REPORT #735

TAX SECTION

New York State Bar Association

Capital Gains Indexation by Regulation

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September 1, 1992

The Honorable William P. Barr
Attorney General of the United States
U.S. Department of Justice
Washington, DC

Dear Mr. Attorney General:

I enclose for consideration by you and your colleagues a memorandum, submitted on behalf of the Tax Section of the New York State Bar Association, that addresses the August 17, 1992 memorandum entitled "The Legal Authority of the Department of the Treasury to Promulgate a Regulation Providing for Indexation of Capital Gains" prepared by Charles J. Cooper and Michael A. Carvin. I have been told that that memorandum is presently being considered by the Department of Justice.

We would be pleased to discuss this subject with you and your colleagues if you think that would be helpful.

Very truly yours,

John A. Corry

cc: The Honorable Nicholas Brady
The Honorable Fred T. Goldberg, Jr.
The Honorable Shirley D. Peterson
The Honorable Dan Rostenkowski
The Honorable Lloyd Bentsen
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Memorandum September 1, 1992

Re: Capital Gains Indexation by Regulation

This memorandum, submitted on behalf of the Tax Section of the New York State Bar Association (the "Tax Section"), addresses the August 17, 1992 memorandum entitled "The Legal Authority of the Department of the Treasury to Promulgate a Regulation Providing for Indexation of Capital Gains" prepared for the National Chamber Foundation and the National Taxpayers Union Foundation by Charles J. Cooper and Michael A. Carvin of Shaw, Pittman, Potts and Trowbridge (the "Cooper Memorandum"). The Cooper Memorandum concludes that such a regulation "should and would be upheld judicially as a valid exercise of the Treasury's interpretative discretion under the IRC", although it acknowledges that the question "is admittedly a close and difficult one ..."

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On February 13, 1992, the Tax Section submitted a memorandum ("the Tax Section Memorandum") to President Bush stating that such regulatory action would be an invalid usurpation of the Congressional legislative authority[1]. Although it has not been possible in the limited period of time available to obtain the reaction of the Tax Section's full Executive Committee to the Cooper Memorandum, the Tax Section's officers have reviewed it and continue to believe that such regulatory action would be invalid.

We have the following specific comments regarding the Cooper Memorandum:

1. The Cooper Memorandum does not cite or consider the four cases, discussed in the Tax Section Memorandum, that recognized that the cost of property for tax basis purposes is the amount paid for the property.[2] Their conclusion, resulting from an interpretation of "cost" under the statute (without reference to any regulation), is an excellent indication of how a judge would decide the issue. The Cooper Memorandum's failure to offer any analysis of the case law is troubling.

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[1] A copy of that memorandum is attached.

[2] Vandenberge v. Commissioner, 147 F.2d 167, 168 (5th Cir. 1945), cert. denied 325 U.S. 875 (1945); Hawke v. Commissioner, 35 B.T.A. 784, 789 (1937) reversed on other grounds 109 F.2d 946 (9th Cir. 1940), cert. denied 311 U.S. 657; Silverstein v. United States. 349 F. Supp. 527, 530 (E.D. La. 1972); Hellermann v. Commissioner, 77 T.C. 1361, 1366 (1981).

2. The Cooper Memorandum also omits any reference to the fact, discussed in the Tax Section Memorandum, that the Internal Revenue Code contains 24 enumerated adjustments to "cost" as the measure of basis. This extensive list of basis adjustments demonstrates that Congress has preempted this field with a degree of precision that would render invalid any regulatory intrusion.

3. The Cooper Memorandum, at pages 36-38, relies on a regulation under the Revenue Act of 1918 which provided that the cost of inherited property was its fair market value at the time of acquisition. The Cooper Memorandum's description of this regulation is incomplete. Both the original 1918 Act regulation and its 1921 amendment contained the following final sentence, to which the Cooper Memorandum does not refer:

"See section 213(b)(3) of the statute and article 73." Section 213(b)(3) of the 1918 Revenue Act provided that gross income does not include "the value of property acquired by gift, bequest, devise or descent."

A leading treatise comments:

> "This cross-reference permits the inference that the basis for the position of the department as reflected in the regulations fixing the value for the purpose of determining gain or loss in that the increment in value prior to the date of acquisition is exempt from tax under §213(b)(3).[3]

[3] Paul and Mertens, Law of Federal Taxation (1934) §18.79, n. 10.

Therefore, in its regulation defining "cost" by reference to value, the Treasury was relying on a specific and directly relevant statutory provision that referred to value and provided that bequests and gifts are not to be taxed. By contrast, there is no similar authority for a regulation that defines "cost" by reference to inflation.

4. The Cooper Memorandum at pp. 38-40 also relies on a 1918 Act regulation that defined cost to require basis adjustments to reflect previously taxed but undistributed partnership income and another regulation that adjusted "cost" for depreciation. Both adjustments reflected the fact that as a matter of tax policy the basis of property should reflect previously reported income or deductions with respect thereto. Otherwise, there would be a double inclusion of income or a double deduction. It is a fundamental tax principle, however, that a basis adjustment does not occur in the absence of income recognition or some other taxable event involving the property in question. Indexation would violate that principle.[4]

5. At pages 51 and 52, the Cooper Memorandum discusses Congressional committee reports written in 1926 and 1934 as supporting the argument that "one of the reasons that neither the Treasury nor the Congress specifically accounted for inflation in the determination of 'cost' is that the adverse effect of inflation was ameliorated by the general capital gains tax preference." This misses the significance of these reports. Vis-a-vis the issue of the alleged regulatory power to redefine "cost", the reports reflect the Congressional recognition, many years before the present regulatory definition was adopted, that the "cost" of property for basis determination purposes does not

[4]The date of death basis for property acquired by inheritance is a striking exception to that rule, but that exception is provided by statute.

reflect any adjustment for inflation. Thus, the existing regulatory definition of cost as representing the price paid for property was not written on a clean slate, but instead is a confirmation of what Congress for many years had considered the definition to be.

