or no value to him.\textsuperscript{50}

Moreover, although this system provides tax benefits early in the life of the property, these must be offset against the extra tax costs when, in effect, the interest-free loan becomes due. For example, an apartment building when new might produce a tax loss, due to large depreciation and interest deductions, but yield a cash profit (e.g., the cash received in rental payments exceeds cash expenditures such as mortgage payments, utilities, etc.) which may be received free of tax. Later, however, as depreciation deductions decline and as that part of the payments on the mortgage which is deductible interest declines relative to the part which is non-deductible principal, the building may operate at a tax profit in excess of the cash profit, and in extreme cases might even produce tax liability for a high tax-bracket owner in excess of the cash profit. Since these increased tax costs of owning the building may be reduced by selling the property,\textsuperscript{51} the system may encourage more rapid turn-over of property than other economic and business factors might indicate. Excessive turn-over may weaken continuity useful to the society and the economy; purchasing property with the expectation of a relatively short holding-period may tend to

\textsuperscript{50} For a study of how the owner's tax bracket affects the rate of return on real property, see McKee, \textit{The Real Estate Tax Shelter: A Computerized Exposé}, 57 U. Va. L. Rev. 521 (1971). The disparity between cost of construction and value according to capitalization of income, which troubled the courts in Joseph E. Seagram & Sons, Inc. v. Tax Comm'n, 18 App. Div.2d 109, 238 N.Y.S.2d 228 (1963), \textit{aff'd} (4-3), 14 N.Y.2d 314, 251 N.Y.S.2d 460, 200 N.E.2d 447 (1964), might have been reduced or eliminated if tax shelter effects had been considered.

\textsuperscript{51} For personal property Section 1245 will recapture all gain, up to total depreciation taken since the appropriate effective date, as ordinary income rather than capital gain. Thus, for personal property, a sale may require full repayment of the interest-free loan. For buildings, however, Section 1250 only recaptures gain attributable to the excess of accelerated depreciation over straight line, and the amount of this excess subject to recapture may be reduced as provided in subparagraphs (1)(B), (2)(B), or (3)(B) of Section 1250(a), depending on when the depreciation deductions were taken, on the type of property, and on the holding period. Thus, for buildings, a sale might require only half the interest-free loan to be repaid.

An alternative means of avoiding repaying the loan is to buy another asset, and use its excess depreciation to shelter the now-overstated income of the first.
cause inadequate maintenance and repair.

With the proposed inflation correction, it should be possible to eliminate all existing methods of accelerated depreciation. These accelerated methods would include both those based on unreasonably short useful lives—such as the 1962 Guidelines and the 1971 Asset Depreciation Range system—and those based on unusual methods of computing depreciation—such as declining balance and sum-of-the-years'-digits permitted by Section 167(b). To the extent that accelerated depreciation might be justified as a subsidy, that function would seem better performed by other mechanisms such as the investment tax credit authorized by Sections 38 and 46-50.

The inflation correction for depreciation proposed here, coupled with the elimination of accelerated methods of determining depreciation, would avoid these problems. It would be geared to inflation, not to the property owner's tax bracket. By accurately reflecting real depreciation, the proposed correction would avoid penalizing long-

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52. Penick, Inflation, Inventories and Related Accounting Matters, 52 Taxes 733, 743-44 (1974), argues that accelerated depreciation and the investment tax credit have barely kept pace with inflation. He relied on Commerce Department estimates that real depreciation exceeded tax depreciation between 1954 and 1971 by $35 billion, producing excess tax of $16 billion, which approximately equaled the investment tax credit for the same period, $15.5 billion. It should be noted, however, that during this period accelerated depreciation was accelerating with the 1962 guidelines and the 1971 asset depreciation range, and the investment tax credit was in effect for only parts of period. Moreover, the Commerce Department estimates do not allow for the deferral advantage of accelerated depreciation.

54. Section 167(m), Treas. Reg. § 1.167(a)-11.
55. Several studies cast doubt on whether tax subsidies to investment are efficient. Brazer, Tax Policy and Capital Formation: A Look at the Record, Tax Notes 7 (Sept. 8, 1975), summarizes several studies of the effect of accelerated depreciation and the investment tax credit. The most favorable estimated that each dollar of lost revenue produced one dollar of new investment, the least favorable, ten cents of new investment. See also Arnold, Investment Credit Rise Has Had Little Impact on Economy So Far, Wall St. J., Aug. 11, 1976, at 1, col. 6; Eisner, Business Investment Preferences, 42 Geo. Wash. L. Rev. 486, 493 (1974) (suggesting increased investment is probably less than the revenue lost through such subsidies as accelerated depreciation and the investment tax credit). E. Brown, Weakness of Accelerated Depreciation as an Investment Stimulus, Tax Policy for Econ. Growth and Stability, 84th Cong., 1st Sess. 495 (Joint Comm. Print 1955). The problem may be that while these tax subsidies do stimulate some new investment by increasing the rate of return, much of the subsidy will go to investment which would have been made without the subsidy. For example, if investment without any subsidy would total $100, and a 10% subsidy would produce an additional $10 investment, the total investment would then be $110, the total subsidy $11, $1 more than the additional investment.

Moreover, it has been suggested that, as our economy switches from manufacturing to services, investment in research and development or in human capital through improved public health and education may be more productive than investment in machines and buildings. See, e.g., A. Hanson, Economic Stability and Growth, Federal Tax Policy for Economic Growth and Stability Joint Econ. Comm., Subcomm. on Tax Policy, 83rd Cong., 1st Sess. 14 (1955).
term property ownership. No longer would property be composed of separate economic and tax assets.

Turning to transition problems—how should property, held at the time the proposed inflation correction and elimination of accelerated depreciation are implemented, be treated? When depreciation rules for buildings were made less generous by the 1969 Tax Reform Act, the old rules were left in effect for owners of existing structures. \(^{56}\) This "grandfathering" protects the expectations of those who invested under the old rules in reliance on the more generous depreciation then available. Similar "grandfathering" might be appropriate if the proposals made here are enacted: the accelerated methods could continue to be used on existing property so long as it is retained by the person owning it on the date of enactment or other effective date, but no inflation correction would be allowed. Owners of existing property who converted to the new system—straight-line depreciation and more realistic useful lives—would be permitted an inflation correction for the adjusted basis of the property as of the date of conversion and for future depreciation.

One might want to apply an inflation correction to past depreciation deductions taken before the effective date of these proposed reforms. Those deductions might be deflated to the date of purchase and then subtracted from the purchase price to determine the adjusted basis, which would be subject to inflation correction in determining future depreciation and gain on sale. For example, if property had been purchased for $1,000 and, prior to the effective date of these reforms, $400 in depreciation deductions had been taken, those deductions might have been worth only $300 if restated in terms of purchase date dollars, so the adjusted basis might be treated as $700 rather than $600. This seems undesirable, however. First, it would introduce yet another set of computations. Second, under our tax system's annual accounting period, there is considerable reluctance to redetermine prior years' tax problems. \(^{57}\) Although that principle does not cover this case, by analogy it would not seem generally unfair to say that inflation correction will be applied only to basis existing on or created after the effective date: those who

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56. Section 167(j)(3). It should be noted, however, that the case for grandfathering is weaker under the proposed reform than it was when accelerated depreciation of buildings was restricted by the 1969 Tax Reform Act. There, the change only removed a tax benefit; here, while the tax benefit of accelerated depreciation is being removed, another benefit, inflation correction, is being created.

57. See, e.g., United States v. Lewis, 340 U.S. 590 (1951) (now modified by Section 1341); Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399 (Ct. Cl. 1967).
earlier sold property, or earlier took depreciation deductions, cannot have the correction. Finally, although those depreciation deductions would not be worth as much as the equivalent dollars used to purchase the property, in many cases those deductions will have exceeded the deductions which would be allowable under realistic, inflation-corrected depreciation, so that the taxpayer has been receiving the benefits of the interest-free loan discussed above.

Another transition problem is that property owners making this conversion in many cases will have taken more depreciation than they should have under the straight-line method over a realistic useful life. Rather than being denied any depreciation for a few years until the point is reached that the property's adjusted basis is what it would have been under more realistic depreciation,58 the property owner should be permitted to allocate his adjusted basis over the property's remaining useful life, much as is now done when changing from declining balance to straight-line depreciation.59

This proposed change in allowable depreciation will produce offsetting revenue effects of uncertain relative magnitude: depreciation deductions will increase (and thus income and taxes will decrease) as depreciation is corrected for inflation, but decrease as the accelerated methods are eliminated.

4. Loans. Lending transactions are of course heavily influenced by inflation. Both borrower and lender operate with knowledge that the loan will be repaid with dollars worth less than those borrowed. Interest rates reflect this expectation of inflation. Current interest rates would appear to be in larger part an inflation correction than a payment for the use of money. For example, A might consider lending B $100 to be repaid at the end of one year with interest. If A expects inflation of 6% during the year, he should regard a 6% interest rate as the minimum required if he is to get back money worth as much as he loaned, and of course he would seek a higher rate to compensate him for the use of his money and for assuming the risk that B would not repay the loan. If B also expects a 6% inflation rate, B should regard a 6% interest rate as being in real terms an interest-

58. For example, if in 4 years taxpayer had taken $600 depreciation on a $1000 asset, but under realistic depreciation he would use straight-line over a 10 year life, taxpayer might be denied any depreciation until after the sixth year, when his existing $400 adjusted basis would equal what it would have been under more realistic depreciation, at which point he could begin taking annual depreciation of $100, which would then be adjusted for inflation.

59. Section 167(e)(1), Treas. Reg. § 1.167(e)-1(b). Taking the example in the previous footnote, taxpayer would spread his $400 adjusted basis over the 6 remaining years of useful life, and be entitled to annual depreciation deductions of $66.67, which would then be corrected for inflation.
free loan, because due to inflation the $106 he repays will be worth
the same amount as the $100 he borrowed. Of course B, like any
borrower, would prefer a lower interest rate, but if necessary he is
likely to be willing to pay a higher interest rate, only the amount in
excess of 6% being the real price for the use of money. If A and B
agree to an interest rate of 8%, three-quarters of the interest rate is
inflation correction and only one-quarter is the price of the use of
money.

But the intervention of the tax code complicates adjustment of
the interest rates as a negotiated inflation correction. All of the inter-
est payments are considered income to the lender, the part which is
an inflation correction as well as the part which is the price of the
use of money. If the lender is to recover the real amount of the loan
tax-free, the portion of the interest payment which is an inflation
correction would need to be large enough so that, after payment of
tax on that portion, the residue equals the inflation rate. The bor-
rrower, on the other hand, is entitled to deduct all interest paid, includ-
ing the inflation correction portion, and recognizes no income even
though he is repaying the loan in cheaper dollars than he borrowed.
Continuing the example at the end of the preceding paragraph, if A
and B are each in a 33% tax bracket, the inflation correction portion
of the interest payment would have to be 9% (more than the total
interest rate in that example). A, after paying a 33% tax, would net
6% of the 9% inflation correction; B, by deducting the 9% and thus
saving one-third of that amount by reducing his taxes, would be out
of pocket only 6%. But only if the agreed interest rate exceeds 9%
does A have any real after-tax return on his money, or B any real
after-tax cost in borrowing. The matter is, of course, further compli-
cated if A and B are in different tax brackets.

The interaction of inflation and the present tax system would
seem to discourage lending, while encouraging borrowing, with a
consequent increase in interest rates due to decreased supply and
increased demand. Exploring the magnitude of this effect and how it
might differ among borrowers and lenders in high and low tax brack-
ets is beyond the scope of this article. For our purposes it is sufficient
to note that the interaction of inflation and the present tax system
may cause economic distortion. Our major concern is accurate state-
ment of income. To the extent that a lender is taxed on that portion
of the interest received which merely equals the inflation rate, he is
being taxed on inflation rather than real income. Similarly, a bor-
rrower in deducting interest will, during a period of inflation, be de-
ducting inflation rather than real expense. This section outlines
changes in our tax system's present treatment of interest and borrow-
ing which will correct for inflation.

The tax system might correct for inflation in loans by adjusting either the principal or the interest. The inflation correction could be delayed until repayment of principal, which would be treated much like a sale: for the lender the amount loaned would be the basis, which would be corrected for inflation, and compared to the amount repaid, treated as the amount realized to determine loss (in a period of inflation) or gain (in a period of deflation); for the borrower, any loss to the lender as determined above would be gain, and any gain, loss. Interest would not be corrected for inflation, if principal were. This approach, however, would delay the inflation correction until the loan is repaid, rather than correcting for inflation as it occurs. Moreover, the correction would have to be applied frequently in the common loan pattern in which there are monthly payments of both principal and interest. Thus, it would probably be better to make the correction currently as interest is paid and received. The inflation rate would be subtracted from the interest rate, with only the difference treated as interest, deductible by the borrower and includable in the income of the lender. The remainder would be considered, which as a matter of economics it is, a repayment of principal. If the interest rate were less than the inflation rate in a particular year, the borrower would have income, and the lender a loss. If the inflation correction is applied to interest it would not be applied to principal.

In general, this proposed inflation correction may have a neutral impact on tax revenues, with reduced taxes for lenders being offset by increased taxes for borrowers. Revenues might be reduced, however, if lenders are generally in higher tax brackets than borrowers, or if smaller interest deductions caused many individuals to use the standard deduction, so that the decrease in interest deductions might not cause a corresponding increase in taxable income. Moreover,

60. Original issue discount on corporate bonds is ratably recognized for tax purposes under Section 1232. See note 103 infra.  
61. Thus, if the interest rate on a loan were 8% during a year in which the inflation rate was 6%, only one-quarter of the interest paid or accrued would be deductible by the borrower or taxable to the lender. When the taxpayer has many separate loans, the computation might be done in the aggregate: the inflation rate times the average balance would be deducted by the lender and includable in the borrower’s income; and interest payments would be treated as they are now. While one might hesitate to impose such computations on millions of citizens with small savings account interest income or home mortgage interest deductions, the computations for most such persons could be easily done by the bank or other savings or lending institution involved.  
62. For example, an individual who now has $4,000 in interest deductions, but who would have a deduction of only $1,000 if the interest were corrected for inflation, might find it advantageous to take the standard deduction allowed by Section 141 of up to $3,200, so that
while holders of federal obligations (and, if the taxable bond option
should be enacted, holders of taxable state and local obligations)
will pay lower taxes if interest is corrected for inflation, there will be
no offsetting revenue increase since the borrowers in regard to those
obligations are tax-exempt government entities. Such revenue losses
must, however, be considered in the context of the numerous revenue
changes which will occur if the many proposals advanced in this
article are adopted. When the overall net revenue change is
determined, an adjustment in tax rates may be appropriate.

