REPORT #824

TAX SECTION

New York State Bar Association

Memorandum to NYSBA Executive Committee

JANUARY 25, 1995

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February 17, 1995

To: Executive Committee

From: Carolyn Joy Lee

Re: Contract with America Indexation Hearings

Enclosed is a copy of (i) Michael Schler's January 25, 1995 Statement at the Hearing before the House Ways & Means Committee; (ii) a February 7, 1995 supplement to that Statement; and (iii) Michael Schler's Statement at the February 16, 1995 hearing before the Senate Finance Committee.

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HEARINGS ON H.R. 9 BEFORE THE

HOUSE WAYS AND MEANS COMMITTEE

JANUARY 25, 1995

STATEMENT BY MICHAEL L. SCHLER ON BEHALF OF

THE TAX SECTION OF THE NEW YORK STATE BAR ASSOCIATION

My name is Michael Schler. I am here on behalf of the Tax Section of the New York State Bar Association. I was the Chair of the Tax Section until my term expired yesterday, and I continue to be a member of our Executive Committee. The Tax Section is dedicated to furthering the public interest in a fair and equitable tax system and to the development of sound tax policy. I am a tax partner at the New York law firm of Cravath, Swaine & Moore and have practiced tax law for over 20 years. I am accompanied by Harold Handler, a tax partner at the firm of Simpson Thacher & Bartlett. He has practiced tax law even longer and is primarily responsible for our work on indexing.

We are very grateful for the opportunity to present our views today. We strongly oppose three provisions of H.R. 9: capital gains indexing, indexing depreciation deductions, and the imposition of new procedural requirements for the issuance of tax regulations. I would like to briefly summarize our reasons.

First, capital gains indexing. We recognize the theoretical correctness of indexing capital gains to take account of inflation. However, we believe there are two fundamental problems with indexing.

The first problem is complexity. The indexing provisions of H.R. 9 on their face add only a few simple paragraphs to the Internal Revenue Code. However, we believe that in the real world indexing will vastly increase the complexity of the tax system for everyone. This includes individuals, businesses of all sizes, and the IRS. Activities that are relatively simple today will involve massive calculations under indexing—buying and improving a home, selling the family car (yes, the car is an indexed asset), buying and selling stock or an interest in a mutual fund, investing in an IRA. Also, if a state chooses not to allow indexing for revenue reasons, everyone in that state will be required to keep two sets of books. Individual taxpayers are likely to be dumbfounded at this prospect.

The other major problem we have with indexing is that it will inevitably result in the return of the tax shelter days of the 1980's. Every experienced tax lawyer who reads the indexing provisions of H.R. 9 immediately dreams up a half dozen ways to “beat the system” and create a tax shelter that eliminates tax on unrelated income. Some of the most obvious opportunities arise from the fact that assets are indexed while liabilities are not. As a result, totally artificial tax deductions can be created with little or no out-of-pocket investment, by borrowing and using the proceeds to buy an indexed asset. Also, there would be many ways besides borrowing to create a tax shelter out of indexing. Just keep in mind that the world of financial products is extraordinarily creative, and very motivated to develop tax favored investments.

I would like to turn briefly now to indexing depreciation deductions. We understand that the effect of this provision is that, on a present value basis, there will be no tax on a reasonable rate of return from the use of equipment. This is another way of saying that qualified equipment is treated like a municipal bond, although the equipment has a much higher tax-free yield. Also, if you borrow money to buy a municipal bond, the interest is not tax deductible. If you borrow money to buy equipment, the profit will be tax-exempt <u>and</u> the interest will be deductible. As a result, we foresee an enormous boom in tax shelters.

Finally, H.R. 9 imposes new procedural requirements before a federal agency can issue regulations. We strongly oppose the application of these requirements to tax regulations. The requirements are so burdensome that the issuance of regulations may come to a grinding halt. Taxpayers need tax regulations to be able to plan their affairs. The biggest complaint among taxpayers is there are too few regulations, not that there are too many.

H.R. 9 would also require that tax regulations be “easily readable”, “written in a reasonably simple and understandable manner”, and not contain any “double negatives, confusing cross references, convoluted phrasing” and so on. I do not believe there is anyone anywhere who thinks that the Internal Revenue Code itself meets any one of these requirements. H.R. 9 is an example of Congress imposing rules on other people and exempting itself from the same rules. It is completely unreasonable to expect that tax regulations can be made simple as long as the Code is almost incomprehensible.

That completes my prepared statement. I would be happy to answer any questions.

1995 Appendix: The 1995 Bill

The 1995 Bill differs from the 1989 Bill in several respects. Many of the changes address concerns which were discussed in the 1990 Report. However, in responding to these concerns, the 1995 Bill creates additional serious problems. This merely demonstrates our belief that any indexation system is inherently unworkable. Many of the modifications which are contained in the 1995 Bill are relatively minor and have little impact from a technical point of view. The following changes could have significant technical implications and are therefore worthy of discussion.

The 1995 Bill Eliminates Even the Inadequate Measures for Mitigating Debt Arbitrage Provided in the 1989 Bill.

The 1990 Report commented on the arbitrage opportunities brought about by the 1989 Bill's failure to index liabilities. The 1995 Bill does not correct this problem. In fact, the 1995 Bill even eliminates the 1989 Bill's limited solution to the debt arbitrage problem. Although the solution contained in the 1989 Bill was problematic, its elimination gives rise to significant concern that the magnitude of the debt arbitrage problem is not fully recognized.

The 1989 Bill attempted to mitigate the potential for debt arbitrage by disallowing basis adjustments that would create or increase a loss. Under the 1989 Bill, the basis of assets could be indexed solely for purposes of determining gain. In contrast, the 1995 Bill allows indexation to create or increase capital, but not ordinary, loss. All ordinary losses generated or increased though indexation will be treated as long term capital losses.

The 1990 Report stated that the loss limitation solution to the debt arbitrage problem was problematic because of its failure to treat similarly situated taxpayers comparably. However, allowing indexation to create losses is highly questionable since it exaggerates the potential for tax arbitrage, thereby sanctioning potentially serious tax avoidance schemes.

In addition, allowing losses to be created through indexation while still failing to index liabilities will create an even greater revenue risk than what would have existed under the 1989 Bill. This further highlights our concern regarding the intrinsic problems with indexation. The 1990 Report provides examples which illustrate this point. See section III (B) (1) of the 1990 Report.

Corporations may Index Assets Under the 1995 Bill.

Corporations would be permitted to index their assets under the 1995 Bill, whereas they could not do so under the 1989 Bill. The 1990 Report noted that not allowing corporations to index assets would tend to increase the tax penalty associated with operating through a C corporation and therefore increase the existing bias against operating in C corporation form. Although the 1995 Bill avoids this situation by allowing corporations to index basis, the inclusion of corporations nonetheless introduces several new areas of significantly heightened complexity to the tax law.

One of the principal areas of concern is the consolidated return rules. To implement appropriate basis adjustment rules, coordinated indexing adjustments would have to be made at each tier of, a consolidated group. This coordination would have to reflect differences that might exist by reason of variances between the basis of a subsidiary's stock and the basis of its assets, the mix of indexable and non-indexable assets at the subsidiary level, and the timing of the sale of stock or assets. For example, because parent corporation P may sell the stock of subsidiary S, which holds indexable assets, before S realized gain on those assets, a mere pass-through of realized indexing adjustments would be inadequate for P. Thus, rather than a single adjustment at the time of disposition, annual basis adjustments with the associated complexity would have to be made and passed through up the chain of stock ownership. Moreover, complex rules would be necessary to deal with cross-ownership of stock among members of a consolidated group to avoid multiplication of indexing adjustments. Special rules also would be required to deal with intercompany transactions. Finally, we note that because the rules that would apply for consolidated returns presumably would reflect the fact that not all assets are indexable, there may be vast differences in the indexing adjustment available to a corporation with respect to stock in otherwise identical corporations where one is consolidated and one is not.

The 1995 Bill Creates Distortions for Holders of Partnership Interests by Eliminating the Special Rule for Section 754 Elections.

Both the 1989 Bill and the 1995 Bill would provide for indexation of partnership assets at the partnership level and a pass-through of the adjustment to the partners. Partnership interests themselves are not indexable assets under either bill. The 1989 Bill, however, contained a special provision applicable to the transfer of a partnership interest if the partnership had made a section 754 election which was in effect at the time of the transfer. Under this provision, the transferor partner would treat the adjustment under section 743(b)(l) as a sale of the partnership assets for purposes of indexation. This provision effectively allowed the transferor partner to index his partnership interest.

The 1990 Report explored some of the substantial problems which would result from the special rule pertaining to section 754 elections. Rather than developing a substantive solution to these problems, however, the 1995 Bill merely eliminates the special provision entirely. In doing so, it has merely replaced the prior difficulties with new problems.

For example, the 1995 Bill now creates an unprincipled distinction between joint ownership of assets and holding assets in partnership form. Consider individual taxpayers A and B who hold an asset jointly. Each has a 50% interest in the asset, which has a cost basis of $100 and a fair market value of $200. In a later year, when A disposes of A's share of the asset, the indexed basis of the asset is $150. Therefore, A's gain upon disposition is $25. Alternatively, if A and B hold the same asset through a partnership, upon a sale of A's partnership interest to C for $100, A would have a $50 gain. Therefore, A is effectively penalized for using the partnership form.

On the other hand, if the value of the asset has declined, there would be a loss on the sale of A's interest to C. If a section 754 election is made, the basis of the partnership assets with respect to C is written down. However, if no election is made, it remains possible for C to get the benefit of buying an interest in an indexable asset at less than original cost where the indexable basis of the asset at the partnership level is significantly higher. In doing so C would gain the benefit of indexation adjustments upon the partnership's ultimate disposition of the asset that may be greatly overstated relative to the actual effect of inflation on the asset during C's holding period. These overstated adjustments could effectively shelter significant real gains. We can anticipate an active market for such tax sheltering opportunities.

1995 Bill uses a GNP Deflator Rather than the Consumer Price Index.

A minor change has been made which relates to how assets will be indexed. The 1989 Bill used an index which was based on the consumer price index while the 1995 Bill uses a GNP deflator. As the 1990 Report indicated, we believe that any indexation factor is destined to produce imprecise results. As it will be pure chance if a basis adjustment actually matches inflation, we believe that which factor is ultimately chosen should an indexation system be put in place is a matter of little consequence as a technical matter.

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January 19, 1995

The Honorable Bill Archer
House of Representatives
Washington, D.C. 20515

Re: Tax Basis Indexing Provisions of H.R. 9

Dear Chairman Archer:

I am writing on behalf of the Tax Section of the New York State Bar Association to strongly oppose any proposals to index the tax basis of assets for inflation.

It is our judgment as tax lawyers that the indexation proposals currently before Congress are fundamentally, flawed. The proposals would:

- permit unwarranted tax avoidance and revenue
- potentially result in the mass marketing of tax shelters to well advised and high income taxpayers, as in the 1980's; and
- vastly increase the burden and complexity of the tax system for all taxpayers (individual, small business and large business) as well as the IRS, at a time when many believe that its complexity has already brought it near the breaking point.

Moreover even if a theoretically sound system of indexation could be developed, the additional

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complexities that would be necessary to do so would completely overwhelm taxpayers and the IRS.

Our position on indexation is based on our particular experience and expertise as tax lawyers rather than on broader policy judgments. We take no position on the policy issues of the appropriate tax rate that should apply to capital gains in general, or the appropriate depreciation rate that should apply to depreciable assets.

We refer specifically to two provisions of H.R. 9, the Job Creation and Wage Enhancement Act of 1995. The first is Section 1002, which (with certain exceptions) indexes the basis of corporate stock and tangible assets that are capital assets or used in a trade or business. The second is Section 2001, which indexes the basis of depreciable property

Section 1002

Section 1002 is based almost entirely on a similar provision in H.R. 3299 introduced in the 101st Congress in 1989 and approved by the Ways and Means Committee in that year (the "1989 Bill"). In 1990 the Tax Section submitted a letter and report discussing that provision (the "1990 Report"), in which we strongly urged Congress to reject indexation.

We enclose a copy of the 1990 Report, as well as a newly prepared Appendix that details the variations between the indexing provisions of the 1989 Bill and H.R. 9. As noted in the Appendix, if anything H.R. 9 provides even greater opportunities for improper tax avoidance than did the 1989 Bill. As a result, almost all the serious issues raised in the 1990 Report are equally valid today.

Much of the tax avoidance potential of indexing in Section 1002 arises from the fact that indexing is not consistently applied:

- assets are indexed to reflect the fact that appreciation in value in dollar terms is illusory to the extent it is offset by a
- liabilities are not indexed even though the real value of the obligation to repay the debt is equally reduced by a decline in real value of the dollar.

This is best illustrated by an extreme but simple example of a “no money down” tax shelter, where the taxpayer starts with no cash, exactly breaks even on a cash flow basis, but ends up with a tax deduction:

> On January 1, 1996, X takes out a recourse loan of $100 and buys a share of common stock for $100. Inflation during 1996 is 3%. The interest rate on the loan is 6%. The stock pays dividends of 6%, just enough to pay the interest on the loan. On January 2, 1997, X sells the stock for $100 and uses the proceeds to pay off the loan.

X made no out-of-pocket investment that lost value due to inflation. There is thus no possible justification for applying indexation to X. Nevertheless, under the indexing proposals X's tax basis in the stock increases from $100 to $103 because of the 1996 inflation of 3%. X can therefore claim a taxable loss of $3 on the sale of stock. Thus, on a <u>transaction which was totally break-even to X under any interpretation, X has created a capital loss that permits X to avoid all tax on $3 of other unrelated capital gain.</u>

This result is perfectly legal under H.R. 9, and any tax lawyer would give an unconditional tax opinion that it worked. Moreover, while the example involves the creation of a capital loss that could only offset capital gains, a slight variation in the example would result in the creation of an ordinary loss that could offset unrelated ordinary investment income of an individual, and any unrelated ordinary income of a corporation.[1]

Moreover, individuals could use home equity loans to purchase indexed assets. Since interest deductions on such loans are not subject to the “investment interest” limitations of the Code, the reduced capital gain on the sale of an asset due to indexing would “free up” interest deductions that could be used to shelter salary and other noninvestment income.[2] It is from examples like this, however, that tax shelters are made and marketed.

To be sure, in the example, X bore the risk that the stock would decline in value and that a real economic loss would result. A tax shelter would not be attractive on this basis. However, there are numerous opportunities under the statutory provision to substantially reduce or eliminate risk of loss, thereby creating a pure “tax loss generator” that requires little or no investment, and that involves little or no risk of loss.

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[1] Suppose that the stock paid no dividends and was sold for $106 instead of $100. There would still be just enough cash to pay interest and principal on the debt, but X would have $3 of capital gain (taking into account the indexed basis of $103) and a $6 interest deduction. The result would be that at least $3 of unrelated ordinary investment income would be sheltered from tax. Taking into, account the 50% capital gains deduction also in H.R. 9, there would be only $1.50 of income on the sale, and the $6 interest deduction would permit $4.50 of other ordinary investment income (or $9 of other capital gain) to be sheltered from tax. In the case of a corporation, the Section 163(d) investment interest limitations do not apply, and the unrelated income could be sheltered even if were not investment income.

[2] Interest on business loans is also exempt from the investment interest limitations. The result in the text could therefore also be achieved if a self-employed individual were permitted to take out a business loan and indirectly use the proceeds of the loan to purchase an indexed investment (through the technique of using the loan proceeds in the business and withdrawing “different” cash from the business to make the investment). This technique raises the “tracing” issue discussed below.

It would be possible in theory to avoid results such as these that are based on leverage by:

(1) disallowing indexing on debt-financed property,

(2) indexing liabilities the proceeds of which were used to acquire indexed assets, so that a borrower would have income on the repayment of principal on such a loan to reflect the economic gain arising from the fact that the loan was repaid with dollars that were worth less than the borrowed dollars because of inflation; or.

(3) similar to (2), disallowing each year a portion of the deduction for otherwise deductible interest on debt used to acquire indexed assets, based on that year's inflation rate.

However, we believe the resulting complexity of any of these approaches would be so overwhelming that any such attempt would fail.[3] Very significantly, there would need to be complex rules “tracing” liabilities to indexed assets, so that one of the foregoing consequences would arise only to the extent the debt “relates” in some fashion to indexed assets.[4]

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[3] For example, under approaches (2) and (3), if a home mortgage were used to acquire an indexed asset (including the home itself or a car, both of which are indexed assets), either a portion of each monthly interest payment would be nondeductible or else income would arise on each monthly principal payment.

[4] The interest tracing rules are already among the most complex tax provisions applicable to individuals, and new tracing rules for indexing would simply be overwhelming. Moreover, taxpayers would make great efforts to “separate” their debts from their indexed assets. To illustrate part of the problem, suppose an individual simultaneously (1) used money in the bank to buy indexed stock and (2) borrowed money to buy a bond that is not eligible for indexing. Would one of the adverse consequences apply to the loan or the stock, as would be the case if (1) the cash was used to buy the bond and (2) the loan was used to buy the stock?

Moreover, debt financing is not the only technique that could be used to create unwarranted tax benefits from indexing. Indexing could be used to generate artificial tax losses, with no significant risk to the taxpayer, through financial transactions such as (i) net leasing that did not come within the net leasing exclusion in the bill, (ii) preferred stock with small upside potential that did not come within the preferred stock exclusion in the bill, and (iii) equity swaps forward sales, and other financial products, none of which come within the short sale rule in the bill.

Of course, attempts could be made to preclude all unintended results of indexing. However, this would create further complexity and would likely prove ineffective in any event.[5] In addition, a large amount of otherwise productive economic resources would be shifted into tax planning schemes.

As a result, we strongly oppose the provisions of Section 1002 of H.R. 9.

Section 2001

We turn now to Section 2001 of H.R. 9, relating to "Neutral Cost Recovery". That provision in effect indexes the basis of depreciable property for inflation, and, in the case of property with a depreciable life of 10 years or less, an additional 3.5% per year. We understand that the latter adjustment is intended to be the financial equivalent of immediately expensing the asset, and that immediate expensing is in turn financially equivalent to the expected return on an asset being completely free of tax.

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[5] Moreover, if indexing is adopted and turns out to be undesirable for these or other reasons, even if it were repealed its complexities might linger for decades. Taxpayers would likely expect to retain the full indexed basis of assets as of the repeal date, even if future indexing of all assets was prohibited. Thus, records concerning the brief application of indexing would have to be maintained for as long as those assets were held.

Each of our objections to capital gains indexing applies equally to basis indexing for depreciation purposes, and to an even greater extent to indexing in excess of the inflation rate. We believe the effect will be a vastly more complicated Tax Code, greatly increased opportunities for tax avoidance, and a great shifting of economic resources into tax planning schemes.[6]

For example, short-lived equipment will be similar to a municipal bond in that expected earnings will in effect be tax-free. Such equipment will actually be a far better investment than a municipal bond, however, because interest on debt to purchase the equipment will be fully tax-deductible while interest on debt incurred to purchase a municipal bond is not deductible. This result has the potential for reduction of the corporate income tax far beyond that apparently contemplated by the drafters of the statute. For these reasons, we also strongly oppose Section 2001.

Conclusion

We would be pleased to assist in any way possible in trying to make these or other indexing proposals more workable. However, for the reasons stated above we believe such efforts would be overwhelmingly complex and are not likely to succeed. We therefore strongly oppose the indexing proposals and believe their adoption would be a serious error.

We also wish to point out an additional very significant issue relating to state taxes. The indexing provisions in H.R. 9, if applicable for state tax purposes, would cause a significant loss of state revenue. As a result, some states may not be willing to allow indexing of some or all assets. Enormous additional complexity would result if individuals or corporations, or both, were required to maintain separate tax basis and other related records for

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[6] We may provide additional technical comments on this provision in the future.

Federal and state tax purposes.

Finally, we understand that the United Kingdom and several other countries have forms of basis indexing. As indicated in our 1990 Report, however, we understand that a series of anti-abuse amendments has been necessary in the U.K. Moreover, we understand that some countries (such as the U.K.) do not also have the reduced capital gains rate provided in H.R. 9, and others (such as Israel) have experienced severe inflation necessitating indexing despite its drawbacks.

Most importantly, we are not aware of the extent to which discontinuities in the tax systems of those other countries are exploited by taxpayers in order to achieve unintended tax benefits. We believe, however, that recent history in the U.S. indicates that such results here are extremely likely.

Very truly yours,

Michael L. Schler
Chair, Tax Section

cc: Congressman Sam Gibbons

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Tax Report #662

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June 28, 1990

The Honorable Dan Rostenkowski
Chairman
House Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Rostenkowski:

I write to express the strongly held view of the Executive Committee of the Tax Section that Congress should reject any proposal to adjust or “index” the basis of capital assets for inflation. As described in the enclosed Report, an indexation regime would create intolerable administrative burdens for taxpayers and tax administrators as well as offer numerous tax arbitrage and avoidance opportunities for aggressive tax planners. As tax practitioners, we are seriously concerned that any indexation system will permit the use of its inherent complexities, distortions and tax avoidance opportunities to severely erode the revenue base. An indexed tax system will also place a great deal of additional strain on an audit system already stretched beyond the limits of its real capacity.

Adoption of indexation in even the most limited manner would make the tax law significantly more complex. We view this incremental complexity as particularly insidious

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because the implementing legislation may be deceptively simple. The indexation provisions adopted by the Ways and Means Committee in the course of considering the Omnibus Budget Reconciliation Act of 1989, discussed in some detail in our Report, represent just this type of deceptive simplicity. In effect, simplicity is achieved by simply ignoring the many difficult problems inherent in the statute.

Although we express our grave concern about the desirability of implementing an indexation regime, we wish to make clear that we are not at this time expressing any position regarding the desirability of enacting any form of preferential taxation of capital gains including the adoption of a preferential rate.

Very truly yours,

Arthur A. Feder
Chair

Enclosure

I. INTRODUCTION

In the ongoing debate regarding the implementation of some form of preferential taxation of capital gain income, many legislative alternatives will be considered. One such alternative is adjusting or “indexing” the basis of certain capital assets to reflect general price level inflation, thereby attempting to tax only “real” as opposed to inflationary gains.[1] This Report discusses the issues, problems, and other considerations raised by the indexing of the basis of capital assets.

The principal argument in favor of indexing basis is that the tax system would be more equitable if only “real” as opposed to inflationary gains are taxed. Nevertheless, it is our view that the implementation of any indexing regime would necessarily introduce far reaching new complexities and distortions into the tax system, without necessarily resulting in the taxation of only “real” gains. We believe the tax law would be ill served if Congress were to enact any such system.

In addition to increased complexity, any indexation system would by its nature provide taxpayers with additional deductions or basis adjustments which would diminish income, and thus tax revenues. Any system of indexation must also be designed with great care to avoid creating “abusive” opportunities for tax arbitrage, that is, providing deductions or reduction of taxable income for high-bracket taxpayers while allowing income to be or shifted to tax-exempt or nontaxable entities. As we explore in some detail below, an indexation system which only selectively attempts to index the tax system would create numerous

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[1] Several Bills currently are pending before Congress that would provide for some form of basis indexing. See S. 171. S.182; S.645; S.664; S.1311; S.1286; S.1771; H.R.57; H.R.232; H.R.449; H.R.504; H.R.719; H.R.1242; H.R.2370; H.R.3628; and H.R.4105

opportunities for such tax arbitrage.[2] As tax practitioners, we cannot stress more strongly our concern that the tax arbitrage opportunities presented by an indexation system and, in particular, any selective indexation proposal, will have a corrosive effect on the revenue base.

This Report is not intended to present an exhaustive analysis of the issues raised by basis indexing or to develop what inevitably would be complex solutions to the various problems raised. Many of these issues and problems have been thoughtfully developed elsewhere.[3] Rather, the Report is intended (1) to demonstrate the sheer enormity of any attempt to develop an administrable system of indexing that does not create distortions as bad or worse than those intended to be avoided, (2) to indicate the pervasive transactional complexities that basis indexing would introduce into the tax system, and (3) to describe some of the tax arbitrage opportunities inherent in any indexation system.

The discussion below is directed at what we see as the basis elements of any indexation system. As an example of the problems and issues created by an indexation system, the Report offers some specific comments regarding those provisions of the Omnibus Budget Reconciliation Act of 1989 as passed by the House

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2 See Part II.F. and Part III.B., infra.

3 See Durst. Intlition and the Tax Coda: Guidelines tor Policymaking. 73 Minn. L. Rev. 1217 (1989) (hereinafter “Durst”): Hickman. Interest, Depreciation and Indexing, 5 Va. Tax Rev. 773 (1986): Halpenn & Steuerle, Indexing the Tex System for Inflation, in Uneasy Compromise Problems of a Hybrid Income-Consumption Tax (H. Aaron. H. Galper & J. Pechman. eds.. Brookings 1988); Note. Inflation and the Federal Income Tax, 82 Yale L.J. 716 (1973); Shuldiner, Indexing the Federal Income Tax, unpublished paper presented at NYU School of Law Tax Seminar for Government (March 1990) (cited with the author's permission) (hereinafter “Shuldiner”).

of Representatives[4] (although not contained in the final version of the legislation) that would have implemented a form of basis indexing. The Report also discusses the tax arbitrage opportunities presented by the selective indexation proposal contained in the 1989 Bill, and the 1989 bill's failure to provide effective limits on arbitrage opportunities.

In summary, it is the position of the Tax Section that implementing any indexation system would be inadvisable. We wish to make clear, moreover, that this Report is not intended to express any position regarding the desirability of enacting any form of preferential taxation of capital gains, or in particular to support the adoption of a preferential rate for capital gains.

II. STATUTORY AND TRANSACTIONAL COMPLEXITY

A. In General

The single most important issue regarding any indexation system is the potentially pervasive if not overwhelming complexity that would be introduced into the tax system. Basis indexing has the potential to touch every area of the tax law from depreciation to excise taxes to employee benefits. This fact cannot be avoided with limited or simple indexing proposals. To the extent that Congress addresses all the implications of basis indexing, the complexity of the statute will grow directly. If Congress chooses to ignore those implications, the code will grow over time as “fix” after “fix” is added to eliminate revenue losing oversights and tax arbitrage opportunities.

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[4] H.R. 3299, 101st Cong., 1st Sess., sections 11951 et seq. (hereinafter, the “1989 Bill”): H.R. Rep. No 147 101st Cong., 1st Sess., pp. 1474-1480 (hereinafter, the “House Report”)

No taxpayer...will be able to prepare a tax return that Includes the sale of a...home or a business, without professional help.

Thus, even in an ideal system of indexing,[5] the complexity of the code would be increased, taxpayers' compliance burdens would be augmented, and disputes concerning a variety of legal issues would proliferate.[6] This undoubtedly will result in a system in which no taxpayer (particularly individuals and small businesses) will be able to prepare a tax return that includes the sale of a major asset, such as a home or a business, without professional help. Moreover, the administrative burden imposed on the Internal Revenue Service by any indexation system is likely to exceed its present capacity to respond. The auditing process alone may be severely compromised. But, in addition, a far more serious burden of dealing with scores of interpretive and legislative regulations will exacerbate the serious existing problem of the Internal Revenue Service's inability to promulgate regulations on a timely basis.

On the other hand, attempts to “simplify” any regime of indexing, perhaps by adopting partial indexing measures will introduce new distortions and opportunities for tax arbitrage. Taxpayers inevitably will devise techniques to exploit any discontinuities created m the process of simplifying an indexation system. Such exploitation could be prevented only by adopting rules that are equally, if not more complex, than the

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

6 An excellent description of the generic problems associated with indexation is provided in Cohen. The Pending Proposal to Index Capital Gains, 45 Tax A/ores 103, 105 (Oct. 2. 1989)(hereinafter “Cohen”).

rules that “simplified indexation” tried to avoid. There is no such thing as a simple indexation system.

B. Indexing Complex Transactions

While indexing calculations for the simple sale of property for a simultaneous cash payment may be relatively straightforward, property often is acquired or disposed of pursuant to options, forward contracts, section 1256 contracts, installment sales, and contracts requiring contingent payments. In addition, property can be deemed disposed of pursuant to corporate or partnership distributions. Any rational system of indexing would need to develop rules to provide for indexing calculations to be made in these circumstances.[7] For example, although an indexation system might include in indexable basis from the time of acquisition the amount of a purchase money note.[8] it is less clear that indexable basis should include basis attributable to contingent payments for any period before contingent payments are made.

