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Inflation and the Tax Code: Guidelines for Policymaking

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Inflation and the Tax Code: Guidelines for Policymaking

Michael C. Durst*

TABLE OF CONTENTS

Introduction ................................................ 1218

I. The Effects of Inflation on Capital Gains,
   Depreciation Allowances, and Loan Balances ........ 1222
   A. Capital Gains .................................... 1222
      1. The Effects of Inflation on the Measurement
         of Capital Gains .................................. 1222
      2. Factors Other Than Inflation Affecting
         Capital Gains Policy ............................... 1226
      3. The Code's Historical and Current
         Approaches to Capital Gains .................. 1232
   B. Depreciation ..................................... 1238
      1. Inflation's Magnification of the Tax Burden
         on Income from Depreciable Assets .......... 1238
      2. Methods of Adjusting Depreciation
         Allowances for Inflation ....................... 1242
      3. The Code's Historical and Current
         Approaches to Depreciation Allowances ..... 1246
   C. The Effects of Inflation on the Tax
      Consequences of Interest Payments .......... 1251
      1. The Basic Effects of Inflation on the Tax
         Burdens of Lenders and Borrowers ........... 1251
      2. Net Tax Effects of Inflation on Holders of

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INTRODUCTION

Economists and policymakers have long recognized that unless the tax law incorporates corrective measures, price inflation can greatly magnify the effective rate of taxation on income from capital. Inflation magnifies the apparent “gain” enjoyed by holders of appreciated property, often to the extent
of creating taxable income when no economic income exists. Inflation, moreover, diminishes the real value of depreciation allowances,\(^1\) depriving the asset owner of deductions for the full economic costs of doing business.

To remedy this problem, the Treasury Department's 1984 tax reform plan,\(^2\) on which Congress in part based the Tax Reform Act of 1986,\(^3\) proposed a system for "indexing" various components of the tax code to adjust for the effects of future price changes. The Treasury plan would have permitted the owner of a capital asset to increase the asset's historical cost "basis" each year for inflation, so that capital gain reflected only the asset's real increase in value. Similarly, the plan would have adjusted depreciation allowances each year to reflect changes in the value of the dollar over time. As ultimately enacted, however, the Tax Reform Act of 1986 incorporated none of the Treasury's price adjustment mechanisms,\(^4\) leaving the political accord on which Congress based the current Code vulnerable to accelerations of inflation in the future.

The rejection of indexation in the 1986 Act reflects a number of concerns. Most importantly, while inflation increases the tax burden on capital gains and on income from depreciable property, inflation also confers tax benefits on debtors, who enjoy economic income from the shrinkage in the real value of their repayment obligations without any corresponding tax cost. Thus, taxpayers who have financed capital assets or depreciable property with debt arguably should not benefit from indexation of capital gains or of depreciation allowances. The practical difficulties of limiting indexation only to holders of equity-financed assets, or more ambitiously, as proposed in the Treasury plan,\(^5\) adjusting all taxpayers' interest payments and receipts to remove the distortions of inflation, have posed a significant impediment to attempts to adjust the tax base for inflation.

Other impediments are political in nature, including an apparent concern among some advocates of tax preferences for

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1. The tax laws generally base depreciation allowances on an asset's historical cost "basis," without adjustment for inflation since the time the taxpayer purchased the asset. See infra notes 68-80 and accompanying text.
4. See infra notes 56-64, 107-16 and accompanying text.
5. See infra notes 124-27 and accompanying text.
capital formation that allowing indexation might divert political attention from other, potentially stronger, investment incentives. Faced with this and other difficulties, Congress to date has rejected the incorporation of inflation adjustments into the Code, relying instead on lawmakers' ability to revise the Code periodically to adjust to changes in the rate of inflation.

This approach may reflect a failure to recognize the full economic and political significance of inflation’s effects on the tax burden on income from capital. It also may result from an exaggerated perception of the administrative and political difficulties of providing asset owners with some measure of insurance against the tax effects of inflation. Especially in a period of serious concern for federal revenues, the provision of some measure of inflation protection can respond to the most intellectually compelling demands for relief from taxation of income from capital, while avoiding the potentially more expensive alternative of across-the-board capital incentives. A limited degree of inflation protection would offer taxpayers a less volatile investment environment, and also could mitigate the political instability that has afflicted the tax code during the past decade.