As a transition measure, interest on loans outstanding when the
inflation correction for loans proposed here is implemented might be
exempted from the correction, to preserve the parties’ bargain as
made in light of the present tax system. That could produce substan-
tial complication, however, as loans for periods in excess of thirty
years—such as home mortgages and some corporate bonds—are
not uncommon. Since the parties assumed substantial risks in esti-
mating future inflation, subjecting them to the additional risk of
major changes in the tax system does not seem unfair. Accordingly,
it would seem best to apply the correction to all interest—that on pre-
xisting as well as future loans.

Adjusting loans for inflation will interact with adjusting basis for
inflation, both for computing gain or loss on sales and for determin-
ing depreciation, when property is acquired in part through a mort-
gage. Without any inflation correction to either the property or the
loan, the purchaser is over-taxed on the property, because the total
of the amount which he may receive free of tax—whether as deprecia-
tion deductions taken against the income from the property (or other
income), or as adjusted basis to reduce the amount of gain recognized
on sale of the property—will be less than his real (inflation-corrected)
cost of the property. But he is under-taxed on the loan, because he

the inflation correction would increase his income only $800 rather than $3,000, if he had few
other itemized deductions.

63. At present, the interest paid on state and municipal obligations is in general exempt
from federal income taxation under Section 103, which results in the interest paid on such
obligations being lower than the interest rate for similar corporate securities. The taxable bond
option would give state and local governments the option of receiving partial payment of their
interest costs by the federal government. In exchange for the subsidy, the interest on the state
and local government obligations would be subject to federal income taxation. See S. SURREY,
PATHWAYS TO TAX REFORM 210-22 (1973), for a description of how the taxable bond option
was defeated in 1969, and of developments since.

63.5. Parker, Inflation’s Impact on Corporate Tax Rates, 54 TAXES 580 (1976), esti-
imated the effects on income of correcting depreciation, inventories, and loans for inflation, for
1,050 corporations in 1974. Although in total the change was slight, income changed by more
than 25% for 419 corporations—increasing for 158 and decreasing for 261.
need not recognize the release of indebtedness which occurs as he pays the loan in dollars worth less than those he borrowed. For example, a taxpayer might borrow $1000, use it to buy land, then at the end of one year during which there has been 10% inflation sell the land for $1000 and use the proceeds to repay the loan. He has sustained a real loss on the land, because the dollars paid for it would be worth $1100 at the time of sale if corrected for inflation. However, he has realized a real gain on the loan, because the dollars he borrowed would be worth $1100 at the time of repayment if corrected for inflation. (The interest payments made on the loan will have been deducted, so they do not enter into consideration of this problem.) These effects are equal and opposite, to the extent of the mortgage, so theoretically they could be ignored, with inflation correction allowed only from the time the mortgage is paid.

That approach, however, would be hard to administer. Seldom does the mortgage equal the entire cost of the property, so even if inflation correction were not made to the mortgage or to the property up to the amount of the mortgage, it would have to be made to that portion of the cost of the property in excess of the mortgage, with two separate depreciation computations. Moreover, mortgages normally are not paid off in one lump sum; rather there will often be a series of uniform payments, each consisting of part interest and part principal, with the ratio of interest to principal changing. Such principal repayment would require a series of depreciation computations in regard to each asset—one for the mortgaged portion, one for the never-mortgaged portion, and an additional computation in regard to each payment of principal. It seems much simpler to treat the property and the mortgage separately in making inflation corrections: the basis in the property against which inflation corrections will be made will be the stated purchase price; the time from which those corrections will be measured will be the date of purchase; and the fact that the property was not paid for until later will be taken into account by an inflation correction applied to the loan.

Property purchased with a mortgage, before the changes proposed here are implemented, will pose the problem discussed in the prior paragraph in a form less easily resolved. To use the purchase price and the purchase date as the basis for an inflation correction in such circumstances may appear to give the taxpayer a windfall, because the mortgage payments were not made with the relatively expensive dollars existing at the time of purchase but with the relatively cheaper dollars of the later dates when the mortgage was repaid. To illustrate this problem, taxpayer might have bought property for $1000 three years before the suggested reform using a mortgage, paid
off the mortgage the year before the reform after 20% inflation had occurred, and then sold the property the year after the reform, after an additional 10% inflation had occurred. To treat him as having purchased the property with dollars as of the purchase date—dollars 30% more valuable than sale-date dollars—distorts reality, because the dollars were not paid then but rather two years later, and the dollars paid were only 10% more valuable than sale-date dollars.

There are two approaches to this problem. One could ignore the problem and let the taxpayer have the windfall, an approach that has the advantage of simplicity.\textsuperscript{64} Such a taxpayer, after all, is little different from some other person who borrowed the purchase price using other property as security rather than mortgaging the purchased property. This simple approach to the problem could be rationalized by noting that what might appear to be a windfall in regard to the property when the adjusted basis is being corrected for inflation after implementation of the reform, is actually the type of pre-reform windfall which all borrowers had in not recognizing income when the loan was repaid with dollars worth less than the dollars borrowed. Using the example in the prior paragraph, the taxpayer's windfall took place when 20% inflation occurred between purchase and mortgage repayment, before the reform—it did not occur after the reform when his adjusted basis was determined as if he had paid dollars 30% more valuable than current dollars, though the dollars he actually paid were only 10% more valuable. Determining when the windfall occurs may not be logically possible, so the question might have to be resolved on a more pragmatic basis—by balancing revenue loss against costs of complication.

If it is determined that the windfall is post-reform and that it should not be allowed, the appropriate remedy is to deflate each principal payment from its value in dollars at the time it is paid, to its value in dollars at the time of purchase, and treat the sum of such deflated payments and cash paid at the time of purchase as the basis. Using the example above, the mortgage repayment dollars would be deflated to the purchase date by multiplying them by 1/1.2, then inflated to the sale date by multiplying them by 1.3/1. In this case, where the entire property was purchased with a mortgage which was repaid at one time, it would be simpler to treat the mortgage repayment date as the purchase date and use the ratio 1.3/1.2 to inflate those dollars to match the sales dollars. The footnote shows sample

\textsuperscript{64} This approach would be analogous to the suggestion in section II A 3 of this article, \textit{supra}, that past depreciation deductions not be corrected for inflation.
computations involving both a down payment and periodic payments on the mortgage. The process could be simplified by arbitrarily selecting the inflation index for the time when half the mortgage has been paid, and applying that index to deflate all mortgage payments to the purchase date, adding the down payment, then inflating the total. If there were still a balance outstanding on the mortgage when the proposed revision took effect, that too would be deflated from the effective date of the new system to the purchase date; that balance would be treated as a loan made on the effective date and subject thereafter to inflation correction like other loans. The basis so computed would be the limit on allowable depreciation: if past depreciation exceeded this amount, no further depreciation would be allowable, but the excess need not be retroactively disallowed, as it was allowable when taken. If past depreciation did not exceed this amount, the taxpayer could either continue his past method of depreciation until his basis was exhausted, or spread the remainder over the asset’s remaining useful life, with the amounts thus allowable for each year adjusted for inflation which occurred between the year of purchase and the year the depreciation is allowable.

5. Departures from Annual Accounting

In a variety of ways, the tax system permits departures from the normally required annual accounting period. For example, net operating losses may normally be carried back three years and forward seven, the investment tax credit may be carried back three years and forward seven, capital losses may be carried back three years and forward five for corporations and carried forward indefinitely for

<table>
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<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
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<td>100</td>
<td>100</td>
<td>100</td>
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<td>1.3</td>
<td>1.4</td>
<td>1.5</td>
<td>1.6</td>
<td>1.7</td>
<td></td>
</tr>
<tr>
<td>Deflation Ratio</td>
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<td>1.2/1.3</td>
<td>1.2/1.4</td>
<td>1.2/1.5</td>
<td>1.2/1.6</td>
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<tr>
<td>Deflated Amount</td>
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<td>89.71</td>
<td>80</td>
<td>75</td>
<td>70.59</td>
<td>903.6</td>
</tr>
</tbody>
</table>

66. See text and accompanying notes 56-59 supra.
67. See Section 172.
68. See Section 46(b).
individuals, certain charitable contributions may be carried forward five years, certain items included in income under claim of right may later be excluded if repaid, recovery of a prior deduction may be taxable only to the extent of that portion of the deduction which produced a tax benefit, and fluctuating income may be averaged. The inflation correction should be applied for each of the provisions. In carrying back a net operating loss, for example, the loss would be deflated to correspond to the value of the dollar in the year to which it was carried back. As the remainder of the loss not used in that year was carried forward, that remainder would then be inflated to correspond to the value of the dollar in the year it was used. If in successive years the inflation index were 1, 1.1, 1.2, 1.3., a loss in the fourth year would be multiplied by 1/1.3 when carried to the first year, and the excess carried from the first year to the second would be multiplied by 1.1/1, etc.

Inflation could become so severe that it would be necessary to determine at what point within the year income was received. For example, if in one year the dollar were worth $1.00 on January 1, $0.50 on June 30, and $0.25 on December 31, a constant weekly salary would be four times more valuable if received at the start of the year than at the end. With such inflation, it might be possible to index according to when income was received, or the annual accounting system could be replaced by monthly or weekly accounting, with of course appropriate changes in the rate structure and generous averaging and carryover provisions.

6. Mechanics

Implementing the inflation corrections will create some technical problems.

Over short periods of time it may be that too little inflation will occur to justify the expense of computing the inflation correction. It might be that an inflation correction would be made only for transactions spread over a year or more. Or it might be better to state the minimum period for inflation correction not in terms of time

69. See Section 1212.
70. See Section 170(d).
71. See Section 1341.
72. See Section 111.
73. See Sections 1301-05.
75. Cf. Treas. Reg. § 1.1232-3A(b)(2) .
but rather in terms of the inflation which has occurred: for example, the period might be that in which 3% inflation occurs. During times of severe inflation or deflation the correction might be available for transactions covering less than six months, whereas in more stable periods the minimum period might be two or three years. On the other hand, having such a restriction will likely cause transactions to be accelerated or deferred to achieve a tax benefit, an undesirable distortion. Also, a taxpayer who engages in a series of short-term transactions, such as a retailer whose inventory turns over rapidly or a maker of short-term loans, is having his income distorted by inflation. This would suggest that the period over which inflation will be ignored for administrative convenience should be very short, such as a month. Inflation correction might even be permitted for transactions covering less than that period, through use of an annual index. For example, a retailer whose inventory, on the average, turned over twice a month in a year in which the average annual inflation rate was 12% might be permitted to increase his cost of goods sold by 1/2%. While this correction might appear too small to be worth making, in a high-volume, low-margin business it could have a substantial impact on the computation of net income.

Choosing the appropriate index for inflation is difficult, because the value of dollars used to purchase some property or services may change more than the value of dollars used to purchase other properties or services. Put another way, the prices of some things change more than do the prices of other things. Accordingly, one might adopt different indexes for different types of transactions, but to do so would have two major drawbacks. First, such a system of multiple indexes would be difficult to administer. Lines between transactions using different indexes would have to be defined and policed. If the index were based, not on the transaction producing the dollars, but on the use to which those dollars were put, additional problems of tracing would be created. Second, a system of multiple indexes would tend to exempt appreciation from the income tax. An increase in the market price of buildings may seem to be inflation to a person contemplating buying one, but to the person already owning a building that price rise may be appreciation. Accordingly, it seems best to measure inflation according to one index rather than to use multiple indexes.

There are three major general inflation indexes available, the Wholesale Price Index (WPI), the Consumer Price Index (CPI), and
the Gross National Product Implicit Price Deflator (IPD).\textsuperscript{76} The WPI has two major defects as a general inflation index: it is based only on prices of commodities, whereas much of our economy's output is services, and it is based on bulk sales rather than on retail transactions. Because the WPI covers so small a part of our economy, it may not accurately reflect the value of the dollar generally.

The CPI is a measure of the cost of consumption goods and services for an urban wage earner or clerical worker. A survey is made to determine how much such persons spend on particular consumption—for example, 25% of their consumption expenditures might be for housing, 40% for food, 15% for clothing, 10% for recreation, 5% for medical care, etc. Changes in the prices of these goods will be weighted according to the percentage of total consumption the survey showed them to constitute in order to determine the cost of living. Thus, the CPI is not a general index of the cost of consumption, because it is weighted according to the consumption pattern of urban wage earners and clerical workers, whose consumption patterns may differ from those of other people. And, it may become inaccurate even as to those it is intended to cover, because their patterns of consumption may, over a number of years, shift significantly from those shown by the survey.

The IPD is the broadest inflation index. It is obtained by dividing the current cost of everything included in the Gross National Product by that cost expressed in constant dollars. Thus it reflects changes in price weighted according to what is currently produced, rather than being weighted according to amounts produced in some earlier period. While this might not satisfy an academic desire for tidiness, it would seem to present a more accurate indication of the worth of the dollar at any particular time. Its defects as a general inflation index are that it includes government expenditures—which are not a direct cost to persons in the society—and investment expenditures. Increases in the price of investment goods such as buildings and machinery need not be inflationary. With the value of such goods often being determined by capitalizing the income they produce, one would generally expect that if that income were to double, their value would double. But whether this increase in value represents an increase in real value or productivity, or merely inflation.

\textsuperscript{76} The WPI and CPI are described in Statistical Abstract of the United States 1976 at 431, and the IPD is described in \textit{id.} at 391. Table number 700, \textit{id.} at 433, compares inflation as measured by each of these indexes for the years 1961 through 1975. A comparison of these indexes for the years 1916 through 1971 may be found in Committee on Sales, Price-Level Basis Adjustment—A Modest Proposal, 26 Tax Lawyer 189, 210-11 (1972).
tion would seem to depend on what one could purchase with the dollars of income being produced. Because the change in value of any investment will contain this uncertainty, it seems necessary to determine the worth of dollars by the amount of consumer goods and services they will buy. This would suggest that the appropriate inflation index is either the CPI or that portion of the IPD attributable to personal consumption expenditures.77

Another problem is the possibility that available inflation indexes overstate inflation as they measure not only changes in the cost of living but also improvements in the quality of life. For example, the price of tomatoes might rise because of inflation or a decline in the value of the dollar, but it might also rise because tomatoes are fresher, more pleasingly shaped or colored, more nutritious, freer of insects or chemicals—in short, better. Whether improved indexes could be developed to reflect inflation more accurately would seem a matter best left to econometricians. The possibility that the index is measuring a rise in the quality of life as well as in the cost of living could be roughly corrected by disregarding that percentage of the rise in the index, such as one-half or one-quarter, or that amount of the rise in the index, such as 1% or 2%, which according to the state of the art seems to correspond to the improvement of the quality of life, with the percentage or amount subject to periodic redetermination, recognizing that this approach must be somewhat arbitrary. Taxpayers need not be concerned with selection of the proper index or the appropriate amount to discount it, as these questions will be decided legislatively or administratively.