Every rule or solution addressing such transactions, however, would impose additional computational burdens of a magnitude far greater than the single basis calculation now required upon disposition of an asset. Moreover, these solutions necessarily would be detailed and complex and one can expect Congress to avoid difficult and inherently complex problems by relying on “regulations to be provided.” The 1989 Bill, to quote just a single example, uses such an escape hatch for RICs and REITs:

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7 for an excellent description of the theoretical methodology for indexing property acquired pursuant to options, forward contracts, and section 1256 contracts, see Shuldiner at (16-19).

8 But see discussion of “debt arbitrage” in Part III.B.1., infra.

> [I]n order to deny the benefit of indexing to corporate shareholders of the RIC or REIT, the bill provides that, under regulations, (i) the determination of whether a distribution to a corporate shareholder is a dividend will be made without regard to this provision, (ii) the amount treated as a capital gain dividend will be increased to take into account that the amount distributed was reduced by reason of the indexing adjustment, and (iii) such other adjustments as are necessary shall be made to ensure that the benefits of indexing are not allowed to corporate shareholders.[9]

The temptation to avoid addressing such significant and complex issues will be a major concern. Personal and business decisions regarding a wide variety of transactions cannot reasonably be expected to wait out the delays, which have become increasingly common, in promulgating regulations-governing a system that could affect virtually every area of the code.[10]

Simplifying conventions... will arbitrarily deny Indexation benefits or offer planning opportunities.

Although certain simplifying conventions can be adopted, these simplifications will arbitrarily deny indexation benefits or offer planning opportunities. For example, the 1989 Bill denied indexation benefits to options.[11] This denial would inappropriately deny inflation relief to purchasers under options and extend overly generous benefits to sellers under options. Moreover, for taxpayers who are deemed to sell property by reason of corporate or partnership distributions, simple mechanical rules comparing basis and selling price can operate to deny indexation benefits entirely.

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

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

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

C. Disputes Regarding Timing of Asset Transfers

Because indexing basis would amplify the degree to which a taxpayer's holding period affects tax liability when an asset is disposed of any indexation system will produce numerous new legal disputes relating to the precise time tax ownership is treated as having passed Assets may be transferred in a variety of ways, such as installment sales, conditional sales, sales pursuant to options, and long term leases, that obscure the proper acquisition or disposition date for tax purposes. Although determining when an asset is acquired or sold is necessary under present law for determining the taxable year to Report gain, the taxable year to begin depreciating property and several other purposes, the precise time that an asset is acquired or sold in a taxable year seldom is of any significance.[12] Indexing basis changes all of this and inevitably will lead to a meaningful increase in disputes over these issues.[13]

Careful consideration must be given to the already complex rules governing the tacking and tolling of holding periods.

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

[13] Furthermore, the theoretically proper time for indexing to begin or end is at the time that the "risk of inflation" with respect to the property passes and not at the time that the technical tax holding period commences or ends. See Cohen, p. 105. Implementing this theoretically correct solution would be difficult at best and would give rise in at least some cases to the obviously undesirable result of taxpayers having two different holding periods for the property. However, failure to address this issue will result in taxpayers receiving inflation relief in cases where they have no risk of inflation. For example, assume that individual A contracts to sell stock or other indexable assets to tax-exempt entity B at a fixed price, the closing to occur two years after the date of the contract. Where does A's entitlement to inflation adjustment end? Moreover, the risk of inflation would be a new element of ownership to be considered in the already murky area of holding period determination.

D.   Holding Period Rules

In any indexation system, careful consideration must be given to the already complex rules governing the tacking and tolling of holding periods Although the present rules could be used for many situations, special rules modifying the present law “tacking” rules applicable to wash sales,[14] stock acquired pursuant to the exercise of rights acquired in a tax-free distribution,[15] and the treatment of property acquired from a decedent may be needed.[16] At the same time, consideration would need to be given to modifying the “tolling” rules that apply in

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14 Under present law the holding period and basis of property acquired in a wash sale includes the holding period and loss realized on the sale of the substantially identical property, code section 1223(4). This form of tacking generally places the wash seller in the same position as if he had not sold the property. Nevertheless, where holding periods are tacked and the deferred loss is added to basis, the “compounding” effect of allowing indexing based on an amount that exceeds fair market value arguably confers an inappropriate benefit on the short seller. See text accompanying fn. 60, infra.

15 Unless modified tor purposes of the indexing calculation, sections 1223(5) and 1223(6) would deny the benefits of indexing for that portion of the basis of stock allocable to the basis of the pre-exercise holding period of the rights

16 It would be inappropriate to apply for purposes of any indexing calculations, section 1223(11) which provides a minimum one-year holding period for property acquired from a decedent where the basis of the property is determined under section 1014.

connection with short sales,[17] straddles,[18] and commodity futures transactions.[19]

Furthermore, the number of necessary exceptions and special rules would increase significantly if a system of “partial indexing” is adopted. For example, if the benefits of indexing were granted to individuals but not corporations, virtually all the holding period and basis rules relating to transactions between corporations and shareholders would have to be modified in a manner that undoubtedly would enhance their complexity.[20] Finally, a detailed set of special holding period tacking and tolling rules would need to be adopted for transition purposes.

E. Other Statutory Complexity

The code already provides for indexing of various items (tax brackets in particular), and these indexing provisions must be coordinated with any basis indexing provisions to prevent the

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17 The simplest approach to short sales would be to treat the short and long positions as separate transactions and toll their respective holding periods for the period that the taxpayer holds both positions. The 1989 Bill adopted this approach. However, this simple rule can lead to anomalous results, most often favoring the taxpayer. See Shuldmer, p. 15.

18 The tolling rules of Temporary Regulation section 1.1092(b) 2T will produce anomalous results similar to those under the “simple” approach to short sales. Moreover, unlike the pro-taxpayer effect of these anomalies generally, these rules would particularly favor the government with respect to the treatment of “qualified covered call options” (within the meaning of section 1092(C)(4)). It is unclear that the same policies that underlay the tolling of holding period for qualified covered calls should be applied to exclude the benefits of indexing for the stock with respect to which the call option is written. “The special rules contained in section

19 The special rules contained in section 1223(8) must also be coordinated with the option rules described in further detail in Pan III.B.2., infra.

20 These rules are discussed in further detail in Part III.B 3 c. infra.

granting of double benefits. Consideration would need to be given to the extent that the benefits of basis indexing should be preserved where basis is to be reduced under section 1017. Modification of computations under section 1231 may be necessary. If corporations are included in an indexation system, consideration must be given to the treatment of earnings and profits, consolidated returns, section 304, and many other aspects of corporate transactions.[21]

Rules must be created to address the treatment of common individual investments such as insurance policies, variable annuity contracts, and voluntary contributions to pension plans. Computation of a taxpayer's income in each of these cases requires more than merely determining basis, holding period, and amount realized. Rather, the withdrawal of assets and recovery of basis over time will require the development of special indexing rules that will further complicate the treatment of these relatively ordinary products.[22]

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

22 Annuity payments generally are included in the annuitant's gross income. See section 72(a). However, a proportion of each annuity payment is excluded from gross income to the extent it represents a return of the annuitant's investment in the insurance or annuity contract. See section 72(b)(l). Similarly, section 72(e) generally provides that the amount received upon surrender, redemption, or maturity of an annuity contract should be included in income only to the extent such amount exceeds the annuitant's investment in the contract. Under section 72(c)(l). an annuitant s “investment in the contract” is defined as the aggregate amount of premiums and other consideration paid for the contract, less amounts previously received under the contract that were excluded from the annuitant's gross income. This amount should correspond to the annuitant's basis in the contract.

Under any comprehensive indexation system, an annuitant's “investment in the (annuity or insurance] contract” (viz., the annuitant's basis) logically should be indexed for inflation. To the extent an annuity payment or receipt of cash upon surrender, redemption, or maturity of an annuity contract represents a return of the annuitant's basis, the annuitant will be overtaxed upon receipt of an annuity payment if the annuitant's basis is not indexed for inflation.

F. Selective Indexing and Tax Arbitrage

Another major concern with respect to any indexation system is whether indexation is to be comprehensive or selective. Obviously, it is more difficult to draft a statute if all assets and liabilities are to be indexed. Moreover, such a statute would be far more complex. However, if (i) provision is made for indexing the basis of assets without provision for indexation of liabilities.[23] (ii) holding period requirements deny the benefit of indexing to assets held for a short duration, (iii) only certain taxpayers are eligible for the benefits of indexing, or (iv) only certain assets are eligible for the benefits of indexing, the problems associated with tax arbitrage become enormous.

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

Taxpayers are adept at electing against the fiscal authority and will structure their affairs to receive favored tax treatment.[24] Accordingly, any system which is selective rather than comprehensive will create opportunities for financial engineering adverse to the revenue base, in effect allowing the law of adverse selection to operate against the fisc. A straightforward example of the type of planning that will be possible is for

[23] This results in augmented basis or expenses without a corresponding increase in income or reduction in interest deductions to reflect the borrower's gain from the decrease in the real value of the principal amount of his liability attributable to inflation. See Part III.B.1.d.i., infra.

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

investor A, who is entitled to indexation benefits to purchase indexable property and give a participating mortgage [25] to investor B, who is not entitled to indexation benefits, effectively allowing the latter to share in the property's appreciation Nevertheless, this arrangement will allow investor A to benefit from indexation of the entire basis on the property, while deducting as interest the amount of capital appreciation enjoyed by investor B, truly a windfall at the government's expense.

The problems associated with each possible selective approach to indexing are well illustrated by the 1989 Bill. As discussed in Part III.B., below, this causes innumerable problems.

G. The Treatment of Passthrough Entities

Any indexation system will create significant additional complexity in the treatment of passthrough entities, specifically partnerships. S corporations, mutual funds (RICs) real estate investment trusts (REITs), trusts, subchapter T cooperatives, common trust funds, and conceivably real estate mortgage investment conduits (REMICs). This complexity arises in several ways.

First, entity level and interest holder level adjustments must be coordinated so that all adjustments are reflected, but only once. Second, appropriate allocations of the indexing adjustments among the interest holders must be provided for. Third, new rules would be required for application of the holding period tolling rules to passthrough entities and their

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25 For example, the lender receives stated interest plus additional interest based on appreciation in the value of the property, subject to a ceiling on the aggregate interest rate.

beneficial holders. Fourth, extremely difficult problems would be presented by a publicly traded partnership, especially the need to deal with continuous section 754 adjustments and other aspects of indexation adjustments attributable to partnership assets or interests. All of these complexities may become particularly acute where there are tiered passthrough entities (e.g.. partnerships or REITs owning partnership interests), and the complexities are further compounded where the benefits of indexing are extended only to certain assets or certain taxpayers. More detailed discussion of the application of an indexing regime is presented below in the discussion of the provisions of the 1989 Bill.[26]

Any Indexation system will create significant additional complexity in the treatment of passthrough entitles

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H. Cross-Border Investment

Additional complexity will exist for foreign taxpayers that conduct their U.S. activities in a manner that causes them to be subject to U.S. withholding on expatriated payments, instead of the federal income tax regime imposed on domestic U.S. corporations or other domestic entities. Although these foreign persons may avoid some of the problems associated with indexation applied to transactions of domestic entities, an indexation system will create difficulties for any payments that are subject to withholding based on the foreign person's capital gain. In particular, withholding pursuant to section 1446 will be considerably more difficult.

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

In addition, for outbound investment, the interplay of the capital gains rules and the foreign currency rules can operate to limit inappropriately the indexation benefit to which an investor should be entitled or to offer too generous an indexation benefit. If, for example, a U.S. investor purchased an investment in a "strong" currency and earned an overall (i.e., combined currency gain and property appreciation) return exactly equal to the rate of inflation, it would seem appropriate under an indexation system to impose no tax. Nevertheless, to achieve this apparently simple result, foreign currency would need to be treated as an indexable asset, at least to the extent of the amount invested in the indexable capital asset. On the other hand, if the investment were in a "weak" currency, and the overall gain were less than the inflation rate, gain realized on the asset could be completely eliminated by indexing, while the taxpayer would still be entitled to deduct the currency loss. This result would be inappropriate in a system that did not otherwise permit indexing to result in a loss.

III. THE 1989 BILL: A REVIEW

A. In General

Many of the general and specific concerns expressed above are well illustrated by the 1989 Bill. Without doubt, the simplicity of the 1989 Bill is attractive. A few pages of seemingly clear statutory provisions index the tax system for inflation with respect to certain capital assets. This deceptive simplicity, however, conceals an array of troublesome administrative, computational, and substantive issues. In particular, the 1989 Bill would have provided sharp-sighted taxpayers with ample arbitrage possibilities. One can only imagine the series of technical correction acts and omnibus reconciliation act "revenue raising" proposals which would follow adoption of a proposal comparable to the 1989 Bill. This part focuses on some of these issues.

B. Selective Indexing

1. Failure to Index liabilities

a. In general. The 1989 Bill indexed the basis of capital assets without any indexing of debt. Nevertheless, inflation s effect on borrowers and lenders is just as profound as its effect on owners of assets. As is the case for owners of assets, the code presently does not account for inflation's effect on borrowers and lenders. By allowing borrowers generally to deduct the entire amount of their interest payments and requiring lenders to include all such interest in income without offsetting adjustments for the diminishing real value of the principal amount of the debt, the code as a general matter currently overtaxes lenders and undertaxes borrowers. The partial indexation system of the 1989 Bill would have exacerbated that situation.

b. Example. The failure to index debt results in a gross undermeasurement of the real income of a taxpayer who borrows to finance the purchase of an indexed asset.[27] Assume that Mr. A invests $20.000 in cash to buy Blackacre, a nonincome producing real estate asset subject to an $80,000 mortgage. Five years later, when cumulative inflation has amounted to 30 percent,[28] he sells Blackacre for $130.000, satisfies the $80.000 mortgage, and realizes $50.000 of cash. Under the 1989 Bill, the original tax basis of $100,000 for Blackacre would be adjusted to $130.000 and Mr. A would have no taxable gain. Nevertheless, Mr. A's $20.000

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[27] See. e.g., Durst, pp. 1251-1256

[28] For simplicity, inflation and interest percentage rates in this report will be stated on a cumulative basis, including compounding.

cash investment has grown to $50,000, an increase far in excess of inflation with respect to his actual investment.[29]

If interest deductions are reflected, the income distortion is even greater. Assume Mr. A's mortgage bears 10 percent interest. Mr. A would have an annual interest deduction of $8,000, or $40.000 over the five-year holding period. Under the 1989 Bill, Mr. A presumably would have no taxable gain on Blackacre and $40.000 in interest deductions to be applied against other real estate income. i.e., his taxable income from Blackacre would have been an overall loss of $40,000. Without indexation, Mr. A would have a taxable gain of $30,000, interest deductions of $40.000, and a $10.000 net taxable loss.

c. Tax arbitrage potential. The distortion of income created by the failure to index debt will encourage taxpayers to enter into tax-motivated transactions. Transactions undoubtedly will be developed to allocate excess income (without indexation) to low-bracket or tax-exempt taxpayers and excess deductions or indexation adjustments to high-bracket taxpayers. It is likely, for example, in this type of environment for investment bankers to create investment pools in which tax-exempt investors will receive the income and in which taxable investors secure deductions and indexed basis advantages of the 1989 Bill system. Moreover, any indexation system, particularly one which selectively indexes the basis of assets, would encourage new attempts to create Americus Trust transactions. These transactions attempt to separate the income interest of an investment from capital appreciation, and sell each interest to

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

separate investors. As indicated by their history,[30] the propriety of such arrangements is questionable.

d. 1989 Bill solutions to “debt arbitrage”. The 1989 bill attempted to limit debt arbitrage opportunities in two ways. First, the 1989 bill would have amended section 163(d) to exclude gain from the sale or disposition of indexed assets from the definition of investment income. This limitation represents at best a very limited solution to restricting arbitrage transactions involving debt financed purchases of indexed assets. Second, the 1989 Bill does not allow basis adjustments that would create or increase a loss. This loss limitation may create situations where similarly situated taxpayers will be treated differently, and in many circumstances the limitations will be avoided.

I. Investment interest limitation. The 1989 Bill investment interest limitation solution is entirely ineffective with respect to taxpayers for whom interest expense is treated as a “business interest “or as” passive interest,” provided that the taxpayer has sufficient passive income. Moreover, the solution is not even effective for taxpayers with sufficient investment income from nonindexed sources to offset their investment interest expense. For example, assume investor Y, who has $10 million a year of dividend income, borrows $100 million at 10 percent interest and purchases a $100 million capital asset that

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[30] See T.D. 8080.1986-1 C.B. 371. T.D.8080 issued final regulations under section 7701 that denied trust classification to Americus investment trusts, effectively prohibiting such investment trusts. Sea Regulation section 7701-4. Moreover, T.D. 8080 stated that one of the major problems produced by such investment trusts was the “potential for complex allocations of trust income among investors, with correspondingly difficult issues of how such income is to be allocated for tax purposes.” For an excellent description of these transactions and their legislative and administrative history, see Walter and Strasen. The Americus Trust “Prime” and “Score” Units, 65 Taxes 221 (1987).

qualifies for indexation. The 10 percent interest expense on investor Y's $100 million loan matches her dividend income of $10 million. One year later, investor Y sells her capital asset for $105 million after having received $5 million in current income from the asset. If inflation is five percent, the indexed basis of the asset is $105 million, and investor Y recognizes no gain or loss on the sale of the asset. After repaying her loan, investor Y is left with $10 million, and has effectively transformed $5 million of her $10 million dividend income into tax-free income. This transformation arises from investor Y's ability to take interest deductions at their full nominal amount, while repaying her loan with inflated dollars.

Failure to allow Indexing to generate losses will result in dissimilar treatment for taxpayers with identical economic Incomes.

In a full indexation system, investor Y's nominal interest deduction would be decreased by the amount of inflationary gain she realizes as a borrower from the diminishing real value of the loan principal. If interest deductions were indexed in this manner, the 1989 Bill's investment interest limitation would be unnecessary. In the example above, investor Y's $10 million interest deduction would be decreased by $5 million, the amount by which the real value of the $100 million loan principal has declined in one year due to five percent inflation. As a result, in a fully indexed system, investor Y's net income would be $10 million, i.e., $15 million dividend and other income less 35 million indexed interest deduction. The exclusion from the computation of investment income of investor Y's indexed gain from the sale of her capital asset under the

1989 Bill is ineffective because she has sufficient investment income to offset her unindexed debt interest expense.

II. Loss limitation. The 1989 Bill's loss limitation approach to debt arbitrage also is problematic. First, failure to allow indexing to generate losses will result in dissimilar treatment for taxpayers with identical economic incomes.[31] For example, A purchases stocks X and Y for $50 each and B purchases stock Z for $100. If stock 2, appreciates to $200, stock Y to $200, and stock X depreciates to SO. A and B both have economic gain of $100, However, because of the loss limitation rule, A will receive no indexation benefit on his losing investment in stock X. and the indexation benefit from his profitable investment m stock Y, with an indexable cost basis of $50, will be only half of the benefit realized by B, who has an indexable cost basis of $100 for stock Z.

In addition, a loss disallowance rule will exacerbate the “lock-in” effect of the capital gains tax by encouraging the asset holder to hold the asset until the full indexation benefit can be used, i.e., until the asset's fair market value at least equals its indexed basis. This result can only be described as ironic in the context of a proposal intended generally to lessen the tax burden on capital gains, rules would prevent the avoidance of the investment interest limitation contained in the 1989 Bill. Similarly, such tracing could be used as a mechanism for providing indexing only to a taxpayer's net (i.e., equity) investment in property. Although tracing may be the most expedient method of addressing debt arbitrage, it is well understood that to the extent money can be considered fungible; tracing rules will be artificial and will tend to favor the most creditworthy taxpayers. For example, the rules disallowing

[31] Cohen, p. 105.

interest incurred to carry tax-exempt obligations are largely meaningless to wealthy individuals who can borrow against portfolios of stocks or taxable bonds to invest in tax-exempt obligations. Moreover, we would not recommend a further complication of the already complex tracing rules associated with the different treatment of interest with respect to personal expenditures, personal residences, trades or businesses, passive activities, portfolio investments and other investments, not to mention source rules and foreign tax credit calculations. We are greatly concerned that creating any further reliance on debt tracing would only further entrench the current system and hinder legitimate simplification efforts[32]

Further reliance on debt tracing would only further entrench the current system and hinder legitimate simplification efforts.

The debt arbitrage problem also could be solved by disallowing interest deductions attributable to the acquisition or holding of indexed assets. This type of solution would be highly dependent on problematic debt tracing rules, as discussed above, and undoubtedly would create major complexity.[33]

Still another means o Still another means of solving the problem would be the “avoided cost” method now used for construction period interest. This would involve significant complexity in allocating debt to specific assets for purposes of

[32] See letter from Arthur A Feder. Chair of the New York State Bar Association Tax Section, to Chairman Rostenkowski, recommending among other things simplification of the interest allocation rules (April 23, 1990).

[33] See. e.g., New York State Bar Association Tax Section Report on section 163(j) (March 14.1990).

denying inflation adjustments, particularly in situations where debt levels change frequently.

2. Exclusion of certain assets from indexation. The 1989 Bill makes unprincipled distinctions by granting indexation to certain capital assets and denying indexation to other assets that are equally affected by inflation. For example, the 1989 Bill does not allow indexation with respect to debt and certain debt-like assets, as well as all intangible assets other than stock, even though these assets are demonstrably affected by inflation as significantly as assets that are indexed under the 1989 Bill. Moreover, convertible debt, warrants, options, and other contracts with respect to stock are denied indexing despite economic attributes very similar to assets that are indexed under the 1989 Bill. In addition, the limitation of indexation benefits only to capital assets will deny indexing benefits to taxpayers who sell property constructed over a long period of time, such as a construction project, sophisticated equipment, or property described in section 1221(3), even though these taxpayers suffer the effects of inflation in much the same way as holders of capital assets. These exclusions are arbitrary and often illogical.

Under the 1989 Bill, stock received by the conversion of convertible debt, for example, is allowed an indexation adjustment only for the period after conversion; the holding period of the convertible debt before conversion is excluded. In contrast, convertible preferred stock apparently would qualify for indexation throughout a shareholder's holding period. Although the 1989 Bill excluded preferred stock from indexation, it defined preferred stock as stock with fixed dividends and no significant participation in corporate growth. Convertible preferred, by virtue of the conversion privilege, should be considered as participating in corporate growth, and therefore qualify for indexation. Even accepting the premise that debt assets should not be indexed if an indexation regime is adopted, a premise we believe faulty, it is truly impossible to rationalize this distinction, particularly in a tax system where convertible debt can be converted into stock without gain recognition and with a carryover basis and tacked holding period. Disparate treatment of convertible preferred and convertible debt would simply aggravate the already problematic distinction between debt and equity.

Warrants, options, and other contracts with respect to stock are also ineligible for indexation under the 1989 Bill.[34] The investment in or holding period of the warrant or option prior to exercise or disposition would thus not have the benefit of indexation. The reason for this exclusion is unclear, but it may reflect a limited attempt to prevent the tax arbitrage opportunity that might arise if the option writer (who in a properly structured system would be hurt by indexing) is a low bracket or tax-exempt taxpayer (e.g.. a pension trust or foreign person) and the option holder (who would benefit from indexing) is a high bracket taxpayer. In any case, the exclusion is illogical, as the following example shows.

Assume A purchases an option for $50, which gives him the right to purchase one share of XYZ Corp. stock three years later for $100. Inflation over the three-year period amounts to 35 percent. If the fair market value of XYZ Corp. stock is $165 when A exercises the option, and A immediately sells the XYZ Corp. stock, what should be his taxable gain? Under the 1989

[34] The 1989 Bill also excludes from indexation options, contracts, and other rights to acquire an interest in property. The problem described here with respect to stock options thus also would apply to an option to purchase real property.

Bill, A would have a taxable gain of $15, since the sum of the option purchase price and the exercise price for the XYZ Corp. stock is $150, $15 less than the fair market value of the stock. In real economic terms, however, A has a loss on the option; the 35 percent inflation, when applied to his option purchase price of $50, would require XYZ Corp. shares to sell at a fair market price of $167.50 for A to break even ($50 plus 35 percent inflation plus $100 exercise price). Similar results occur if A sells the option instead of exercising it. Thus, if A sold the option for $60, he would suffer a real economic loss of $7.50, yet would have a taxable gain of $10 under the 1989 Bill.

Under current law, the exercise of an option or a warrant is not a taxable event, and the cost of the exercised option or warrant increases the property's sales price and cost basis. This treatment recognizes implicitly that amounts paid for an option properly are treated as a cost of acquiring or proceeds from the sale of an interest in the property. Accordingly, to reflect the actual economic cost of the property, the holder of a warrant or option should be allowed to index basis attributable to the purchase price of the warrant or option for the period before its exercise with respect to any property received upon exercise.[35] Similarly, holders of warrants and options also should be able to index their basis with respect to gains upon disposition of a warrant or option.[36]

The denial of Indexation benefits to Intangible assets except for stock raises significant problems.

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[35] See Shuldiner, p. 10.

[36] Cf. section 1234 (granting sale or exchange treatment to the expiration of options, in effect providing preferential capital gains treatment).

Further, the denial of indexation benefits to intangible assets except for stock raises significant problems. First, this arbitrary distinction will cause taxpayers in identical economic circumstances to be taxed differently based on their choice of investment vehicle. For example, payments made with respect to stock market indexed debt instruments or stock market indexed annuities will reflect inflation in the same manner as stocks underlying the index, yet the 1989 Bill would provide no indexation.

Moreover, in practice the distinction between tangible and intangible property will lead to numerous disputes regarding allocation of purchase price where tangible and intangible assets are sold together. For example, where a lessee of real property sells the leasehold interest together with any self-constructed improvements, the 1989 Bill would make it mutually advantageous for the buyer and seller to allocate as much of the purchase price as possible to the improvements to maximize actual or potential indexation benefits. Such an allocation would be unlikely to have great significance under current law, since the buyer will depreciate both the leasehold and the improvements over the remaining term of the leasehold. Although current law places limitations on artificial allocations, the 1989 Bill would test the effectiveness of current law in new circumstances, with uncertain consequences.

Finally, it appears to us to be somewhat incongruous to allow indexation of corporate stock without regard to whether the corporation holds assets that would be indexable if the corporation itself were eligible for indexation. One might argue that by reason of this feature, the 1989 Bill represents a haphazard form of corporate tax integration more than a principled mechanism to provide inflation relief for deserving assets.

3. Benefits for only certain taxpayers. Limiting the benefit of any favorable method of capital gains indexation to specific taxpayers will create additional complexity and distortion of the tax system. In this regard, the 1989 Bill would create other arbitrage opportunities. The 1989 Bill does not allow C corporations to index assets, but allows shareholders to index their basis In C corporation common stock. In contrast, under the 1989 Bill, passthrough entities such as partnerships and S corporations would be allowed to index their assets, but individuals would not be allowed to index their S corporation shares or partnership interests.

a. Distorted Incentives for holding assets. Making basis indexing available to some but not all taxpayers creates an artificial incentive for those taxpayers permitted to basis indexing to hold eligible assets relative to taxpayers denied the benefits of indexing. Moreover, the introduction of this tax-related incentive will tend to result, as would any uneconomic incentive, in an inefficient allocation of resources.[37] While this result is undesirable in its own right, the inevitable engineering of transactions designed to maximize the availability of the benefits of indexing will aggravate the distortion.

b. Exclusion of C corporations. The exclusion of C corporations from the indexing system under the 1989 Bill disproportionately taxes individuals who invest through C corporations. For example, in contrast to the illustration presented in Part III.B.1.b., above, assume Ms. B invests $20,000

[37] Needless to say, providing tax incentives for holding certain assets in favor of others without clear policy justification is a major retreat from the “level playing field” policy of the Tax Reform Act Of 1986.

in a C corporation, receiving all its stock. If the C corporation borrows $80,000 and purchases Whiteacre for $100,000, the corporation would not be able to index its basis in Whiteacre and Ms. B would be able to index only her $20.000 basis for the corporation'; stock. The tax burden on Ms. B's investment in a C corporation would be significantly higher than Mr. A's similar investment as an individual.[38]

As a result, the bias against C corporations in our current system will be furthered. Consequently, well advised taxpayers will be further encouraged to use partnerships or S corporations to avail themselves of the benefits of indexing. This bias against C corporations already exaggerated by the “inversion” of individual and corporate tax rates and by the repeal of the General Utilities doctrine in 1986, undoubtedly has contributed to an erosion of the corporate revenue base. Nevertheless, not all taxpayers can use subchapter S,[39] and partnerships may not provide adequate liability protection. Thus, the already asymmetrical system of taxing incorporation and dissolution of corporations that was created by the 1986 Act[40] now will further penalize the uninformed or those who must use the subchapter C mode.

c. Enforcement of the limitation: additional statutory complexity. The 1989 Bill contains only broad and vague regulatory authority designed to assure that the benefits of basis indexing are limited to intended beneficiaries.

