Indexing Basis for Inflation: The Intractable Problem of Debt

by Deborah A. Geier

To the Editor:

Joel D. Kuntz recommends that capital gains be taxed at the same rate as ordinary income but that asset basis be indexed for inflation (except for cash, inventory, and bank deposits in U.S. dollars) in measuring gain ("Reform: Apply Full Rates to Capital Gains Adjusted for Inflation," *Tax Notes*, June 26, 2017, p. 1869). I applaud the first suggestion but bring a reality check to the second: the political and practical impossibility of indexing debt (assets of lenders) and the rampant tax arbitrage problems if you fail to index debt. Even the cash bank deposit that Kuntz would except from indexing implicates debt (the bank's asset). Moreover, the realization requirement — a big time-value-of-money benefit — often more than makes up for failing to index capital asset basis for inflation.

As I explain elsewhere,[1] let's assume that Parker deposits $10,000 in a savings account at National Bank on January 1 of year 1 and that the account terms entitle Parker to receive 2 percent interest each year. Parker is a "lender" to National Bank, which is borrowing Parker's money to use in its business of lending to others (for, say, a home loan or business loan). On January 2 of year 2, Parker withdraws the $10,000 principal (a tax-free recovery of basis), as well as the $200 interest, and spends the $10,200 on consumption. Under section 61(a)(4), Parker must include in his year 1 gross income the $200 interest, even if inflation for year 1 is also 2 percent, so that his inflation-adjusted wealth remains unchanged between January 1 of year 1 and January 2 of year 2 when he withdraws the $10,200 principal and interest. Indeed, because Parker's interest is deemed realized as it accrues, Parker must include the $200 year 1 interest even if he fails to withdraw it in year 2 but rather leaves it in the account to earn further interest.

Alternatively, assume Parker purchases Blackacre (a capital asset in his hands) on January 1 of year 1 for $10,000, that he sells Blackacre for $10,200 on January 2 of year 2, and that inflation is 2 percent during year 1. Parker's section 1001 realized gain under current law is $200 ($10,200 AR less $10,000 AB), which he must include in his gross income under section 61(a)(3), even though his inflation-adjusted wealth remains unchanged from its January 1, year 1 level.

Finally, assume the same facts as immediately above except that Parker is a real estate dealer so that Blackacre is inventory in his hands and not a capital asset. Once again, Parker would measure his wealth increase on the sale in nominal dollars, not inflation-adjusted dollars, and he would include $200 in his gross income.

In each case, we could amend the law so that Parker's basis in his savings account and Blackacre, respectively, are increased for inflation each year so that any possible wealth accession is measured in inflation-adjusted real terms instead of nominal terms. The 2 percent inflation in year 1 would result in an increase in his savings account (loan) basis from $10,000 to $10,200, as well as an increase in his Blackacre basis from $10,000 to $10,200. The $200 labeled "interest" paid into his savings account would actually be a tax-free increase in his "principal," and he would realize no section 1001 gain when he sells Blackacre for $10,200, whether he holds Blackacre as a capital asset or as inventory, because the sale price would equal his inflation-adjusted basis of $10,200.

As these simple examples illustrate, introducing a reduced tax rate for capital gains solely on the argument that it would ameliorate taxation of inflation gain is nonsensical. First, a rate reduction applicable only to capital gain and not to other forms of capital return violates the neutrality norm because *every kind of capital income* is subject to the inflation problem, not merely capital asset gain. Indeed, capital gain is the form of capital return *least* in need of a preferential rate to account for inflation's effects because of the deferral privilege inherent in the realization requirement, an economic benefit that does not accompany other forms of capital return, such as interest, rent, and royalties. Parker must include the $200 interest earned on his savings account annually as it accrues and pay tax at ordinary income rates even if he does not withdraw the interest from his savings account but rather leaves

[1] Deborah A. Geier, *U.S. Federal Income Taxation of Individuals 2017* (2016).

it in the account to continue to earn more interest. Parker's savings account is taxed according to income tax principles because the increase in his savings account (by $200) is taxed each year, and thus the future interest earned on that $200 increase in his account balance (if he fails to withdraw it) is earned on after-tax dollars.[2]

In contrast, the appreciation in Parker's Blackacre (whether held as a capital asset or as inventory) is not taxed until sale or exchange. Thus, the realization requirement is a subtle consumption tax feature embedded in current law because it allows a future return to be partially earned on pretax dollars (the untaxed appreciation) during the ownership period. Stated another way, apart from any preferential tax rate, section 1001 property gain is subject to reduced taxation under consumption tax principles during the ownership period — even if it is taxed at the same statutory rate as other types of income when finally realized. In short, the deferral privilege inherent in the realization requirement offsets potential inflation gain in whole or in part. Thus, if inflation is said to be at the heart of the rate preference, the preference is directed at exactly the wrong kind of capital return.