Putting in an inflation correction such as is outlined here would ease the transition to a system which would not give preference to capital gains. If capital gains were eliminated and no other changes were made, it would probably be necessary to retain the preference for existing appreciation, as a matter of fairness and protecting expectations the Code has created and as a matter of legislative and political practicality. That, in turn, would require either valuing all property—a staggering undertaking—or using the sort of crude adjustment Congress adopted in prospectively eliminating the step-up basis at death. If, however, elimination of the capital gains preference were coupled with allowance of an inflation correction, the amount

77. See Table number 701 in Statistical Abstract of the United States at 433. For other discussions of the appropriate index, see Committee on Sales, Price-Level Basis Adjustment—A Modest Proposal, 26 Tax Lawyer 189, 209 (1972); McDonald, Inflation: Concepts of Income Tax Reform, 28 Tax Lawyer 533, 547 (1975); Comment, The Feasibility of Adjusting for Inflation in Computing Taxable Income, 49 Wash. L. Rev. 873, 891 (1974).
taken with the first step would, to varying degrees, be offset by the second step so that it would not be inequitable to apply both steps to existing appreciation. Good inflation indexes are available going back several decades. Since the 1920's and 1930's were a long period relatively free of inflation, and most property will have been created or changed hands so as to have its basis determined since that time, it should be administratively feasible to apply the correction to earlier acquired property.

Having a sword with two edges—eliminating the preferential taxation of capital gains but allowing a correction for inflation—is also politically advantageous, because it may divide those now benefiting from capital gains, a formidable opponent of the preference's elimination. While those with substantial gains over relatively short periods will be disadvantaged by these coupled reforms, those whose gains are proportionately smaller or whose holding periods are relatively longer may gain more from the inflation correction than they lose by eliminating capital gains.

B. Rate Structure

The last subsection dealt with the need to correct for inflation in order to state income accurately. This subsection deals with the problem of keeping tax rates constant in real terms in a period of inflation. These are different problems.

Perhaps an example will clarify this difference. Suppose A agreed to lease vacant land to another for a term of five years at an annual rental of $20,000. If between the first year and the fifth year of that lease the inflation index rose from 1.0 to 1.25, A had less real income in the fifth year than he had in the first year. The value of the $20,000 received in the fifth year may be reduced to its equivalent value in the first year by multiplying it by the ratio of the indexes, i.e., \( \frac{1}{1.25} \times 20,000 = 16,000 \). But in the fifth year the income of A is not different from the income of B, who receives rent on vacant land of $20,000 under a month-to-month lease. Each has received, in the fifth year, income in dollars having the same value as all other fifth year dollars. Their incomes may fairly be compared to the incomes of other persons receiving dollars in the fifth year. But doesn't A have a special problem because he is locked into a long-term lease? A may have a problem, but the problem is caused by changes in the

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79. Between 1922 and 1942 the annual average Consumer Price Index ranged between 38.8 and 53.0, using 1967 = 100, the high being 36.6% greater than the low. See note 78 supra.
fair rental value of land, rather than by inflation per se. A is worse off than a landowner without a long-term lease if the fair rental value of land is rising, but better off if that value is falling (relative to rent set in the long-term lease, which will of course reflect the parties’ expectations as to future rental values). But the amount by which he is better or worse off is the same, whether the change in rental value of land is due entirely to changes in the value of the dollar, to changes in real rental value of land, or to some combination of the two. Whatever the changes are, in the year in question he may be receiving a different number of that year’s dollars than are owners of similar land under short-term leases, but that is a situation created by the lease, not by inflation. (Of course, inflation is one of the factors which may cause land rental values to change, but there are many other factors affecting the supply of and demand for rentable vacant land and hence its rental value.) It may be noted that in the example above there is no mention of how the rental value of the land might have changed. This is because our tax system is based on the income which is realized and does not generally concern itself with whether a person’s income is higher or lower than it otherwise might have been, nor—except for averaging and loss carryovers—with whether income is rising or falling. What matters is what income is realized this year in this year’s dollars.

Perhaps the tax system should take into account whether a person’s income is rising or falling: a stream of income might be viewed as a kind of property, whose value is that amount of income capitalized.\textsuperscript{80} For example, if the prevailing interest rate were 10%, someone earning $20,000 annually in rent on vacant land, or for performance of services, or in any other manner, might usefully be considered to own property worth that amount capitalized, or $200,000. If the real value of that income stream is reduced, the value of that property is reduced. Perhaps the tax system should reflect such a change in the value of such property. But the value of the property will be altered by many factors including a change in the capitalization rate, a

\textsuperscript{80} The value of property which produces income may be determined by capitalizing the income expected from the property as indicated by the following equation: \textit{Income/Rate of Return = Value.} For example, if property produces an annual income of $15,000, and if the normal rate of return for property with similar risks is 7.5%, then the value of that property is $15,000/0.075 = $200,000. If the property has a limited useful life, then the rate of return should include not only return on the amount invested, but also return of the amount invested. For example, if property had a useful life of 40 years, 2.5% of the value of that property should be recovered each year. In the example, in addition to a return on investment of 7.5%, there should be a return of investment of 2.5%, for a total rate of return of 10%. The value of the property would then be $15,000/0.10 = $150,000.
change in the anticipated income even though this year’s income has not changed, changes in the number of dollars and changes in the real value of the dollars in the income stream. Such alterations in value might be recognized as part of a system of taxing unrealized appreciation or depreciation such as is discussed in section IV B. For now, however, consideration of this alternative to the present system will be deferred.

Contrast the position of A and B discussed above with that of C, who in the first year of the same five-year period bought two parcels of vacant land for $100,000 each, then in the first year sold one for $120,000 and in the fifth year sold the other for $145,000. In the first year C realized income of $120,000-$100,000 = $20,000; in the fifth year, without any inflation correction, C appears to realize income of $145,000 - $100,000 = $45,000. But the dollars C receives in the fifth year are not worth as much as the dollars he spent in the first year. To determine his real gain, both his purchase price and his sale price should be stated in dollars having the same value. His sale price could be restated in first year dollars, or his purchase price could be restated in fifth year dollars. Since it is his income for the fifth year which must be determined, so that that income can be taxed as are other incomes realized in the fifth year, the proper procedure is to restate his purchase price in fifth year dollars, by multiplying it by the ratio of the indexes, $100,000 x 1.25/1 = $125,000. Thus the income C realizes in the fifth year is $145,000 - $125,000 = $20,000.

Only after an inflation correction has been applied to C’s purchase price can he accurately determine his fifth year income in fifth year dollars. Once C has accurately determined his fifth year income, he then has the same inflation problem that A and B have—how to compare this year’s real income to another year’s real income. C’s first problem is different because, to determine his income, an expenditure in one year must be matched with a receipt in another year; once this problem is solved, his second problem is the same as A’s and B’s. The preceding section dealt with problems like C’s first problem: How can the many different types of income and forms of deductions in our tax system be corrected for inflation so that each person can compute his net income for a particular year in a manner consistent with other persons’ computations of their respective net incomes for that particular year? This section deals with C’s second problem and A’s and B’s problem: How can this year’s net income be compared to another year’s net income in real, inflation-corrected terms? These two types of problems are fundamentally different: to the second we now turn.

A progressive income tax will increase in real terms during a
period of inflation. Suppose, for example, the tax rate was 10% on income up to $5,000 and 20% on income in excess of $5,000. A person with a net income of $8,000 would pay a tax of (10% x $5,000) + (20% x $3,000) = $1,100, or a tax of 13.8% of his total income. Now suppose over a period of ten years the inflation index rises from 1 to 1.6. A person with a net income of $8,000 in the tenth year will still pay a tax of $1,100 or 13.8% of his total income. But this person's post-inflation income, if restated by multiplying it by the ratio of the indexes, 1/1.6, is the real equivalent of only $5,000 in the first year, which would have been taxed at only 10%. A rise in dollar income from $5,000 to $8,000 over the ten years would have produced no increase in real income, but taxes would have increased from 10% of that income to 13.8%, an increase of 38%.

The effect of inflation on a taxpayer in this example of a simplified tax system is similar to inflation's impact on him in our much more complex tax system. Section 1 creates four tax schedules for individuals, each having between 25 and 33 different brackets, and the standard deduction authorized by Section 141 and the deductions for personal and dependency exemptions authorized by Section 151 may be viewed as creating an additional tax bracket subject to a zero percent tax. In addition, there are limits expressed in dollar amounts on an individual taxpayer's deduction of capital losses against ordinary income under Section 1211(b) and on the child care credit under Section 44A as well as on other deductions and credits. In a period of inflation, with the same real income being taxed at higher rates, and the real amounts of certain allowable deductions or credits being reduced, taxes will take an increasing percentage of constant real incomes.81

Whether this inflation-induced tax increase is desirable is a difficult question of values. Such an increase may serve to counter inflation by reducing consumer spending power (unless, of course, government spending increases at the same pace its revenues do). Given the general reluctance of elected officials to propose or approve tax increases, if one believes that there is a need for greater spending in the public sector, such tax increases may be desirable as a matter of practical politics. Tax cuts have often been a part of the price for tax

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81. In a few areas, inflation could decrease taxes. For example, although losses are normally deductible only if incurred in a transaction entered into for profit, Section 165(c)(3) permits an individual to deduct losses of non-business property caused by fire or other casualty, but only to the extent each such loss exceeds $100; inflation, by reducing the real value of that $100 floor, will permit a larger portion of the same real loss to be deducted, so will tend to reduce taxes. In general, however, inflation will increase taxes as a percentage of a constant real income.
reform; if the tax cuts merely counteract inflation-caused tax increases, those tax cuts need not reduce spending in the public sector. Moreover, the periodic tax cuts have generally kept pace with inflation, at least for lower income individuals,82 and as a practical matter it may be simpler to have legislation periodically adjust some of the dollar amounts in the Code for inflation, rather than to annually adjust all such amounts administratively to comply with an automatic inflation correction. On the other hand, a system which relies on public deception is far from our professed ideals. Moreover, one may believe that spending in the public sector should not be increased, or that it should be increased only after deliberately balancing the benefits of a proposed increase against the need for an explicit tax increase. One could go either way on the question of whether to index tax brackets for inflation, based on one's general political philosophy.

If the rate structure and other fixed dollar amounts in the tax code are to be automatically adjusted for inflation, the technique would be analogous to that used to correct the basis of property for inflation. To keep the fixed dollar amounts in the Code in round numbers, the correction should be limited so that it will occur only when it becomes appropriate to reach the next round number. For example, when the inflation index rises from 1.2 to 1.4, each tax bracket and all other fixed dollar amounts in the Code would be multiplied by 1.4/1.2; to preserve round numbers, fixed dollar amounts below $2,000 might be changed only in increments of $100, those between $2,000 and $10,000 in increments of $500, etc. The correction could be made administratively and included in the pamphlets the IRS distributes to taxpayers.

Solving the problem of keeping real tax rates constant in a period of inflation, whether that problem is to be solved legislatively from time to time or by an automatic inflation correction, might be simplified if the Code specified fewer dollar amounts. For example, the $100 floor on casualty losses might be replaced by a floor based on a percentage of adjusted gross income, similar to the floor of 3% of adjusted gross income on medical deductions under Section 213. A similar change was made in 1976 when the child care deduction under Section 214 was replaced by a credit under Section 44A: although both the old deduction and the credit have a fixed dollar ceiling on qualifying child care expenses, the additional ceiling on parental income for the old deduction was a fixed dollar amount of

adjusted gross income, whereas the parental income ceiling for the new credit is based on the lesser of the earned incomes of the two spouses.

III. BUNCHING

As discussed in section I B of this article, the present treatment of capital gains might be justified as a crude remedy for the bunching problem. Briefly summarizing that discussion, a progressive tax system may impose a greater total tax on a person whose income fluctuates over a number of years than on another person who received the same total income over those years in equal annual amounts. For example, a couple with taxable income of $20,000 in each of three years would pay a total of $13,140 in taxes, but if that total taxable income of $60,000 were received as $5,000 in each of two years and $50,000 in the third year, the total tax would be $18,680—42% higher. Appreciating property may create such a bunched income problem. Under the present tax system, gain on appreciating property in general is taxable only when the property is sold or the gain is otherwise realized. Such gain, which might fairly be said to have been earned over the entire period the property was held, will thus all be taxed in one year, producing higher taxes than would have been due had the gain been spread over the holding period. The present treatment of capital gains might be justified as a crude solution to this bunching problem: by exempting half of such gains from tax, it reduces the tax which would otherwise be due when several years’ appreciation is recognized in one year, thus reducing the inequity which bunching may create. But this capital gains form of averaging is very crude: it will frequently over-compensate or occasionally under-compensate for bunching problems; since the holding period required for favorable capital gains treatment is only one year, capital gains “averaging” will be available for transactions in which there is unlikely to be a bunching problem; capital gains “averaging” operates without regard to other income or capital gains in this or other tax years, so may be available although there is no bunching problem; capital gains “averaging” ignores the benefits of deferral, which may exceed the tax cost of bunching.

Sections 1301 to 1305 now permit a taxpayer to average one year’s high income against four prior years’ lower income.\(^{83}\) Averag-

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83. Under Section 1301-05, the taxpayer determines his average taxable income for the four years preceding the high income year. This average is multiplied by 1.2 and subtracted from the high income year’s taxable income. The difference, which must exceed $3,000 for averaging to be available, is then divided by 5. The tax is computed on 1.2 times the average
ing entered our tax system as a series of narrow provisions intended to provide relief to taxpayers with particular bunching problems. General averaging was adopted in a fairly restricted form in 1964, and liberalized in 1969. The existence of these provisions, adopted after the enactment of the preferential tax treatment for capital gains, substantially weakens the bunching problem justification for current capital gains taxation.

Perhaps the averaging provisions should be revised further as part of the elimination of the capital gains preference. The years against which the gain could be averaged might be extended to include all the years the asset was held, if it were held longer than the five years for which averaging is now allowed. A longer averaging period might further reduce taxes, and could be justified on the grounds that income realized when the asset was sold should be spread over all the years the asset was held. Such a further extension of the averaging period, however, would present a variety of problems.

First, averaging should consider other income as well as gain on the asset, lest the individual who regularly realizes capital gain on assets held for substantial periods or who has substantial other income be unnecessarily benefited. An individual, who was in the same tax bracket in the years he wants to include in the averaging period, income for the four prior years and subtracted from the tax on that income plus one-fifth of the excess. The tax for the high income year is the tax on 1.2 times the four-year average income plus five times the difference computed in the preceding sentence. For example, if an individual had annual taxable incomes of $8,000, $9,000, $11,000, $12,000 and $62,000, the average for the four prior years would be $10,000, multiplying by 1.2 would yield $12,000, which subtracted from $62,000 would leave $50,000, which divided by 5 would yield $10,000. The tax under Section 1(a) on $12,000 is $2,260, the tax on $12,000 + $10,000 = $22,000 is $5,020, and the difference is $2,760. Thus the total tax would be $2,260 + (3 x $2,760) = $16,060. Without averaging, the tax would be $23,360. The reduction occurs because, while without averaging the tax rate would go as high as 53%, with averaging the rate does not exceed 32%. The tax saving is of course less dramatic where the earlier years' income is more or the increase in the year to be averaged is less.