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

[39] A common example of inability to use subchapter S would a start-up venture which incorporated to achieve limited liat and which has a corporation as a major equity funding source.

[40] i.e., the repeal of Genera/ Utilities permits the incorporation of appreciated assets tax-free, but imposes a tax upon the withdrawal of the same asset from corporate solution.

Specifically, the 1989 Bill provides the IRS with the authority to disallow all or part of any indexing adjustment in the case of any transfer, the "principal purpose" of which is to secure or increase the indexing adjustment. The 1989 Bill also would deny the indexing adjustment for sales of depreciable property between certain related parties. These rules are likely to prove inadequate to limit the benefits of indexing only to the intended beneficiaries. In particular, the "principal purpose" standard is likely to prove difficult for the IRS to administer.[41]

The 1989 Bill would unfairly prevent the Intended beneficiaries from receiving the benefits of Indexing In certain circumstances.

At the same time, the 1989 Bill would unfairly prevent the intended beneficiaries from receiving the benefits of indexing in certain circumstances. For example, consider the sole individual shareholder of a C corporation who contributes to the corporation property that has appreciated, but whose fair market value and indexed basis are the same. The policy of the 1989 Bill would indicate that the precontribution gain in these circumstances should not result in any tax. This would require the corporation in the example to receive an increased basis for the Indexation available to the individual before the transfer of the appreciated property to the corporation. Otherwise, the 1989 Bill would cause the shareholder to suffer from the possibility of corporate taxation upon a post-contribution sale of the corporation s assets without the benefit of inflation adjustments. Even though the potential tax could be avoided if

[41] A "principal purpose" standard has been notably difficult to apply under code section 269. See O. Watts, Acquisitions Made to Avoid Taxes. Section 269, 34 Tax L Rev. 539, 549-552 (1979) (discussing complexities of "principal purpose" test). In fact, it was largely the ineffectiveness of section 269 that led to the enactment of section 382 in both its present and earlier versions.

the shareholder sold the property and contributed the proceeds, this will not always be a practical solution, particularly where the property is unique and necessary to the business.

These deficiencies in the 1989 Bill could be cured by ambitious statutory modifications, addressing a wide array of different possible transfers of assets from eligible to ineligible or ineligible to eligible taxpayers. Different rules would be required for transfers between related parties and transfers between unrelated parties. In addition, different rules will be appropriate for transfers in taxable and tax-free transactions.

Further, special rules will be needed to address basis and holding period problems of transferees, particularly for assets acquired in tax-free transactions. Other special rules will be needed for corporate partners as well as for conversions of C corporations to S corporations and vice versa. Finally, rules would be required for addressing situations where related eligible and ineligible holders of assets hold offsetting positions with respect to capital assets. Numerous disputes arising from the application of these special rules are easily foreseeable.

4. one-year holding period. Other provisions in the 1989 Bill raise recognition and timing issues. The 1989 Bill imposes a one-year minimum holding period before an eligible asset is indexed. Several problems immediately present themselves with respect to this seemingly innocuous requirement. First, taxpayers will be required to separate their securities portfolios, capital assets, and assets used in a trade or business between assets held less than one year and assets held

more than one year.[42] With virtually no preferential treatment of long-term as opposed to short-term gains under present law, the extent to which this must be done currently is limited. Second, taxpayers will time their transactions so as to qualify or not for indexation, depending on the different tax outcomes. Third, with respect to the interaction of this provision with the 1989 Bill's separate indexation of any substantial improvement to an indexed property, taxpayers will be required to keep track of and make independent indexation calculations for an indexed property and each substantial improvement to it and exclude entirely from indexation the basis attributable to any substantial improvements less than one year old.

The 1989 Bill's provisions for passthrough... will create great disparities between the direct ownership... and... ownership... through a passthrough entity.

C. Passthrough Entities

1. In general. The 1989 Bill's provisions for passthrough of indexation adjustments are problematic in many respects. As discussed below, these provisions will create great disparities between the direct ownership of property and the ownership of that property through a passthrough entity. Although these disparities in many cases will favor the government, in many situations the taxpayers will be favored with beneficial results and attractive planning opportunities.

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42 See, e.g., Hoerner, Indexing Capital Gains: The British Experience. Tax Notes—News Analysis 988, 989 (Feb. 26, 1990) According to Philip Levi, personal tax manager for Grant Thornton, the one-year holding period created “a great deal of bother over the timing of transactions” and the separation of assets held less than one year and all other assets. Id. The one-year holding period was eliminated from the British indexation system by the 1965 reforms which allow indexing from the month of acquisition. Ibid.

2. Partnerships

a. Allocation of indexing benefits. The proper allocation of indexing benefits among partners is not as simple as it initially appears. A simple rule apportioning the indexation adjustment in proportion to the overall partnership income allocation would not be sufficient. For example, A and B form a partnership. A contributes property worth $100 and A and B both contribute services. The partnership agreement provides that on liquidation the first (100 of proceeds are paid to A, the remainder split 50 percent each. A receives the first $10 of annual partnership income and the remainder is divided equally between A and B.

In effect. A is being treated as the continuing economic “owner” of the $100 asset and is receiving payments (10 percent of income or $10 per year) for the partnership's use of the asset. How should the indexation adjustment be allocated if the property is sold after two years for $170 and A receives $45 and B receives $25? Since A supplied all the partnership capital, should B receive any part of the indexation adjustment? Presumably, A should be allocated the entire indexation adjustment upon disposition of the asset, rather than a simple allocation according to the partners' overall interests. Unless some mechanism were created to achieve this result, it is easy to see how indexation benefits can be transferred at a taxpayer's option. On the other hand, even if such rules were put into place, benefit shifting still would be possible to a significant extent by modifying slightly the form of the transaction, making the partner entitled to the preferred return as a lender.

The allocation problem becomes even greater if partners share income unequally, e.g., A receives 70 percent and B 30 percent of the partnership income until A receives $100 return and income is shared equally thereafter, or some other formula of shifting income allocations is used. It is unclear under the 1989 Bill how indexation adjustment allocations should be made in such situations. Rules will be needed to handle such allocation issues. Moreover, the formulation of rules governing such allocation issues should not be left to regulations because the allocation problem is immediate and widespread.

b. Timing of adjustments. Under the 1989 Bill, the basis of a partnership interest generally is indexed with respect to an indexable partnership asset only when the partnership disposes of the asset. In addition, if a section 754 election is in effect, a partner transferring his interest will receive a share of any indexation adjustment that has accrued at the partnership level at that time. Thus, for the first time, section 754 will provide a positive benefit for the seller, as well as the buyer, of a partnership interest. As a result, transfers of partnership interests will raise issues regarding the allocation of indexation adjustments.

First, section 754 elections almost always are made on a tax-motivated basis. For example, suppose A. B, and C form the ABC partnership to purchase an indexable asset for $150. After 10 years, the asset has a fair market value of $180, but an indexed basis of $240. If partner A sold his partnership interest for $60, he would recognize a $10 gain, if no section 754 election is in effect.

At this point, the House Report on the 1989 Bill inexplicably fails to provide clear guidance with respect to the intended treatment of the indexation adjustment with respect to partner A's transferee, new partner D. The House Report states that the “transferee partner will be entitled to the benefits of indexing for inflation occurring after the transfer.”[43] This would suggest that the transferee partner does not receive, upon a subsequent disposition of the partnership asset, a proportionate share of the indexation adjustment that had accrued at the time of his acquisition of a partnership interest. In contrast, however, Example (3) of the House Report provides that transferee partner D would, if no section 754 election is in effect, receive a proportionate share of the partnership's indexation adjustment with respect to the asset, including the indexation benefit accruing before he joined the partnership.[44] The failure of the 1989 Bill to provide a clear rule for such transactions is another example of the complexity involved in any indexation system.

The correct result in this situation is far from clear. If a transferee partner receives only indexation benefits accruing after his purchase of a partnership interest, the partnership will be required to track not only the indexation adjustment applicable to a particular asset, but also the amount of indexation accrued with respect to each partner at all times. Upon a partnership's sale of an asset, the partners would receive different indexation adjustments according to the exact date each partner joined the partnership, the amount of indexation adjustment accrued at that time with respect to that particular asset, and the amount of indexation adjustment occurring after the partner joined the partnership. This would clearly be an administrative and computational nightmare.[45]

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43 House Report, p. 1479 (emphasis added).

44 Id.

45 These problems are even more pronounced for such as law firms or accounting firms whose partners interests frequently shift from year to year without any sale or exchange

On the other hand, if Example (3) contains the correct rule under the 1989 Bill, partner A's sale of his partnership interest to new partner D would not result in the loss of accrued indexation benefits with respect to D's partnership interest, and the partnership's ability to utilize the full $240 indexed basis of the asset would continue. New partner D thus would receive the previously “accrued” indexation adjustment benefit from the partnership property if the property appreciates after his purchase. So long as the partnership is not dissolved and the proceeds of sale remain in partnership solution, no tax will be imposed on the potential permanent difference between “outside” and “inside” basis.

The exaggeration of any differential between outside and inside basis of the partnership may provide for abusive planning possibilities.

Furthermore, if the ABD partnership subsequently sold the asset for $240, partner D would receive flowthrough of the indexation benefits equal to $30 (one-third of the difference between the assets indexed and unindexed basis), increasing his basis in his partnership interest to $90. If the partnership distributed the sale proceeds to its partners, partner D would receive $80 tax free, although his investment has increased in value from $60 to $80 during a period in which no further inflation occurred in sum, partner A in effect transferred to partner D the potential for $20 of tax-free future appreciation in the partnership's asset.

Second, the exaggeration of any differential between outside and inside basis of the partnership may provide for abusive planning possibilities. If original partner A were tax-exempt or otherwise able to offset the gain upon transfer of his partnership interest to D, the tax benefits of such transactions would be further enhanced. For example, if partner D in Example 3 of the House Report is a foreign individual and ABO is a U.S. partnership doing business outside the U.S., and the partnership sold the indexed asset in a legitimate transaction and realized the gain offshore, there would be no U.S. tax. Nevertheless, the foreign individual would have the artificially high basis and may be able to transfer the asset to a U.S. corporation, which would then have the "built-in" loss.[46]

Section 754, therefore, will assume even greater importance. There will, however, be circumstances where the section 754 election is not available (e.g., because all partners do not consent) or the partnership inadvertently fails to elect, or the partnership is sufficiently large and complex that the cost of making section 754 calculations is simply too high. Moreover, if partnership assets have depreciated, it is unlikely

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[46] Even without engineered abuses, the ability to transfer interests in partnerships, the fair market value of whose assets is below the partnership's indexed basis, creates an inherently tax advantaged investment. The advantage lies in the fact that inflation adjustments at the partnership level will continue to be based on the high basis while any appreciation in the asset will occur based on the asset's fair market value. While this type of phenomenon occurs upon the transfer of any partnership interest where the partnership has depreciated assets, indexing will greatly compound this effect in a potentially limitless way.

that a section 754 election would be made.[47] This may lead to thoughts of making section 754 elections mandatory, similar to the treatment of section 704(c) by the Deficit Reduction Act of 1984. At this point, one should recall that, after six years, regulations governing the mandatory section 704(c) provisions have not been forthcoming, with consequent difficult problems for legitimate business transactions.

The rules are clearly not consistent for S corporations and partnerships.

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3. S corporations. The provisions of the 1989 Bill relating to the treatment of S corporations and their shareholders raise several of the same issues as for partnerships discussed in Part VI.B.3.b, “Timing of Adjustments.” above. Nevertheless, certain additional issues are raised. In particular, the rules are clearly not consistent for S corporations and partnerships. No analogy to section 754 exists for S corporations, with the consequence that a shareholder who sells his interest will be at a severe disadvantage to a comparably situated partner with a section 754 election in place. This situation will be encountered frequently where the S corporation has assets that are not freely transferable, such as a franchise, a labor contract, or a nonassignable lease. In these circumstances, the S corporation stock can be sold, usually without any significant tax detriment to the sellers. In addition, even if the S corporation's assets are freely

[47] should be noted that the absence of a section 754 election at the partnership level can be mitigated where the partners' basis in their partnership interests exceeds the partnership's bases in its assets when the partnership is deemed to liquidate under section 708, since the rules under section 732(b) provide partners with a step-up in the basis of partnership property to their basis in their partnership interests upon such a distribution of the partnership's assets.

transferable, the seller of a minority interest in an S corporation will not be able to receive indexation benefits on the sale of his stock.

In addition, it is not clear under the 1989 Bill how indexing adjustments would be allocated where stock is sold during a taxable year. Although it may be reasonable to assume that indexing adjustments would track allocation of gain, it is possible that the 1989 Bill intended that the adjustments be made on the basis of the time of sale. Discontinuities in economic appreciation and basis adjustments will be created by either approach, particularly in light of the special rules for allocating gain in the case of transactions that terminate S corporation status, that terminate a particular shareholder's ownership, or that involve a transfer of more than 50 percent of the corporation's stock. Finally, the statement of the House Report that “indexing does not apply” for purposes of sections 1374 and 1375[48] leaves open the manner in which indexing computations will be made where sections 1374 or 1375 are applicable.

4. RICs and REITs.

a. In general. The 1989 Bill allowed RICs and REITs to index their taxable income and earnings and profits. In addition, to the extent that RIC’s or REIT’s assets qualify for indexation, the 1989 Bill allowed its individual shareholders to index their bases for the RIC or REIT stock. Corporate shareholders, however, were denied these indexation benefits.

b. Avoidance of lots limitation provisions. The general rule that no losses may be created through indexing

[48] House Report, p. 1479.

clearly will be violated by the rules relating to RICs. The following example demonstrates that shareholders of RICs will be able to blend gain and loss positions in the RICs securities in calculating individual gains or losses.

Assume that a RIC acquires three indexable securities, each for $ 1.OOO.[49] If indexation over three years is 20 percent, the aggregate indexed basis would become $3,600. Assume that asset 1 does not appreciate, asset 2 depreciates to $900, and asset 3 appreciates to $1.700. Under this scenario, a one-third owner of the entity would be entitled to sell his interest for $1.200, have an indexed basis of $1.200, and no taxable gain, while an individual owner of one-third of each of the three assets would have a net taxable gain of $133.34 (1/3 of $500 gain on asset 3 after $200 indexation adjustment minus $33.33 loss on asset 2). This will provide a RIC investor with a sizeable advantage over individual investors in stocks and securities.

Aside from the ability to avoid the loss limitation provisions, RIC shareholders receive additional benefits from indexing by reason of continued indexing of their RIC stock in the absence of any corresponding inflationary gains on the RIC's assets. For example, assume that a RIC purchases two blocks of stock for $1.000 each. Within one year, one block becomes worthless, while the other block triples in value. Inflation for the year is 10 percent. If the RIC sold the appreciated shares, it would recognize a $1.900 gain (i.e., $3.000 minus indexed basis of $1.100). After offsetting the capital loss, the RIC would have a net capital gain of $900 which it distributes as a capital gain dividend. After the distribution, the RIC shares would be worth $2,100, yet the aggregate indexed shareholder basis would be $2,200. The excess basis at the shareholder level

49 For simplicity, diversification rules are ignored.

is attributable to the indexing of a “nonexistent” asset at the RIC level (the worthless shares). This excess basis either would allow its shareholders to recognize a loss upon disposition of the RIC stock, or if losses are not allowed, would allow the shareholders to avoid recognition of gain if they sold their stock after the RIC's assets had further real appreciation of $100. Only an unthinkably complex regime of passing through realized and unrealized losses to RIC shareholders for purposes of indexing calculations would prevent this result.

c. Indexing of less than all of the entity's asset. The 1989 Bill would require a valuation of the RIC's or REIT's indexable and nonindexable assets on a regular basis. For RICs, the 1989 Bill required monthly asset valuations, but for REITs, due to the difficulty and cost, those valuations were required only every three years. While requiring REIT trustees to make “good faith” monthly judgments regarding a REIT's indexable to nonindexable asset ratio, the 1989 Bill's three-year valuation requirement provides ample opportunities for tax avoidance and arbitrage.

Further complexity Is Introduced where the benefits of indexing basis are intended to be provided to only certain taxpayers.

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d. Indexing for not all taxpayers. Further complexity is introduced where the benefits of indexing basis are intended to be provided to only certain taxpayers. The rules to effect this limitation which will be issued under regulations are certain to be complex. Moreover, to properly limit the benefits of indexing, it is likely that tracing share ownership will be necessary. Doing so, however, will have the undesirable if not disastrous consequence of rendering shares in a publicly traded mutual fund nonfungible.

5. Other passthrough entitles. The 1989 Bill would create major additional complexity and opportunities for arbitrage with respect to trusts. In many respects, the complexities and arbitrage opportunities will be similar in nature to those arising in connection with the types of passthrough entities previously discussed. Nevertheless, many additional issues arise.

In particular, the taxation of trusts will be burdened with difficult computational issues arising under the throwback rules, the treatment of disposition of qualified real property under section 2032A, and the treatment of split interests in property. Moreover, the technical basis and holding period rules for property held by or acquired r through a trust will provide numerous planning opportunities, particularly in circumstances involving transfers of interests in the trust as opposed to its corpus We consider it highly unlikely that the in terrorem “principal purpose” rule will eliminate the perceived opportunities.

Partnerships and S corporations would have to maintain records... to determine Indexation adjustments to partners' or shareholders' Interests upon the sale of an Indexed asset

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It should be noted that the 1989 Bill effectively denied the benefits of basis indexing to holders of interests in subchapter T cooperatives. We assume that this denial represents a conscious choice favoring the simplicity of denying the benefit over the difficult task of crafting rules to preserve the benefit of indexing in this context. Nevertheless, it must be recognized that this choice favors the interests of taxpayers large enough to conduct operations without dealing with cooperative over smaller taxpayers who must conduct significant aspects of their affairs through cooperatives.

6. Other problems with the 1989 Bill flowthrough provisions. The provisions of the 1989 Bill relating to passthrough entities significantly increase record keeping and computational burdens on taxpayers. Under the 1989 Bill, partnerships and S corporations would have to maintain records for each indexed asset to determine indexation adjustments to partners or shareholders' interests upon the sale of an indexed asset. For partnerships, already complicated issues regarding the allocation of gain, loss, income, and deductions related to assets contributed to a partnership by a partner under section 704(c) would be further complicated by the additional layer of issues and computations regarding indexation adjustments to such assets. Similarly, as anyone who has had to work through the adjustments and the individual valuation of all partnership assets in a complex partnership will attest, section 754 is not a simplification measure:

An example should illustrate the magnitude of the problem Assume X and Y form a partnership. X contributes property with a fair market value of $480. Y contributes property with a fair market value and tax basis of $120. The properties contributed by X and Y are depreciable over 10 years on a straight-line basis. The partnership has no items of income, gain, loss, or deduction other than depreciation and gain or loss with respect to the property.

Partner Capital Accounts

	X	Y	Property

	Book	Tax	Book	tax	Book Value	Tax Basis
Contribution.	.480	0	120	120	600	120
Depreciation, Years 1-5. .	(240)	0	(60)	(60)	(300)	(60)
Balance, Year 5.	.240	0	60	60	300	60

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

Assume that X's property has a tax basis of zero upon contribution. Assume that at the beginning of year six, both properties are sold for $600 and that inflation is 50 percent for the five-year period. First, the treatment of the partners without indexation of the partnership's assets

$240 of the tax gain is allocated entirely to X as section 704(c) gain. The section 704(c) gain is the remaining disparity attributable to the value/basis differential of X's property, computed as the difference between the property's adjusted book value (240) and adjusted tax basis (0).

The additional $300 of tax gain and the book gain of $300 is allocated 80 percent to X (240) and 20 percent to Y (60), so that the capital account balances are:

	X		Y	
	Book	Tax	Book	Tax
Balance Year 5……………………………..	240	0	60	60
Gain………………………………………………..	240	480	60	60
Balance………………………………………….	480	480	120	120

Liquidation proceeds, which are distributed in accordance with the Book Capital Account balances, will be distributed 40 to X and 120 to Y, resulting in an 80%/20% distribution ratio. Neither party should recognize gain or loss upon liquidation, as the proceeds received will equal the tax basis in their partnership interests (i.e., their Tax Capital Accounts).

This already complex system of partnership allocations Is further complicated by the addition of Indexation adjustments and allocations Issues.

This already complex system of partnership allocations is further complicated by the addition of indexation adjustments and allocations issues. With indexation, the tax basis of the partnership's property would be 180 (150% of a 120 tax basis).50 Thus:[50]

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

At this point, numerous issues arise. First, how is the section 704(c) allocation to X to be determined? If the indexed tax basis is used, only 120 of the tax gain would be allocated to X as section 704(c) gain the difference between the property s

50 The 1989 Bill provides that for purposes of determining the amount of depreciation recapture, basis adjustments attributable to indexing are not taken into account. Thus, the partnership will have $60 of recapture gain. The remaining gain is determined by using the $120 basis (sum of $60 basis before recapture plus $60 recapture), and applying a 50 percent indexation adjustment.

adjusted book value (300) and the indexed tax basis (180). On the other hand, the unindexed adjusted tax basis might be used, resulting in the same section 704(c) allocation as before: this, of course, would require taxpayers to keep track of and make yet another basis determination.

Second, how is the indexation adjustment of 60 to be allocated between X and Y? If in proportion to X and Y's partnership interests, X would receive an increase in his partnership interest basis of 48 (80%) and Y would receive 12 (20%) as their flowthrough indexation adjustments. Since the sale at $600 in an indexed system produces an overall loss, such an allocation effectively allows X and Y to blend their losses and gains on their respective property contributions to the partnership. X's property has a large built-in gain of 480, presumably unreduced by inflationary indexing since its basis is zero. Nevertheless, the partnership has experienced an economic loss on X's property. Y s property also experiences a significant loss in value due to inflation.

An allocation of indexation adjustments according to X and Y’s respective partnership interests would give X indexation adjustments when, without a partnership with Y, X's property would not receive any indexation. Similarly, Y has transferred 80 percent of the indexation benefits attributable to Y's property to X through the partnership structure. Moreover, this transfer of indexation benefits has allowed Y to avoid the 1989 Bill's restriction on losses created by inflationary indexing; the partnership's indexation benefit of 60 is entirely produced by an inflationary loss of Y's property. Additional rules will be necessary to determine allocations on a property-by-property basis, if indexation, as the 1989 Bill provides, cannot create or increase a loss

Moreover, the 1989 Bill provides that substantial improvements or additions to indexed property should be separately indexed. This will inevitably create serious problems regarding the netting of gains and losses between the indexed property itself and any substantial improvement to it the allocation of indexation benefits between the property and the substantial improvement, and the allocation of such benefits between, for example, partners contributing different amounts of capital, appreciated property, built-in loss property, or services to the indexed property and to any substantial improvement.

While these problems may have solutions, solutions, whether complex or simple, will only be the result of in-depth study and considerable effort focused on each particular aspect of S corporation or partnership flowthrough. The 1989 Bill, in contrast, naively assumes that solutions lie in ignoring the problem areas. Thus, the House Report on the 1989 Bill states that partnership interests and S corporation stock were not made indexed assets to avoid “the complexity which would result in determining the proper measure of the basis adjustment if indexing were to take into account the fluctuating basis of the S corporation or partnership interest or the varying mix of indexed and unindexed assets held by an S corporation or partnership. [51] Yet, as the above example illustrates, problems of asset mix and indexation, among others, would arise immediately upon the sale of any partnership interest or S corporation stock, and cannot, as the 1989 Bill presumes, be deferred until the partnership or S Corporation disposes of a particular asset.

[51] House Report, p. 1479.

IV. COMPLIANCE BURDENS

As our review of the 1989 Bill indexing proposal reveals, the complexity of the substantive issues raised by any basis indexing proposal could hardly be understated. The effect of any indexing proposal on the current tax system's complexity, however, also must be measured in terms of increased compliance burdens on taxpayers. Moreover, these increased compliance burdens will further strain an already overburdened audit system. This part of the report briefly identifies some of the compliance burdens that would be created or increased by an indexing system.

In many common circumstances, the indexing calculation would be a complex one.

A. The Basic Indexing Calculation

The first additional compliance burden attributable to indexing is the need to adjust the basis of assets that otherwise would not be adjusted or to make an additional adjustment where adjustment already is required. The additional complexity would be lessened- if adjustments were made only annually (as opposed to quarterly) although there would be some sacrifice in accuracy.[52] As a practical matter, because the adjustment would be made only when an asset is disposed of, the incremental burden of adjusting the basis of any particular asset would be fairly modest in the simplest cases. However, even the relatively modest incremental calculations can amount to a significant additional burden for taxpayers who have a great number of otherwise simple

[52] Cohen, p. 104

transactions, such as an active trader of securities or an investor who has regularly reinvested dividends in a mutual fund, or pursuant to a corporate dividend reinvestment plan (hereinafter referred to as “DRIP”). Moreover, as discussed above, in many common circumstances, the indexing calculation would be a complex one. We question the wisdom of introducing any incremental complexity where the tax law already is widely perceived as overly complex.[53]

B. Increased Record Keeping

Under present law, once the holding period of an asset exceeds the applicable holding period for long-term capital gain or loss treatment, there is no further need to ascertain the precise period for which it has been held.[54] If the basis of assets were to be indexed, however, it would be important to establish the precise holding period of any asset so that the indexing calculation can be made accurately. We anticipate that certain conventions would be adopted for making the relevant indexing computations. These conventions may serve to simplify somewhat the indexing computations where payment or payments for

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[53] See. e.g., H Stout. Codified Contusion, Tax Law Is Growing Evermore Complex. Outcry Even Louder, Wall St. J., Apr. 12. 1990. p. A1, col 6: Rostenkowski Pushes Simplification As Hearings Begin on Tax Reform, 46 Tax Notes 738 (Feb. 12.1990) (“committee will make tax simplification a top priority”); F. Goldberg, Statement before the House Ways and Means Committee (Feb. 7. 1990) (“The cumulative impact of repeated law changes—coupled with a statutory, regulatory, and administrative focus on theoretical purity—have imposed a staggering burden of complexity, uncertainty, and administrative costs ....”); K. Gideon. Statement before the House Ways and Means Committee (Feb. 7, 1990)(“We must work together in an effort to identify ways to simplify the system in a manner consistent with maintaining both the reality and perception of fairness.”).

[54] Moreover, even this information usually is unnecessary cause the distinction between long-term and short-term cat gains is virtually irrelevant under present law.

assets are made either before or after the acquisition of the asset. Although records generated in the ordinary course of business probably would contain most of the information relevant to the indexing computation and conventions, the degree of detail that taxpayers would need to develop from these records would be markedly enhanced.

This is particular true for long-term investments of individual taxpayers, such as homes (or home improvements) or investments in family businesses, precisely the area of tax law in which additional complexity is to be added with the greatest of trepidation. For example, if a taxpayer were to build a new addition to his home, records generated by the transaction may indicate multiple dates, reflecting the payments made and the delivery of various parts and labor. In performing the relevant indexing computation, either all or none of the dates reflected would be relevant. Under present law, none of the dates would be relevant so long as at least one year has passed from the time the addition was completed (which usually would be the case).

Under a regime of indexing, however, each periodic date will be a “cliff.” the passing beyond of which will be to the taxpayer's advantage. Moreover, major concerns as to complexity arise when a taxpayer sells his principal residence and purchases a new principal residence within the period allowed by section 1034. Except in the fortuitous event that the cost of the new residence is exactly equal to the sale proceeds of the old residence, the basis for the new residence will be different from the basis of the old, and complex adjustments will be required. Similar complex adjustments would be required for reorganizations with boot or any tax-favored exchange with boot, e g., section 1031, because the basis of the acquired asset is different from that of the transferred asset.

C. Possible Institutional Responses

Some commentators have suggested that much of the compliance burden inherent in an indexation system, particularly for taxpayers with multiple transactions, could be absorbed by financial institutions that have sophisticated computer capability.[55] Reliance on institutions to shield taxpayers from the additional burdens of complexity is fundamentally misguided.

First, the extent to which institutions can perform this role may be overstated. For example, some commentators have suggested that institutions will relieve the individual taxpayer of the burden of indexing computations for stock acquired under a DRIP. In many cases, however, an individual cannot participate in a DRIP if the stock is held through a brokerage account, eliminating the possibility that the brokerage firm can perform the required calculations.