Part I of this Article reviews the economic arguments that analysts have raised in favor of indexation of depreciation allowances and capital gains. It focuses both on the massive distortions of tax burdens that inflation can impose on holders of equity-financed assets, and on the difficulties of indexing when assets are debt-financed. This portion of the discussion gives attention to the situation of owners of “venture capital” enterprises—a situation that policymakers sometimes misunderstand, and which thus raises a special threat of inappropriate tax legislation.

Part II discusses the political consequences of the lack of an indexation system. The discussion concludes that an acceleration of inflation would upset the political balance underlying the current Code, and would very possibly open the Code to yet another wholesale revision.

Part III examines a number of factors that apparently have led to the rejection of indexation measures in the past. These factors include normative arguments against indexing, which

6. See infra notes 232-36 and accompanying text.
7. Very recently, however, legislators have expressed renewed interest in indexing. See, e.g., infra note 181 and accompanying text.
suggest that Congress should limit any policy of indexation, but
which are insufficient to justify the complete rejection of ex-
plicit indexation mechanisms in the 1986 Act. The discussion
also addresses the possibility that an interest in tax instability
on the part of various participants in the tax legislative process
has contributed to the rejection of indexation mechanisms.
This possibility does not in itself undermine the normative ar-
guments against indexation, but it suggests that Congress may
have given those arguments more deference than they warrant.

The Article concludes generally that a “safety valve” ap-
proach to partial indexation of the tax base could protect asset-
holders from the most serious potential distortions of inflation,
while at the same time responding to many of the economic
and political factors that may render full indexation infeasible.
The safety-valve approach, based in part on a measure proposed
in the House version of the 1986 Act, would provide for infla-
tion adjustments only to the extent that inflation significantly
exceeds the level legislators presupposed in reaching the polit-
ical accommodation reflected in the Act. The proposal offered
here departs from the House version in a novel fashion, how-
ever, by making the safety-valve adjustment available only to
asset-owners who accept a partial indexation of interest deduc-
tions, effectively limiting the availability of inflation adjust-
ments to the extent that assets are debt-financed. This
approach responds to the concerns associated with debt financ-
ing without the need for cumbersome attribution rules, such as
those requiring the “tracing” of debt obligations to particular
depreciable or capital assets. Congress could employ the pro-
posed election in connection with a wide range of policies to-
ward the taxation of income from capital, including the full
indexation of capital gains and depreciation, or implicit indexa-
tion through accelerated depreciation or a capital gains
preference.

The Article’s approach should be adaptable to the problem
of unindexed depreciation allowances without serious technical
difficulty, and the Article proposes that Congress incorporate
safety-valve protections into the Code’s current depreciation
provisions at the earliest opportunity. The design of inflation
protection mechanisms for the capital gain provisions is more
difficult. Nevertheless, by applying the principles underlying
the safety-valve approach to depreciation allowances, this Arti-
cle suggests mechanisms that might render a future capital

8. See infra notes 193-94 and accompanying text.
gains policy more satisfactory on both economic and political
grounds.

I. THE EFFECTS OF INFLATION ON CAPITAL GAINS,
DEPRECIATION ALLOWANCES, AND
LOAN BALANCES

A. CAPITAL GAINS

1. The Effects of Inflation on the Measurement of Capital
Gains

The Tax Reform Act of 1986 represents, in broad outline, a
movement closer to an "accretion" model of the tax base, ac-
cording to which taxable income consists of every increment to
the taxpayer's net wealth during the year.9 Under the accre-
tion model, the theoretically proper treatment of capital gain is
clear: to the extent that a taxpayer owns assets that have in-
creased in value during the taxable year, the taxpayer has en-
joyed an accession to wealth and therefore has income subject
to taxation.10