This system is not true averaging. Rather than allocating some of the high income year's income to prior years, and subjecting the income thus allocated to the other years' tax rates, it considers only the high income year's tax rates. Computations thus are somewhat simpler under the current system than they would be under true averaging.

Computations under the current system might be modified. The high year and the four prior years might be averaged and the result subtracted from the high year. If the difference exceeded $3,000, tax would be computed on the average, and on the average plus one-fifth of the difference between the high year and the average. The tax would be the tax on the average plus five times the difference between the two taxes computed in the preceding sentence. Under this approach, more income would be subject to averaging if this high year was less than twice the average of the four prior years; otherwise, less would be subject to averaging.

as he is in the year he realizes gain on the sale of property, does not have a bunching problem: averaging will not change his income. A person who realizes $100,000 gain one year has a bunching problem if his prior years' income was $10,000 but not if his prior years' income was $100,000. Considering other years' income requires considering tax returns and other records from those years, and as more time elapses those returns and records are more likely to have been lost.

Second, any claim that the current system artificially bunches income may be discounted by the value of the interest-free loan which, in effect, the property owner received when he was not required to pay taxes on the appreciation as it occurred.  

Finally, although one's lifestyle and ability to pay taxes are influenced by income in other years, as the years become more distant the influence is reduced. The current five-year averaging provision is probably a reasonable approximation of the impact of other years' incomes on this year's tax-paying ability. To permit earlier years to be included in the averaging period might cause severe lost records problems.

A different modification of the averaging provisions might be appropriate, however. Instead of lengthening the averaging period further backward, that period might be extended forward. It is difficult to see why the year before the current year has a major impact on one's ability to pay taxes, but the year after has no impact, as seems to be the assumption underlying the present averaging provisions. One might expect the opposite relationship. A person with rising income presumably retains some of his earlier and less wealthy life style, so his personal expenses should be relatively low, and his rising income should be producing substantial resources from which to pay taxes. Such an individual appears to have little need for averaging; he may even be able to bear a greater tax burden with less perceived hardship than could an individual who had been regularly receiving the higher income. An individual with declining income, however, may be slow to forego his former lifestyle, so his personal expenses may remain high, leaving relatively little of his declining resources available to pay taxes. It would not be unreasonable to permit such an individual to average his later, low-income years against his earlier, high-income years and obtain a partial refund of

86. See section IV of this article for a discussion of why unrealized appreciation may be considered income, and why a failure to tax unrealized appreciation may be viewed as an interest-free loan from the government to the taxpayer.
the taxes paid in those high-income years. Tacking future years on to the averaging period would permit those with declining income to use averaging, while also permitting the individual with very large non-recurring gains to spread those gains over more years than the current five. And permitting such averaging would not invite the lost records problem inherent in a longer extension backwards of the existing averaging provisions. Where present provisions seem designed for the young and the rising middle class, the revision would benefit also those persons retiring, becoming unemployed, or in declining industries or communities.

This proposed liberalization of the present averaging provisions is not particularly related to the problem of bunching caused when all the gain in property which has appreciated over several years is recognized in the year of sale, a problem which is crudely corrected by capital gains. That problem would suggest averaging the gain over the years the property was owned, whereas the proposed liberalization would permit averaging against years after the property had been sold. It should be noted, however, that averaging over the holding period was rejected, in part, because of practical problems, such as risk of lost records. Forward averaging may be viewed as replacing earlier years of the holding period, years for which records are most likely to be lost, with subsequent years for which the risk of record loss is less. Basically, however, a fairer averaging period will benefit

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87. The smallest modification of existing averaging provisions, that would permit forward averaging in addition to the current backwards averaging, would be to let the averaging year be the first year in the five year period, rather than as now requiring that it be in the last year. Taxpayer, in order to average other than the last year, would perform the computations outlined in note 83 supra, and receive a refund of the difference between the taxes originally paid for the high income year and the taxes shown to be due under averaging. To be more generous, the averaging year might be any year in the five years, not just the first or the last.

With such modifications there is a possibility of double taxpayer benefit. If the taxpayer has two fat years separated by four lean years, he may receive a double benefit from those lean years by averaging the first fat year forwards and the second fat year backwards. Accordingly, when the years in the averaging period have already been used for averaging, but the averaging period does not include the earlier averaging year, the years already used for averaging should be treated for purposes of further averaging as though they each included one-fifth of the earlier averageable amount.

If the averaging period is to be extended forward, computations will be much as under the current system, as set out in note 83 supra, except the number of years averaged will increase, and the factor 1.2 should be reduced to 1.17 for 6 years, 1.14 for 7 years, 1.13 for 8 years, 1.11 for 9 years, and 1.10 for 10 years, and the averageable amount divided by 6, 7, 8, 9, or 10, respectively. Or computations might be modified as suggested in the last paragraph of note 83 supra. The longer averaging period will produce significant tax saving only if the average income is low and the high year much higher. Using the example in the first paragraph of note 83 supra where averaging over five years reduced the tax from $23,360 to $16,060, the averaging outlined in the first sentence of this paragraph over ten years (assuming the average income for the additional years was $10,000) would further reduce taxes only to $14,520.
anyone with fluctuating income, and some of those persons will have realized gains on appreciated property. Moreover, avoiding too high a tax on the sale of appreciated property will reduce the problem of lock-in, to which the discussion now turns.

IV. LOCK-IN, DEFERRAL, AND UNREALIZED APPRECIATION

One of the major justifications for the present system which taxes only one-half of capital gains is to reduce tax barriers to transfers of property. Investment flexibility is necessary for economic efficiency. An investor should be able to shift his resources into more productive areas; one investor who can make little use of particular resources should be able to transfer them to another for whom they will be more productive. The disincentive for such shifts and transfers created by imposing a tax when they occur may be a barrier to economic efficiency. Taxing gain when property is sold, as our system does, tends to "lock-in" an investor to the appreciated property he presently holds, because by not selling he may delay paying the tax. The present treatment of capital gains reduces the tax when property is sold by only taxing half the gain. With the tax thus reduced, there should be less lock-in.

It should be noted, however, that lock-in is the consequence of the tax advantage of deferral. The reason a large tax is due on sale of appreciated property is because no tax was imposed as that appreciation occurred. This delay in taxation is very valuable to the holder of appreciating property.

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88. The advantage of deferral has been discussed above as being equivalent to an interest-free loan, of the amount which would be due if the appreciation were taxed as it occurred, for the period between the time the appreciation occurred and the time it was realized. A more dramatic way to describe the advantage of deferral is that it has the same effect as taxing the appreciation but exempting the income it earns. This effect may be more clearly seen by starting with the case of a deduction for investment. For example, in a tax-free world, one might buy land for $1,000, receive annual rental income of $100, then sell the land for $1,000, earning a 10% return on one's investment. Imposing an income tax at a rate of 40% would reduce the after-taxes return to $60, but would not change the cost of making the investment, since investments are not normally deductible, nor would it change the amount realized on sale, since this amount would be a tax-free return of basis. Thus a 40% tax would reduce the net return from 10% to 6%. But if the initial investment were deductible, it would reduce taxes otherwise owed on other income by $400, so that the after-tax cost of making the investment would be only $600. The amount realized on the sale would be taxable, because since the amount of the investment was deducted it would have a zero basis, so after taxes the taxpayer would have $600, the same as the after-tax cost of making the investment. The annual rental would be reduced from $100 to $60, an after-tax return of 10% on the after-tax cost of the investment. This is the equivalent of an investment of $600 which could not be deducted, but with its income exempt from tax. As is discussed later in the text, a failure to tax unrealized appreciation may be considered to be the equivalent of allowing a deduction for amounts invested. Accepting that concept, a failure to tax unrealized appreciation has the same economic effect as taxing it but then exempting its earnings.
to reduce lock-in gives an additional tax benefit to the holder of appreciating property, the reduction in tax rates applied to the ultimate gain on sale of the property being added to the tax benefit of deferral, and thus accentuates the inequality in our tax system.

The preceding paragraph refers to deferring tax on appreciation until it is realized as an advantage, implying that appreciation is income. But, one might ask, is unrealized appreciation income? For the present tax system it is not, although section IV B of this article will argue that on equitable grounds it should be and that taxing unrealized appreciation may be administratively practicable. The inquiry for the moment, however, is less involved with the details of taxation and more involved with the basic social and economic question of whether unrealized appreciation may be considered as income, regardless of how it is treated for tax purposes. As a theoretical matter, unrealized appreciation would be income under Simons's widely-accepted definition:

Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in value of the store of property rights between the beginning and end of the period in question. 88

For this definition, it would not matter, when the value of a person's property increased during a particular period, whether that increase occurred because he used some of his salary to buy additional property or because the property which he owned at the start of the period increased in value. The point that an increase in wealth is income may be viewed another way: if an increase in wealth is not income, in determining a person's income we should subtract from the salary he receives those amounts which he saves or invests or uses to buy property. But we don't do that, not even as a matter of ordinary use of language, tax definitions aside. If an increase in wealth through

investment is income, so in theory should an increase in wealth through appreciation be income.

As a practical matter it makes sense to treat appreciation as income. True, appreciation is not cash, but it would seem that if someone were paid for services performed by being given a share of stock or a new car, under normal use of the language that person would be generally understood to have received income, so that our general concept of income is not restricted to cash transactions. And appreciation is often easily convertible into cash: the property owner could sell the property or, short of that, he could borrow using the property as security, and the amount of borrowing the property would secure would be greater because it had appreciated in value. Moreover, the owner of appreciated property may receive benefits from the appreciation other than by using it to obtain cash. If the property is a home, the homeowner who now lives in a house worth $40,000 for which he paid $20,000 is getting as much benefit from the $20,000 appreciation as he is from the $20,000 paid: if he were living in a house worth $20,000, that house would be smaller or otherwise less desirable than the one he owns. If the property pays interest, rent or dividends, its owner receives more income than he would if only the amount invested and not the appreciation were earning income.

It should not matter whether such income-producing property has appreciated because it now produces more income or because the same income is now more highly capitalized. For example, an apartment might double in value because its rents double, or a long term bond might double in value because interest rates are halved. A bond paying 10% will double in value if interest rates go to 5%, because twice as much would be required to be invested to equal the return on that bond. The person who owns such a bond in such circumstances will be receiving the same interest income as the prevailing interest rate falls, but he is still benefiting from appreciation: to purchase that same interest income would now require twice the cash outlay he originally made, the same cash outlay others are now making to purchase the same amount of interest income. This point might be more acceptable to those with a pro-taxpayer bias if made in the context of falling interest rates. If a 5% bond is purchased for $1000, when interest rates rise to 10% that bond’s value may fall to $500. The owner of such a bond might sell it for $500 and reinvest the proceeds in a 10% bond yielding the same interest income. Though he has the same income, he has sustained a loss.

Even if the property cannot be used by its owner and pays no current income, so that the only return is appreciation, the part of
the property which represents past appreciation has the same prospects of further appreciation as does the part of the property which represents initial investment.

But, it may be argued, the value of property is merely the capitalized value of expected future benefits. Since those benefits may be taxed, taxing the increase in value may amount to double taxation. That is not quite right: while value is often capitalized earnings, this does not mean income is doubly taxed. If the property has only a limited useful life, its cost may be deductible from the income it produces as amortization or depreciation. If the property has an indefinite useful life, presumably, it can be sold for what was paid for it, with gain or loss recognized to the extent the presumption was incorrect. In either case, income is being taxed only once, the cost of the property being either deducted from income or used to exclude from income a part of the amount realized as a return of basis. Moreover, this concept—that property's value is the capitalization of its future income—does not distinguish between appreciation in property already owned and the purchase of new property. For both the appreciation and the new property, the value exists because of future income potential. The stock that A bought for $10 may now be worth $20 because of the capitalized value of the future income it may be expected to produce. B, who owned stock which he purchased for $10 but which has not appreciated, by buying another $10 worth of stock is putting himself into the same position A has occupied due to appreciation. A and B both have a claim on future earnings which, capitalized, is worth $20. A and B are not distinguished, nor are unrealized appreciation and new investment distinguished, by the concept that capitalized anticipated earnings determine value.

In sum, as a practical matter, it seems reasonable to consider appreciation as income. And, returning to tax considerations, deferring tax on appreciation until the property is sold or the gain otherwise realized can fairly be considered a tax benefit. Whether this benefit should be retained, because the administrative costs of attempting to eliminate it are too great, will be discussed below. What matters for present purposes is that it may reasonably be considered a tax benefit.

Accepting that unrealized appreciation is income, so too are benefits an individual provides himself: the carpenter who builds his own home, the rental value of the home one owns, the cooking and housecleaning a person does in his own home, the lawyer who drafts his own will, etc. Returning to the Simons's definition quoted above,

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90. A similar concept—not giving a deduction for saving taxes consumption twice—has substantial merit; it will be elaborated in section IV C.
all have either increased consumption or increased investment, so each has income. Since none pays tax on this income, each might be considered the beneficiary of discrimination, relative to those who purchase homes, cooking or cleaning services, or will-drafting or who rent apartments with after-tax income. Why should the discrimination in favor of unrealized appreciation be eliminated, if the discrimination in favor of services a person provides himself is to continue? For purposes of this article there are four answers. First, perhaps such income should be taxed, but that is a question beyond the scope of this article.91 Second, some of this imputed income—such as the value of the home the carpenter builds for himself—might be taxed under a system which taxed unrealized appreciation. Third, it may be that most imputed income is common to most taxpayers and is of relatively small value—the services one performs for oneself would seem unlikely to be worth more than a few thousand dollars annually—so that failing to tax it may not result in significant inequities. Unrealized appreciation, however, may be both unevenly distributed among taxpayers and very substantial in amount. Finally, the administrative burdens of determining a taxpayer's imputed income, valuing that income, and collecting taxes from an activity which neither generates cash nor produces salable or mortgageable property would be great. Whether the administrative burdens of taxing unrealized appreciation would be too great will be discussed below.

One other type of income or unrealized appreciation, which this article does not propose taxing, should briefly be mentioned. The value of property may usefully be considered the capitalized value of the income the property may be expected to produce. Accepting that concept, then any stream of income may be considered an interest in property, and a change in the stream may be considered a change in the value of that property interest. A man who marries into a wealthy family, a woman who graduates from Stanford Business School, or an employee who is promoted or given a pay increase can reasonably expect a higher income. Should that person be taxed on the capitalized value of that expected increase in income? The answer would seem to be "no" but the difference between this increase in well-being and an increase in the value of more conventional property such as stocks or buildings is more a matter of degree than a difference in kind. Such expected increases in well-being may not materialize: marriage may end in divorce, highly educated people may choose

low-paying public service jobs, employees may be fired or become disabled. Whether more conventional property will produce the income expected of it may also be uncertain, but the uncertainty would seem greater as to marriage, degree, and promotion. Unlike more conventional property, the improved income prospects of a marriage, degree, or promotion cannot be bought and sold. And, as with imputed income, the problems of identifying, valuing, and collecting a tax on such improved income prospects are likely to be severe. Moreover, the amounts of such improved prospects may be broadly distributed and seldom very great. Having considered why unrealized appreciation should be treated as income, and why various other benefits such as imputed income or improved prospects of receiving income need not, for purposes of this article, be treated as income, the discussion returns to the tax treatment of unrealized income.