More important, if basis is to be indexed for inflation, *all* basis must be indexed. As illustrated in the above examples, if inflation is 2 percent in the year, the basis of all assets (whether a capital asset, inventory, a savings account, or any other form of debt instrument or loan) would increase by 2 percent, decreasing the amount of taxable capital return, whether that return is in the form of section 1001 gain or, as in the case of Parker's savings account, interest. But not only would such a system be complex to administer, the optics would be difficult to explain to voters.

For example, assume that Sara and Jonathan purchase a home for $100,000 on January 1 of year 1, borrowing the entire $100,000 from National Bank at 5 percent interest each year ($5,000) until the $100,000 loan principal is repaid in a single, balloon payment at the end of year 10. Also assume that inflation is 3 percent each year and that Sara and Jonathan's interest payments satisfy the definition of deductible "qualified residence interest" within the meaning of section 163(h)(3). Under current law, Sara and Jonathan's home basis remains unchanged as time passes, they can deduct 100 percent of their $5,000 interest payments each year under section 163(h)(3), and National Bank must include 100 percent of the $5,000 annual interest payments under section 61(a)(4).

If current law were amended to index basis for inflation, however, both Sara and Jonathan's home basis and the bank's $100,000 loan principal basis would increase by 3 percent each year. Upon the payment and receipt of the $5,000 in nominal interest each year, $3,000 would be recharacterized as principal payments ($100,000 x 0.03), nondeductible by Sara and Jonathan (notwithstanding the "interest" label in their loan documents) and excludable as a "principal" receipt by the bank (ditto). Can you imagine politicians trying to explain to voters why a portion of their annual interest payment on their home loan is not *really* "interest" (regardless of what their loan documents say) and thus not deductible, notwithstanding section 163(h)(3), thereby increasing their tax burden? And can you imagine politicians trying to explain why banks are henceforth permitted to exclude for income tax purposes a portion of each "interest" payment received from borrowers, thereby reducing the banks' tax burden?

Because of these political difficulties, what if all assets *except* debts (whether Parker's loan to National Bank in the form of his savings account or National Bank's loan to Sara and Jonathan) were indexed for inflation? That outcome would be even worse, as it would create enormous arbitrage problems. To illustrate, let's move from a personal residence to investment property or stock (often leveraged). Assume that Doug purchases land for investment at a cost of $100,000 on January 1 of year 1, borrowing the entire $100,000 from National Bank at 3 percent interest each year ($3,000). Also assume that Doug sells the land on January 2 of year 2 for $103,000 and repays his debt (both principal and interest) to National Bank.

[2]For an investment to be taxed according to income tax principles, both (1) the investment must be made with after-tax dollars, and (2) the return must be fully included. If either of those two requirements is absent, the investment is accorded more preferential consumption tax treatment.

If we ignore the tax consequences for a moment, we can see that Doug's purchase, ownership, and sale of the land is an economic wash for him. While he is able to sell the land for $103,000 after purchasing it for only $100,000 (entirely with borrowed money), Doug must use the entire $103,000 obtained on the sale to repay the $103,000 of total principal ($100,000) and interest ($3,000) owed to National Bank. He walks away with nothing, neither suffering a wealth reduction nor enjoying a wealth increase. Thus, his income tax consequences should also be a wash.

What tax consequences would arise, however, if (1) inflation is 3 percent each year, (2) the land's basis is indexed for inflation, (3) the bank's loan basis is *not* indexed for inflation, and (4) Doug can deduct the interest that he pays to National Bank under section 163?

If we index Doug's land basis for inflation, Doug's initial $100,000 land basis would increase to $103,000 at the time of sale to account for the 3 percent annual inflation that occurred during his ownership. Thus, when Doug sells for $103,000, he would realize neither a gain nor a loss under section 1001 ($103,000 AR less $103,000 AB, as increased for inflation). If National Bank's debt basis is not indexed for inflation but analyzed in nominal dollars, however, only $100,000 of the $103,000 that Doug pays to National Bank is characterized as principal, while $3,000 would be respected as "interest," which we have stipulated that Doug would be permitted to deduct under section 163, potentially offsetting other investment income that Doug realizes. Although Doug's leveraged investment was an economic wash, he would treat it for tax purposes as resulting in a wealth reduction if we permitted him to index his land basis for inflation but did not require him to index debt basis.

The reduced tax burden that Doug would enjoy by deducting $3,000 that does not represent an actual wealth reduction suffered by him is essentially funded by other taxpayers. It would represent pure economic rent — a mere transfer of wealth from other taxpayers (you and me) to Doug. Such a result would not only be unfair but economically inefficient, as it would encourage such arbitrage behavior on the part of taxpayers, which does nothing to generate wealth for the economy as a whole. The only way to avoid this result is to index both the land and the debt basis for inflation or to index neither basis for inflation. Indexing only the land basis but not the debt basis is both unfair and inefficient. Debt is a huge part of the economy, and much capital is purchased with leverage.

England introduced basis indexing in 1982 but repealed it in 1988 because of just such intractable problems.

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