Second, institutions will not necessarily have available all the information necessary to make the relevant indexing computations. For example, if an investor removes securities from an account at one brokerage firm and deposits those securities at another, information about acquisition dates will not necessarily be transferred at the same time. Finally it will be impossible for any particular institution attempting to calculate a taxpayer's indexation adjustment to take into account all the special rules relating to the indexing calculation, many of which will require information not available to it. One brokerage firm will not necessarily be aware of transactions that toll the holding period for particular assets if the taxpayer executed

[55] See Durst, p. 1274, Steuerle & Haiperin. p. 359.

those transactions through another brokerage firm. For example, a taxpayer may own shares of stock through one brokerage firm and nave sold put options with respect to the same stock through another brokerage firm. The combination of heavy reliance on institutions for computations with the inability of the institutions to take into account all relevant aspects of the indexing calculation is a recipe for widespread reporting errors, noncompliance or gaming against the Treasury

V. THE WEAK THEORETICAL BASIS FOR INDEXING

All the complexity and exposure to significant erosion of the revenue base would be problematic even under a perfect indexation system, because the primary theoretical bases supporting indexation of the tax system are themselves problematic.

A. Inexact Nature of Adjustments

The main premise underlying any indexing proposal, i.e., that indexing the basis of an asset will result in the taxation of not only real appreciation, is highly questionable. The four factors discussed below contribute to this conclusion. Given the reality that any inflation adjustment would be imprecise at best, we believe, in fact of the problems discussed in the preceding portion of this Report, that any form of indexation would be extremely bad tax policy.

First, the use of any particular inflation index will offer inexact relief to the owner of any particular asset. For example, if the consumer price index is used, exact relief will be given only to an owner who plans to use the income from the asset for consumption, as opposed to business or investment purposes, and then only if the composition of the owner's planned or actual consumption matches that of the basket of goods whose price level is measured in composing the index. Although it may be said that consumption is the ultimate goal or at least use for all income, it nevertheless is true that for certain periods, investment goals may predominate. This has caused some to question whether use of an index other than the consumer price index would be appropriate.[56]

Second, the price of an asset and the returns available from that asset already may be adjusted to account for inflation. For example, if a lessor charges higher rents to compensate for the overtaxation attributable to inflation, basis adjustments would provide the lessor with redundant relief. For this reason, it is unclear whether it would be preferable to index basis for actual or expected inflation.[57]

Third, deferring basis indexation adjustments until disposition creates arbitrary results where income-producing property generates periodic returns in excess of the “real” rate of return. For example, if the current income generated by property were sufficiently high, there would be relatively little real or nominal appreciation in that property. All the currently received income would be treated as ordinary income to the recipient, notwithstanding the fact that in an inflationary environment, a portion of that income in economic terms would represent a return of principal. Thus, indexing basis would be of limited usefulness to the holder of this type of property for whom property appreciation attributable to inflation would be

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[56] Bravenec & Curatola, Indexing the Federal Tax System for Inflation, 28 Tax Notes 457 (July 22.1985).

[57] Steuerle & Halperm. pp. 366-368.

recognized as ordinary income over the period the property is held, accompanied by a capital loss (if losses are allowed) or diminution of capital gain on disposition.[58] Ironically, the benefit of basis indexation is greater for property that does not generate current income and that as a result already enjoys the benefit of tax deferral.[59]

Basis adjustments will match Inflationary increases only by happenstance.

Finally, even assuming that the proper measure of inflation in an asset can be determined with reasonable precision, it can be demonstrated that in most cases actual basis adjustments will match inflationary increases only by happenstance. This unfortunate result occurs because in the absence of gain realization, annual adjustments are made to the basis of the asset without regard to its fair market value. Nevertheless, inflation in any period by its nature will increase the nominal price of an asset relative to its value at the beginning of the measurement period

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[58] This result is most easily understood in the context of an investment in nonparticipating preferred stock. For example, individual Investor A pays $1,000 for $1.000 face amount of XYZ Corp. preferred stock, which has a 10 percent annual dividend. Inflation of five percent is anticipated in determining the dividend rate and inflation actually occurs at that rate. A's stock is redeemed after 10 years for $1.000. At that time, A's indexed basis in the stock is $1,629, resulting in a capital (and economic loss of $629. This loss occurs because each unindexed dividend payment represents economically a return of capital in part. Cl. section 1059(f) The same phenomenon occurs with respect to depreciable property if basis is indexed only on disposition and depreciation deductions are not indexed.

[59] See Part V.B., infra.

For example, assume that Ms. A purchased an asset for $1,000. After one year the asset is still worth $1.000. After two years, Ms. A sells the asset for $1.300. Inflation in each year is 10 percent. Under an indexation system, Ms. A would have a basis in the asset at the time of sale of $1.210 (i.e., $1,000 plus $100 for the first year and $110 for the second year). Although Ms. A's inflation adjustment of $100 for the first year is appropriate, her inflation adjustment for the second year should be limited to $100. Price level increases in the second year only inflated the actual value of her asset, not the asset's adjusted basis. Ms. A's taxable gain is $10 less than her “real” gain.[60] By comparison, Mr. B purchases an asset for $1,000. The asset is worth $1,200 after one year and is sold for $1,300 after two years. At the time of sale, Mr. B's basis also would be $1,210, but his inflation adjustment for the second year should have been $120 rather than $110, resulting in tax of $10 of gain in excess of real gain.

Accordingly, the basis adjustment for an asset will exactly equal the measure of its price inflation (assuming that the exact amount of price inflation can be measured in any event) only where the asset appreciates at exactly the rate of inflation. Basis adjustments will be inadequate to adjust for inflation where an asset appreciates faster than the rate of inflation, and basis adjustments will be excessive where an asset appreciates at a rate slower than inflation.

Thus, it must be recognized that the connection between the actual effects of inflation on any particular asset and the relief provided by any system of basis adjustments is quite tenuous.

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

B. Neutral Taxation of Capital Income

Another often-stated premise underlying indexation proposals is that indexation is needed to achieve neutral taxation of income from capital as compared to other sources, i.e., to prevent capital income from being taxed more heavily than other income by reason of including inflationary as well as real gains in the tax base. This premise too is false. It is well understood that the current system taxes income from capital more favorably than income from other sources because gain from the appreciation of capital is not taxed unless realized and avoids tax altogether if the asset is held at death. Other advantages include accelerated depreciation, the availability of interest deductions on related indebtedness, and UFO inventories.[61] Thus, unless these other benefits are eliminated, indexing of basis will allow income from capital to enjoy an even more favored tax status relative to income from other sources than it now enjoys.

VI. CONCLUSION

It is our position that the implementation of any indexation system as a part of a modification of the present tax system would be highly inadvisable. While this Report is intended to discuss only some of the potential problems with any indexation system, we believe it clearly identifies the nature of the numerous distortion, complexity, and tax arbitrage issues that any indexation system would create.

This Report reflects our position as professional tax practitioners. We are seriously concerned that any indexation

[61] See Steuerle & Halpenn. pp. 353-356.

system will permit the use of these distortions and tax arbitrage opportunities to seriously erode the revenue base. This will clearly be counterproductive m the current budgetary environment.

APPENDIX 1

Indexing In the United Kingdom

In 1982, following the high inflation of the 1970s and after several years of discussion,[1] the U.K. indexed the basis of certain assets in an attempt to avoid the taxation of inflationary gain.[2] Announcing the measure, the Chancellor of the Exchequer said in his Budget speech:

> I come now to the incidence of capital gains tax on inflationary gains. This is a matter which has rightly given rise to a great deal of discontent. No one has yet succeeded in finding a solution to this problem. Innumerable proposals for full indexation, for tapering and other ingenious devices have been put forward. None, unfortunately, overcame all the practical difficulties. I cannot, however, allow this injustice to continue. It is intolerable for people to be permanently condemned to pay tax on gains that are apparent but not real—that exist only on paper.

Thus, acknowledged at the outset that the measure was imperfect, basis indexing was created in the U.K. Since its introduction, the basis indexing provisions have undergone two major revisions, the second of which, in 1986, was part of a

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[1] See. e.g., Nobes, Capital Gains Tax and Inflation, 1977 Brit. Tax Rev 154: Watson & O'Reilly, A Schema for the Indexation of Capital. Gains Tax, 1978 Brit. Tax Rev, 4.

[2] See sections 86 and 87 of the U.K Finance Act of 1982 and section 68 of the U.K. Finance Act of 1985.

larger revision of the capital gains tax (“CGTV”)[3].

The U.K. indexing rules provide for adjustment to the basis of an asset upon its disposal. On the disposal of an asset, an indexation allowance is given, equal to relevant allowable expenditure multiplied by a fraction, the denominator of which is the retail price index[4] (“RPI”) for the month of disposal and the numerator of which is the RPI for the month of disposal less the RPI for the month of acquisition. The indexation allowance is treated as deduction from the gain or loss computed under general CGT rules. It may reduce a gain, turn a gain into a loss, or increase a loss.

Where an asset acquired before April 1, 1982, is disposed of after April 5.1988, the adjustment is calculated by reference to the market value on March 31, 1982 (rather than the taxpayer's cost basis before that date), if this gives a result favorable to the taxpayer. For dispositions of assets from April 1982 until April 1985, relief was given on a more restricted basis.[5]

A continuing problem with the U.K. indexing provisions has been the complexity of identifying the asses that have been

[3] In the U.K., the CGT is a separate tax from the income tax. Until 1988, a flat rate of 30 percent was imposed on a taxpayer's capital gains: the rate is now linked with the income tax rate so that for individuals, capital gains are added as the top slice of income to determine the appropriate rate, of up to 40 percent. Corporate capital gains are taxed at the full corporate rate of 35 percent (25 percent m the case of “small companies”).

[4] The RPI figure is released by the Inland Revenue each month.

[5] Specifically, (i) only changes due to inflation after March-1982 were taken into account: (ii) no relief was given for char due to inflation occurring during the first 12 months of ownership, thus excluding relief whether the asset was disposed of' within those 12 months or not: and (iii) the indexing adjustment could only reduce (or eliminate) a gain.

sold to determine their eligibility for the allowance, and the correct cost basis to be attributed to them, especially in the case of securities. Because of the relevant effective date provisions, assets had to be divided between those acquired before March 1982 and after. Another allocation had to be made initially for assets held for less than one year, which were not eligible for the allowance. In 1985, the one-year rule was abandoned, but the taxpayer was given the ability to choose whether to calculate the allowance for assets acquired before March 1982 using the base cost on acquisition before March 1982 or the fair market value of the asset in March 1982, requiring further allocations. Expenditure on property after March 1982 itself qualified for a separate calculation to determine the allowance due in respect of it. Part disposals also had their own rules. The effect has been to impose a considerable administrative burden on taxpayers who generally have been unable to compute their basis adjustments without professional help.[6] The shifting of basis of all assets to their value on March 1982 is expected to ease that burden somewhat, but carries with it obvious administrative problems of its own.

In 1985, the rules were revised to allow the allowance even when it created a capital loss. Attempts to take advantage of this have resulted m legislation to prevent abuses [7] For example, the Finance Act of 1988 contains provisions' preventing linked companies from manufacturing an artificial loss through

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[6] See Hoerner. Indexing Capital Gains The British Experience. 46 Tax Notes 988 (Feb 26. 1990)

[7] For example, the distortion caused by indexing gains on securities, while fully taxing interest as income, will result in sections and devices designed to convert the return on securities from income (unindexed) into capital gains (indexed) In the UK this has led to a series of anti-avoidance legislation Section 114 and Sched 11. Finance Act 1988

the sale of certain intercompany debts. Other problems include the failure to index gains or losses on debt, creating arbitrage possibilities, and resulting in frequent legislative action to stop it.

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January 19, 1995

The Honorable Bob Dole
United States Senate
Washington, D.C. 20510

The Honorable Newt Gingrich
Speaker of the House
House of Representatives
Washington, D.C. 20515

Re: Legislative Restrictions on Tax Regulations

Dear Senator Dole and Congressman Gingrich:

I am writing on behalf of the Tax Section of the New York State Bar Association to express our Strongly held views that:

- any legislative moratorium on the issuance of regulations by the Executive branch should not apply to tax regulations issued by the IRS and Treasury Department, and

- additional burdens should not be placed on the issuance of tax regulations.

Our reasons for these conclusions are that:

- as indicated in a very recent GAO report, "businesses have difficulty with the [Internal Revenue Code] because of numerous and unwieldy cross-references and overly broad, imprecise and ambiguous language"[1]/

FORMER CHAIRS OF SECTION
Howard O. Colgan, Charles L. Kades, Carter T. Louthan, Samuel Brodsky, Thomas C. Plowden-Wardlaw, Edwin M. Jones, Hon. Hugh R. Jones, Peter Miller, John W. Fager, John E. Morrissey Jr., Charles E. Heming, Richard H. Appert, Ralph O. Winger, Hewitt A. Conway, Martin D. Ginsburg, Peter L. Faber, Hon. Renato Beghe, Alfred D. Youngwood, Gordon D. Henderson, David Sachs, J. Roger Mentz, Willard B. Taylor, Richard J. Hiegel, Dale S. Collinson, Richard G. Cohen, Donald Schapiro, Herbert L. Camp, William L. Burke, Arthur A. Feder, James M. Peaslee, John A. Corry, Peter C. Canellos

[1] Tax System Burden: Tax Compliance Burden Faced by Business Taxpayers (GAO/T-GGD-95-42, December 9, 1994).

- as a result, all taxpayers (including individuals, small businesses and large businesses) are extremely dependent upon tax regulations to tell them the tax consequences of their activities, even ordinary and routine activities, and

- the uncertainties to taxpayers created by a freeze on tax regulations would be costly, disruptive and an inefficient use of resources.

I wrote a letter to you (and an identical letter to President Clinton) dated December 19, 1994 expressing these views in the context of your proposal for an immediate moratorium on all Federal regulations. A copy of that letter is attached. I am now writing to supplement our prior letter in light of the introduction of three bills in Congress that are applicable to tax regulations, and on which action may be taken shortly.

The remainder of this letter describes those bills and provides our comments with regard to the application of the bills to tax regulations. We express no views on the application of the bills to other regulations. We respectfully request the opportunity to present our views at the Congressional hearings to be held on these bills.

I. H.R. 450

H.R. 450 was introduced in the House of Representatives by Congressman DeLay on January 9, 1995, and referred to the Committee on Government Reform and Oversight.

Under the bill, (1) no federal regulatory rulemaking action (i.e., any rulemaking normally published in the Federal Register) could occur from the date of enactment through June 30, 1995, and (2) in the case of any rulemaking action taken between November 9, 1994 and the date of enactment, the effectiveness of that action would be suspended from the date 30 days after-enactment until June 30, 1995. The only exception that might possibly apply to tax regulations requires the agency to certify that the regulation is limited to “repealing, narrowing, or streamlining a rule ... or otherwise reducing regulatory burdens”.

Any party adversely affected by an agency action in violation of these provisions can bring a civil action against the agency to obtain appropriate relief, as well as attorney fees.

Comments. We strongly urge that an exception to this bill be made for tax regulations. As stated above and in our prior letter, tax regulations in fact do reduce the burden on taxpayers by providing needed guidance as to the tax consequences of transactions. However, because the burden that is reduced is not “regulatory burden”, H.R. 450 does not recognize this benefit to taxpayers and applies to these regulations.

Moreover, we wish to point out that our prior letter was directed solely at the adverse effects of a regulatory freeze on taxpayers. A regulatory freeze might well also have an adverse effect on government revenues. A taxpayer will commonly take a position for tax reporting purposes that is based on the most favorable interpretation of the Code and regulations that is reasonably possible. Such a position would normally not be subject to penalties.

However, if the Code is vague (as is often the case), extremely pro-taxpayer positions might be plausible in the absence of clarifying regulations, and a freeze on regulations would extend the period during which these positions could be taken. Even if a regulation has already been issued and is not subject to the freeze, the freeze would prevent the IRS from modifying the regulation if it determines that taxpayers are interpreting the existing regulation in an unintended pro-taxpayer manner. In fact, Congress routinely adds a clause to new tax provisions authorizing regulations to prevent the avoidance of the provisions through various means, and now to prohibit the issuance of such regulations would certainly be contrary to the original Congressional intent.[2]

Beyond these considerations applicable to a freeze on new regulations, however, H.R. 450 raises further significant issues because of its “suspension” of the effectiveness of tax regulations already adopted since November 9. We believe such a suspension would cause still further disruption and unfairness far beyond that applicable to a freeze on new regulations.

The IRS regularly issues large numbers of “technical” regulations that affect all kinds of routine activities of taxpayers. Many of these regulations have been adopted since November 9 and are now in effect.[3]

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[2] A freeze might even encourage taxpayers to take unusually favorable interpretations of the Code and existing regulations, with the knowledge that new regulations could not be issued in the near future and, when issued, would probably not be retroactive

[3] For example, among the final or temporary regulations published in the Federal Register between November 9 and December 31, 1994, are those relating to (i) how individuals are to compute their alternative minimum tax liability (November 25), (ii) information reporting for the recipients of points on a residential mortgage (December 6), (iii) the exclusion from income for certain military moving allowances (December 21), (iv) withholding on distributions of Indian gaming profits (December 22), (v) defining “sewage facilities” eligible for tax-exempt bond financing (December 23), (vi) the requirements for natural gas producers to elect out of partnership rules (December 23), (vii) defining “compensation” for purposes of the Railroad Retirement Tax Act (December 23), (viii) authorizing modification of agreements for taxpayers to pay their tax in installments when the financial condition of the taxpayer deteriorates or improves (December 23), (ix) rules for the taxation of “built-in gain” of Subchapter S corporations that were previously C corporations (December 27), (x) the taxation of nuclear decommissioning funds on the disposition of an interest in the underlying power plant (December 27), (xi) rules on tax allocations following a contribution of appreciated assets to a partnership (December 28), and <xii) rules concerning the capitalization of interest for debt-financed real estate and other construction (December 29).

Suspension of these existing regulations would have the following adverse effects:

1. Whether or not taxpayers like a particular regulation, taxpayers generally adjust their behavior and activities to conform to regulations as they are issued. If Congress were now to “suspend” regulations that were reasonably believed by taxpayers to be effective for the indefinite future, considerable unfairness could result to taxpayers who had arranged their affairs in reliance on these regulations. This would also - foster disrespect for and distrust of the tax system, which could be quite harmful for the voluntary compliance that is necessary for the tax system to function.

2. Enormous complexity and confusion would be created if an existing regulation were in effect for the beginning (and possibly the end) of 1995 and “no regulation” were in effect for a few months in the middle of the year. One of the biggest complaints taxpayers have about the tax system is its unpredictability and the constant changes to the rules. In its effort at regulatory reform, the bill would greatly exacerbate this problem.

3. Since many regulations (such as the alternative minimum tax regulation cited in the preceding footnote) determine the method of calculating taxable income for an entire calendar year, total confusion could result from two different methods being in effect for different portions of a year.

4. Taxpayers who are unfavorably affected by a particular regulation suspended by the bill would concentrate as many of their transactions as possible into the “gap” period. Conversely, _ taxpayers that are favorably affected by a suspended regulation would attempt to engage in their transactions before the suspension began or wait until the suspension ended. Of course, the same taxpayer might well be trying to

engage in some types of transactions before or after the gap and in other types of transactions during the gap. All of this would create enormous economic inefficiencies as well as considerable revenue loss as the government is whipsawed by its on-again/ off-again regulations.

As a result of the foregoing, we reiterate our strong opposition to the application of H.R. 450 to tax regulations, and our particular -concerns with the suspension of existing regulations.

II. S. 219

S. 219 was introduced in the Senate on January 12, 1995, by Senator Nickles and referred to the Committee on Governmental Affairs. We understand that hearings will occur shortly. It is in general the same as H.R. 450, but contains an exception for actions “limited ... to issuing or promulgating a rule required to make effective tax relief provided by statute”.

Comments. Our comments concerning H.R. 450 are equally applicable to S. 219. Moreover, as discussed below we do not believe that the exception for certain tax regulations will apply in more than a very small number of cases. As a result, we strongly urge that the exception be broadened to cover all tax regulations.

The reasons for our concern are as follows:

1. The exception only seems to apply if there is a provision of the Internal Revenue Code providing tax relief, and regulations are necessary to effectuate that relief. The fundamental problem is that the great majority of Code sections provide tax rules, not tax relief. Regulations interpreting these sections would therefore not be eligible for the exemption, even if they provide essential guidance and clarification to taxpayers.

2. Even regulations that were generally considered favorable to taxpayers would not be generally covered by the exemption. While such a regulation could itself be considered to provide “tax relief”, it would generally not be effectuating a statutory provision providing tax relief. As a result, few if any tax regulations would be exempted from the freeze.

3. Because “tax relief” is not a term used in the Internal Revenue Code, it is completely unclear how the statutory exception would apply in numerous cases. This issue is more than academic because any affected taxpayer may bring suit under the civil enforcement provisions of the bill. Thus, considerable litigation over the meaning of “tax relief” could ensue.

> Consider, for example, the common situation where a Code provision provides a basic taxing rule, an exception to taxation under that provision, and an exception to the exception. Is the IRS precluded from issuing a regulation under the basic rule, but permitted to issue a regulation under the exception? What about the exception to the exception?
>
> As another example, consider Section 108(c), clearly a pro-taxpayer relief provision relating to the discharge of real property debt. Regulations under that section are eagerly awaited and would seem to be squarely within the scope of the exception. But would regulations be permitted under Section 108(c)(5), which specifically authorizes regulations “preventing the abuse of this subsection” through certain means?

4. Even statutory provisions that generally do provide tax relief may adversely affect some taxpayers. It is not clear whether a regulation under such a provision would be exempted from the freeze

to the extent a particular taxpayer was adversely affected. If no adverse effect was permitted as to any taxpayer, the IRS is unlikely to be willing to issue regulations with such a one-sided effect, and the statutory exception would be meaningless.

For example, consider Section 197(e)(4)(D), which authorizes regulations to exempt taxpayers from 15-year amortization of intangibles if they acquire rights under a contract with a duration of less than 15 years. While regulations under this provision would almost always help taxpayers, some taxpayers with net operating losses might prefer the longer 15-year amortization. Would such a taxpayer be bound by a regulation making the authorized “tax relief” effective for the great majority of taxpayers?

It might be thought that some of the above problems could be solved by revising the statute to allow regulations that themselves provide “tax relief” to taxpayers, even if the regulations are not based on a statutory tax relief provision. However, this approach would leave intact the foregoing problems. Most tax regulations do not fit into the category of tax relief, since they have some provisions that taxpayers generally favor and others that taxpayers generally consider unfavorable. Moreover, even if a regulation is generally favorable (i.e., generally provides “tax relief”) to taxpayers, unless a regulation provides a purely elective rule there are almost always some taxpayers who are adversely affected by the regulation. Unless the IRS was permitted to issue a balanced regulation that applied equally to all taxpayers, it would most likely not issue the regulation at all.

III. H.R. 9.

H.R. 9 was introduced in the House of Representatives on January 9 by Congressman Archer and others, and hearings are being held during January. Title VII of the bill, relating to regulatory reform, contains a number of provisions that would apply to tax as well as all other federal regulations.[4]

First, under section 7004 of the bill, a regulatory impact analysis would be required for any regulation affecting more than 100 persons. The analysis would be required to contain 23 items, including such items as a demonstration that the rule provides the least costly or least intrusive approach for meeting its intended purpose, a description of <u>any</u> (emphasis added) alternative approach considered by the agency or suggested by interested persons and the reason for the rejection, an estimate of the costs persons will incur in complying with the rule, an evaluation of the costs versus the benefits derived from the rule, an estimate of the cost to the agency for implementation and enforcement of the regulation, and so on.

In addition, under section 7006 of the bill, entitled “Standards of Clarity”, no proposed regulation could be published in the Federal Register unless the director of the Office of Management and Budget certified that to the extent practicable, among other things, it (i) “is written in a reasonably simple and understandable manner”, (ii) “is easily readable”, (iii) “conforms to commonly accepted principles of grammar,” and (iv) “does not contain any double negatives, confusing cross references, convoluted phrasing, unreasonably complex language, or term of art or word with

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[4] He also note Section 8101, in Title VIII of the bill, which provides that every person that is the subject of a federal “investigative or enforcement action” is entitled to a number of rights upon the “initiation of an inspection, investigation, or other official proceeding”. These rights include rights to remain silent, to be warned that statements can be used against them, to be advised whether the person has a fight to a warrant, and to have an attorney or accountant present. It is not clear whether under the bill every IRS tax auditor will be required to provide such a statement of rights to every taxpayer at the commencement of an audit.

multiple meanings that may be misinterpreted and is not defined”.

<u>Comments on Regulatory Impact Analysis</u>. We are very concerned that if the proposed regulatory impact analysis were applied to tax regulations, the resulting burden on the IRS would create a result that was similar to a freeze on tax regulations. Although intended to help the public, this requirement would have just the opposite effect, by making it harder for taxpayers to understand their tax obligations.

Assistant Secretary of the Treasury (Tax Policy) Leslie B. Samuels testified on January 10 that the regulatory impact analysis “would bog down the guidance process and increase compliance burdens on taxpayers”. We agree. It is clear that compliance with the statutory standards would substantially increase the amount of paperwork involved in promulgating regulations, and require the shifting of personnel from the drafting of regulations to the procedural aspects of promulgating them.

Moreover, we note that the IRS generally publishes extensive preambles to proposed and final tax regulations explaining the reasons for the principal decisions made in the regulations. We are not aware of any significant taxpayer demand that these explanations be expanded. In fact, in our experience the IRS officials whose names and telephone numbers are given in these preambles are generally quite willing to discuss the regulations. In addition, under Section 7805(f) of the Internal Revenue Code, the IRS is already required to specifically consider the impact of regulations on small business. Finally, it is not at all clear how some of the items in the regulatory impact analysis are intended to apply to tax regulations. For example, given that the purpose of the tax statute is to raise money, how does one demonstrate that a particular regulation “provides the least costly or least intrusive approach for meeting its intended purpose”?

As a result of the foregoing, we believe the regulatory impact analysis should not apply to tax regulations, or at least should be modified to greatly reduce the burden and better reflect the purposes of tax regulations.

Comments on Standards of Clarity. We applaud the goal of clear and simple regulations of all types, including tax regulations, and we routinely make suggestions for simplifying regulations.[5] Moreover, we applaud the progress the IRS has made in recent years in issuing clearer and simpler regulations.

The problem, however, is that, as indicated in our prior letter, the Internal Revenue Code itself is extraordinarily complex and does not come close to meeting any one of the standards of clarity quoted above. Moreover, when Congress cannot determine the appropriate manner in which a particular Code provision should apply to a complex situation, it generally delegates to the IRS the power to issue regulations to deal with the difficult situation.

As a result, we think it is simply quixotic to expect that the Code can be interpreted with “easily readable” regulations. We believe that the goal of simple tax regulations cannot ultimately be successful except at the margins until Congress greatly simplifies the Code. Moreover, some transactions engaged in by taxpayers are extremely complex and, aside from whether the relevant Code provisions are simple or complex, require complex regulatory responses.

We believe that either the Standards of Clarity in the bill will in effect be ignored for tax regulations (perhaps under the guise that the Standards only apply “to the extent practicable”), or else the Standards will be

[5] We note that the goal of simple regulations is not universally accepted. Some taxpayers prefer more detailed regulations to cover every situation that they might encounter, and dislike the broad anti-abuse rules that the IRS generally feels are necessary to accompany less detailed regulations.

followed and regulations will be severely delayed or not issued at all. Neither of these outcomes is desirable. We therefore believe that either the Standards should not apply to tax regulations in the first instance, or at least there should be an acknowledgment in the statute or legislative history that tax regulations cannot “practicably” be expected to be much simpler than the statute they are interpreting, or to be much less complex than the transactions on which they are providing guidance.

4. Conclusion

Consistent with our prior letter, we strongly oppose these bills to the extent that they would have the effect of freezing tax regulations or making their issuance more difficult. We believe that reform in the tax area should start with the Internal Revenue Code, not with the regulations interpreting the Code for taxpayers.[6] Even to the extent present regulations can be simplified, a freeze is not the right way to go about the simplification effort.

In fact, given the present state of the Code, legislation requiring “easily readable” tax regulations is an example of Congress requiring others to apply a standard from which Congress itself is exempt. No expert or nonexpert in the tax law would call the Code itself “easily readable”, and there is no shortage of “confusing cross references” and “convoluted phrasing”. Moreover, Congress routinely delegates to the IRS the “dirty work” of writing regulations to deal with situations too complex for Congress itself to resolve in the statute. It would therefore be extraordinary

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6 He note the recently expressed view that a moratorium on tax regulations would be a good idea because it would force attention to be placed on the complexity of the Code, and presumably put additional pressure on Congress to simplify the Code. Henderson, “The NYSBA Tax Section's Call for More Regulations,” Tax Notes, January 16, 1995, page 436. Mr. Henderson agrees, however, that a moratorium would make no sense unless Congress were in fact to use the interim period to simplify the Code.

for Congress now to demand that tax regulations be simple.