The purpose of this section is in part to outline mechanisms more equitable than the present treatment of capital gains for reducing any threat lock-in may pose to economic efficiency. Those mechanisms are: first, to tax appreciation at death; second, more generally, to tax unrealized appreciation; third, as an alternative, a cash-flow income tax; and fourth, various restrictions on use of unrealized appreciation. Before proceeding with a discussion of those mechanisms, however, it should be noted that the reforms proposed in other sections of this article will tend to reduce lock-in. The inflation correction for sales described in section II A 2 will reduce apparent gains to real ones, so that less tax will be due upon the sale of property than would now be the case if the apparent gain on a sale were taxed as ordinary income, although the tax on the real gain as ordinary income may be greater than the capital gains tax on apparent gains under present law. The elimination of accelerated methods of depreciation, suggested in section II A 3 will restrict depreciation deductions and hence restrict adjustments lowering basis, so that the gain to be recognized on a sale—the difference between the amount realized and the adjusted basis—will be less as the adjusted basis will be greater. The liberalized averaging proposed in section III will in certain cases lead to less tax being imposed on whatever gain is

92. Some doubt that lock-in is a severe problem even under the current tax system. See, e.g., W. Heller, Investor's Decisions, Equity and the Capital Gains Tax, Fed. Tax Pol. for Econ. Growth and Stability, Joint Econ. Comm., Tax Policy Subcom. 83rd Cong., 1st Sess. 381 (1955), Holt & Shelton, Lock-In Effect of Capital Gains, 15 Nat. Tax J. 337, 350 (1962), David, Alternative Approaches to Capital Gains 227 (1968). This article will not attempt to determine how serious lock-in problems are under the present tax system or under the reforms proposal here, but will rather suggest means of reducing lock-in if lock-in should be determined by others to be a serious problem.
recognized. And the integration of the personal and corporate income
taxes, to be discussed in Part II of this article appearing at a later
date, will result in an increase in a taxpayer’s basis in his stock as he
is taxed on the corporation’s retained earnings, and thus reduce the
gain to be recognized on the sale of stock. These changes will all tend
to reduce lock-in, and, if the reduction of lock-in were the goal, they
could perhaps make unnecessary the two proposals next dis-
cussed—taxing appreciation at death and taxing unrealized apprecia-
tion. But as indicated above, the present tax system’s treatment of
unrealized appreciation discriminates between two types of increase
in wealth—that due to unrealized appreciation on property already
owned, and that due to purchase of property with cash obtained in a
taxable form such as salaries or interest. Accordingly, these propos-
als are also justified on grounds of equity and fairness.

A. Taxing Appreciation at Death

The taxation of appreciation at death has been the subject of
extensive discussion elsewhere, so it will be dealt with somewhat
briefly here. This subsection will consider past treatment of apprecia-
tion at death, changes made by the 1976 Tax Reform Act, and further
changes which might be made.

Prior to 1977, Section 1014 provided, in general, that the basis
of property acquired by bequest or inheritance would be its fair mar-
ket value at the date of death. Thus, appreciation which occurred
between the time a person purchased property and his death would
never be subject to the income tax. This was commonly called the
“step-up in basis at death” (although if property’s value had declined
below its basis Section 1014 would provide a step-down in basis). This
provision could be quite inequitable: a person who sold property
shortly before his death would be taxed on the appreciation, but the
appreciation in property held until death would not be taxed as in-
come. This inequity would not be cured by the estate tax, as the after-
tax proceeds of property sold before death would be subject to the
estate tax just as the unrealized appreciation would be. Both realized
and unrealized gains are subject to the estate tax since the estate tax
is a tax on wealth, but under Section 1014 only unrealized apprecia-

93. See, e.g., Taxation of Appreciation of Assets Transferred at Death or by
Gift, Joint Publication, House Comm. on Ways and Means and Senate Comm. on
Finance, 21 Cong., 2nd Sess. 331-40 (1969), Comment, Taxing Appreciated Property at
Death: The Case for Reform, 51 Ore. L. Rev. 364 (1972), Graetz, Taxation of Unrealized
Compare, Comment, Proposed IRC Sec. 84: Income Taxation of Unrealized Appreciation at
tion would be exempted from the income tax.

Beyond problems of equity, Section 1014 aggravated problems of lock-in. Whereas, without Section 1014, delaying the sale of property would merely delay being taxed on appreciation, Section 1014 would convert the delay of taxation into an exemption. The possibility of completely avoiding taxation, rather than merely delaying taxation, may strengthen a person’s resolve not to sell his property, thus accentuating lock-in.

Beginning in 1977, Section 1023 provides generally a step-up in basis at death only to the value of the property on December 31, 1976; the basis to the heirs or devisees will not be further increased to reflect appreciation occurring between that date and the date of the decedent’s death. Under Section 1023(h), the step-up in basis to the December 31, 1976 value will be based on the actual value on that date for marketable bonds and securities, but for other property—i.e., real estate, stock in closely held corporations, etc.—the value on that date will be roughly approximated: the appreciation at death will be apportioned according to the time the property was held before and after December 31, 1976. Thus, if property were purchased on December 31, 1966 for $200 and held until death on December 31, 1986, when it was worth $300, half the $100 appreciation would be deemed to have occurred before December 31, 1976, and the property’s basis to the heirs would be $250. This crude approximation for property other than marketable securities avoids the staggering undertaking of determining the actual value of all property on December 31, 1976, but in particular cases this provision may provide a basis far different from the actual value on December 31, 1976. In the example, the actual value on that date might have been $100 (a decline in value between purchase and that date) or $200 (no appreciation), or $300 (all appreciation between purchase and that date).

Section 1023 will reduce the inequity as to future appreciation which Section 1014 might produce, in that such appreciation eventually will be taxed. However, Section 1023 does little to alleviate, and may aggravate, the lock-in produced by Section 1014. First, under Section 1023 there is still the possibility of a substantial step-up in basis at death, if the property had appreciated substantially before December 31, 1976, or if it is deemed to have appreciated by then. As time passes, the lock-in caused by the step-up in basis to the December 31, 1976 value will gradually disappear, but that lock-in may be significant for decades. Second, Section 1014 at least eliminated lock-in once a generation. The heirs could immediately sell the property without incurring any income tax liability. Under Section 1023 the heirs generally will take the decedent’s basis in the prop-
erty, so that if they sell the property, they will be taxed not only on any appreciation occurring while they held the property but also on appreciation while the testator held it, and perhaps also appreciation while the testator’s testator held it. This could produce a tax high enough that significant lock-in might occur.

Taxing appreciation at death would substantially reduce lock-in. Property owners would no longer have the prospect of avoiding all income taxation on appreciation (or at least the actual or constructive pre-1977 appreciation). The heirs and devisees could immediately sell the property without incurring income tax liability. And the equitable problem of exempting some appreciation from the income tax would be eliminated. Existing appreciation could be subjected to taxation at death, eliminating the confusion created under Section 1023 in making the new rules apply prospectively only, if accompanied by an inflation correction such as is outlined above in section II A 2: those who may have relied on Sections 1014 and 1023 will be given the benefit of inflation correction, which they presumably did not expect, to compensate for the loss of the benefits they did expect under Sections 1014 and 1023. Also, it would seem that in general those relying on Sections 1014 and 1023 would have held their property for a relatively long time so that they may benefit more from an inflation correction than they suffer by the loss of preferential capital gains; in such cases the reduced tax on lifetime sales is an additional benefit to offset against the loss of Sections 1014 and 1023.

Some of the mechanics of taxing appreciation at death might be briefly mentioned. To tax appreciation at death, the decedent would be treated as though on the date of death he had sold the property for its market value; the difference between that value and his adjusted basis, corrected for inflation, would be taxed as income. Since this procedure could result in a substantial amount of income being taxed in one year, creating a substantial bunching problem, averaging provisions more generous than those proposed above in section III might be appropriate. For example, the decedent’s average income for the four years before his death might be computed, then this amount could be treated as though it were the average for ten or fifteen years, which would then be averaged against the year in which his death occurred. Presumably there would be exemptions such as those in Section 1023(d) for small estates or, in regard to the estate tax, in Sections 2056 and 2057 for transfers to a surviving spouse or to minor children. Provisions might be included in a system of taxing appreciation at death analogous to Section 2032A, which provides that valuing certain real and farm property for estate tax purposes will be based on that property’s current use rather than on its fair
market value if put to its most lucrative use. To ease liquidity problems, payment of the tax on appreciation at death might be made over an extended period, much as Section 6161(a)(2) permits the payment of estate taxes over a period as long as ten years in appropriate cases. The income tax on appreciation at death would be deducted from the taxable estate, so it would not be possible for the total of income taxes and estate taxes to exceed the value of the estate. If appreciation were to be taxed at death, a strong case could be made for taxing appreciation when gifts are made.

Further elaboration of such matters is beyond the scope of this article. For present purposes, it is enough that none of these problems seems unsolvable, so that if the elimination of the capital gains preference as proposed in this article, considered in light of other accompanying reforms, is feared to result in too much lock-in, lock-in may be reduced by replacing Sections 1014 and 1023 with a system of taxing appreciation at death. If further reductions in lock-in are considered necessary, it is possible that they could be achieved through taxing unrealized appreciation, as discussed in the next subsection.

**B. Taxing Unrealized Appreciation**

Lock-in is created by imposing a tax on the sale of the appreciated property, and is reduced by decreasing the tax imposed at that time. Under our present tax system, lock-in is reduced under the capital gains provisions by taxing only one-half of the gain, and taxing that gain only when the property is sold or when that gain is otherwise unrealized. Thus, half the gain from appreciation in property is never taxed (except for the minimum tax of 15% imposed by Section 56, far less than the maximum normal rates of up to 70% imposed under Section 1). An alternative method of reducing the tax on disposition and thus of decreasing lock-in is to tax some or all of the appreciation earlier, before it is realized, so that less appreciation remains to be taxed when the property is sold. This alternative method will not produce the inequity of exempting certain income from tax found in the present tax system of taxing capital gains. It should be emphasized that this discussion assumes an inflation correction as outlined above in section II A 2, so that only real, inflation-corrected appreciation will be taxed.

This subsection will first discuss the constitutional problems and then the administrative problems in taxing unrealized appreciation.

1. **Constitutional Problems.** Taxing unrealized appreciation strikes at one of the early corner-stones of our tax policy—*Eisner v.*
**Macomber,** which held that a stock dividend did not constitute income within the meaning of the sixteenth amendment, because income includes only "a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital" and does not include "a growth or increment in value in the investment."

**Eisner v. Macomber** may be a decision reaching an appropriate result in the case then being decided, but adopting a rule of law which goes beyond the needs of that case, a rule of law which when considered in other contexts may be seen to be inaccurate or overly broad.

It is reasonable that a dividend of common stock paid to common-stock holders not be considered income, because such a dividend does not represent any significant change in economic circumstances. After such a dividend the stockholder has the same interest in the same corporation as before. In the view of the majority in **Eisner,** income has not been severed from capital, in contrast to payment of a cash dividend. But, even if unrealized appreciation is considered income, payment of a stock dividend would not be an appropriate time to impose a tax. A stock dividend may be paid to those whose stock has not appreciated, for example, those owning stock in a corporation with substantial retained earnings whose stock for some reason has not appreciated in the market place, or those who only recently purchased stock which has been appreciating. Moreover, if unrealized appreciation is to be taxed, it should be taxed even though no stock dividend is paid. Thus, whether or not unrealized appreciation can be taxed, a stock dividend is not an appropriate occasion for the imposition of tax, and the Court's statements in **Eisner** about whether unrealized appreciation may be taxed were thus not necessary to decision of the case before it.

**Eisner** has been eroded with the passage of time, as others have

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94. 252 U.S. 189 (1920). Justice Holmes in a brief dissent joined by Justice Day argued that the purpose of the sixteenth amendment was to get rid of questions such as this. *Id.* at 219. Justice Brandeis in a dissent joined by Justice Clarke attempted without much success to show that stock dividends were the same as cash dividends. *Id.* at 220.

95. *Id.* 207 (emphasis in original).

96. For an example of this phenomenon in another context, compare Fuentes v. Shevin, 407 U.S. 67 (1972), in which the Supreme Court when confronted with prejudgment attachment involving virtually no procedural safeguards held that the Due Process Clause required opportunity for a pre-attachment hearing, with Mitchell v. W.T. Grant Co., 416 U.S. 600 (1974), where the Court held that such safeguards as requiring a specific affidavit, issue of the writ of attachment by a magistrate rather than by a clerk, and opportunity for a prompt post-attachment hearing were adequate. *See also* North Georgia Finishing, Inc. v. Di-Chem Inc., 419 U.S. 601 (1975) discussed in Note, *Prejudgment Creditors' Remedies—Another Recipe for the Due Process Cookbook,* 47 U. COLO. L. REV. 129 (1975).
discussed.97 The owners of various entities may be taxed on the entity's retained earnings: foreign personal holding companies,98 controlled foreign corporations,99 Subchapter S corporations,100 regulated investment companies,101 and partnerships.102 In addition, holders of corporate bonds issued with an original issue discount may be required to include in income ratable portions of that discount.103

But there is a more fundamental flaw in Eisner. As suggested above in the introduction to this section, unrealized appreciation should be considered to be income. To defer tax on this kind of income but not other kinds of income raises problems of fairness and equity. Persons becoming wealthier through property appreciation do so without currently paying income tax, while those becoming wealthier by saving out of wages or salaries can do so only from after-tax income. Deferring tax payment can have the same effect as a tax cut. If the interest rate is 8%, deferring payment of the tax for nine years is equivalent to halving the tax.104 Because property is much more unevenly distributed in our society than is income, the more favorably taxed means of increasing wealth is available primarily to the wealthy. Such economic discrimination may conflict with equal protection notions contained in the Due Process Clause of the fifth amendment, though this is not to suggest that the Constitution requires taxation of unrealized appreciation. First, equal protection has little application to taxation, in order that the courts not disrupt this very difficult and important legislative process.105 Second, as discussed below, there are substantial practical problems in attempting to tax unrealized appreciation. The point is merely that, with the

98. Sections 551 to 558. These provisions were held to be constitutional in Eder v. Commissioner, 138 F.2d 27 (2d Cir. 1943).
99. Sections 851 to 855.
100. Sections 701 to 761.
101. Section 1232. Interest may be paid on a bond periodically, for example, $100 paid monthly on a $20,000 bond, or when the bond is redeemed, for example, a bond might be issued for $750 and redeemable five years later for $1000, the difference between issue price and redemption price being interest, often called original issue discount. In general, Section 1232 requires that the original discount on corporate bonds issued after May 27, 1969, be ratably included in income: for a bond issued for $750 and redeemable for $1000 five years later, $50 interest would be included in income each year, even though this interest will not be received until the bond is redeemed in the fifth year.
102. See note 20 supra.
decline in the doctrine of *Eisner v. Macomber* and the increase in importance of doctrines of equal protection, the Constitution leans toward rather than away from taxing unrealized appreciation. For the reasons stated above, there does not appear to be a constitutional barrier to taxing unrealized appreciation. The next section discusses the practical problems involved in such taxation, which are more severe.