6. The Cooper Memorandum devotes substantial discussion to legislative initiatives of the past 14 years regarding indexation and concludes that Congress' failure to enact any of these proposals does not demonstrate Congressional opposition to indexation. Again the Cooper Memorandum misses the real point: in its ongoing consideration of the question of inflation indexing, Congress has consistently demonstrated its acceptance of the long-standing regulatory interpretation under existing law. This background makes clear that the definition of "cost" is not one "which Congress itself either inadvertently did not resolve, or intentionally left to be resolved by the agency charged with the administration of the statute in light of everyday realities"[5].

7. This legislative history further demonstrates the primacy of the legislature's authority to deal with the issue. It is particularly noteworthy that the most recent Congressional initiatives have not been directed to the definition of "cost" in section 1012, where any change would necessarily apply to all assets (unless a substitute or carryover basis is otherwise prescribed) and would apply in determining loss as well as gain. Instead, Congress considered narrowly drafted proposals which would have applied only to certain assets held by certain taxpayers, and only for purposes of computing gain. Thus, legislation passed earlier this year by the House of Representatives applied only to shares of corporate stock and

[5]Chevron U.S.A. v. Natural Res. Def. Council, 467 U.S. 837, 865-866 (1984).

tangible property that are capital assets or property used in a trade or business, and then only to assets held by taxpayers other than c corporations for more than one year.

8. The Cooper Memorandum stresses the judicial deference paid to Treasury Department and Internal Revenue Service regulatory interpretations based upon the expertise of these agencies in administering and interpreting the tax laws. The arguments that have been advanced in favor of indexation, however, relate to broad questions of economic policy — issues that bear no relation to tax policy as such and are not within any special province of tax-related administrative expertise.

9. The Cooper Memorandum discusses the definition of "cost" only in the context of the determination of capital gain. It does not address whether any regulatory redefinition can be limited in this manner or whether a regulatory redefinition of cost would instead have to apply to the determination of loss as well (and indeed whether there is a gain or a loss), to the disposition of all assets, whether capital or ordinary and for depreciation purposes. The statute draws no distinction between the cost of capital assets and the cost of ordinary income assets, and the statutory basis for determining gain or loss is identical (except where a Code provision specifically provides otherwise). Therefore, as the Tax Section Memorandum states, there is no statutory support for a regulation distinguishing between gains and losses in the definition of cost, or for different definitions of "cost" for capital and non-capital assets. The issue of such distinctions may not be directly relevant to the narrow question of regulatory authority to define cost, but it certainly is relevant to any regulation that purports to differentiate between asset types or gains and losses. Furthermore, the extent of basis indexation clearly is

relevant to any analysis of revenue effects. Accordingly, these questions must be considered in reaching any decision on this issue.

10. The concluding paragraph of the Cooper Memorandum is a broad disclaimer of any consideration of the myriad of practical and budgetary implications of basis indexation through regulation. Tax basis is not a narrow, interstitial issue that can be modified by "interpretative" regulations without serious attendant consequences. Basis is fundamental to the calculation of taxable income and is part of the Code's essential architecture. The issues not dealt with in the Cooper Memorandum are of grave importance, and that they cannot be ignored.

11. The Cooper Memorandum does not adequately address the risk that a serious legal challenge will be made to the Administration's authority to redefine basis. Some taxpayers could be adversely affected by a regulatory change.[6] Given the acknowledgement in the Cooper Memorandum that the question of legal authority is a close and difficult one, it must be anticipated that a legal challenge to the regulation might prevail. If a taxpayer successfully challenged the indexation regulation -- and indeed during the pendency of any serious challenge -- there would be massive confusion and serious retroactive effect concerns on taxpayers' planning. While the proponents of basis indexation would undoubtedly respond that, in such a case, Congress would be forced to ratify the indexation

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[6]Examples include the following: The reduction of corporate earnings and profits under Code section 312(f) and the possible resulting adverse effects on the intercorporate dividends received deduction under Code section 243 and the computation of the deemed paid foreign tax credit under Code section 902(a); prejudicial results under the allocation rules for determining interest deductions under Code sections 864(e) and 882(c) and the regulations thereunder; and the regulated investment company and real estate investment trust qualification tests contained in Code sections 851(b)(2) and 856(c)(2), where qualifying income includes gains from the disposition of certain assets.

regulation by statute, that argument would only highlight the usurpation which is implicit in the basis indexation proposal.

Conclusion

The Cooper Memorandum fails to address satisfactorily two crucial, and in our opinion controlling, legal points.

1. For many years, and long before the 1957 promulgation of the existing regulation, it was absolutely clear that both the Congressional and Executive branches of the Government understood that the word "cost" in section 1012 and its predecessors meant the amount paid for property.

2. Through its repeated consideration of and failure to adopt any form of basis indexation, Congress has affirmed its exclusive authority to initiate any introduction of the concept into existing law.

In addition, the Cooper Memorandum ignores essential practical issues raised by the indexation-through- regulation proposal, and by failing to address the realities of regulatory indexation is an unsuitable basis for taking action.

Viewing together these legal points, the extraordinary significance of the proposal, and its uncertain effect on government revenue, we believe that it is Congress alone that has the power to redefine what "cost" means.

John A. Corry
Chair