We have and will continue to support simplification of the Internal Revenue Code, and renew our offer to be helpful to the tax staffs in that effort in any way possible. However, until such simplification of the statute occurs, taxpayers will be largely dependent on tax regulations for guidance. We believe it simply makes things worse to begin the reform effort by reducing the guidance available to taxpayers.

Very truly yours,

Michael L. Schler
Chair, Tax Section

cc: Senator John Glenn
Senator Daniel P. Moynihan
Senator Don Nickles
Senator Bob Packwood
Senator William Roth, Jr.

Congressman Bill Archer
Congressman William F. Clinger, Jr,
Congressman Cardiss Collins
Congressman Tom DeLay
Congressman Sam Gibbons

Hon. Robert E. Rubin
Hon. Leslie B. Samuels
Hon. Cynthia G. Beerbower
Hon. Edward Knight

Hon. Margaret M. Richardson
Hon. Stuart L. Brown

Mark Prater
Joseph H. Gale
James B. Clark
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Michael Hirschfeld
Charles M. Morgan, III

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New York State Bar Association

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December 19, 1994

Senator Bob Dole
United States Senate
Washington, D.C. 20510

Representative Newt Gingrich
House of Representatives
Washington, D.C. 20515

<u>Application of Proposed Regulatory Freeze to Tax Regulations</u>

Dear Senator Dole and Representative Gingrich:

I am writing on behalf of the Tax Section of the New York State Bar Association in connection with the immediate moratorium on federal regulations recently proposed in a letter sent by you and others to President Clinton. I understand President Clinton has rejected the proposal, but I am writing to express our views in case the same issue arises in the future.

We urge in the strongest possible terms that any moratorium on regulations not apply to tax regulations issued by the Internal Revenue Service and the Treasury Department. This position was adopted by a unanimous vote of our Tax Section Executive Committee at a meeting attended by 37 tax lawyers of all political persuasions. We took the same position in 1992 when President Bush was considering a moratorium on regulations. (A copy of our prior letter is attached.) Moreover, we note that your letter contemplates the possibility of exceptions to

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the moratorium, although it does not mention tax regulations specifically.

There are several reasons for our position. The Internal Revenue Code, which is the statute interpreted by tax regulations, is not a simple statute. It is well described in a GAO Report requested by Representative Houghton (Ranking Minority Member of the Oversight Subcommittee of the House Ways and Means Committee) and released this past week:

> "Business officials and tax experts told us that, overall, the federal tax code is complex, difficult to understand, and in some cases indecipherable .... More specifically, they said businesses have difficulty with the code because of numerous and unwieldy cross-references and overly broad, imprecise, and ambiguous language."[1]/

As a result of this complexity, taxpayers are extremely dependent upon tax regulations to tell them the tax consequences of their activities and transactions. An absence of regulations often results in great uncertainty about the tax consequences of proposed actions, even if the actions are ordinary and routine. The risk of unexpected tax liability resulting from tax uncertainties creates economic disincentives for normal commercial activity (and even burdens routine personal tax planning). The consequence is considerable economic inefficiency and dislocation. This effect applies to the entire spectrum of taxpayers, including large corporations, small businesses, real estate owners and individuals. An absence of regulations also results in increased tax litigation, because of differing interpretations of the Internal Revenue Code by IRS agents and taxpayers.

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[1]/ Tax System Burden: Tax Compliance Burden Faced by Business Taxpayers (GAO/T-GGD-95-42, December 9, 1994). The Appendix to the study states that the companies studied were mostly medium-sized, and that the results concerning the sources of tax compliance burden were consistent with the literature that was reviewed.

Taxpayers and taxpayer groups therefore spend an enormous amount of time and energy requesting (sometimes even begging) the IRS and Treasury to issue regulations in a variety of areas. The overwhelming complaint among taxpayers and tax lawyers is that the IRS and Treasury take too long to issue regulations, and that there are too few rather than too many regulations.

This again is confirmed by the GAO report quoted above. The report discusses at length problems that businesses have with the complexity of the Internal Revenue Code itself, but its only discussion of tax regulations is that the lack of regulations makes things worse:

> "Of those [business officials and tax experts] who cited difficulties with IRS, problems identified were ....the amount of time IRS takes to issue regulations .... For many tax provisions businesses depend upon IRS regulations for guidance in complying with the code and correspondingly reducing their burden. Without timely regulations, according to some respondents, businesses must guess at the proper application of the law and then at times amend their decisions when the regulations are finally issued."

As a result, a freeze on tax regulations would be extremely costly and disruptive. An immediate freeze would already have precluded the issuance on December 15 of long-awaited (and taxpayer-favorable) proposed regulations concerning the tax treatment of an employer's reimbursement of travel expenses of the spouse of an employee. Solely for illustrative purposes, taxpayers are currently awaiting regulatory guidance from the IRS on such matters as environmental settlement funds, real estate mortgage workouts, purchases of computer software and other intangibles, and the substantiation requirements for charitable contribution deductions.

The situation involving tax regulations should be contrasted with the reasons for a regulatory moratorium stated in your letter:

that overregulation imposes costly burdens and slows economic growth and job creation. We have no particular expertise outside the tax area and pass no judgment on the merits of a moratorium generally. However, we do believe as tax lawyers that the stated reasons have little or no application to tax regulations, and that the economic benefits of issuing tax regulations far outweigh any disadvantages. As a result, we strongly oppose a moratorium on tax regulations.

We are sending a substantially identical letter to President Clinton.

Very truly yours,

Michael L. Schler
Chair, Tax Section

cc: Senator Thad Cochran
Senator Trent Lott
Senator Daniel Patrick Moynihan
Senator Don Nickles
Senator Bob Packwood

Representative Bill Archer
Representative Richard Armey
Representative John Boehner
Representative Tom DeLay
Representative Sam Gibbons
Representative Amo Houghton

TAX SECTION

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January 22, 1992

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

Dear President Bush:

On behalf of the Tax Section of the New York State Bar Association, I strongly urge that any moratorium on regulations you announce not apply to regulations issued by the Internal Revenue Service. Representatives of the Internal Revenue Service have announced that a significant number of regulations on which they are working are likely to be issued in proposed or final form during the next three months. A number of these regulations interpret provisions of the Internal Revenue Code that were enacted more than five years ago. United States taxpayers, including corporations, need the interpretative assistance these regulations will provide.

Press reports indicate that the goal of a regulatory moratorium is to stimulate the economy by removing costly and burdensome regulations that affect U.S. businesses. Issuance of these tax regulations, however, would for the most part benefit U.S. businesses, by resolving uncertainties that inhibit productive activity.

The 1981 moratorium ordered by President Reagan specifically excluded

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regulations issued by the Internal Revenue Service. Any moratorium you order should do likewise.

Respectfully submitted,

James M. Peaslee
Chair

cc: Hon. Kenneth H. Gideon
Hon. Fred T. Goldberg, Jr.
Abraham N.M. Shashy, Jr., Esq.

HEARINGS ON H.R. 9 BEFORE THE
HOUSE WAYS AND MEANS COMMITTEE
JANUARY 25, 1995

SUPPLEMENTAL STATEMENT BY MICHAEL L. SCHLER ON BEHALF
OF THE TAX SECTION OF THE NEW YORK STATE BAR ASSOCIATION
FEBRUARY 7, 1995

This statement supplements my statement at the January 25, 1995 hearing concerning capital gains indexing. It responds to the statement and testimony by Dr. Norman Ture, who was a later witness on the same day. Dr. Ture asserts that indexing assets but not liabilities provides the theoretically correct results, and calls “without merit” the earlier testimony by Assistant Secretary Samuels that indexing assets but not liabilities leads to tax arbitrage and tax shelter opportunities. This assertion by Dr. Ture is in effect an assertion that our prior statement is also incorrect.

For the reasons stated below, we believe that Mr. Samuels' testimony is correct and that Dr. Ture is not. Moreover, Dr. Ture's error appears to be a simple mathematical error. We do not believe this issue is an abstract economic or philosophical issue upon which there can be differences of opinion, any more than there can be any differences as to the sum of 2 plus 2.

We begin, as does Dr. Ture, with the example given by Mr. Samuels. Taxpayer T purchases land in year 1 for $100,000, giving a $20,000 cash down payment and borrowing $80,000. The land is sold several years later (assume in year 5), after there has been 30% inflation, for $130,000. Thus, the entire $30,000 of nominal profit represents an inflationary increase in the value of the property. T takes the $130,000 sale proceeds, pays off the $80,000 debt, and is left with $50,000.

Mr. Samuels points out that T started with $20,000, and to make T whole for 30% inflation it would take an additional 30% of $20,000, or $6,000, of nominal profit for a total cash proceeds (after debt repayment) of $26,000. That is, $26,000 in year 5 has the same value that $20,000 had in year 1. To the extent T receives more than $26,000 of cash in year 5, the extra cash is real profit that should be subject to tax. However, even though T receives $50,000 in cash, with basis indexation T has no tax liability on the sale because the tax basis of the asset has grown to $130,000. Thus, $24,000 of real economic profit has escaped tax.

Dr. Ture's written response to Mr. Samuels' example asserts the following:

> Notice, however, that <u>in terms of constant purchasing-power dollars, the $50.000 in cash [T] has left over after paying off the mortgage indebtedness is only $20.000, exactly the amount of [T’s] original cash investment</u>. If [T] were subject to tax on the $24,000 of gain allocated by Samuels to the mortgage component of the investment, as Samuels suggests, [T] would net only $17,280. The tax would subject [T] to a net loss of $2,720 on the original investment. In fact, the arbitrating that Samuels asserts would result from indexing the basis of the asset but not the debt protects [T] from having to pay tax on a zero gain. The Treasury's complaint is without merit, (emphasis added)

The problem with Dr. Ture's analysis is the simple mathematical error in the first sentence. After 30% inflation, \$20,000 will grow to \$26,000, or alternatively \$38,461 will grow to \$50,000. In no event will 30% inflation turn \$20,000 into \$50,000. We believe it is indisputable that T has a true economic profit of \$24,000 and should pay tax accordingly. We note that this profit is in year 5 dollars, which matches the fact that the tax on the profit would also be paid in year 5 dollars.

We would point out that the \$24,000 of real economic profit that has escaped tax arises from the fact that the entire \$100,000 tax basis of the asset is indexed for inflation, but no portion of the \$80,000 liability is indexed. There are at least two ways of reaching the theoretically correct economic and tax results.

First, indexing could be limited to T's net investment of \$20,000. This would result in an increased tax basis in the property of 30% of \$20,000, or \$6,000. The total tax basis would be \$100,000 plus \$6,000, or \$106,000, and a sale for \$130,000 would give rise to the economically correct taxable gain of \$24,000.

Alternatively, the entire \$100,000 investment as well as the \$80,000 liability could be indexed. Under this approach, T would have no gain on the property (because the total sale proceeds of \$130,000 in year 5 dollars has the same value as \$100,000 in year 1 dollars). However, T would have an economic profit on repayment of the debt, because the year 5 dollars used by T to repay the \$80,000 debt are worth less than the year 1 dollars originally borrowed by T. Given 30% inflation, the \$80,000 year 1 dollars have the same value as \$104,000 year 5 dollars (130% of \$80,000 being \$104,000). Since T is only required to repay $80,000 in year 5 dollars, T has an economic profit of $24,000 in year 5 dollars and should pay tax accordingly.

SENATE FINANCE COMMITTEE

HEARING ON CAPITAL GAINS INDEXING

FEBRUARY 16, 1995

MICHAEL L. SCHLER

TAX SECTION

NEW YORK STATE BAR ASSOCIATION

My name is Michael Schler. I am here on behalf of the Tax Section of the New York State Bar Association. I was the Chair of the Tax Section until my term expired last month, and I continue to be a member of our Executive Committee. The Tax Section is dedicated to furthering the public interest in a fair and equitable tax system and to the development of sound tax policy. I am a tax partner at the New York law firm of Cravath, Swaine & Moore and have practiced tax law for over 20 years.

We are very grateful for the opportunity to present our views today on indexing the tax basis of assets for inflation. The bottom line is that we strongly oppose indexing, because it will vastly increase the complexity of the tax system and it will lead to the return of the tax shelter days of the 1980's.

But before expanding on these reasons, I would like to emphasize several points. First, we are a completely nonpartisan organization, and the members of our Executive Committee are of all political persuasions. Nevertheless, our strong opposition to indexing is essentially the unanimous view of all of these members, Republican as well as Democrat.

Second, our strong opposition to indexing is longstanding. We wrote to Chairman Rostenkowski in 1990 strongly opposing an indexing provision very similar to that now in H.R. 9, and we submitted at that time an extensive report describing our concerns about indexing. Included with my statement today are copies of our 1990 materials, as well as a letter to the same effect we recently sent to Chairman Archer of the House Ways and Means Committee.

Third, we take no position on whether the capital gains <u>rate</u> should be reduced. Our position on indexing is based solely on our technical expertise as tax lawyers. The arguments for and against a lower rate involve policy issues far beyond our particular expertise. We leave that debate to others.

Finally, yes we recognize the theoretical correctness of indexing. If you buy an asset with your own money for $100 and later sell it for $150 after there has been 50% inflation, you have no real gain. In a perfect world you would not have to pay any tax.

On the other hand, capital gains receive other benefits today that even as a theoretical matter offset the failure to index. The maximum rate is 28% (and H.R. 9 reduces the rate to half the ordinary income rate), and no tax has to be paid until you decide to sell the asset.

However, I want to emphasize today two very fundamental practical problems with indexing. These problems far outweigh any theoretical perfection that may arise from indexing. The first problem of course is complexity.

The Internal Revenue Code today is already so complex it is near the breaking point. Much of this complexity arises from Congress (as well as the regulation writers) trying to achieve perfection. We believe that down in the trenches, where real people make honest efforts to comply with the tax laws, indexing will vastly increase the burden and complexity for everyone. This includes individuals, businesses of all sizes, and the IRS.

Activities that are relatively simple today will involve massive calculations under indexing—buying and improving a home, buying and selling stock, or buying an interest in a mutual fund. You could not invest in a simple dividend reinvestment plan without an accountant. Everyone who collects stamps or baseball cards will be required to keep permanent records not only of each purchase price, but also of the calendar quarter in which each stamp or card was acquired. If you ever want to sell a stamp, you'll also need to consult your accountant. (I should point out that for most individuals, accountants' fees are not deductible.)

If this is not bad enough, consider the fact that most states impose their own income tax. If a state chooses not to allow indexing for revenue reasons, everyone in that state will be required to keep two sets of books (even for the baseball cards). Individual taxpayers are likely to be dumbfounded at this prospect.

Finally, suppose indexing is adopted and it turns out to be so complicated that after a few years most people want to repeal it. What do you do about the assets that already have a basis indexed for a few years' inflation? Do you take away that basis that taxpayers are already relying on? Is that a retroactive tax increase?

Or do you let taxpayers keep their indexed basis as of the repeal date, and only disallow future indexing? If you let people keep the indexed basis, you have created a permanent complexity in the Code. Someone selling an asset thirty years from now would have to figure out whether it was owned in 1995, and if so, whether it was eligible for indexing this year.

I could go on, but that is enough on complexity. The other major problem we have with indexing is that it will inevitably result in the return of the tax shelter days of the 1980's. Every experienced tax lawyer who reads the indexing provisions of H.R. 9 immediately dreams up a half dozen ways to “beat the system” and create a tax shelter that eliminates tax on unrelated income. It is inevitable that many of these tax shelter schemes will be mass marketed through ads in the newspapers.

Some of the most obvious opportunities arise from the fact that assets are indexed while liabilities are not. Even the theoretical justification indexing falls apart at this point. Totally artificial tax deductions can be created with little or no out-of-pocket investment, by borrowing and using the proceeds to buy an indexed asset.

Take the simplest possible example. Suppose you borrow $100, buy a share of stock for $100, and sell the stock after two years for $110, after there has been 10% inflation. Also assume the interest rate on the loan is 5% a year, or $10 for two years, and the stock doesn't pay dividends. When you sell the stock for $110 you just have enough money to pay off the principal of the loan ($100) and two years' interest ($10).

You started with no net cash investment, you exactly break even, and you end with no cash. You have no taxable gain on the stock because of the indexed basis. But you get to deduct $10 of interest. You end up with a net tax deduction of $10 on a break-even investment, and you can use that deduction to shelter $10 of other completely unrelated income.

There is no theoretical or other justification for this result. It is a classic tax shelter. I should add that the passive loss rules adopted in 1986 would have no effect on this. Those rules apply to losses on real estate, leasing and other businesses, but not investment losses. There are other rules limiting interest deductions for debt used to make investments.

However, at the very least a taxpayer could use the completely artificial deductions arising from indexing to shelter all of his or her other unrelated interest and dividend income.

I also want to emphasize that there would be many ways besides borrowing to create a tax shelter out of indexing. Keep in mind that the world of financial products is extraordinarily creative, and very motivated to develop tax favored investments.

Just as one example, H.R. 9 indexes only stock and tangible assets that you own, but not bonds. It is not clear why intangibles such as patents are excluded, but that's another story. The reason for excluding bonds is that if you buy a bond for its face amount you get back exactly what you paid. If you were allowed to index the principal amount of the bond you would be guaranteed a tax loss at maturity (even on a Treasury obligation) even though you got back your full principal amount.

But today a taxpayer can convert almost any asset into the economic equivalent of a bond by using equity swaps and other creative techniques. Under H.R. 9, such an asset would still be indexed, because it is not literally a bond. The result is a guaranteed tax loss and not much else.

Another area filled with opportunities for creativity arises from the fact that H.R. 9 indexes all corporate stock regardless of the nature of the assets held by the corporation. For example, if a corporation holds an asset not eligible for indexing, all it has to do is transfer the asset to another corporation. It then gets to index the stock of the second corporation, which may be almost as good.

So much for fun and games. Of course, it would be possible to write a statute to try to prevent all the unintended abuses of the indexing provisions. This would bring us back to theoretical purity (which is where we started). However, the complexity would become truly overwhelming in trying to distinguish “good” from “bad” transactions. Even those ordinary taxpayers intended to be the beneficiaries of indexing would need lawyers to interpret the rules, as well as accountants.

Furthermore, no matter how much effort is put into trying to prevent tax shelters from arising as a result of indexing, with all due respect I believe the effort is doomed to failure. This is not the fault of the excellent and dedicated legislative tax staffs.

The problem is similar to the problem of the manager of a computer system trying to keep out the hackers. You spend a lot of time and effort and set up all your defenses. But once your defenses are in place, you are essentially a sitting duck while hundreds or thousands of very smart hackers probe your defenses for weaknesses. Eventually they will find your weak spot and exploit it to the fullest. And the worst thing is that in many cases you won't know your system is compromised until the revenues mysteriously start declining.

There are other problems with indexing that I haven't had time to discuss. If only certain types of assets are indexed (for example, H.R. 9 limits indexing to stock and tangible assets), economic inefficiencies are created because returns on different assets are taxed at different rates. Even aside from the fact that intangible assets such as patents are not indexed, why is the cost of stock indexed but not the cost of a stock option?

Similarly, the amount of indexing you are entitled to is necessarily based on exactly when you buy and sell an asset. H.R. 9 compares price levels for the calendar quarter in which you buy and the calendar quarter in which you sell. There is then an incentive to buy stock and other indexed assets at the end of one quarter rather than the beginning of the next quarter, and not to sell an asset at the end of a quarter but rather to hold until the beginning of the next quarter. Each of these techniques will give you an extra 3 months of indexing benefits. Legislation could of course go to monthly or even daily indexing calculations, but you obviously pay the price in increased record keeping and complexity. There are no easy solutions to these problems.

Finally, I have been asked to address how other developed countries tax inflationary gains. We have not studied this matter at any length. However, we understand that the U.K. and some other countries do index the tax basis of assets for inflation (although the U.K. does not also have a reduced rate for capital gains). We also understand, however, that a series of anti-abuse amendments has been necessary in the U.K.

Even more importantly, we do not know whether taxpayers in the U.K. and other countries have the deep-seated American urge to exploit loopholes in their tax systems. We also doubt that the financial markets outside the U.S. are as creative in developing tax-advantaged products. Recent history in the United States indicates that taxpayers will take full advantage of the rule that no one needs to pay more taxes than are legally due. We would therefore urge extreme caution in applying the lessons of other countries to the United States.

To close with my original theme, the tax law will never be perfect. The whole Code is a compromise between accuracy and administrability. A “simple” indexing system such as that in H.R. 9 is neither accurate (because liabilities are not indexed) nor administrable. An accurate indexing system would give rise to even more overwhelming complexity and yet would still give rise to tax shelters. We strongly believe that indexing is one situation where all attempts at theoretical accuracy should be sacrificed for administrability.

SENATE FINANCE COMMITTEE

HEARING ON CAPITAL GAINS INDEXING

FEBRUARY 16, 1995

MICHAEL L. SCHLER

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NEW YORK STATE BAR ASSOCIATION

SUPPLEMENTAL MATERIAL

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January 19, 1995

The Honorable Bill Archer
House of Representatives
Washington, B.C. 20515

Re: Tax Basis Indexing Provisions of H.R. 9

Dear Chairman Archer:

I am writing on behalf of the Tax Section of the New York State Bar Association to strongly oppose any proposals to index the tax basis of assets for inflation.

It is our judgment as tax lawyers that the indexation proposals currently before Congress are fundamentally flawed. The proposals would:

- permit unwarranted tax avoidance and revenue loss
- potentially result in the mass marketing of tax shelters to well advised and high income as in the 1980's; and
- vastly increase the burden and complexity of the tax system for all taxpayers (individual, small business and large business) as well as the IRS, at a time when many believe that its complexity has already brought it near the breaking point.

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Moreover, even if a theoretically sound system of indexation could be developed, the additional complexities that would be necessary to do so would completely overwhelm taxpayers and the IRS.

Our position on indexation is based on our particular experience and expertise as tax lawyers rather than on broader policy judgments. We take no position on the policy issues of the appropriate tax rate that should apply to capital gains in general, or the appropriate depreciation rate that should apply to depreciable assets.

We refer specifically to two provisions of H.R. 9, the Job Creation and Wage Enhancement Act of 1995. The first is Section 1002, which (with certain exceptions) indexes the basis of corporate stock and tangible assets that are capital assets or used in a trade or business. The second is Section 2001, which indexes the basis of depreciable property.

Section 1002

Section 1002 is based almost entirely on a similar provision in H.R. 3299 introduced in the 101st Congress in 1989 and approved by the Ways and Means Committee in that year (the "1989 Bill"). In 1990 the Tax Section submitted a letter and report discussing that provision (the "1990 Report"), in which we strongly urged Congress to reject indexation.

We enclose a copy of the 1990 Report, as well as a newly prepared Appendix that details the variations, between the indexing provisions of the 1989 Bill and H.R. 9. As noted in the Appendix, if anything H.R. 9 provides even greater opportunities for improper tax avoidance than did the 1989 Bill. As a result, almost all the serious issues raised in the 1990 Report are equally valid today.

Much of the tax avoidance potential of indexing in Section 1002 arises from the fact that indexing is not consistently applied:

- assets are indexed to reflect the fact that appreciation in value in dollar terms is illusory to the extent it is offset by a decline in the real value of the dollar, but

- liabilities are not indexed even though the real value of the obligation to repay the debt is equally reduced by a decline in real value of the dollar.

This is best illustrated by an extreme but simple example of a “no money down” tax shelter, where the taxpayer starts with no cash, exactly breaks even on a cash flow basis, but ends up with a tax deduction:

> On January 1, 1996, X takes out a recourse loan of $100 and buys a share of common stock for $100. Inflation during 1996 is 3%. The interest rate on the loan is 6%. The stock pays dividends of 6%, just enough to pay the interest on the loan. On January 2, 1997, X sells the stock for $100 and uses the proceeds to pay off the loan.

X made no out-of-pocket investment that lost value due to inflation. There is thus no possible justification for applying indexation to X. Nevertheless, under the indexing proposals X's tax basis in the stock increases from $100 to $103 because of the 1996 inflation of 3%. X can therefore claim a taxable loss of $3 on the sale of stock. Thus, <u>on a transaction which was totally break-even to X under any interpretation, X has created a capital loss that permits X to avoid all tax on $3 of other unrelated capital gain.</u>

This result is perfectly legal under H.R., 9, and any tax lawyer would give an unconditional tax opinion that it worked. Moreover, while the example involves the creation of a capital loss that could only offset capital gains, a slight variation in the example would result in the creation of an ordinary loss that could offset unrelated ordinary investment income of an individual, and any unrelated ordinary income of a corporation.[1]

Moreover, individuals could use home equity loans to purchase indexed assets. Since interest deductions on such loans are not subject to the “investment interest” limitations of the Code, the reduced capital gain on the sale of an asset due to indexing would “free up” interest deductions that could be used to shelter salary and other noninvestment income.[2] It is from examples like this, however, that tax shelters are made and marketed.

To be sure, in the example, X bore the risk that the stock would decline in value and that a real economic loss would result. A tax shelter would not be attractive on this basis. However, there are numerous opportunities under the statutory provision to substantially reduce or eliminate risk of loss, thereby creating a pure “tax loss generator” that requires little or no investment, and that involves little or no risk of loss.

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[1] Suppose that the stock paid no dividends and was sold for $106 instead of $100. There would still be just enough cash to pay interest and principal on the debt, but X would have $3 of capital gain (taking into account the indexed basis of $103) and a $6 interest deduction. The result would be that at least S3 of unrelated ordinary investment income would be sheltered from tax. Taking into, account the 50% capital gains deduction also in H.R. 9, there would be only $1.50 of income on the sale, and the $6 interest deduction would permit $4.50 of other ordinary investment income (or $9 of other capital gain) to be sheltered from tax. In the case of a corporation, the Section 163(d) investment interest limitations do not apply, and the unrelated income could be sheltered even if were not investment income.

[2] Interest on business loans is also exempt from the investment interest limitations. The result in the text could therefore also be achieved if a self-employed individual were permitted to take out a business loan and indirectly use the proceeds of the loan to purchase an indexed investment (through the technique of using the loan proceeds in the business and withdrawing “different” cash from the business to make the investment). This technique raises the “tracing” issue discussed below.

It would be possible in theory to avoid results such as these that are based on leverage by:

(1) disallowing indexing on debt-financed property,

(2) indexing liabilities the proceeds of which were used to acquire indexed assets, so that a borrower would have income on the repayment of principal on such a loan to reflect the economic gain arising from the fact that the loan was repaid with dollars that were worth less than the borrowed dollars because of inflation; or.

(3) similar to (2), disallowing each year a portion of the deduction for otherwise deductible interest on debt used to acquire indexed assets, based on that year's inflation rate.

However, we believe the resulting complexity of any of these approaches would be so overwhelming that any such attempt would fail.[3] Very significantly, there would need to be complex rules "tracing" liabilities to indexed assets, so that one of the foregoing consequences would arise only to the extent the debt "relates" in some fashion to indexed assets.[4]

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[3] For example, under approaches (2) and (3), if a home mortgage were used to acquire an indexed asset (including the home itself or a car, both of which are indexed assets), either a portion of each monthly interest payment would be nondeductible or else income would arise on each monthly principal payment.

[4] The interest tracing rules are already among the most complex tax provisions applicable to individuals, and new tracing rules for indexing would simply be overwhelming. Moreover, taxpayers would make great efforts to "separate" their debts from their indexed assets. To illustrate part of the problem, suppose an individual simultaneously (1) used money in the bank to buy indexed stock and (2) borrowed money to buy a bond that is not eligible for indexing. Would one of the adverse consequences apply to the loan or the stock, as would be the case if (1) the cash was used to buy the bond and (2) the loan was used to buy the stock?

Moreover, debt financing is not the only technique that could be used to create unwarranted tax benefits from indexing. Indexing could be used to generate artificial tax losses, with no significant risk to the taxpayer, through financial transactions such as (i) net leasing that did not come within the net leasing exclusion in the bill, (ii) preferred stock with small upside potential that did not come within the preferred stock exclusion in the bill, and (iii) equity swaps forward sales, and other financial products, none of which come within the short sale rule in the bill.

Of course, attempts could be made to preclude all unintended results of indexing. However, this would create further complexity and would likely prove ineffective in any event.[5] In addition, a large amount of otherwise productive economic resources would be shifted into tax planning schemes.

As a result, we strongly oppose the provisions of Section 1002 of H.R. 9.