2. **Administrative and Practical Problems.** Appreciation may be ephemeral. Paper profits notoriously may disappear before they are converted to cash. Recognizing unrealized gains and losses may produce many offsetting transactions in different years with money flowing into and out of the Treasury, and thus out of and into the hands of taxpayers, more frequently than economics and sound fiscal policy would indicate.106

But much appreciation or depreciation is lasting, and readily convertible to cash. To give taxpayers complete control over when these changes in value are to be recognized may give them too much control over their reportable incomes. By retaining appreciated assets while those which declined in value are sold, the taxpayer may persistently understate his real income. The problem of disappearing appreciation might be resolved as a part of a system which in general did tax unrealized appreciation. For example, only 50% or 75% of the difference between the adjusted basis and the fair market value of the property might be recognized as gain or loss each year (with any gain thus recognized added to basis and any loss subtracted), on the theory that this much of the gain or loss is likely to be permanent, whereas the remainder may be more likely to be subject to fluctuations. If the change in value persists or continues, more gain or loss will be recognized in future years; if the change reverses itself, in many cases no correction will be needed because the value of the property will not return past the basis as adjusted for gain or loss earlier recognized, and in other cases the correction is likely to be relatively small.107 In addition, the gain or loss recognized might be limited to 50% or 25% of the adjusted basis of the property at the beginning of the year. Such

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107. For example, if only 50% of the difference between adjusted basis and fair market value of property is recognized for tax purposes, only 25 of gain will be recognized if property purchased for 100 becomes worth 150. The next year, loss would be recognized only if the property's value declined below 125; if that value remained at 150 an additional 12.5 would be taxed that year, 6.25 the next year, etc.
a limit might be justified on the theory that dramatic shifts in value indicate volatility which may suggest opposite swings are also to be anticipated. If the shift in value is permanent, it will all be recognized over the course of a few years; if it is not permanent, the future corrections will be small or in many cases unnecessary.\textsuperscript{108}

A system of taxing unrealized appreciation must be phased in gradually to avoid the huge tax burden which would be imposed if all the unrealized appreciation in the property owned by U.S. taxpayers were to be taxed in one year. Applying the tax only to future appreciation is probably unnecessarily complex, and would continue the problems of lock-in and the benefits of deferral for past appreciation.\textsuperscript{109} A simpler transition measure would be to start including very low percentages of appreciation in income, with the percentages gradually increasing to the permanent levels discussed in the preceding paragraph over a substantial period such as ten years.\textsuperscript{110}

These limits on the amounts of appreciation or depreciation recognized may also ease the problem of inaccurate valuation, discussed below. If the full amount of appreciation were taxed, an estimate of value which was too high would result in tax liability for nonexistent income. However, with only part of the measured appreciation taxed, that measure may err more without creating income. For example, if only half the measured appreciation were taxed, and a property's measured value went from $100 to $150, so long as the true value was at least $125, no nonexistent income would be taxed. While

\begin{enumerate}
\item For example, the amount of unrealized gain to be recognized might be limited to the lesser of 50\% of the appreciation or 25\% of the adjusted basis. If property with a basis of 100 became worth 300, the first limit would be 50\% (300-100) = 100, the second 25\% (100) = 25, so 25 gain would be recognized, and the basis would become 125. If the property were worth 300 the next year, the first limit would be 50\% (300-125) = 87.5, the second 25\% (125) = 31.25, so 31.25 gain would be recognized and the basis would become 156.25, etc. In addition, changes of value which do not exceed 10\% of basis might not be recognized for tax purposes, to ease the administrative problems of taxing unrealized appreciation.
\item See the discussion of Section 1023 and taxing appreciation at death in the preceding subsection.
\item For example, for the first 3 years only 10\% of the difference between adjusted basis and fair market value of the property might be recognized for tax purposes, during the next 3 years only 20\%, with an additional 10\% recognized each year thereafter until the permanent level of 50\% is reached. Or the system could start at 5\% the first year and increase 5\% each year until the final level was reached. Although with such phasing the percentage of the difference between basis and value will increase, the amount of gain required to be recognized may be fairly uniform, as gain recognized in past years will increase the adjusted basis, and thus reduce the amount of the difference between basis and value. Of course if the property continues to appreciate there may be increasing amounts subject to tax.
\item The alternative limit to recognizing unrealized appreciation, based on a percentage of adjusted basis, might alleviate this transitional problem. See note 108 and accompanying text \textit{supra}. \end{enumerate}
the owner of this property is taxed more than if the property's value were accurately measured, a certain imprecision in the administration of the tax system is probably unavoidable. In many cases a taxpayer who has one property overvalued will have other property undervalued, so that in the aggregate he may not be unfairly treated. Errors in one year may be corrected the next, and short accelerations or deferrals of tax liability may not be too serious.

Valuing property is an imprecise art rather than a science, and an expensive one to practice or use. Even if it were possible, one would be reluctant to devote the resources necessary to create the army of appraisers which would be required if all property in the country were to be appraised each year. Taxing unrealized appreciation should not be attempted if appraisals must be made as they have been in the past. Other methods exist or are being developed, however, which may make taxing unrealized appreciation practical.

Much of the nation's wealth exists in the form of regularly traded securities in large corporations; such securities may be readily valued based on stock exchange prices, over-the-counter markets, or the computerized unified national securities market now being developed.\textsuperscript{111} It may be practical to value stock in closely-held corporations by capitalizing the earnings of such corporations.\textsuperscript{112} If this approach is practical and if the personal and corporate income taxes are integrated, it would not be necessary to value the assets of a corporation whose stock could be valued. Thus, the particularly difficult problems of appraising relatively unique assets which are infrequently sold, such as steel mills and utilities networks, might be avoided.

Much of the nation's non-corporate wealth consists of real estate. The existing crazy-quilt pattern of assessments for purposes of state and local real property taxes is the sort of national scandal\textsuperscript{113}

\begin{itemize}
  \item \textsuperscript{111} Compare Section 1023(h)(1).
  \item \textsuperscript{112} This approach must be applied cautiously. While one might expect the market value of publicly-traded stock to reflect appreciation in the corporation's assets, this principle would not apply to closely-held entities. While appreciation of some of those entities' assets would be reflected in income, other assets such as vacant land might appreciate without causing any increase in income. The latter types of assets might cause capitalization of income to understate the value of the entity.
  
  On the other hand, capitalization of income may overstate the value of a business entity, if that business is heavily dependent on the skills and efforts of the owner, unless the income is reduced by a "reasonable allowance for salaries." There has been considerable difficulty in applying that term under Section 162(a)(1).

  Because of such problems, it may not be practical to value closely-held entities based on capitalization of income, so it may be necessary to value the properties they own.
  
  \item \textsuperscript{113} See, e.g., \textit{In re Kents 2124 Atlantic Ave., Inc.}, 34 N.J. 21, 29, 166 A.2d 763, 767 (1961):
\end{itemize}
one would be reluctant to let encroach on our relatively fair and efficient income tax system. However, alternatives are being developed to replace the expensive and inaccurate prior practice of using last year's assessment, or a guess based on a quick survey, or laborious individual inspections and searches for sales of similar properties.

Computerized assessment systems have been developed in which real property is described by location, land area, building area, type of construction, age, etc. All arms-length exchanges of real property are fed into a computer which, based on equations correlating the many factors describing each property, determines with remarkable accuracy the value of all property based on the prices at which relatively few properties are sold. It should be emphasized that this is not a case of an author coming to a problem he cannot solve and invoking a computer as *deus ex machina*: these systems are in existence and they work very well. While such systems can only work when one can deal with large numbers of relatively similar properties, a statistically significant portion of which are sold each year, that description may apply to much of the real property in the country: certainly to homes, possibly to farms, apartments and office buildings, stores, and small factories. As indicated in the preceding paragraph, it may not be necessary to value the property of publicly-held corporations and perhaps even closely-held corporations, which if true will eliminate the need to value much unique or specialized real property. Capitali-

The testimony of the assessors in the present case reveals a total indifference to their statutory duty. The assessment rolls were copied year after year, with no effort to achieve a general revaluation. Thus inequalities due to progressive inflation, changing neighborhood fortunes and perhaps other causes, were perpetuated. The assessors apparently revised assessments only when new construction required them to act. In describing how they valued new construction, the assessors expressly eschewed any conception of the value of the properties.

See also Committee for Economic Development, Modernizing Local Government 54 (1966):

Real property tax administration suffers from two major sources of inequity: unequal assessment and underassessment. In view of the primary reliance on real property taxes, it is quite shocking that in most parts of the country—whether urban or rural—its administration may be accurately described as inequitable, inefficient, incompetent, or corrupt. There is no more vivid illustration of the need for reform of local institutions.

114. See Cole, Gustafson & Reynolds, *ESP and The Appraiser: A Practical Statistical Application* (1970), reprinted in O. Oldman & F. Schoettle, *State and Local Taxes and Finance* 160-62 (1974), describing the operation and accuracy of such systems in several cities in California. They report coefficients of dispersion ranging from under 3% to approximately 10%. In contrast, a national sample indicates that less than 7% of all local assessing jurisdictions have coefficients of dispersion under 10%, and more than half such jurisdictions have coefficients of dispersion of 20% or more. See 2-2, 1972 *Census of Governments*, Table 6 (1973) (prepared by the Bureau of the Census).
zation of earnings may also be the best method of valuing apartments and office buildings, where sales are too infrequent for use of computerized assessment.

With assessment of common properties largely computerized, and with other properties valued on an entity or capitalization of income basis, the existing appraisal resources could be concentrated on properties which have to be valued by more difficult processes such as determining the replacement cost less depreciation. The valuation of such difficult properties may be eased by the efforts of the accounting profession to modify the "historical cost accounting" system now in general use to reflect changes in replacement cost. These efforts may produce more accurate techniques to value buildings and machinery, such as using various indexes of construction cost and deterioration or obsolescence, which could be used as part of a system of taxing unrealized appreciation. The administrative costs of such a system may not be significantly greater than for any but the most haphazard of manual appraisal systems, and by incurring such costs it should be possible to improve both the property tax and the income tax significantly. If valuing all property annually is too expensive, valuation might be done only every third or fifth year, with a different third or fifth of all property valued each year.

Certain other properties may be valued with relative ease, either because they are frequently exchanged—such as automobiles—or because their earnings are capitalized, as in the case of licensed patents or copyrights.

Of course many kinds of property may be very difficult to value: art, jewelry, furniture, perhaps small businesses or farms heavily dependent on the efforts and skills of the owner, patents or copyrights used by the business which owns them, etc. Where valuation is difficult and the total value of all such properties is a small proportion of the national wealth, such properties might be excluded from any tax on unrealized appreciation, or appreciation in such properties might be recognized only every fifth or tenth year, rather than annually or every few years. Certain properties might thus be excluded from a tax on unrealized appreciation, or less frequently val-

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116. If the value of property will be determined infrequently for purposes of taxing unrealized appreciation, there may be a problem of bunching income much as may occur under the present system of taxing appreciation only when the property is sold. If the time between valuations is more than the normal five-year averaging period, it may be appropriate to permit averaging against earlier years. Also, it may be necessary to raise the limits suggested in notes 107, 108 and accompanying text supra on the amount of appreciation recognized if property is valued infrequently.
ued, if the tax revenue collected is not likely to be worth the expense of valuation and collection, and if the misallocation of tax burdens in favor of those owning the relatively few types of property on which unrealized appreciation is not taxed, and the economic distortion caused by those seeking to benefit from that misallocation, are likely to be slight.

Taxing unrealized appreciation may create cash-flow problems, because the property owner will have incurred tax liability without having received any cash or other resources with which to pay the tax. The real magnitude of such problems should not be exaggerated, however.

First, the tax on unrealized appreciation is proposed only if there is also an inflation correction. Thus the amount of appreciation which will be taxed is less than the apparent appreciation we think of now, without an inflation correction. Moreover, with an inflation correction, much apparently appreciated property will be seen to have declined in real value, producing losses which may be offset against the gain recognized on real appreciation in other property. Thus, the additional tax liability created by recognizing unrealized changes in real values may not be too great.

Second, it should be noted that under the present system tax liability may be incurred without the taxpayer receiving resources with which to pay the tax. Examples include original issue discount,117 income assigned before receipt but still taxed to the assignor,118 and disposition of property which has been depreciated so that its adjusted basis is less than the mortgage.119 Cases where an individual will be taxed although no cash has been received include transfer of property for services,120 exchanges of property which do not fit within one of the non-recognition provisions,121 and use of appreciated property to pay an obligation.122 To add another area of taxability without receipt would not be breaking new conceptual ground. Taxing unrealized appreciation would, however, make taxability without receipt a generally applicable principle, whereas the examples described are each of fairly narrow application. But making this change in most cases would not seem to be unduly burdensome. Individuals normally have a variety of resources such as bank accounts, salary or other

117. See Section 1232.
120. See Section 83.
121. See, e.g., Sections 1031-34.
income, liquid assets, etc. To ignore these resources while focusing on a single transaction involving taxation without receipt is to imagine hardships where in many cases none in fact will exist. While it might be necessary in some situations for the taxpayer to sell some of his property to pay the taxes on the unrealized appreciation, such an individual does not seem significantly different from the wage-earner who can buy less property because part of his wages must be paid in taxes rather than invested. Each could, of course, buy or own more property if relieved from taxes, as would be the case if a system generally exempting saving from taxes were adopted. But the distinction between having to sell some of one's investments and being able to make fewer investments does not seem substantial enough to justify treating saving through appreciation by property owners differently from saving out of wages, salaries and other cash incomes.