Section 2001

We turn now to Section 2001 of H.R. 9, relating to “Neutral Cost Recovery”. That provision in effect indexes the basis of depreciable property for inflation, and, in the case of property with a depreciable life of 10 years or less, an additional 3.5% per year. We understand that the latter adjustment is intended to be the financial equivalent of immediately expensing the asset, and that immediate expensing is in turn financially equivalent to the expected return on an asset being completely free of tax.

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[5] Moreover, if indexing is adopted and turns out to be undesirable for these or other reasons, even if it were repealed its complexities might linger for decades. Taxpayers would likely expect to retain the full indexed basis of assets as of the repeal date, even if future indexing of all assets was prohibited. Thus, records concerning the brief application of indexing would have to be maintained for as long as those assets were held.

Each of our objections to capital gains indexing applies equally to basis indexing for depreciation purposes, and to an even greater extent to indexing in excess of the inflation rate. We believe the effect will be a vastly more complicated Tax Code, greatly increased opportunities for tax avoidance, and a great shifting of economic resources into tax planning schemes.[6]

For example, short-lived equipment will be similar to a municipal bond in that expected earnings will in effect be tax-free. Such equipment will actually be a far better investment than a municipal bond, however, because interest on debt to purchase the equipment will be fully tax-deductible while interest on debt incurred to purchase a municipal bond is not deductible. This result has the potential for reduction of the corporate income tax far beyond that apparently contemplated by the drafters of the statute. For these reasons, we also strongly oppose Section 2001.

Conclusion

We would be pleased to assist in any way possible in trying to make these or other indexing proposals more workable. However, for the reasons stated above we believe such efforts would be overwhelmingly complex and are not likely to succeed. We therefore strongly oppose the indexing proposals and believe their adoption would be a serious error.

We also wish to point out an additional very significant issue relating to state taxes. The indexing provisions in H.R. 9, if applicable for state tax purposes, would cause a significant loss of state revenue. As a result, some states may not be willing to allow indexing of some or all assets. Enormous additional complexity would result if individuals or corporations, or both, were required to maintain separate tax basis and other related records for

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[6] We may provide additional technical comments on this provision in the future.

Federal and state tax purposes.

Finally, we understand that the United Kingdom and several other countries have forms of basis indexing. As indicated in our 1990 Report, however, we understand that a series of anti-abuse amendments has been necessary in the U.K. Moreover, we understand that some countries (such as the U.K.) do not also have the reduced capital gains rate provided in H.R. 9, and others (such as Israel) have experienced severe inflation necessitating indexing despite its drawbacks.

Most importantly, we are not aware of the extent to which discontinuities in the tax systems of those other countries are exploited by taxpayers in order to achieve unintended tax benefits. We believe, however, that recent history in the U.S. indicates that such results here are extremely likely.

Very truly yours,

Michael L. Schler
Chair, Tax Section

cc: Congressman Sam Gibbons

Senator Daniel P. Moynihan
Senator Bob Packwood

Hon. Robert E. Rubin
Hon. Leslie B. Samuels
Hon. Cynthia G. Beerbower
Hon. Edward Knight

Hon. Margaret M. Richardson
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1995 Appendix: The 1995 Bill

The 1995 Bill differs from the 1989 Bill in several respects. Many of the changes address concerns which were discussed in the 1990 Report. However, in responding to these concerns, the 1995 Bill creates additional serious problems. This merely demonstrates our belief that any indexation system is inherently unworkable. Many of the modifications which are contained in the 1995 Bill are relatively minor and have little impact from a technical point of view. The following changes could have significant technical implications and are therefore worthy of discussion.

The 1995 Bill Eliminates Even the Inadequate Measures for Mitigating Debt Arbitrage Provided in the 1989 Bill.

The 1990 Report commented on the arbitrage opportunities brought about by the 1989 Bill's failure to index liabilities. The 1995 Bill does not correct this problem. In fact, the 1995 Bill even eliminates the 1989 Bill's limited solution to the debt arbitrage problem. Although the solution contained in the 1989 Bill was problematic, its elimination gives rise to significant concern that the magnitude of the debt arbitrage problem is not fully recognized.

The 1989 Bill attempted to mitigate the potential for debt arbitrage by disallowing basis adjustments that would create or increase a loss. Under the 1989 Bill, the basis of assets could be indexed solely for purposes of determining gain. In contrast, the 1995 Bill allows indexation to create or increase capital, but not ordinary, loss. All ordinary losses generated or increased though indexation will be treated as long term capital losses.

The 1990 Report stated that the loss limitation solution to the debt arbitrage problem was problematic because of its failure to treat similarly situated taxpayers comparably. However, allowing indexation to create losses is highly questionable since it exaggerates the potential for tax arbitrage, thereby sanctioning potentially serious tax avoidance schemes.

In addition, allowing losses to be created through indexation while still failing to index liabilities will create an even greater revenue risk than what would have existed under the 1989 Bill. This further highlights our concern regarding the intrinsic problems with indexation. The 1990 Report provides examples which illustrate this point. See section III (B) (1) of the 1990 Report.

Corporations may Index Assets Under the 1995 Bill.

Corporations would be permitted to index their assets under the 1995 Bill, whereas they could not do so under the 1989 Bill. The 1990 Report noted that not allowing corporations to index assets would tend to increase the tax penalty associated with operating through a C corporation and therefore increase the existing bias against operating in C corporation form. Although the 1995 Bill avoids this situation by allowing corporations to index basis, the inclusion of corporations nonetheless introduces several new areas of significantly heightened complexity to the tax law.

One of the principal areas of concern is the consolidated return rules. To implement appropriate basis adjustment rules, coordinated indexing adjustments would have to be made at each tier of, a consolidated group. This coordination would have to reflect differences that might exist by reason of variances between the basis of a subsidiary's stock and the basis of its assets, the mix of indexable and non-indexable assets at the subsidiary level, and the timing of the sale of stock or assets. For example, because parent corporation P may sell the stock of subsidiary S, which holds indexable assets, before S realized gain on those assets, a mere pass-through of realized indexing adjustments would be inadequate for P. Thus, rather than a single adjustment at the time of disposition, annual basis adjustments with the associated complexity would have to be made and passed through up the chain of stock ownership. Moreover, complex rules would be necessary to deal with cross-ownership of stock among members of a consolidated group to avoid multiplication of indexing adjustments. Special rules also would be required to deal with intercompany transactions. Finally, we note that because the rules that would apply for consolidated returns presumably would reflect the fact that not all assets are indexable, there may be vast differences in the indexing adjustment available to a corporation with respect to stock in otherwise identical corporations where one is consolidated and one is not.

<u>The 1995 Bill Creates Distortions for Holders of Partnership Interests by Eliminating the Special Rule for Section 754 Elections.</u>

Both the 1989 Bill and the 1995 Bill would provide for indexation of partnership assets at the partnership level and a pass-through of the adjustment to the partners. Partnership interests themselves are not indexable assets under either bill. The 1989 Bill, however, contained a special provision applicable to the transfer of a partnership interest if the partnership had made a section 754 election which was in effect at the time of the transfer. Under this provision, the transferor partner would treat the adjustment under section 743(b)(l) as a sale of the partnership assets for purposes of indexation. This provision effectively allowed the transferor partner to index his partnership interest.

The 1990 Report explored some of the substantial problems which would result from the special rule pertaining to section 754 elections. Rather than developing a substantive solution to these problems, however, the 1995 Bill merely eliminates the special provision entirely. In doing so, it has merely replaced the prior difficulties with new problems.

For example, the 1995 Bill now creates an unprincipled distinction between joint ownership of assets and holding assets in partnership form. Consider individual taxpayers A and B who hold an asset jointly. Each has a 50% interest in the asset, which has a cost basis of $100 and a fair market value of $200. In a later year, when A disposes of A's share of the asset, the indexed basis of the asset is $150. Therefore, A's gain upon disposition is $25. Alternatively, if A and B hold the same asset through a partnership, upon a sale of A's partnership interest to C for $100, A would have a $50 gain. Therefore, A is effectively penalized for using the partnership form.

On the other hand, if the value of the asset has declined, there would be a loss on the sale of A's interest to C. If a section 754 election is made, the basis of the partnership assets with respect to C is written down. However, if no election is made, it remains possible for C to get the benefit of buying an interest in an indexable asset at less than original cost where the indexable basis of the asset at the partnership level is significantly higher. In doing so C would gain the benefit of indexation adjustments upon the partnership's ultimate disposition of the asset that may be greatly overstated relative to the actual effect of inflation on the asset during C's holding period. These overstated adjustments could effectively shelter significant real gains. We can anticipate an active market for such tax sheltering opportunities.

1995 Bill uses a GNP Deflator Rather than the Consumer Price Index.

A minor change has been made which relates to how assets will be indexed. The 1989 Bill used an index which was based on the consumer price index while the 1995 Bill uses a GNP deflator. As the 1990 Report indicated, we believe that any indexation factor is destined to produce imprecise results. As it will be pure chance if a basis adjustment actually matches inflation, we believe that which factor is ultimately chosen should an indexation system be put in place is a matter of little consequence as a technical matter.

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June 28, 1990

The Honorable Dan Rostenkowski
Chairman
House Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Rostenkowski:

I write to express the strongly held view of the Executive Committee of the Tax Section that Congress should reject any proposal to adjust or "index" the basis of capital assets for inflation. As described in the enclosed Report, an indexation regime would create intolerable administrative burdens for taxpayers and tax administrators as well as offer numerous tax arbitrage and avoidance opportunities for aggressive tax planners. As tax practitioners, we are seriously concerned that any indexation system will permit the use of its inherent complexities, distortions and tax avoidance opportunities to severely erode the revenue base. An indexed tax system will also place a great deal of additional strain on an audit system already stretched beyond the limits of its real capacity.

Adoption of indexation in even the most limited manner would make the tax law significantly more complex. We view this incremental complexity as particularly insidious

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because the implementing legislation may be deceptively simple. The indexation provisions adopted by the Ways and Means Committee in the course of considering the Omnibus Budget Reconciliation Act of 1989, discussed in some detail in our Report, represent just this type of deceptive simplicity. In effect, simplicity is achieved by simply ignoring the many difficult problems inherent in the statute.

Although we express our grave concern about the desirability of implementing an indexation regime, we wish to make clear that we are not at this time expressing any position regarding the desirability of enacting any form of preferential taxation of capital gains including the adoption of a preferential rate.

Very truly yours,

Arthur A. Feder
Chair

Enclosure

I. INTRODUCTION

In the ongoing debate regarding the implementation of some form of preferential taxation of capital gain income, many legislative alternatives will be considered. One such alternative is adjusting or "indexing" the basis of certain capital assets to reflect general price level inflation, thereby attempting to tax only "real" as opposed to inflationary gains.[1] This Report discusses the issues, problems, and other considerations raised by the indexing of the basis of capital assets.

The principal argument in favor of indexing basis is that the tax system would be more equitable if only "real" as opposed to inflationary gains are taxed. Nevertheless, it is our view that the implementation of any indexing regime would necessarily introduce far reaching new complexities and distortions into the tax system, without necessarily resulting in the taxation of only "real" gains. We believe the tax law would be ill served if Congress were to enact any such system.

In addition to increased complexity, any indexation system would by its nature provide taxpayers with additional deductions or basis adjustments which would diminish income, and thus tax revenues. Any system of indexation must also be designed with great care to avoid creating "abusive" opportunities for tax arbitrage, that is, providing deductions or reduction of taxable income for high-bracket taxpayers while allowing income to be or shifted to tax-exempt or nontaxable entities. As we explore in some detail below, an indexation system which only selectively attempts to index the tax system would create numerous

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[1] Several Bills currently are pending before Congress that would provide for some form of basis indexing. See S. 171. S.182; S.645; S.664; S.1311; S.1286; S.1771; H.R.57; H.R.232; H.R.449; H.R.504; H.R.719; H.R.1242; H.R.2370; H.R.3628; and H.R.4105

opportunities for such tax arbitrage.[2] As tax practitioners, we cannot stress more strongly our concern that the tax arbitrage opportunities presented by an indexation system and, in particular, any selective indexation proposal, will have a corrosive effect on the revenue base.

This Report is not intended to present an exhaustive analysis of the issues raised by basis indexing or to develop what inevitably would be complex solutions to the various problems raised. Many of these issues and problems have been thoughtfully developed elsewhere.[3] Rather, the Report is intended (1) to demonstrate the sheer enormity of any attempt to develop an administrable system of indexing that does not create distortions as bad or worse than those intended to be avoided, (2) to indicate the pervasive transactional complexities that basis indexing would introduce into the tax system, and (3) to describe some of the tax arbitrage opportunities inherent in any indexation system.

The discussion below is directed at what we see as the basis elements of any indexation system. As an example of the problems and issues created by an indexation system, the Report offers some specific comments regarding those provisions of the Omnibus Budget Reconciliation Act of 1989 as passed by the House

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2 See Part II.F. and Part III.B., infra.

3 See Durst. Intlition and the Tax Coda: Guidelines tor Policymaking. 73 Minn. L. Rev. 1217 (1989) (hereinafter “Durst”): Hickman. Interest, Depreciation and Indexing, 5 Va. Tax Rev. 773 (1986): Halpenn & Steuerle, Indexing the Tex System for Inflation, in Uneasy Compromise Problems of a Hybrid Income-Consumption Tax (H. Aaron. H. Galper & J. Pechman. eds.. Brookings 1988); Note. Inflation and the Federal Income Tax, 82 Yale L.J. 716 (1973); Shuldiner, Indexing the Federal Income Tax, unpublished paper presented at NYU School of Law Tax Seminar for Government (March 1990) (cited with the author's permission) (hereinafter “Shuldiner”).

of Representatives[4] (although not contained in the final version of the legislation) that would have implemented a form of basis indexing. The Report also discusses the tax arbitrage opportunities presented by the selective indexation proposal contained in the 1989 Bill, and the 1989 bill's failure to provide effective limits on arbitrage opportunities.

In summary, it is the position of the Tax Section that implementing any indexation system would be inadvisable. We wish to make clear, moreover, that this Report is not intended to express any position regarding the desirability of enacting any form of preferential taxation of capital gains, or in particular to support the adoption of a preferential rate for capital gains.

II. STATUTORY AND TRANSACTIONAL COMPLEXITY

A. In General

The single most important issue regarding any indexation system is the potentially pervasive if not overwhelming complexity that would be introduced into the tax system. Basis indexing has the potential to touch every area of the tax law from depreciation to excise taxes to employee benefits. This fact cannot be avoided with limited or simple indexing proposals. To the extent that Congress addresses all the implications of basis indexing, the complexity of the statute will grow directly. If Congress chooses to ignore those implications, the code will grow over time as “fix” after “fix” is added to eliminate revenue losing oversights and tax arbitrage opportunities.

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[4] H.R. 3299, 101st Cong., 1st Sess., sections 11951 et seq. (hereinafter, the “1989 Bill”): H.R. Rep. No 147 101st Cong., 1st Sess., pp. 1474-1480 (hereinafter, the “House Report”)

No taxpayer...will be able to prepare a tax return that Includes the sale of a...home or a business, without professional help.

Thus, even in an ideal system of indexing,[5] the complexity of the code would be increased, taxpayers' compliance burdens would be augmented, and disputes concerning a variety of legal issues would proliferate.[6] This undoubtedly will result in a system in which no taxpayer (particularly individuals and small businesses) will be able to prepare a tax return that includes the sale of a major asset, such as a home or a business, without professional help. Moreover, the administrative burden imposed on the Internal Revenue Service by any indexation system is likely to exceed its present capacity to respond. The auditing process alone may be severely compromised. But, in addition, a far more serious burden of dealing with scores of interpretive and legislative regulations will exacerbate the serious existing problem of the Internal Revenue Service's inability to promulgate regulations on a timely basis.

On the other hand, attempts to “simplify” any regime of indexing, perhaps by adopting partial indexing measures will introduce new distortions and opportunities for tax arbitrage. Taxpayers inevitably will devise techniques to exploit any discontinuities created m the process of simplifying an indexation system. Such exploitation could be prevented only by adopting rules that are equally, if not more complex, than the

[5] Moreover, the theoretical soundness of any indexation system is itself questionable, as discussed in Part V, infra.

[6] An excellent description of the generic problems associated with indexation is provided in Cohen. The Pending Proposal to Index Capital Gains, 45 Tax A/ores 103, 105 (Oct. 2. 1989)(hereinafter “Cohen”).

rules that “simplified indexation” tried to avoid. There is no such thing as a simple indexation system.

B. Indexing Complex Transactions

While indexing calculations for the simple sale of property for a simultaneous cash payment may be relatively straightforward, property often is acquired or disposed of pursuant to options, forward contracts, section 1256 contracts, installment sales, and contracts requiring contingent payments. In addition, property can be deemed disposed of pursuant to corporate or partnership distributions. Any rational system of indexing would need to develop rules to provide for indexing calculations to be made in these circumstances.[7] For example, although an indexation system might include in indexable basis from the time of acquisition the amount of a purchase money note.[8] it is less clear that indexable basis should include basis attributable to contingent payments for any period before contingent payments are made.

Every rule or solution addressing such transactions, however, would impose additional computational burdens of a magnitude far greater than the single basis calculation now required upon disposition of an asset. Moreover, these solutions necessarily would be detailed and complex and one can expect Congress to avoid difficult and inherently complex problems by relying on “regulations to be provided.” The 1989 Bill, to quote just a single example, uses such an escape hatch for RICs and REITs:

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[7] for an excellent description of the theoretical methodology for indexing property acquired pursuant to options, forward contracts, and section 1256 contracts, see Shuldiner at (16-19).

[8] But see discussion of “debt arbitrage” in Part III.B.1., infra.

> [I]n order to deny the benefit of indexing to corporate shareholders of the RIC or REIT, the bill provides that, under regulations, (i) the determination of whether a distribution to a corporate shareholder is a dividend will be made without regard to this provision, (ii) the amount treated as a capital gain dividend will be increased to take into account that the amount distributed was reduced by reason of the indexing adjustment, and (iii) such other adjustments as are necessary shall be made to ensure that the benefits of indexing are not allowed to corporate shareholders.[9]

The temptation to avoid addressing such significant and complex issues will be a major concern. Personal and business decisions regarding a wide variety of transactions cannot reasonably be expected to wait out the delays, which have become increasingly common, in promulgating regulations-governing a system that could affect virtually every area of the code.[10]

Simplifying conventions... will arbitrarily deny Indexation benefits or offer planning opportunities.

Although certain simplifying conventions can be adopted, these simplifications will arbitrarily deny indexation benefits or offer planning opportunities. For example, the 1989 Bill denied indexation benefits to options.[11] This denial would inappropriately deny inflation relief to purchasers under options and extend overly generous benefits to sellers under options. Moreover, for taxpayers who are deemed to sell property by reason of corporate or partnership distributions, simple mechanical rules comparing basis and selling price can operate to deny indexation benefits entirely.

9 House Report, pp. 1478-1479 (emphasis added).

10 See Part III.C.6., infra.

11 See Part III.B.2., infra.

C. Disputes Regarding Timing of Asset Transfers

Because indexing basis would amplify the degree to which a taxpayer's holding period affects tax liability when an asset is disposed of any indexation system will produce numerous new legal disputes relating to the precise time tax ownership is treated as having passed Assets may be transferred in a variety of ways, such as installment sales, conditional sales, sales pursuant to options, and long term leases, that obscure the proper acquisition or disposition date for tax purposes. Although determining when an asset is acquired or sold is necessary under present law for determining the taxable year to Report gain, the taxable year to begin depreciating property and several other purposes, the precise time that an asset is acquired or sold in a taxable year seldom is of any significance.[12] Indexing basis changes all of this and inevitably will lead to a meaningful increase in disputes over these issues.[13]

Careful consideration must be given to the already complex rules governing the tacking and tolling of holding periods.

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

[13] Furthermore, the theoretically proper time for indexing to begin or end is at the time that the “risk of inflation” with respect to the property passes and not at the time that the technical tax holding period commences or ends. See Cohen, p. 105. Implementing this theoretically correct solution would be difficult at best and would give rise in at least some cases to the obviously undesirable result of taxpayers having two different holding periods for the property. However, failure to address this issue will result in taxpayers receiving inflation relief in cases where they have no risk of inflation. For example, assume that individual A contracts to sell stock or other indexable assets to tax-exempt entity B at a fixed price, the closing to occur two years after the date of the contract. Where does A's entitlement to inflation adjustment end? Moreover, the risk of inflation would be a new element of ownership to be considered in the already murky area of holding period determination.

D. Holding Period Rules

In any indexation system, careful consideration must be given to the already complex rules governing the tacking and tolling of holding periods Although the present rules could be used for many situations, special rules modifying the present law “tacking” rules applicable to wash sales,[14] stock acquired pursuant to the exercise of rights acquired in a tax-free distribution,[15] and the treatment of property acquired from a decedent may be needed.[16] At the same time, consideration would need to be given to modifying the “tolling” rules that apply in

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[14] Under present law the holding period and basis of property acquired in a wash sale includes the holding period and loss realized on the sale of the substantially identical property, code section 1223(4). This form of tacking generally places the wash seller in the same position as if he had not sold the property. Nevertheless, where holding periods are tacked and the deferred loss is added to basis, the “compounding” effect of allowing indexing based on an amount that exceeds fair market value arguably confers an inappropriate benefit on the short seller. See text accompanying fn. 60, infra.

[15] Unless modified tor purposes of the indexing calculation, sections 1223(5) and 1223(6) would deny the benefits of indexing for that portion of the basis of stock allocable to the basis of the pre-exercise holding period of the rights

[16] It would be inappropriate to apply for purposes of any indexing calculations, section 1223(11) which provides a minimum one-year holding period for property acquired from a decedent where the basis of the property is determined under section 1014.

connection with short sales,[17]straddles,[18] and commodity futures transactions.[19]

Furthermore, the number of necessary exceptions and special rules would increase significantly if a system of "partial indexing" is adopted. For example, if the benefits of indexing were granted to individuals but not corporations, virtually all the holding period and basis rules relating to transactions between corporations and shareholders would have to be modified in a manner that undoubtedly would enhance their complexity.[20] Finally, a detailed set of special holding period tacking and tolling rules would need to be adopted for transition purposes.

E. Other Statutory Complexity

The code already provides for indexing of various items (tax brackets in particular), and these indexing provisions must be coordinated with any basis indexing provisions to prevent the

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[17] The simplest approach to short sales would be to treat the short and long positions as separate transactions and toll their respective holding periods for the period that the taxpayer holds both positions. The 1989 Bill adopted this approach. However, this simple rule can lead to anomalous results, most often favoring the taxpayer. See Shuldmer, p. 15.

[18] The tolling rules of Temporary Regulation section 1.1092(b) 2T will produce anomalous results similar to those under the "simple" approach to short sales. Moreover, unlike the pro-taxpayer effect of these anomalies generally, these rules would particularly favor the government with respect to the treatment of "qualified covered call options" (within the meaning of section 1092(C)(4)). It is unclear that the same policies that underlay the tolling of holding period for qualified covered calls should be applied to exclude the benefits of indexing for the stock with respect to which the call option is written. "The special rules contained in section

[19] The special rules contained in section 1223(8) must also be coordinated with the option rules described in further detail in Pan III.B.2., infra.

[20] These rules are discussed in further detail in Part III.B 3 c. infra.

granting of double benefits. Consideration would need to be given to the extent that the benefits of basis indexing should be preserved where basis is to be reduced under section 1017. Modification of computations under section 1231 may be necessary. If corporations are included in an indexation system, consideration must be given to the treatment of earnings and profits, consolidated returns, section 304, and many other aspects of corporate transactions.[21]

Rules must be created to address the treatment of common individual investments such as insurance policies, variable annuity contracts, and voluntary contributions to pension plans. Computation of a taxpayer's income in each of these cases requires more than merely determining basis, holding period, and amount realized. Rather, the withdrawal of assets and recovery of basis over time will require the development of special indexing rules that will further complicate the treatment of these relatively ordinary products.[22]

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

22 Annuity payments generally are included in the annuitant's gross income. See section 72(a). However, a proportion of each annuity payment is excluded from gross income to the extent it represents a return of the annuitant's investment in the insurance or annuity contract. See section 72(b)(l). Similarly, section 72(e) generally provides that the amount received upon surrender, redemption, or maturity of an annuity contract should be included in income only to the extent such amount exceeds the annuitant's investment in the contract. Under section 72(c)(l). an annuitant s “investment in the contract” is defined as the aggregate amount of premiums and other consideration paid for the contract, less amounts previously received under the contract that were excluded from the annuitant's gross income. This amount should correspond to the annuitant's basis in the contract.

Under any comprehensive indexation system, an annuitant's “investment in the (annuity or insurance] contract” (viz., the annuitant's basis) logically should be indexed for inflation. To the extent an annuity payment or receipt of cash upon surrender, redemption, or maturity of an annuity contract represents a return of the annuitant's basis, the annuitant will be overtaxed upon receipt of an annuity payment if the annuitant's basis is not indexed for inflation.

F. Selective Indexing and Tax Arbitrage

Another major concern with respect to any indexation system is whether indexation is to be comprehensive or selective. Obviously, it is more difficult to draft a statute if all assets and liabilities are to be indexed. Moreover, such a statute would be far more complex. However, if (i) provision is made for indexing the basis of assets without provision for indexation of liabilities.[23] (ii) holding period requirements deny the benefit of indexing to assets held for a short duration, (iii) only certain taxpayers are eligible for the benefits of indexing, or (iv) only certain assets are eligible for the benefits of indexing, the problems associated with tax arbitrage become enormous.

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

Taxpayers are adept at electing against the fiscal authority and will structure their affairs to receive favored tax treatment.[24] Accordingly, any system which is selective rather than comprehensive will create opportunities for financial engineering adverse to the revenue base, in effect allowing the law of adverse selection to operate against the fisc. A straightforward example of the type of planning that will be possible is for investor A, who is entitled to indexation benefits to purchase

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[23] This results in augmented basis or expenses without a corresponding increase in income or reduction in interest deductions to reflect the borrower's gain from the decrease in the real value of the principal amount of his liability attributable to inflation. See Part III.B.1.d.i., infra.

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

indexable property and give a participating mortgage [25] to investor B, who is not entitled to indexation benefits, effectively allowing the latter to share in the property's appreciation Nevertheless, this arrangement will allow investor A to benefit from indexation of the entire basis on the property, while deducting as interest the amount of capital appreciation enjoyed by investor B, truly a windfall at the government's expense.

The problems associated with each possible selective approach to indexing are well illustrated by the 1989 Bill. As discussed in Part III.B., below, this causes innumerable problems.

G. The Treatment of Passthrough Entities

Any indexation system will create significant additional complexity in the treatment of passthrough entities, specifically partnerships. S corporations, mutual funds (RICs) real estate investment trusts (REITs), trusts, subchapter T cooperatives, common trust funds, and conceivably real estate mortgage investment conduits (REMICs). This complexity arises in several ways.

First, entity level and interest holder level adjustments must be coordinated so that all adjustments are reflected, but only once. Second, appropriate allocations of the indexing adjustments among the interest holders must be provided for. Third, new rules would be required for application of the holding period tolling rules to passthrough entities and their beneficial holders. Fourth, extremely difficult problems would be

[25] For example, the lender receives stated interest plus additional interest based on appreciation in the value of the property, subject to a ceiling on the aggregate interest rate.

presented by a publicly traded partnership, especially the need to deal with continuous section 754 adjustments and other aspects of indexation adjustments attributable to partnership assets or interests. All of these complexities may become particularly acute where there are tiered passthrough entities (e.g.. partnerships or REITs owning partnership interests), and the complexities are further compounded where the benefits of indexing are extended only to certain assets or certain taxpayers. More detailed discussion of the application of an indexing regime is presented below in the discussion of the provisions of the 1989 Bill.[26]

Any Indexation system will create significant additional complexity in the treatment of passthrough entitles

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H. Cross-Border Investment

Additional complexity will exist for foreign taxpayers that conduct their U.S. activities in a manner that causes them to be subject to U.S. withholding on expatriated payments, instead of the federal income tax regime imposed on domestic U.S. corporations or other domestic entities. Although these foreign persons may avoid some of the problems associated with indexation applied to transactions of domestic entities, an indexation system will create difficulties for any payments that are subject to withholding based on the foreign person's capital gain. In particular, withholding pursuant to section 1446 will be considerably more difficult.

In addition, for outbound investment, the interplay of the capital gains rules and the foreign currency rules can

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

operate to limit inappropriately the indexation benefit to which an investor should be entitled or to offer too generous an indexation benefit. If, for example, a U.S. investor purchased an investment in a “strong” currency and earned an overall (i.e., combined currency gain and property appreciation) return exactly equal to the rate of inflation, it would seem appropriate under an indexation system to impose no tax. Nevertheless, to achieve this apparently simple result, foreign currency would need to be treated as an indexable asset, at least to the extent of the amount invested in the indexable capital asset. On the other hand, if the investment were in a “weak” currency, and the overall gain were less than the inflation rate, gain realized on the asset could be completely eliminated by indexing, while the taxpayer would still be entitled to deduct the currency loss. This result would be inappropriate in a system that did not otherwise permit indexing to result in a loss.

III. THE 1989 BILL: A REVIEW

A. In General

Many of the general and specific concerns expressed above are well illustrated by the 1989 Bill. Without doubt, the simplicity of the 1989 Bill is attractive. A few pages of seemingly clear statutory provisions index the tax system for inflation with respect to certain capital assets. This deceptive simplicity, however, conceals an array of troublesome administrative, computational, and substantive issues. In particular, the 1989 Bill would have provided sharp-sighted taxpayers with ample arbitrage possibilities. One can only imagine the series of technical correction acts and omnibus reconciliation act “revenue raising” proposals which would follow adoption of a proposal comparable to the 1989 Bill. This part focuses on some of these issues.

B. Selective Indexing

1. Failure to Index liabilities

a. In general. The 1989 Bill indexed the basis of capital assets without any indexing of debt. Nevertheless, inflation s effect on borrowers and lenders is just as profound as its effect on owners of assets. As is the case for owners of assets, the code presently does not account for inflation's effect on borrowers and lenders. By allowing borrowers generally to deduct the entire amount of their interest payments and requiring lenders to include all such interest in income without offsetting adjustments for the diminishing real value of the principal amount of the debt, the code as a general matter currently overtaxes lenders and undertaxes borrowers. The partial indexation system of the 1989 Bill would have exacerbated that situation.

b. Example. The failure to index debt results in a gross undermeasurement of the real income of a taxpayer who borrows to finance the purchase of an indexed asset.[27] Assume that Mr. A invests $20.000 in cash to buy Blackacre. a nonincome producing real estate asset subject to an $80,000 mortgage. Five years later, when cumulative inflation has amounted to 30 percent,[28] he sells Blackacre for $130.000, satisfies the $80.000 mortgage, and realizes $50.000 of cash. Under the 1989 Bill, the original tax basis of $100,000 for Blackacre would be adjusted to $130.000 and Mr. A would have no taxable gain. Nevertheless, Mr. A's $20.000

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[27] See. e.g., Durst, pp. 1251-1256

[28] For simplicity, inflation and interest percentage rates in this report will be stated on a cumulative basis, including compounding.

cash investment has grown to $50,000, an increase far in excess of inflation with respect to his actual investment.[29]

If interest deductions are reflected, the income distortion is even greater. Assume Mr. A's mortgage bears 10 percent interest. Mr. A would have an annual interest deduction of $8,000, or $40.000 over the five-year holding period. Under the 1989 Bill, Mr. A presumably would have no taxable gain on Blackacre and $40.000 in interest deductions to be applied against other real estate income. i.e., his taxable income from Blackacre would have been an overall loss of $40,000. Without indexation, Mr. A would have a taxable gain of $30,000, interest deductions of $40.000, and a $10.000 net taxable loss.

c. Tax arbitrage potential. The distortion of income created by the failure to index debt will encourage taxpayers to enter into tax-motivated transactions. Transactions undoubtedly will be developed to allocate excess income (without indexation) to low-bracket or tax-exempt taxpayers and excess deductions or indexation adjustments to high-bracket taxpayers. It is likely, for example, in this type of environment for investment bankers to create investment pools in which tax-exempt investors will receive the income and in which taxable investors secure deductions and indexed basis advantages of the 1989 Bill system. Moreover, any indexation system, particularly one which selectively indexes the basis of assets, would encourage new attempts to create Americus Trust transactions. These transactions attempt to separate the income interest of an investment from capital appreciation, and sell each interest to

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

separate investors. As indicated by their history,[30] the propriety of such arrangements is questionable.

d. 1989 Bill solutions to "debt arbitrage". The 1989 bill attempted to limit debt arbitrage opportunities in two ways. First, the 1989 bill would have amended section 163(d) to exclude gain from the sale or disposition of indexed assets from the definition of investment income. This limitation represents at best a very limited solution to restricting arbitrage transactions involving debt financed purchases of indexed assets. Second, the 1989 Bill does not allow basis adjustments that would create or increase a loss. This loss limitation may create situations where similarly situated taxpayers will be treated differently, and in many circumstances the limitations will be avoided.

I. Investment interest limitation. The 1989 Bill investment interest limitation solution is entirely ineffective with respect to taxpayers for whom interest expense is treated as a "business interest "or as" passive interest," provided that the taxpayer has sufficient passive income. Moreover, the solution is not even effective for taxpayers with sufficient investment income from nonindexed sources to offset their investment interest expense. For example, assume investor Y, who has $10 million a year of dividend income, borrows $100 million at 10 percent interest and purchases a $100 million capital asset that

30 See T.D. 8080.1986-1 C.B. 371. T.D.8080 issued final regulations under section 7701 that denied trust classification to Americus investment trusts, effectively prohibiting such investment trusts. Sea Regulation section 7701-4. Moreover, T.D. 8080 stated that one of the major problems produced by such investment trusts was the "potential for complex allocations of trust income among investors, with correspondingly difficult issues of how such income is to be allocated for tax purposes." For an excellent description of these transactions and their legislative and administrative history, see Walter and Strasen. The Americus Trust "Prime" and "Score" Units, 65 Taxes 221 (1987).

qualifies for indexation. The 10 percent interest expense on investor Y's $100 million loan matches her dividend income of $10 million. One year later, investor Y sells her capital asset for $105 million after having received $5 million in current income from the asset. If inflation is five percent, the indexed basis of the asset is $105 million, and investor Y recognizes no gain or loss on the sale of the asset. After repaying her loan, investor Y is left with $10 million, and has effectively transformed $5 million of her $10 million dividend income into tax-free income. This transformation arises from investor Y's ability to take interest deductions at their full nominal amount, while repaying her loan with inflated dollars.

Failure to allow Indexing to generate losses will result in dissimilar treatment for taxpayers with identical economic Incomes.

In a full indexation system, investor Y's nominal interest deduction would be decreased by the amount of inflationary gain she realizes as a borrower from the diminishing real value of the loan principal. If interest deductions were indexed in this manner, the 1989 Bill's investment interest limitation would be unnecessary. In the example above, investor Y's $10 million interest deduction would be decreased by $5 million, the amount by which the real value of the $100 million loan principal has declined in one year due to five percent inflation. As a result, in a fully indexed system, investor Y's net income would be $10 million, i.e., $15 million dividend and other income less 35 million indexed interest deduction. The exclusion from the computation of investment income of investor Y's indexed gain from the sale of her capital asset under the

1989 Bill is ineffective because she has sufficient investment income to offset her unindexed debt interest expense.

II. Loss limitation. The 1989 Bill's loss limitation approach to debt arbitrage also is problematic. First, failure to allow indexing to generate losses will result in dissimilar treatment for taxpayers with identical economic incomes.[31] For example, A purchases stocks X and Y for $50 each and B purchases stock Z for $100. If stock 2, appreciates to $200, stock Y to $200, and stock X depreciates to SO. A and B both have economic gain of $100, However, because of the loss limitation rule, A will receive no indexation benefit on his losing investment in stock X. and the indexation benefit from his profitable investment m stock Y, with an indexable cost basis of $50, will be only half of the benefit realized by B, who has an indexable cost basis of $100 for stock Z.

In addition, a loss disallowance rule will exacerbate the “lock-in” effect of the capital gains tax by encouraging the asset holder to hold the asset until the full indexation benefit can be used, i.e., until the asset's fair market value at least equals its indexed basis. This result can only be described as ironic in the context of a proposal intended generally to lessen the tax burden on capital gains, rules would prevent the avoidance of the investment interest limitation contained in the 1989 Bill. Similarly, such tracing could be used as a mechanism for providing indexing only to a taxpayer's net (i.e., equity) investment in property. Although tracing may be the most expedient method of addressing debt arbitrage, it is well understood that to the extent money can be considered fungible; tracing rules will be artificial and will tend to favor the most creditworthy taxpayers. For example, the rules disallowing

31 Cohen, p. 105.

interest incurred to carry tax-exempt obligations are largely meaningless to wealthy individuals who can borrow against portfolios of stocks or taxable bonds to invest in tax-exempt obligations. Moreover, we would not recommend a further complication of the already complex tracing rules associated with the different treatment of interest with respect to personal expenditures, personal residences, trades or businesses, passive activities, portfolio investments and other investments, not to mention source rules and foreign tax credit calculations. We are greatly concerned that creating any further reliance on debt tracing would only further entrench the current system and hinder legitimate simplification efforts[32]

Further reliance on debt tracing would only further entrench the current system and hinder legitimate simplification efforts.

The debt arbitrage problem also could be solved by disallowing interest deductions attributable to the acquisition or holding of indexed assets. This type of solution would be highly dependent on problematic debt tracing rules, as discussed above, and undoubtedly would create major complexity.[33]

Still another means o Still another means of solving the problem would be the “avoided cost” method now used for construction period interest. This would involve significant complexity in allocating debt to specific assets for purposes of denying inflation adjustments, particularly in situations where debt levels change frequently.

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32 See letter from Arthur A Feder. Chair of the New York State Bar Association Tax Section, to Chairman Rostenkowski, recommending among other things simplification of the interest allocation rules (April 23, 1990).

33 See. e.g., New York State Bar Association Tax Section Report on section 163(j) (March 14.1990).

2. Exclusion of certain assets from indexation. The 1989 Bill makes unprincipled distinctions by granting indexation to certain capital assets and denying indexation to other assets that are equally affected by inflation. For example, the 1989 Bill does not allow indexation with respect to debt and certain debt-like assets, as well as all intangible assets other than stock, even though these assets are demonstrably affected by inflation as significantly as assets that are indexed under the 1989 Bill. Moreover, convertible debt, warrants, options, and other contracts with respect to stock are denied indexing despite economic attributes very similar to assets that are indexed under the 1989 Bill. In addition, the limitation of indexation benefits only to capital assets will deny indexing benefits to taxpayers who sell property constructed over a long period of time, such as a construction project, sophisticated equipment, or property described in section 1221(3), even though these taxpayers suffer the effects of inflation in much the same way as holders of capital assets. These exclusions are arbitrary and often illogical.

Under the 1989 Bill, stock received by the conversion of convertible debt, for example, is allowed an indexation adjustment only for the period after conversion; the holding period of the convertible debt before conversion is excluded. In contrast, convertible preferred stock apparently would qualify for indexation throughout a shareholder's holding period. Although the 1989 Bill excluded preferred stock from indexation, it defined preferred stock as stock with fixed dividends and no significant participation in corporate growth. Convertible preferred, by virtue of the conversion privilege, should be considered as participating in corporate growth, and therefore qualify for indexation. Even accepting the premise that debt assets should not be indexed if an indexation regime is adopted, a premise we believe faulty, it is truly impossible to rationalize this distinction, particularly in a tax system where convertible debt can be converted into stock without gain recognition and with a carryover basis and tacked holding period. Disparate treatment of convertible preferred and convertible debt would simply aggravate the already problematic distinction between debt and equity.

Warrants, options, and other contracts with respect to stock are also ineligible for indexation under the 1989 Bill.[34] The investment in or holding period of the warrant or option prior to exercise or disposition would thus not have the benefit of indexation. The reason for this exclusion is unclear, but it may reflect a limited attempt to prevent the tax arbitrage opportunity that might arise if the option writer (who in a properly structured system would be hurt by indexing) is a low bracket or tax-exempt taxpayer (e.g.. a pension trust or foreign person) and the option holder (who would benefit from indexing) is a high bracket taxpayer. In any case, the exclusion is illogical, as the following example shows.

Assume A purchases an option for $50, which gives him the right to purchase one share of XYZ Corp. stock three years later for $100. Inflation over the three-year period amounts to 35 percent. If the fair market value of XYZ Corp. stock is $165 when A exercises the option, and A immediately sells the XYZ Corp. stock, what should be his taxable gain? Under the 1989 Bill, A would have a taxable gain of $15, since the sum of the option purchase price and the exercise price for the XYZ Corp.

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[34] The 1989 Bill also excludes from indexation options, contracts, and other rights to acquire an interest in property. The problem described here with respect to stock options thus also would apply to an option to purchase real property.

stock is $150, $15 less than the fair market value of the stock. In real economic terms, however, A has a loss on the option; the 35 percent inflation, when applied to his option purchase price of $50, would require XYZ Corp. shares to sell at a fair market price of $167.50 for A to break even ($50 plus 35 percent inflation plus $100 exercise price). Similar results occur if A sells the option instead of exercising it. Thus, if A sold the option for $60, he would suffer a real economic loss of $7.50, yet would have a taxable gain of $10 under the 1989 Bill.

Under current law, the exercise of an option or a warrant is not a taxable event, and the cost of the exercised option or warrant increases the property's sales price and cost basis. This treatment recognizes implicitly that amounts paid for an option properly are treated as a cost of acquiring or proceeds from the sale of an interest in the property. Accordingly, to reflect the actual economic cost of the property, the holder of a warrant or option should be allowed to index basis attributable to the purchase price of the warrant or option for the period before its exercise with respect to any property received upon exercise.[35] Similarly, holders of warrants and options also should be able to index their basis with respect to gains upon disposition of a warrant or option.[36]

The denial of Indexation benefits to Intangible assets except for stock raises significant problems.

Further, the denial of indexation benefits to intangible assets except for stock raises significant problems. First, this

[35] See Shuldiner, p. 10.

[36] Cf. section 1234 (granting sale or exchange treatment to the expiration of options, in effect providing preferential capital gains treatment).

arbitrary distinction will cause taxpayers in identical economic circumstances to be taxed differently based on their choice of investment vehicle. For example, payments made with respect to stock market indexed debt instruments or stock market indexed annuities will reflect inflation in the same manner as stocks underlying the index, yet the 1989 Bill would provide no indexation.

Moreover, in practice the distinction between tangible and intangible property will lead to numerous disputes regarding allocation of purchase price where tangible and intangible assets are sold together. For example, where a lessee of real property sells the leasehold interest together with any self-constructed improvements, the 1989 Bill would make it mutually advantageous for the buyer and seller to allocate as much of the purchase price as possible to the improvements to maximize actual or potential indexation benefits. Such an allocation would be unlikely to have great significance under current law, since the buyer will depreciate both the leasehold and the improvements over the remaining term of the leasehold. Although current law places limitations on artificial allocations, the 1989 Bill would test the effectiveness of current law in new circumstances, with uncertain consequences.

Finally, it appears to us to be somewhat incongruous to allow indexation of corporate stock without regard to whether the corporation holds assets that would be indexable if the corporation itself were eligible for indexation. One might argue that by reason of this feature, the 1989 Bill represents a haphazard form of corporate tax integration more than a principled mechanism to provide inflation relief for deserving assets.

3. Benefits for only certain taxpayers. Limiting the benefit of any favorable method of capital gains indexation to specific taxpayers will create additional complexity and distortion of the tax system. In this regard, the 1989 Bill would create other arbitrage opportunities. The 1989 Bill does not allow C corporations to index assets, but allows shareholders to index their basis In C corporation common stock. In contrast, under the 1989 Bill, passthrough entities such as partnerships and S corporations would be allowed to index their assets, but individuals would not be allowed to index their S corporation shares or partnership interests.

a. Distorted Incentives for holding assets. Making basis indexing available to some but not all taxpayers creates an artificial incentive for those taxpayers permitted to basis indexing to hold eligible assets relative to taxpayers denied the benefits of indexing. Moreover, the introduction of this tax-related incentive will tend to result, as would any uneconomic incentive, in an inefficient allocation of resources.[37] While this result is undesirable in its own right, the inevitable engineering of transactions designed to maximize the availability of the benefits of indexing will aggravate the distortion.

b. Exclusion of C corporations. The exclusion of C corporations from the indexing system under the 1989 Bill disproportionately taxes individuals who invest through C corporations. For example, in contrast to the illustration presented in Part III.B.1.b., above, assume Ms. B invests $20,000 in a C corporation, receiving all its stock. If the C corporation borrows $80,000 and purchases Whiteacre for $100,000, the

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37 Needless to say, providing tax incentives for holding certain assets in favor of others without clear policy justification is a major retreat from the “level playing field” policy of the Tax Reform Act Of 1986

corporation would not be able to index its basis in Whiteacre and Ms. B would be able to index only her $20.000 basis for the corporation'; stock. The tax burden on Ms. B's investment in a C corporation would be significantly higher than Mr. A's similar investment as an individual.[38]

As a result, the bias against C corporations in our current system will be furthered. Consequently, well advised taxpayers will be further encouraged to use partnerships or S corporations to avail themselves of the benefits of indexing. This bias against C corporations already exaggerated by the “inversion” of individual and corporate tax rates and by the repeal of the General Utilities doctrine in 1986, undoubtedly has contributed to an erosion of the corporate revenue base. Nevertheless, not all taxpayers can use subchapter S,[39] and partnerships may not provide adequate liability protection. Thus, the already asymmetrical system of taxing incorporation and dissolution of corporations that was created by the 1986 Act[40] now will further penalize the uninformed or those who must use the subchapter C mode.

c. Enforcement of the limitation: additional statutory complexity. The 1989 Bill contains only broad and vague regulatory authority designed to assure that the benefits of basis indexing are limited to intended beneficiaries. Specifically, the 1989 Bill provides the IRS with the authority to disallow all or part of any indexing adjustment in the case of

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

[39] A common example of inability to use subchapter S would a start-up venture which incorporated to achieve limited liat and which has a corporation as a major equity funding source.

[40] i.e., the repeal of Genera/ Utilities permits the incorporation of appreciated assets tax-free, but imposes a tax upon the withdrawal of the same asset from corporate solution.

any transfer, the “principal purpose” of which is to secure or increase the indexing adjustment. The 1989 Bill also would deny the indexing adjustment for sales of depreciable property between certain related parties. These rules are likely to prove inadequate to limit the benefits of indexing only to the intended beneficiaries. In particular, the “principal purpose” standard is likely to prove difficult for the IRS to administer.[41]

The 1989 Bill would unfairly prevent the Intended beneficiaries from receiving the benefits of Indexing In certain circumstances.

At the same time, the 1989 Bill would unfairly prevent the intended beneficiaries from receiving the benefits of indexing in certain circumstances. For example, consider the sole individual shareholder of a C corporation who contributes to the corporation property that has appreciated, but whose fair market value and indexed basis are the same. The policy of the 1989 Bill would indicate that the precontribution gain in these circumstances should not result in any tax. This would require the corporation in the example to receive an increased basis for the Indexation available to the individual before the transfer of the appreciated property to the corporation. Otherwise, the 1989 Bill would cause the shareholder to suffer from the possibility of corporate taxation upon a post-contribution sale of the corporation s assets without the benefit of inflation adjustments. Even though the potential tax could be avoided if the shareholder sold the property and contributed the proceeds,

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41 A “principal purpose” standard has been notably difficult to apply under code section 269. See O. Watts, Acquisitions Made to Avoid Taxes. Section 269, 34 Tax L Rev. 539, 549-552 (1979) (discussing complexities of “principal purpose” test). In fact, it was largely the ineffectiveness of section 269 that led to the enactment of section 382 in both its present and earlier versions.

this will not always be a practical solution, particularly where the property is unique and necessary to the business.

These deficiencies in the 1989 Bill could be cured by ambitious statutory modifications, addressing a wide array of different possible transfers of assets from eligible to ineligible or ineligible to eligible taxpayers. Different rules would be required for transfers between related parties and transfers between unrelated parties. In addition, different rules will be appropriate for transfers in taxable and tax-free transactions.

Further, special rules will be needed to address basis and holding period problems of transferees, particularly for assets acquired in tax-free transactions. Other special rules will be needed for corporate partners as well as for conversions of C corporations to S corporations and vice versa. Finally, rules would be required for addressing situations where related eligible and ineligible holders of assets hold offsetting positions with respect to capital assets. Numerous disputes arising from the application of these special rules are easily foreseeable.

4. one-year holding period. Other provisions in the 1989 Bill raise recognition and timing issues. The 1989 Bill imposes a one-year minimum holding period before an eligible asset is indexed. Several problems immediately present themselves with respect to this seemingly innocuous requirement. First, taxpayers will be required to separate their securities portfolios, capital assets, and assets used in a trade or business between assets held less than one year and assets held

more than one year.[42] With virtually no preferential treatment of long-term as opposed to short-term gains under present law, the extent to which this must be done currently is limited. Second, taxpayers will time their transactions so as to qualify or not for indexation, depending on the different tax outcomes. Third, with respect to the interaction of this provision with the 1989 Bill's separate indexation of any substantial improvement to an indexed property, taxpayers will be required to keep track of and make independent indexation calculations for an indexed property and each substantial improvement to it and exclude entirely from indexation the basis attributable to any substantial improvements less than one year old.

The 1989 Bill's provisions for passthrough... will create great disparities between the direct ownership... and... ownership... through a passthrough entity.

C. Passthrough Entities

1. In general. The 1989 Bill's provisions for passthrough of indexation adjustments are problematic in many respects. As discussed below, these provisions will create great disparities between the direct ownership of property and the ownership of that property through a passthrough entity. Although these disparities in many cases will favor the government, in many situations the taxpayers will be favored with beneficial results and attractive planning opportunities.

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42 See, e.g., Hoerner, Indexing Capital Gains: The British Experience. Tax Notes—News Analysis 988, 989 (Feb. 26, 1990) According to Philip Levi, personal tax manager for Grant Thornton, the one-year holding period created “a great deal of bother over the timing of transactions” and the separation of assets held less than one year and all other assets. Id. The one-year holding period was eliminated from the British indexation system by the 1965 reforms which allow indexing from the month of acquisition. Ibid.

2. Partnerships

a. Allocation of indexing benefits. The proper allocation of indexing benefits among partners is not as simple as it initially appears. A simple rule apportioning the indexation adjustment in proportion to the overall partnership income allocation would not be sufficient. For example, A and B form a partnership. A contributes property worth $100 and A and B both contribute services. The partnership agreement provides that on liquidation the first (100 of proceeds are paid to A, the remainder split 50 percent each. A receives the first $10 of annual partnership income and the remainder is divided equally between A and B.

In effect. A is being treated as the continuing economic “owner” of the $100 asset and is receiving payments (10 percent of income or $10 per year) for the partnership's use of the asset. How should the indexation adjustment be allocated if the property is sold after two years for $170 and A receives $45 and B receives $25? Since A supplied all the partnership capital, should B receive any part of the indexation adjustment? Presumably, A should be allocated the entire indexation adjustment upon disposition of the asset, rather than a simple allocation according to the partners' overall interests. Unless some mechanism were created to achieve this result, it is easy to see how indexation benefits can be transferred at a taxpayer's option. On the other hand, even if such rules were put into place, benefit shifting still would be possible to a significant extent by modifying slightly the form of the transaction, making the partner entitled to the preferred return as a lender.

The allocation problem becomes even greater if partners share income unequally, e.g., A receives 70 percent and B 30 percent of the partnership income until A receives $100 return and income is shared equally thereafter, or some other formula of shifting income allocations is used. It is unclear under the 1989 Bill how indexation adjustment allocations should be made in such situations. Rules will be needed to handle such allocation issues. Moreover, the formulation of rules governing such allocation issues should not be left to regulations because the allocation problem is immediate and widespread.

b. Timing of adjustments. Under the 1989 Bill, the basis of a partnership interest generally is indexed with respect to an indexable partnership asset only when the partnership disposes of the asset. In addition, if a section 754 election is in effect, a partner transferring his interest will receive a share of any indexation adjustment that has accrued at the partnership level at that time. Thus, for the first time, section 754 will provide a positive benefit for the seller, as well as the buyer, of a partnership interest. As a result, transfers of partnership interests will raise issues regarding the allocation of indexation adjustments.

First, section 754 elections almost always are made on a tax-motivated basis. For example, suppose A. B, and C form the ABC partnership to purchase an indexable asset for $150. After 10 years, the asset has a fair market value of $180, but an indexed basis of $240. If partner A sold his partnership interest for $60, he would recognize a $10 gain, if no section 754 election is in effect.

At this point, the House Report on the 1989 Bill inexplicably fails to provide clear guidance with respect to the intended treatment of the indexation adjustment with respect to partner A's transferee, new partner D. The House Report states that the "transferee partner will be entitled to the benefits of indexing for inflation occurring after the transfer."[43] This would suggest that the transferee partner does not receive, upon a subsequent disposition of the partnership asset, a proportionate share of the indexation adjustment that had accrued at the time of his acquisition of a partnership interest. In contrast, however, Example (3) of the House Report provides that transferee partner D would, if no section 754 election is in effect, receive a proportionate share of the partnership's indexation adjustment with respect to the asset, including the indexation benefit accruing before he joined the partnership.[44] The failure of the 1989 Bill to provide a clear rule for such transactions is another example of the complexity involved in any indexation system.

The correct result in this situation is far from clear. If a transferee partner receives only indexation benefits accruing after his purchase of a partnership interest, the partnership will be required to track not only the indexation adjustment applicable to a particular asset, but also the amount of indexation accrued with respect to each partner at all times. Upon a partnership's sale of an asset, the partners would receive different indexation adjustments according to the exact date each partner joined the partnership, the amount of indexation adjustment accrued at that time with respect to that particular asset, and the amount of indexation adjustment occurring after the partner joined the partnership. This would clearly be an administrative and computational nightmare.[45]

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

[44] Id.

[45] These problems are even more pronounced for such as law firms or accounting firms whose partners interests frequently shift from year to year without any sale or exchange

On the other hand, if Example (3) contains the correct rule under the 1989 Bill, partner A's sale of his partnership interest to new partner D would not result in the loss of accrued indexation benefits with respect to D's partnership interest, and the partnership's ability to utilize the full $240 indexed basis of the asset would continue. New partner D thus would receive the previously “accrued” indexation adjustment benefit from the partnership property if the property appreciates after his purchase. So long as the partnership is not dissolved and the proceeds of sale remain in partnership solution, no tax will be imposed on the potential permanent difference between “outside” and “inside” basis.

The exaggeration of any differential between outside and inside basis of the partnership may provide for abusive planning possibilities.

Furthermore, if the ABD partnership subsequently sold the asset for $240, partner D would receive flowthrough of the indexation benefits equal to $30 (one-third of the difference between the assets indexed and unindexed basis), increasing his basis in his partnership interest to $90. If the partnership distributed the sale proceeds to its partners, partner D would receive $80 tax free, although his investment has increased in value from $60 to $80 during a period in which no further inflation occurred in sum, partner A in effect transferred to partner D the potential for $20 of tax-free future appreciation in the partnership's asset.

Second, the exaggeration of any differential between outside and inside basis of the partnership may provide for abusive planning possibilities. If original partner A were tax-exempt or otherwise able to offset the gain upon transfer of his partnership interest to D, the tax benefits of such transactions would be further enhanced. For example, if partner D in Example 3 of the House Report is a foreign individual and ABO is a U.S. partnership doing business outside the U.S., and the partnership sold the indexed asset in a legitimate transaction and realized the gain offshore, there would be no U.S. tax. Nevertheless, the foreign individual would have the artificially high basis and may be able to transfer the asset to a U.S. corporation, which would then have the "built-in" loss.[46]

Section 754, therefore, will assume even greater importance. There will, however, be circumstances where the section 754 election is not available (e.g., because all partners do not consent) or the partnership inadvertently fails to elect, or the partnership is sufficiently large and complex that the cost of making section 754 calculations is simply too high. Moreover, if partnership assets have depreciated, it is unlikely that a section 754 election would be made.[47] This may lead to thoughts of making section 754 elections mandatory, similar to the treatment of section 704(c) by the Deficit Reduction Act of 1984. At this point, one should recall that, after six years,

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[46] Even without engineered abuses, the ability to transfer interests in partnerships, the fair market value of whose assets is below the partnership's indexed basis, creates an inherently tax advantaged investment. The advantage lies in the fact that inflation adjustments at the partnership level will continue to be based on the high basis while any appreciation in the asset will occur based on the asset's fair market value. While this type of phenomenon occurs upon the transfer of any partnership interest where the partnership has depreciated assets, indexing will greatly compound this effect in a potentially limitless way.

[47] should be noted that the absence of a section 754 election at the partnership level can be mitigated where the partners' basis in their partnership interests exceeds the partnership's bases in its assets when the partnership is deemed to liquidate under section 708, since the rules under section 732(b) provide partners with a step-up in the basis of partnership property to their basis in their partnership interests upon such a distribution of the partnership's assets.

regulations governing the mandatory section 704(c) provisions have not been forthcoming, with consequent difficult problems for legitimate business transactions.