Third, hardships in particular cases might be avoided by providing exemptions from a tax on unrealized appreciation. The limits discussed above on the amount of unrealized appreciation subject to tax each year would provide some relief. There might be an exemption for unrealized appreciation in owner-occupied homes. Such appreciation might be completely exempted from the tax, or the exemption could be limited to a certain dollar amount of appreciation, with that amount being phased out as other income increased. There might also be an exemption for appreciation from all sources, up to a similar limit. Relatively non-liquid cash-poor institutions such as family farms and small businesses might also be exempted, or family farms might in certain cases be valued as farms rather than as if put

123. See section IV C infra.

124. The child care deduction permitted by § 214 (which was repealed and replaced by a credit under § 44A of the 1976 Tax Reform Act) was fully available only to a taxpayer with an adjusted gross income of $35,000 or less. For higher adjusted gross income, $1 of deduction was lost for each $2 of additional income.

125. Such an exemption would accord with common experience in tax reform. While it is relatively easy to close the top part of a loophole, through which a few taxpayers each extract substantial tax savings, closing the bottom part of the loophole, through which many taxpayers each extract relatively small savings, is considerably more difficult. See, e.g., Section 163(d), which generally disallows deductions for investment interest in excess of investment income plus $10,000, Section 613A, which repealed percentage depletion for a taxpayer's oil and gas production in excess of 2,000 barrels per day, gradually reduced to 1,000 after 1979, and Section 1201(b), which limits the alternative tax of 25% on long term capital gains to the first $50,000 in such gains. In each case—the $10,000 in Section 163(d), the 2,000 barrels in Section 613A, and the $50,000 in Section 1201(b)—the old rules were retained for relatively small taxpayers when the rules were changed generally. The "relatively small" taxpayers thus grandfathered may be fairly large. At an interest rate of 10%, $10,000 would be the interest owed on a $100,000 obligation, and with oil prices above $10 per barrel the 2,000 barrel-per-day exemption would include taxpayers with annual gross oil revenues in excess of $7 million.
to some other use such as sub-divisions, much as is done for estate tax purposes under Section 2032A.

The practical problems of taxing unrealized appreciation are great. But other simplifications may follow. With an accurate system of measuring unrealized appreciation and depreciation, the present system of using very loose estimates for depreciation might be eliminated. This point should not be over-stated: a system of taxing unrealized appreciation will involve estimates and computations, much as in determining depreciation under the present tax system. But those unrealized appreciation computations may be in large part a substitute for, rather than an addition to, depreciation computations now performed. Another possible simplification would occur in the integration of the personal and corporate income taxes. Such integration might be achieved by taxing shareholders on dividends received and on changes in the value of their stock, while repealing the corporate income tax. Again, not to overstate, taxing unrealized appreciation will be complex, but this complexity may in part be offset by simplifying the present interrelationship of the individual and corporate income taxes. Finally, under present law, deduction of capital losses from ordinary income is restricted by Section 1211, apparently to prevent individuals from choosing to recognize some of the losses in their portfolios so as to offset salary, dividend, or interest income. How is such use of losses to be restricted, if, as this article proposes, the capital gains preference is eliminated? One could choose not to restrict deduction of such losses, but that might result in the loss of substantial amounts of revenue. One could develop a concept of investment losses, somewhat like the present concept of capital losses but perhaps more rationally defined, in which deduction from ordinary income would be restricted. However, by analogy to the present system's unlimited allowance of capital losses as deductions against capital gains, there would be a strong case for allowing such losses to be deducted from investment gains. That in turn would mean that we would need a system of keeping track of investment gains and losses, a system perhaps simpler than our present system for distinguishing ordinary income and loss from capital gain and loss, but likely to be extremely complex nonetheless. One could impose other restrictions on deduction of realized losses, such as are discussed in subsection D below. Or one could substantially eliminate the problem, at the cost of substantial complexity, by generally recognizing unrealized appreciation and depreciation for tax purposes.

Taxing unrealized appreciation will mark a drastic change in our tax system. The practical problems of such a tax will be great, though they may not be unsolvable. It may be that so much property would
have to be exempted from a tax on unrealized appreciation that the
problems of discrimination between holders of exempt and non-
exempt property and the problems of drawing and enforcing the line
between exempt and non-exempt property, when added to the costs
of valuing the non-exempt property, would not be worth the addi-
tional revenue collected. One may doubt whether the lock-in problem
in the light of the other reforms proposed here would justify such a
drastic change. But lock-in is not the only problem; there are major
problems of equity. As discussed above, failure to tax such apprecia-
tion provides a substantial tax advantage to those owning property.
Those people are disproportionately the wealthy, because property
ownership in our society is substantially more unequal than income
distribution. They become more wealthy as their property appreci-
ates yet they incur no tax. Those who invest their salary or invest-
ment earnings, on the other hand, are taxed on their increase in
wealth, because the salary or earnings are taxable and there is no
deduction for saving or investment. It would seem to be worthwhile
to incur a fair amount of administrative burdens and complexity in
order to reduce or eliminate this discrimination under the present tax
system between those with appreciating property and those who save
or invest from after-tax income.

C. A Cash-Flow Income Tax

Professor Andrews has elaborated an alternative method of deal-
ing with the problems of equity and lock-in created by the present tax
system's treatment of unrealized appreciation—a consumption-type
or cash-flow personal income tax.126 This subsection will briefly de-
scribe the operation of such a tax, outline some of its justifications,
and discuss a few of its problems.

Under a cash-flow income tax, computation of income would
begin much as it does under our present income tax. Income would
include wages and salaries, dividends, interest, rents, etc. The major
differences would be that a deduction would be permitted for
amounts saved or invested, which would include repayment of loans,
and that both amounts borrowed and the entire amount for which
property was sold would be considered income. At first glance, it
might appear that a cash-flow income tax would increase lock-in,
because on a sale of property it would treat as income the entire
amount realized, rather than just the excess of the sales price over
the property's cost or basis, as under present law. For example, if

126. Andrews, A Consumption-Type or Cash Flow Personal Income Tax, 87 Harv. L.
property is purchased for $150 and sold for $200, the gain or income is $50 under this present system, but under a cash-flow income tax the income would be $200. However, this increase in income under a cash-flow income tax when property is sold would be offset by a deduction if the proceeds were re-invested. Normally a person who sells property for a large amount of money does not immediately spend the proceeds on consumption. Instead, he will either reinvest the proceeds or put them in a bank account until he is ready to spend them on consumption. Even if the sale produces a large amount of income there may be little or no net income since he will be permitted a deduction for the amount reinvested or saved. For an individual willing to reinvest the proceeds there will be no tax-caused lock-in.

It might be argued that while an individual would not be locked into any particular investment, he is locked into investing in general, because the proceeds of an investment are not taxed only if re-invested. But the proceeds from selling an investment are treated no differently than wage or salary income or dividends: none of those amounts are taxed if invested or saved, all are taxed if consumed. The discrimination in the present tax system between those becoming wealthier from unrealized appreciation and those becoming wealthier from savings out of income would also be ended. Where taxing unrealized appreciation would end the discrimination by taxing both ways of becoming wealthier, a cash-flow income tax would end that discrimination by taxing neither. Moreover, a cash flow tax would be much less complicated than either the present income tax or the income tax with the reforms proposed here. Under a cash-flow tax there would be no need to compute depreciation; instead of deducting the cost of productive assets over their useful lives, that cost would be deducted in the year it was paid. Without depreciation and with sales taxed on the total amount realized rather than only on the gain, basis would be irrelevant. Therefore, records of past purchase prices—which under the present tax system may be needed decades after purchase in order to determine basis and gain on a sale—would not need to be kept beyond the time the return for the year of purchase could be re-examined for purposes of deficiencies or refunds. With all transactions of tax significance measured in current dollars, inflation corrections would not be required. In addition, the corporate income tax could be eliminated, since corporations are not natural persons and cannot be said to consume, thus avoiding the problems of integrating the personal and corporate income taxes (which will be discussed in Part II, to be published at a later date). With its major justifications gone, the capital gains preference could be eliminated as well. The simplification achieved in a cash-flow or consumption-type income tax is breathtaking.
Basic questions regarding a consumption-type or cash-flow personal income tax still must be addressed, however. For instance, why is a tax measured by consumption better than one measured by income? And if the tax is to be measured by consumption, why this tax rather than some other consumption tax?

Andrews, in proposing a cash-flow income tax, assumes that the purpose of taxation is to shift resources from private consumption to public use, so that it is appropriate to use consumption as the standard for imposing the tax. That assumption will be questioned below, but for now it will be accepted. According to Andrews, our current income tax effectively taxes consumption through savings twice, while taxing current consumption only once. In Andrews's example, a person who earns $100, invests it at 9%, and reinvests the interest, would have $800 after 24 years in a world without taxes. With a 33% tax rate, only $67 of the $100 earned could be invested, and the annual return of 9% would be reduced to 6% after payment of taxes, so that after 24 years the person would have $267, only one-third as much as $800 in a tax-free world. This is double taxation of savings since the investor is effectively taxed at a rate of 67% despite a nominal tax rate of 33%. Andrew's cash-flow or consumption tax, however, would permit a deduction for $100 of earnings invested, exempt the 9% return, and tax the $800 at a 33% rate when it was consumed, leaving the person $533. Thus, with a cash-flow tax, consumption would be reduced by the applicable tax rate, whether that consumption was done when income was first earned or later, after investment. Of course, tax rates may change, as may an individual's tax bracket, between the investment year and the consumption year. If so, an individual's tax will be comparable to the tax paid by others consuming equal amounts in the year he consumes. Thus, unlike the present system, a cash-flow income tax would not discriminate against deferred consumption or savings. Although an income tax deduction for investment might be considered the equivalent of an interest-free loan of the taxes saved by the deduction, it could be justified by its effective elimination of double taxation if the object of a tax is indeed consumption.

Moreover, in contrast to other taxes measured by consumption such as the sales tax127 or the value added tax,128 Andrews's consu

127. A sales tax is normally imposed on all retail sales at a flat rate, although sales of certain goods such as prescription drugs or food may be exempt or taxed at a different rate. For a discussion of the sales tax as used in the United States and Canada, see Due, Development of Retail Sales Taxes in the 1960's and 1970's, 19 CAN. TAX J. 545 (1971) (hereinafter cited as Due).

128. A value added tax is imposed on each stage of production from supplier of raw
tion tax could be an easily administered and progressive one. Where a sales tax or value added tax imposes a tax on each of many transactions in our economy, Andrews's tax measures consumption indirectly: consumption is what is left over after income has been reduced by savings and by certain personal deductions such as those for large medical expenses and charitable contributions, and increased for borrowing. For example, a sales tax is collected each time a person purchases groceries, clothes, sporting goods, cosmetics, etc., and a value added tax is collected at each stage of the production of each of those goods. But a person would determine his consumption tax liability by adding his salary, the money he borrowed from a credit union, the dividends he received and the amount realized when he sold the stock, then subtracting the amount he paid for additional stock, loan repayments, and his medical expenses. Andrews's system will be more easily administered than a sales tax or value added tax which attempts directly to tax consumption transactions, because most people have far more consumption transactions than sources of income.

The cash-flow tax can be imposed at progressive rates, because it will impose a tax on an individual's aggregate annual consumption rather than on individual consumption transactions. In contrast, sales and value added taxes may be regressive, because they are normally imposed at flat rates. Accordingly, such taxes normally take a larger portion of poorer taxpayers' incomes, because such persons tend to consume a higher proportion of their incomes than do higher income persons. For example, individuals with $10,000 in income might save nothing, but those with $100,000 in income might save $20,000. A flat 5% tax on consumption such as a sales tax would collect 5% x $10,000 = $500 or 5% of total income from the individual earning $10,000, but would collect only 5% x ($100,000-$20,000) = $4,000 or 4% of total income from the individual earning $100,000. A cash-flow tax could be made progressive, for example, by taxing the first $10,000 of consumption at 4%, the next $10,000 at 5%, etc., so that tax would be progressive as to consumption or even as to income. Moreover,
Andrews suggests, because saving is inversely related to wealth for any given income, his consumption tax may be more egalitarian than the income tax by taxing the wealthy more than the not so wealthy. Thus, of two individuals with $20,000 income, the one who has no savings or investments might consume only $15,000 and save the remainder, while the one who owns property worth $100,000 might consume more or even all of his income. The first would have a lower liability under a cash-flow tax, so that such a tax could, in effect, be progressive as to wealth. Andrews recognizes the problem of the wealthy miser who saves most of his large income, but suggests such persons are sufficiently rare that they should be dealt with by wealth or estate taxes, rather than by the general income tax.

Andrews's article is a significant contribution to consideration of tax policy. There are, however, various problems in replacing our present income tax with his consumption tax. He recognizes many of these problems, and therefore suggests that his proposals be phased in, perhaps beginning as a form of minimum tax, rather than immediately implemented. Some of these problems are discussed below.

First, it is not clear that the purpose of taxes is to divert resources only from private consumption; rather, the purpose would seem to be to divert them from private use, whether consumption or investment. Having the tax borne disproportionately by either consumption or investment is likely to disrupt the economy. If taxes are disproportionately borne by consumption, the rate of return on existing investment may fall since there will be less demand for the consumer goods produced by that investment, possibly causing businesses to fail and risking a recession. If taxes are borne disproportionately by investment, investment will be discouraged, causing shortages of the product of that investment and risking inflation. When the government needs additional resources, not only do we want people buying fewer hula hoops, we also want people building fewer hula hoop factories. When the economy is over-heated and the inflation rate increases, it may be as important to reduce capital outlays as consumption outlays.

Second, although Blum and Kalven have suggested that selecting criteria for taxation cannot be the product of rigorous logic and the scientific method, it is not clear that consumption is the best measure for tax. Another measure might be ability to pay; that term is of course vague, but it would seem that, under any reasonable mean-

ing of the term, a man consuming $10,000 per year and saving nothing has less ability to pay tax than one consuming $10,000 per year and also saving $10,000. Another measure for imposing taxes might be benefits received from the government. Tracing particular direct government benefits to particular tax payments probably would not be fruitful. Some benefits such as providing national defense may be so diffuse as not to be traceable; others such as welfare payments are easily traced, but to tax the welfare recipient on the value of the welfare payment would frustrate the purpose of the welfare program. However, it may be useful to take a broader view of the benefits which government provides. Income is a meaningful concept only in an organized society. Income exists because what one produces, whether directly or through one's investments, is of value to others who will exchange some of their output for it, whether directly through barter or indirectly through a series of money transactions. Organized society does not exist without government, so the cost of having a government may be considered a cost of having an organized society, and the costs of having an organized society may be considered a cost of having income, and thus government may be considered a cost of having income. Therefore, taxes based on income do measure the benefit one receives from society and hence from government. Wealth or net worth, as an alternative to income as a measure of ability to pay taxes or of benefit received, may be an undesirable basis upon which to impose tax, because such a system might discourage the capital formation necessary to our economy and tend to erode existing stocks of capital as each year they are subjected to the tax. Perhaps, however, it would be desirable to use some combination of wealth, consumption, and income taxes,132 rather than relying primarily on only one tax, whether it be the present income tax, the income tax with the reforms proposed in this article, or Andrews's consumption tax. But retaining the income tax will eliminate the simplification possible if we were to tax only consumption, and a tax on wealth would present problems of property valuation and cash flow similar to those presented by taxing unrealized appreciation under the income tax.