The rules are clearly not consistent for S corporations and partnerships.

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3. S corporations. The provisions of the 1989 Bill relating to the treatment of S corporations and their shareholders raise several of the same issues as for partnerships discussed in Part VI.B.3.b, “Timing of Adjustments.” above. Nevertheless, certain additional issues are raised. In particular, the rules are clearly not consistent for S corporations and partnerships. No analogy to section 754 exists for S corporations, with the consequence that a shareholder who sells his interest will be at a severe disadvantage to a comparably situated partner with a section 754 election in place. This situation will be encountered frequently where the S corporation has assets that are not freely transferable, such as a franchise, a labor contract, or a nonassignable lease. In these circumstances, the S corporation stock can be sold, usually without any significant tax detriment to the sellers. In addition, even if the S corporation's assets are freely transferable, the seller of a minority interest in an S corporation will not be able to receive indexation benefits on the sale of his stock.

In addition, it is not clear under the 1989 Bill how indexing adjustments would be allocated where stock is sold during a taxable year. Although it may be reasonable to assume that indexing adjustments would track allocation of gain, it is possible that the 1989 Bill intended that the adjustments be made on the basis of the time of sale. Discontinuities in economic appreciation and basis adjustments will be created by either approach, particularly in light of the special rules for allocating gain in the case of transactions that terminate S corporation status, that terminate a particular shareholder's ownership, or that involve a transfer of more than 50 percent of the corporation's stock. Finally, the statement of the House Report that “indexing does not apply” for purposes of sections 1374 and 1375[48] leaves open the manner in which indexing computations will be made where sections 1374 or 1375 are applicable.

4. RICs and REITs.

a. In general. The 1989 Bill allowed RICs and REITs to index their taxable income and earnings and profits. In addition, to the extent that RIC’s or REIT’s assets qualify for indexation, the 1989 Bill allowed its individual shareholders to index their bases for the RIC or REIT stock. Corporate shareholders, however, were denied these indexation benefits.

b. Avoidance of lots limitation provisions. The general rule that no losses may be created through indexing clearly will be violated by the rules relating to RICs. The following example demonstrates that shareholders of RICs will be able to blend gain and loss positions in the RICs securities in calculating individual gains or losses.

Assume that a RIC acquires three indexable securities, each for $ 1.OOO.[49] If indexation over three years is 20 percent, the aggregate indexed basis would become $3,600. Assume that

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[48] House Report, p. 1479.

[49] For simplicity, diversification rules are ignored.

asset 1 does not appreciate, asset 2 depreciates to $900, and asset 3 appreciates to $1.700. Under this scenario, a one-third owner of the entity would be entitled to sell his interest for $1.200, have an indexed basis of $1.200, and no taxable gain, while an individual owner of one-third of each of the three assets would have a net taxable gain of $133.34 (1/3 of $500 gain on asset 3 after $200 indexation adjustment minus $33.33 loss on asset 2). This will provide a RIC investor with a sizeable advantage over individual investors in stocks and securities.

Aside from the ability to avoid the loss limitation provisions, RIC shareholders receive additional benefits from indexing by reason of continued indexing of their RIC stock in the absence of any corresponding inflationary gains on the RIC's assets. For example, assume that a RIC purchases two blocks of stock for $1.000 each. Within one year, one block becomes worthless, while the other block triples in value. Inflation for the year is 10 percent. If the RIC sold the appreciated shares, it would recognize a $1.900 gain (i.e., $3.000 minus indexed basis of $1.100). After offsetting the capital loss, the RIC would have a net capital gain of $900 which it distributes as a capital gain dividend. After the distribution, the RIC shares would be worth $2,100, yet the aggregate indexed shareholder basis would be $2,200. The excess basis at the shareholder level is attributable to the indexing of a “nonexistent” asset at the RIC level (the worthless shares). This excess basis either would allow its shareholders to recognize a loss upon disposition of the RIC stock, or if losses are not allowed, would allow the shareholders to avoid recognition of gain if they sold their stock after the RIC's assets had further real appreciation of $100. Only an unthinkably complex regime of passing through realized and unrealized losses to RIC shareholders for purposes of indexing calculations would prevent this result.

c. Indexing of less than all of the entity's asset. The 1989 Bill would require a valuation of the RIC's or REIT's indexable and nonindexable assets on a regular basis. For RICs, the 1989 Bill required monthly asset valuations, but for REITs, due to the difficulty and cost, those valuations were required only every three years. While requiring REIT trustees to make “good faith” monthly judgments regarding a REIT's indexable to nonindexable asset ratio, the 1989 Bill's three-year valuation requirement provides ample opportunities for tax avoidance and arbitrage.

Further complexity Is Introduced where the benefits of indexing basis are intended to be provided to only certain taxpayers.

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d. Indexing for not all taxpayers. Further complexity is introduced where the benefits of indexing basis are intended to be provided to only certain taxpayers. The rules to effect this limitation which will be issued under regulations are certain to be complex. Moreover, to properly limit the benefits of indexing, it is likely that tracing share ownership will be necessary. Doing so, however, will have the undesirable if not disastrous consequence of rendering shares in a publicly traded mutual fund nonfungible.

5. Other passthrough entitles. The 1989 Bill would create major additional complexity and opportunities for arbitrage with respect to trusts. In many respects, the complexities and arbitrage opportunities will be similar in nature to those arising in connection with the types of passthrough entities previously discussed. Nevertheless, many additional issues arise.

In particular, the taxation of trusts will be burdened with difficult computational issues arising under the throwback rules, the treatment of disposition of qualified real property under section 2032A, and the treatment of split interests in property. Moreover, the technical basis and holding period rules for property held by or acquired r through a trust will provide numerous planning opportunities, particularly in circumstances involving transfers of interests in the trust as opposed to its corpus We consider it highly unlikely that the in terrorem “principal purpose” rule will eliminate the perceived opportunities.

Partnerships and S corporations would have to maintain records... to determine Indexation adjustments to partners' or shareholders' Interests upon the sale of an Indexed asset

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It should be noted that the 1989 Bill effectively denied the benefits of basis indexing to holders of interests in subchapter T cooperatives. We assume that this denial represents a conscious choice favoring the simplicity of denying the benefit over the difficult task of crafting rules to preserve the benefit of indexing in this context. Nevertheless, it must be recognized that this choice favors the interests of taxpayers large enough to conduct operations without dealing with cooperative over smaller taxpayers who must conduct significant aspects of their affairs through cooperatives.

6. Other problems with the 1989 Bill flowthrough provisions. The provisions of the 1989 Bill relating to passthrough entities significantly increase record keeping and computational burdens on taxpayers. Under the 1989 Bill, partnerships and S corporations would have to maintain records

for each indexed asset to determine indexation adjustments to partners or shareholders' interests upon the sale of an indexed asset. For partnerships, already complicated issues regarding the allocation of gain, loss, income, and deductions related to assets contributed to a partnership by a partner under section 704(c) would be further complicated by the additional layer of issues and computations regarding indexation adjustments to such assets. Similarly, as anyone who has had to work through the adjustments and the individual valuation of all partnership assets in a complex partnership will attest, section 754 is not a simplification measure:

An example should illustrate the magnitude of the problem Assume X and Y form a partnership. X contributes property with a fair market value of $480. Y contributes property with a fair market value and tax basis of $120. The properties contributed by X and Y are depreciable over 10 years on a straight-line basis. The partnership has no items of income, gain. loss, or deduction other than depreciation and gain or loss with respect to the property.

Partner Capital Accounts

	X		Y		Property	
	Book	Tax	Book	tax	Book Value	Tax Basis
Contribution.	.480	0	120	120	600	120
Depreciation, Years 1-5. .	(240)	0	(60)	(60)	(300)	(60)
Balance, Year 5.	.240	0	60	60	300	60

Sale Price	.600
Adjusted Tax Basis	(60)
	540

Sale Price	. 60
Adjusted Book Value	(300)
	300

Assume that X's property has a tax basis of zero upon contribution. Assume that at the beginning of year six, both properties are sold for $600 and that inflation is 50 percent for the five-year period. First, the treatment of the partners without indexation of the partnership's assets

$240 of the tax gain is allocated entirely to X as section 704(c) gain. The section 704(c) gain is the remaining disparity attributable to the value/basis differential of X's property, computed as the difference between the property's adjusted book value (240) and adjusted tax basis (0).

The additional $300 of tax gain and the book gain of $300 is allocated 80 percent to X (240) and 20 percent to Y (60), so that the capital account balances are:

	X		Y	
	Book	Tax	Book	Tax
Balance Year 5........	240	0	60	60
Gain........	240	480	60	60
Balance........	480	480	120	120

Liquidation proceeds, which are distributed in accordance with the Book Capital Account balances, will be distributed 40 to X and 120 to Y, resulting in an 80%/20% distribution ratio. Neither party should recognize gain or loss upon liquidation, as the proceeds received will equal the tax basis in their partnership interests (i.e., their Tax Capital Accounts).

This already complex system of partnership allocations Is further complicated by the addition of Indexation adjustments and allocations Issues.

This already complex system of partnership allocations is further complicated by the addition of indexation adjustments and allocations issues. With indexation, the tax basis of the partnership's property would be 180 (150% of a 120 tax basis).50 Thus:[50]

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

At this point, numerous issues arise. First, how is the section 704(c) allocation to X to be determined? If the indexed tax basis is used, only 120 of the tax gain would be allocated to X as section 704(c) gain the difference between the property s adjusted book value (300) and the indexed tax basis (180). On the other hand, the unindexed adjusted tax basis might be used, resulting in the same section 704(c) allocation as before: this,

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50 The 1989 Bill provides that for purposes of determining the amount of depreciation recapture, basis adjustments attributable to indexing are not taken into account. Thus, the partnership will have $60 of recapture gain. The remaining gain is determined by using the $120 basis (sum of $60 basis before recapture plus $60 recapture), and applying a 50 percent indexation adjustment.

of course, would require taxpayers to keep track of and make yet another basis determination.

Second, how is the indexation adjustment of 60 to be allocated between X and Y? If in proportion to X and Y's partnership interests, X would receive an increase in his partnership interest basis of 48 (80%) and Y would receive 12 (20%) as their flowthrough indexation adjustments. Since the sale at $600 in an indexed system produces an overall loss, such an allocation effectively allows X and Y to blend their losses and gains on their respective property contributions to the partnership. X's property has a large built-in gain of 480, presumably unreduced by inflationary indexing since its basis is zero. Nevertheless, the partnership has experienced an economic loss on X's property. Y s property also experiences a significant loss in value due to inflation.

An allocation of indexation adjustments according to X and Y’s respective partnership interests would give X indexation adjustments when, without a partnership with Y, X's property would not receive any indexation. Similarly, Y has transferred 80 percent of the indexation benefits attributable to Y's property to X through the partnership structure. Moreover, this transfer of indexation benefits has allowed Y to avoid the 1989 Bill's restriction on losses created by inflationary indexing; the partnership's indexation benefit of 60 is entirely produced by an inflationary loss of Y's property. Additional rules will be necessary to determine allocations on a property-by-property basis, if indexation, as the 1989 Bill provides, cannot create or increase a loss

Moreover, the 1989 Bill provides that substantial improvements or additions to indexed property should be separately indexed. This will inevitably create serious problems regarding the netting of gains and losses between the indexed property itself and any substantial improvement to it the allocation of indexation benefits between the property and the substantial improvement, and the allocation of such benefits between, for example, partners contributing different amounts of capital, appreciated property, built-in loss property, or services to the indexed property and to any substantial improvement.

While these problems may have solutions, solutions, whether complex or simple, will only be the result of in-depth study and considerable effort focused on each particular aspect of S corporation or partnership flowthrough. The 1989 Bill, in contrast, naively assumes that solutions lie in ignoring the problem areas. Thus, the House Report on the 1989 Bill states that partnership interests and S corporation stock were not made indexed assets to avoid "the complexity which would result in determining the proper measure of the basis adjustment if indexing were to take into account the fluctuating basis of the S corporation or partnership interest or the varying mix of indexed and unindexed assets held by an S corporation or partnership. [51] Yet, as the above example illustrates, problems of asset mix and indexation, among others, would arise immediately upon the sale of any partnership interest or S corporation stock, and cannot, as the 1989 Bill presumes, be deferred until the partnership or S Corporation disposes of a particular asset.

[51] House Report, p. 1479.

IV. COMPLIANCE BURDENS

As our review of the 1989 Bill indexing proposal reveals, the complexity of the substantive issues raised by any basis indexing proposal could hardly be understated. The effect of any indexing proposal on the current tax system's complexity, however, also must be measured in terms of increased compliance burdens on taxpayers. Moreover, these increased compliance burdens will further strain an already overburdened audit system. This part of the report briefly identifies some of the compliance burdens that would be created or increased by an indexing system.

In many common circumstances, the indexing calculation would be a complex one.

A. The Basic Indexing Calculation

The first additional compliance burden attributable to indexing is the need to adjust the basis of assets that otherwise would not be adjusted or to make an additional adjustment where adjustment already is required. The additional complexity would be lessened- if adjustments were made only annually (as opposed to quarterly) although there would be some sacrifice in accuracy.[52] As a practical matter, because the adjustment would be made only when an asset is disposed of, the incremental burden of adjusting the basis of any particular asset would be fairly modest in the simplest cases. However, even the relatively modest incremental calculations can amount to a significant additional burden for taxpayers who have a great number of otherwise simple

[52] Cohen, p. 104

transactions, such as an active trader of securities or an investor who has regularly reinvested dividends in a mutual fund, or pursuant to a corporate dividend reinvestment plan (hereinafter referred to as “DRIP”). Moreover, as discussed above, in many common circumstances, the indexing calculation would be a complex one. We question the wisdom of introducing any incremental complexity where the tax law already is widely perceived as overly complex.[53]

B. Increased Record Keeping

Under present law, once the holding period of an asset exceeds the applicable holding period for long-term capital gain or loss treatment, there is no further need to ascertain the precise period for which it has been held.[54] If the basis of assets were to be indexed, however, it would be important to establish the precise holding period of any asset so that the indexing calculation can be made accurately. We anticipate that certain conventions would be adopted for making the relevant indexing computations. These conventions may serve to simplify somewhat the indexing computations where payment or payments for

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53 See. e.g., H Stout. Codified Contusion, Tax Law Is Growing Evermore Complex. Outcry Even Louder, Wall St. J., Apr. 12. 1990. p. A1, col 6: Rostenkowski Pushes Simplification As Hearings Begin on Tax Reform, 46 Tax Notes 738 (Feb. 12.1990) (“committee will make tax simplification a top priority”); F. Goldberg, Statement before the House Ways and Means Committee (Feb. 7. 1990) (“The cumulative impact of repeated law changes—coupled with a statutory, regulatory, and administrative focus on theoretical purity—have imposed a staggering burden of complexity, uncertainty, and administrative costs ....”); K. Gideon. Statement before the House Ways and Means Committee (Feb. 7, 1990)(“We must work together in an effort to identify ways to simplify the system in a manner consistent with maintaining both the reality and perception of fairness.”).

54 Moreover, even this information usually is unnecessary cause the distinction between long-term and short-term cat gains is virtually irrelevant under present law.

assets are made either before or after the acquisition of the asset. Although records generated in the ordinary course of business probably would contain most of the information relevant to the indexing computation and conventions, the degree of detail that taxpayers would need to develop from these records would be markedly enhanced.

This is particular true for long-term investments of individual taxpayers, such as homes (or home improvements) or investments in family businesses, precisely the area of tax law in which additional complexity is to be added with the greatest of trepidation. For example, if a taxpayer were to build a new addition to his home, records generated by the transaction may indicate multiple dates, reflecting the payments made and the delivery of various parts and labor. In performing the relevant indexing computation, either all or none of the dates reflected would be relevant. Under present law, none of the dates would be relevant so long as at least one year has passed from the time the addition was completed (which usually would be the case).

Under a regime of indexing, however, each periodic date will be a “cliff.” the passing beyond of which will be to the taxpayer's advantage. Moreover, major concerns as to complexity arise when a taxpayer sells his principal residence and purchases a new principal residence within the period allowed by section 1034. Except in the fortuitous event that the cost of the new residence is exactly equal to the sale proceeds of the old residence, the basis for the new residence will be different from the basis of the old, and complex adjustments will be required. Similar complex adjustments would be required for reorganizations with boot or any tax-favored exchange with boot, e g., section 1031, because the basis of the acquired asset is different from that of the transferred asset.

C. Possible Institutional Responses

Some commentators have suggested that much of the compliance burden inherent in an indexation system, particularly for taxpayers with multiple transactions, could be absorbed by financial institutions that have sophisticated computer capability.[55] Reliance on institutions to shield taxpayers from the additional burdens of complexity is fundamentally misguided.

First, the extent to which institutions can perform this role may be overstated. For example, some commentators have suggested that institutions will relieve the individual taxpayer of the burden of indexing computations for stock acquired under a DRIP. In many cases, however, an individual cannot participate in a DRIP if the stock is held through a brokerage account, eliminating the possibility that the brokerage firm can perform the required calculations.

Second, institutions will not necessarily have available all the information necessary to make the relevant indexing computations. For example, if an investor removes securities from an account at one brokerage firm and deposits those securities at another, information about acquisition dates will not necessarily be transferred at the same time. Finally it will be impossible for any particular institution attempting to calculate a taxpayer's indexation adjustment to take into account all the special rules relating to the indexing calculation, many of which will require information not available to it. One brokerage firm will not necessarily be aware of transactions that toll the holding period for particular assets if the taxpayer executed

[55] See Durst, p. 1274, Steuerle & Haiperin. p. 359.

those transactions through another brokerage firm. For example, a taxpayer may own shares of stock through one brokerage firm and nave sold put options with respect to the same stock through another brokerage firm. The combination of heavy reliance on institutions for computations with the inability of the institutions to take into account all relevant aspects of the indexing calculation is a recipe for widespread reporting errors, noncompliance or gaming against the Treasury

V. THE WEAK THEORETICAL BASIS FOR INDEXING

All the complexity and exposure to significant erosion of the revenue base would be problematic even under a perfect indexation system, because the primary theoretical bases supporting indexation of the tax system are themselves problematic.

A. Inexact Nature of Adjustments

The main premise underlying any indexing proposal, i.e., that indexing the basis of an asset will result in the taxation of not only real appreciation, is highly questionable. The four factors discussed below contribute to this conclusion. Given the reality that any inflation adjustment would be imprecise at best, we believe, in fact of the problems discussed in the preceding portion of this Report, that any form of indexation would be extremely bad tax policy.

First, the use of any particular inflation index will offer inexact relief to the owner of any particular asset. For example, if the consumer price index is used, exact relief will be given only to an owner who plans to use the income from the asset for consumption, as opposed to business or investment purposes, and then only if the composition of the owner's planned or actual consumption matches that of the basket of goods whose price level is measured in composing the index. Although it may be said that consumption is the ultimate goal or at least use for all income, it nevertheless is true that for certain periods, investment goals may predominate. This has caused some to question whether use of an index other than the consumer price index would be appropriate.[56]

Second, the price of an asset and the returns available from that asset already may be adjusted to account for inflation. For example, if a lessor charges higher rents to compensate for the overtaxation attributable to inflation, basis adjustments would provide the lessor with redundant relief. For this reason, it is unclear whether it would be preferable to index basis for actual or expected inflation.[57]

Third, deferring basis indexation adjustments until disposition creates arbitrary results where income-producing property generates periodic returns in excess of the “real” rate of return. For example, if the current income generated by property were sufficiently high, there would be relatively little real or nominal appreciation in that property. All the currently received income would be treated as ordinary income to the recipient, notwithstanding the fact that in an inflationary environment, a portion of that income in economic terms would represent a return of principal. Thus, indexing basis would be of limited usefulness to the holder of this type of property for whom property appreciation attributable to inflation would be

[56] Bravenec & Curatola, Indexing the Federal Tax System for Inflation, 28 Tax Notes 457 (July 22.1985).

[57] Steuerle & Halperm. pp. 366-368.

recognized as ordinary income over the period the property is held, accompanied by a capital loss (if losses are allowed) or diminution of capital gain on disposition.[58] Ironically, the benefit of basis indexation is greater for property that does not generate current income and that as a result already enjoys the benefit of tax deferral.[59]

Basis adjustments will match Inflationary increases only by happenstance.

Finally, even assuming that the proper measure of inflation in an asset can be determined with reasonable precision, it can be demonstrated that in most cases actual basis adjustments will match inflationary increases only by happenstance. This unfortunate result occurs because in the absence of gain realization, annual adjustments are made to the basis of the asset without regard to its fair market value. Nevertheless, inflation in any period by its nature will increase the nominal price of an asset relative to its value at the beginning of the measurement period.

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[58] This result is most easily understood in the context of an investment in nonparticipating preferred stock. For example, individual Investor A pays $1,000 for $1.000 face amount of XYZ Corp. preferred stock, which has a 10 percent annual dividend. Inflation of five percent is anticipated in determining the dividend rate and inflation actually occurs at that rate. A's stock is redeemed after 10 years for $1.000. At that time, A's indexed basis in the stock is $1,629, resulting in a capital (and economic loss of $629. This loss occurs because each unindexed dividend payment represents economically a return of capital in part. Cl. section 1059(f) The same phenomenon occurs with respect to depreciable property if basis is indexed only on disposition and depreciation deductions are not indexed.

[59] See Part V.B., infra.

For example, assume that Ms. A purchased an asset for $1,000. After one year the asset is still worth $1.000. After two years, Ms. A sells the asset for $1.300. Inflation in each year is 10 percent. Under an indexation system, Ms. A would have a basis in the asset at the time of sale of $1.210 (i.e., $1,000 plus $100 for the first year and $110 for the second year). Although Ms. A's inflation adjustment of $100 for the first year is appropriate, her inflation adjustment for the second year should be limited to $100. Price level increases in the second year only inflated the actual value of her asset, not the asset's adjusted basis. Ms. A's taxable gain is $10 less than her “real” gain.[60] By comparison, Mr. B purchases an asset for $1,000. The asset is worth $1,200 after one year and is sold for $1,300 after two years. At the time of sale, Mr. B's basis also would be $1,210, but his inflation adjustment for the second year should have been $120 rather than $110, resulting in tax of $10 of gain in excess of real gain.

Accordingly, the basis adjustment for an asset will exactly equal the measure of its price inflation (assuming that the exact amount of price inflation can be measured in any event) only where the asset appreciates at exactly the rate of inflation. Basis adjustments will be inadequate to adjust for inflation where an asset appreciates faster than the rate of inflation, and basis adjustments will be excessive where an asset appreciates at a rate slower than inflation.

Thus, it must be recognized that the connection between the actual effects of inflation on any particular asset and the relief provided by any system of basis adjustments is quite tenuous.

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

B. Neutral Taxation of Capital Income

Another often-stated premise underlying indexation proposals is that indexation is needed to achieve neutral taxation of income from capital as compared to other sources, i.e., to prevent capital income from being taxed more heavily than other income by reason of including inflationary as well as real gains in the tax base. This premise too is false. It is well understood that the current system taxes income from capital more favorably than income from other sources because gain from the appreciation of capital is not taxed unless realized and avoids tax altogether if the asset is held at death. Other advantages include accelerated depreciation, the availability of interest deductions on related indebtedness, and UFO inventories.[61] Thus, unless these other benefits are eliminated, indexing of basis will allow income from capital to enjoy an even more favored tax status relative to income from other sources than it now enjoys.

VI. CONCLUSION

It is our position that the implementation of any indexation system as a part of a modification of the present tax system would be highly inadvisable. While this Report is intended to discuss only some of the potential problems with any indexation system, we believe it clearly identifies the nature of the numerous distortion, complexity, and tax arbitrage issues that any indexation system would create.

This Report reflects our position as professional tax practitioners. We are seriously concerned that any indexation system will permit the use of these distortions and tax arbitrage

[61] See Steuerle & Halpenn. pp. 353-356.

opportunities to seriously erode the revenue base. This will clearly be counterproductive m the current budgetary environment.

APPENDIX 1

Indexing In the United Kingdom

In 1982, following the high inflation of the 1970s and after several years of discussion,[1] the U.K. indexed the basis of certain assets in an attempt to avoid the taxation of inflationary gain.[2] Announcing the measure, the Chancellor of the Exchequer said in his Budget speech:

> I come now to the incidence of capital gains tax on inflationary gains. This is a matter which has rightly given rise to a great deal of discontent. No one has yet succeeded in finding a solution to this problem. Innumerable proposals for full indexation, for tapering and other ingenious devices have been put forward. None, unfortunately, overcame all the practical difficulties. I cannot, however, allow this injustice to continue. It is intolerable for people to be permanently condemned to pay tax on gains that are apparent but not real—that exist only on paper.

Thus, acknowledged at the outset that the measure was imperfect, basis indexing was created in the U.K. Since its introduction, the basis indexing provisions have undergone two major revisions, the second of which, in 1986, was part of a

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1 See. e.g., Nobes, Capital Gains Tax and Inflation, 1977 Brit. Tax Rev 154: Watson & O'Reilly, A Schema for the Indexation of Capital. Gains Tax, 1978 Brit. Tax Rev, 4.

2 See sections 86 and 87 of the U.K Finance Act of 1982 and section 68 of the U.K. Finance Act of 1985.

larger revision of the capital gains tax ("CGTV")[3].

The U.K. indexing rules provide for adjustment to the basis of an asset upon its disposal. On the disposal of an asset, an indexation allowance is given, equal to relevant allowable expenditure multiplied by a fraction, the denominator of which is the retail price index[4] ("RPI") for the month of disposal and the numerator of which is the RPI for the month of disposal less the RPI for the month of acquisition. The indexation allowance is treated as deduction from the gain or loss computed under general CGT rules. It may reduce a gain, turn a gain into a loss, or increase a loss.

Where an asset acquired before April 1, 1982, is disposed of after April 5.1988, the adjustment is calculated by reference to the market value on March 31, 1982 (rather than the taxpayer's cost basis before that date), if this gives a result favorable to the taxpayer. For dispositions of assets from April 1982 until April 1985, relief was given on a more restricted basis.[5]

A continuing problem with the U.K. indexing provisions has been the complexity of identifying the asses that have been

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3 In the U.K., the CGT is a separate tax from the income tax. Until 1988, a flat rate of 30 percent was imposed on a taxpayer's capital gains: the rate is now linked with the income tax rate so that for individuals, capital gains are added as the top slice of income to determine the appropriate rate, of up to 40 percent. Corporate capital gains are taxed at the full corporate rate of 35 percent (25 percent m the case of "small companies").

4 The RPI figure is released by the Inland Revenue each month.

5 Specifically, (i) only changes due to inflation after March-1982 were taken into account: (ii) no relief was given for char due to inflation occurring during the first 12 months of ownership, thus excluding relief whether the asset was disposed of' within those 12 months or not: and (iii) the indexing adjustment could only reduce (or eliminate) a gain.

sold to determine their eligibility for the allowance, and the correct cost basis to be attributed to them, especially in the case of securities. Because of the relevant effective date provisions, assets had to be divided between those acquired before March 1982 and after. Another allocation had to be made initially for assets held for less than one year, which were not eligible for the allowance. In 1985, the one-year rule was abandoned, but the taxpayer was given the ability to choose whether to calculate the allowance for assets acquired before March 1982 using the base cost on acquisition before March 1982 or the fair market value of the asset in March 1982, requiring further allocations. Expenditure on property after March 1982 itself qualified for a separate calculation to determine the allowance due in respect of it. Part disposals also had their own rules. The effect has been to impose a considerable administrative burden on taxpayers who generally have been unable to compute their basis adjustments without professional help.[6] The shifting of basis of all assets to their value on March 1982 is expected to ease that burden somewhat, but carries with it obvious administrative problems of its own.

In 1985, the rules were revised to allow the allowance even when it created a capital loss. Attempts to take advantage of this have resulted m legislation to prevent abuses [7] For example, the Finance Act of 1988 contains provisions' preventing linked companies from manufacturing an artificial loss through the sale of certain intercompany debts. Other problems include

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6 See Hoerner. Indexing Capital Gains The British Experience. 46 Tax Notes 988 (Feb 26. 1990)

7 For example, the distortion caused by indexing gains on securities, while fully taxing interest as income, will result in sections and devices designed to convert the return on securities from income (unindexed) into capital gains (indexed) In the UK this has led to a series of anti-avoidance legislation Section 114 and Sched 11. Finance Act 1988

the failure to index gains or losses on debt, creating arbitrage possibilities, and resulting in frequent legislative action to stop it.