A third problem with replacing the existing income tax with Andrews's consumption tax is that, even though a consumption tax would be simpler than our present system, some aspects will be more complex. Andrews recognizes the problem of dealing with consumer durables—a home or car does not represent consumption only in the

year purchased but is rather an investment which will yield consumable services over a number of years—though he does not emphasize that this problem under his tax must be faced by millions of individual taxpayers without computers, accountants, or tax lawyers, whereas the complexities of the present income tax largely affect businesses and investors who do have access to such resources.

Another problem will be posed by progressive rates, with their incentive to shift the tax base from one year or one taxpayer to another. These problems may be more acute under a cash-flow tax. Presumably the bottom rates will not be increased. People in lower brackets do little savings, so an income tax is likely to be the same as a consumption tax, and presumably it is not intended in the Andrews proposal to increase the tax payments of those with low incomes. The middle and upper brackets may have to be increased. On the one hand, persons in those brackets save a considerable portion of their income, so in order to raise the same revenue while taxing only consumption the rates must be higher. On the other hand, if loans are included in income and the capital gains preference is eliminated, the income of those in middle or high brackets as computed under Andrews's consumption tax may increase sufficiently to offset the amount which those taxpayers are permitted to deduct as savings or investment. If the tax brackets at the top must be increased, this will increase the importance of shifting consumption between tax years and taxpayers, contrary to the major school of tax reform which would broaden the tax base, thereby permitting lowering of the rates and reducing the incentive for shifting.

Finally, to the extent that saving is done for retirement, the recent reform of the pension laws enacted since Andrews's article was published permits rather generous tax-free investment and accumulation, and it is not clear that anything more is needed. Andrews recognizes that while saving is done in part to provide for specific goals of future consumption such as provision for retirement, it is also done in part to obtain the prestige and influence of being wealthy, apart from whatever consumption that wealth might make possible. It is unclear how a deduction for saving might affect those providing for future consumption. Saving may increase since it is deductible and thus subsidized. On the other hand, since saving is tax-free, people would not have to save as much to provide for the same level of future consumption, so saving may decrease. However, it would seem likely that those with sufficient income who are seeking not merely future consumption but also the prestige and influence of wealth—having one's name on apartments, offices, stores and factories, having the economic power to influence others' social, political, and economic
activities, etc.—may significantly increase saving, with a consequent erosion of the tax base and aggravation of the inequality of wealth in our society. These are risks not present in the pension system.

As Andrews indicates, the benefits of a cash-flow or consumption-type tax appear to be sufficiently substantial to warrant further consideration and study, but the problems may be so serious that such a system should not yet be implemented.

D. *Restrict Taxpayer Use of Unrealized Appreciation*

Several narrower approaches to the problems of lock-in and fairness created by the present tax treatment of unrealized appreciation are available, if for practical or political reasons neither current taxation of unrealized appreciation nor a cash-flow income tax are adopted. It should be re-emphasized that these approaches all assume that basis has been corrected for inflation, so that only real appreciation is being taxed or otherwise dealt with.

One approach would be to increase the occasions when gain is recognized. Mortgaging property in excess of its basis might be made a recognition transaction. Either the amount by which the mortgage exceeds the adjusted basis could be recognized as taxable gain, or the adjusted basis might be allocated between equity and mortgage, much as basis is now allocated in bargain-sales to charities, with the excess of the mortgage, over that portion of the basis allocated to the mortgage, recognized as taxable gain. In either case, the taxpayer's basis in the property would be increased by the amount of gain recognized. The taxpayer at such time has used the appreciation to produce cash in hand, and he thus has the cash with which to pay the tax. It may be helpful to view mortgaging in excess of basis as a sale of the appreciation in the property for cash, with that appreciation then repurchased with a mortgage. While the property owner may have to repay the loan, that repayment is analogous to repayment of an initial mortgage which was part of the purchase price. Alternatively, making mortgaging in excess of basis a taxable event might be justified on the grounds that the mortgage is an anticipation or acceleration of future income, or, if the property is to be sold before the new mortgage is paid off, the loan proceeds might be viewed as a receipt of the down payment of the sale price. Of course,
working through all the consequences of these conceptual approaches may produce apparent contradictions, but these approaches are suggested only as illustrations, and not as rigorously developed models.

The approach suggested here could be generalized: the mortgage may not exceed the basis without adverse tax consequences. This general principle would restrict other abuse areas, such as the highly leveraged tax shelter industry, and the substantial cash profits which go untaxed under Sections 1033 and 1034 when the old property is sold for cash and the new property is purchased through a mortgage. Reducing an individual's ability to make use of unrealized appreciation, short of realizing it, would increase the economic pressure on the individual to realize the appreciation for tax purposes, which would tend to offset lock-in.

Another way of effectively restricting the use of unrealized appreciation would be to restrict the opportunities to deduct realized losses. The current rules on deduction of capital losses are often arbitrary, because under Section 1211(b) capital losses may be deducted only from realized capital gains (plus $3,000 of ordinary income with $2 of long term capital loss required to offset $1 of ordinary income). Some restriction on deduction of losses may be appropriate. Otherwise an investor with a large and diversified portfolio could choose to recognize losses sufficient to offset his interest or dividend income, while deferring the recognition of gains. The benefits of not taxing unrealized appreciation may be unduly increased if an individual who is deferring recognizing gain on his appreciated property is currently recognizing losses on other property. But under the current rules, a taxpayer whose one investment produces a large loss may have to wait a long time to obtain the full tax benefit from that loss. For example, a corporate employee who purchased his employer's stock to provide for his retirement might sustain a loss of $100,000 on the stock if his employer were to go bankrupt. That employee may


136. Section 1033 permits a taxpayer not to recognize gain when his property is involuntarily converted, for example, when property insured for more than its adjusted basis burns down, if he purchases property similar or related in service or use within the appropriate period. Section 1034 defers recognizing gain on the sale of a taxpayer's principal residence if the taxpayer buys a new residence within the appropriate period. Under both sections, gain is recognized only to the extent the cost of the new property does not exceed the amount realized on the old property. But if the amount realized is in cash and the new property is acquired with a mortgage, the taxpayer is in much the same position as if he had mortgaged the old property: taxpayer has cash with which he could pay taxes, cash which he has because the old property had appreciated.

137. See Section I E supra.
not own enough other property to produce capital gains from which to deduct the loss; taking a $3,000 deduction against ordinary income each year will require seventeen years to deduct this loss.\(^{138}\)

As discussed at the end of section IV B of this article, restriction of loss deductions may create substantial problems if the capital gains preference is eliminated. An alternative restriction on loss deductions might be based on unrealized rather than realized gains: taxpayers would be allowed to deduct realized losses only to the extent those losses exceeded unrealized gains. The remainder of the loss might be used to increase the adjusted basis for the retained property, but it would be administratively burdensome to determine how the basis increase should be allocated and to keep records of these adjustments. It would probably be better to put the realized loss not exceeding unrealized gains into a carryover account to be used as the taxpayer's unrealized gains decreased, either because he recognized some of the gains or because the real value of his retained property declined. For example, an individual might buy three different stocks for $50 each; a year later one might have declined to $40 while the other two rose to $60. If the individual were to sell the $40 stock and one of the $60 stocks, under present law the $10 loss on the $40 stock could be deducted from the $10 gain on the $60 stock. Under the system proposed here, however, the $10 loss on the $40 stock could not be deducted, because the taxpayer has $10 in unrealized appreciation on the other $60 stock. Only if he were to realize the $10 gain on that other $60 stock, or if that stock were to decline in value, would the realized $10 loss on the $40 stock be deductible.

Despite initial appearances, this proposal need not be as difficult as taxing unrealized appreciation. First, unlike a tax on unrealized appreciation, the proposed restriction on loss deductions would not create any cash flow problems. Second, it would be necessary to value the taxpayer's other property only if it appeared that the loss might

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138. The loss would produce only $50,000 in deductions against ordinary income, because under Section 1211(b) long-term capital losses are halved before they are deducted from ordinary income. That this is not just a theoretical possibility is demonstrated by cases such as United States v. Generes, 405 U.S. 93 (1972), involving the distinction between business bad debts and nonbusiness bad debts. Taxpayer had gross income of $40,000, of which $31,000 was salary, leaving at most $9,000 as investment income. In one year taxpayer paid to a corporation he owned $320,000, and lost it all when the corporation went into receivership. It would appear that the $320,000 represented taxpayer's entire savings because, even at an interest rate below 3%, it would earn more than taxpayer's $9,000 in investment income. With little or no savings, taxpayer is unlikely to realize significant capital gains. Since only $1,000 of that $320,000 loss could be deducted from ordinary income each year, it would take over 300 years for taxpayer fully to deduct that loss. Even now, with the limit on deducting capital losses from ordinary income raised to $3,000, he would need over 100 years.
exceed the unrealized appreciation. The need for valuation might be further reduced by permitting deduction of losses of up to, for example, $3,000\textsuperscript{139} without regard to whether the taxpayer had any unrealized appreciation. By symmetry, taxpayers could be allowed to defer recognizing gains not in excess of unrealized losses. But this complication and threat to the revenue may not be necessary: normally the taxpayer could avoid any inequity by selling the property and thus recognizing the loss.

Another alternative by which to reduce lock-in and lessen the tax discrimination in favor of unrealized appreciation would be to charge interest—at the rate normally applicable to deficiencies and overpayments under Section 6621—on the tax otherwise due when the taxpayer disposes of the property.\textsuperscript{140} Although such an interest charge would increase the amount of taxes due when the property is finally sold, it should reduce lock-in. Such lock-in now occurs because failure to tax unrealized appreciation may be viewed as the equivalent of an interest-free loan to the extent of the taxes which would be due on the appreciation if it were taxed as it accrued. There is no cost to \textit{having} such a loan, because no interest is charged, but \textit{repaying} the loan—by selling the property and becoming liable for taxes—is of course costly. Just as lock-in may be reduced by lowering the cost of repayment—as is done now through the reduced rate of tax applicable to capital gains—lock-in may also be reduced by increasing the cost of having the loan, that is, by charging interest. The interest could be charged by determining when the appreciation occurred, correcting the appropriate tax returns, and computing interest on the resulting increase in taxes. Such a system would, however, create difficult problems of valuation, and re-opening old returns is generally disfavored. Rough justice might be simply achieved by computing the amount of tax attributable to the sale in the year of sale, and charging interest on this amount from the year in which half the appreciation occurred to the year of sale. That time could be determined in a similarly rough fashion by assuming that the appreciation occurred ratably over the holding period, as is done under Section 1023(h)(2). Such an interest charge, in addition to reducing lock-in, would also reduce the current discrimination in favor of those owning appreciating property.

Methods of modifying the present tax treatment of unrealized appreciation, in addition to those outlined above and short of either

\textsuperscript{139} This figure was selected partially because it has an analog in §1211(b), which limits the amount of ordinary income that may be offset by capital losses to $3000.

\textsuperscript{140} See McDaniel, \textit{supra} note 135, at 837.
taxing unrealized appreciation or adopting a cash-flow or consumption-type personal income tax, may be available to reduce lock-in and increase fairness. The effectiveness of such methods in reducing lock-in and increasing fairness must be weighed against their costs of administration. The costs and benefits of such methods may then be compared to those of the more complete solutions to these problems of lock-in and fairness, either the taxation of unrealized appreciation or a cash-flow or consumption-type income tax.

**CONCLUSION**

Thus far, this article has discussed some of the justifications for the present tax preference for capital gains and concluded that the capital gains system does not adequately respond to those justifications. Discounting for inflation in measuring gains on sales of property may be excessive or inadequate under the capital gains system, a system which provides no relief from the distortion of income caused by inflation in other areas such as inventories, depreciation, and loans. The bunching of income caused when several years' appreciation in property is taxed in the year of sale, with a consequent increase in taxes due to our progressive rate structure, may be overcompensated or, occasionally, undercompensated by capital gains. Lock-in may be reduced by capital gains, but at the cost of exempting substantial amounts of gain from tax. In addition to not adequately responding to these justifications, particularly when a transaction produces a loss, the capital gains system is responsible for much of the complexity in our tax laws. The first part of this article recognizes the seriousness of problems such as inflation, bunching, and lock-in, and proposes mechanisms to solve such problems generally, not merely in the capital gains area. While some of those mechanisms may be relatively simple—an explicit inflation correction and liberalized averaging—others, such as taxing unrealized appreciation or converting to a cash-flow or consumption-type income tax, will be complex. Further study is required to determine an appropriate index of inflation and to develop techniques of measuring value. In addition, the revenue effects of implementing such mechanisms must be investigated. It is hoped that the proposed mechanisms will survive

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141. Some of the problems with present methods of projecting revenue effects of tax changes are set forth in *Tax Expenditures, Budget of the United States Government—Fiscal Year 1976*, 67-79 (office of the President 1976). First, the revenue effect of each change is considered based on the marginal rates for taxpayers under existing law, but when several changes are enacted at once they may dramatically change the marginal rates. In estimating the revenue effects of a package of reforms such as proposed here, it will be necessary to estimate the revenue effects of the package in the aggregate rather than item by item.
such further study.

Another possible justification for capital gains is the amelioration of the double taxation of corporate earnings. As discussed in this article, capital gains does not adequately respond to this justification. Part II of this article, which will be published at a later date, will discuss mechanisms for integrating the personal and corporate income taxes. It will also discuss both partial integration as to dividends, by giving the corporation a deduction for dividends paid or by giving a shareholder a credit for taxes already paid by the corporation on amounts distributed as dividends, and complete integration which would apply not only to dividends but also to retained earnings. Such complete integration mechanisms might include taxing corporate income much as partnership income is now taxed—the corporation would not be a taxable entity, but its income would be taxed pro rata to its shareholders—or by taxing shareholders on increases in the real value of their stock and on dividends received and concurrently repealing the corporate income tax.

With general solutions to the problems of inflation, bunching, lock-in and double taxation, the complexity and apparent inequity created by the capital gains system would be difficult to justify, so that unless justifications for capital gains other than those discussed are very substantial, the capital gains preference may be eliminated.

Second, only first order effects are considered, i.e., it is assumed that neither taxpayer behavior nor general economic conditions change. That assumption is of course unrealistic because both taxpayers and the economy may be expected to be influenced by changes in the tax laws. For minor changes in the tax laws, however, that assumption may provide a reasonable working hypothesis, because the effects of such changes may not greatly influence either taxpayers or the economy. For the major changes proposed here that assumption is probably not a safe working hypothesis. It may be possible to consider second order effects—how taxes collected will rise or fall in light not only of the changes in the tax laws but also of taxpayer and the economy’s reactions to those changes—through use of the complex models of the economy being developed by econometricians. See, e.g., L. Klein, A TEXTBOOK OF ECONOMETRICS 226-80 (2d ed. 1972).