In practice, Congress never has sought to conform the tax
code to this theoretically pure treatment of capital gain. A true
accretion system would impose a tax on capital gains each year
as those gains accrue, whether or not the taxpayer sells an asset
during the taxable year.11 In practice, the Code imposes a tax
only when the owner sells the asset, at which time the Code
imposes a tax on the taxpayer's full profit from the asset, as
measured by the difference between the amount realized on
the sale and the asset's original cost, or "basis."12 If, for exam-
ple, a taxpayer purchases a painting for $1000 in Year 1 and
sells it for $1,100 in Year 2, the taxpayer has earned gross in-

9. H. SIMONS, PERSONAL INCOME TAXATION (1938), represents the most
commonly cited statement of the accretion model. See generally Goode, The
Economic Definition of Income, in COMPREHENSIVE INCOME TAXATION 1 (J.
Pechman ed. 1977) (offering historical analysis of accretion model). Commen-
tators often contrast the accretion model with a competing "consumption tax"
model of the tax base, a fact that has affected policymaking significantly. See
generally Andrews, A Consumption-Type or Cash Flow Personal Income Tax,
87 HARV. L. REV. 1113, 1145-65 (1974) (comparing accretion and consumption
models of tax base); see also infra text accompanying notes 89-92 (discussing
consumption-tax approach to depreciation).

for capital gains taxation under accretion model).

11. Id.

come of $100—the difference between the amount realized of $1100 and the basis of $1000.

Price inflation can create enormous distortions in measuring gross income from capital gains—distortions that do not arise when measuring income from the performance of services. Consider first, as a "baseline," the situation of a taxpayer who earns a salary of $40,000 in Year 1. If this income is taxed at an average rate of twenty-five percent, the taxpayer will pay a tax of $10,000. If, between Year 1 and Year 2, inflation occurs at a rate of ten percent, and if the taxpayer's wages increase to keep pace with inflation, the taxpayer's nominal earnings during Year 2 will be $44,000 and the tax, again imposed at a rate of twenty-five percent, will be $11,000. The real value of this $11,000 of tax in terms of lost purchasing power will be precisely equal to that of the $10,000 paid in tax in the previous year. Inflation will not have changed the taxpayer's real tax burden at all.

Under a progressive system of taxation, that is, one in which tax rates increase with the taxpayer's income, inflation could adversely affect the taxpayer by "bumping" the taxpayer into a higher tax bracket. In that circumstance, inflation would increase the taxpayer's real burden by increasing the rate that the taxpayer pays on income that has not increased in real value. In legislation enacted in 1981, however, Congress eliminated this problem of "bracket creep" by indexing the rate brackets to prevent inflation from affecting the tax rate—and thus the real tax burden—on the taxpayer's income from wages.

The situation of the taxpayer who earns income from the appreciation of capital assets differs significantly. Consider

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13. The general effect of inflation on the computation of capital gains is well known. For a useful introductory discussion, see, for example, R. Goode, The Individual Income Tax 183-86 (1976); see also H. Simons, supra note 9, at 155-56.

14. See Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 104, 95 Stat. 172, 188-90; see also I.R.C. §§ 1(f), 1(g)(4) (West 1989) (indexing "cutoff" points in rate brackets themselves); id. § 151(d)(3) (indexing level of personal exemption); id. § 63(c)(4) (indexing level of standard deduction).

"Bracket creep" is "[t]he situation in which incomes rise due to inflation, and that rise puts taxpayers in higher income tax brackets so that a large percentage of their income is automatically paid to governments." D. Moffat, Economics Dictionary 32 (2d ed. 1983).

15. Virtually all discussions of inflation and the tax code point to the conceptual independence of bracket indexation from indexation of capital gains, depreciation allowances, and other elements of the tax base. See, e.g., Brinner, Inflation and the Definition of Taxable Personal Income, in Inflation and
again the situation of the taxpayer who purchases a painting for $1000 in Year 1. Assume also that in a year in which neither inflation nor deflation occurs, the painting increases in value to $1100.\textsuperscript{16} If the taxpayer sells the painting at the end of the year, the taxpayer will have gross income of $100 and, assuming a tax rate of twenty-five percent, the taxpayer will owe a tax of $25.

Assume now, however, that in addition to a real increase in the painting’s value from $1000 to $1100, the economy experiences general price inflation during the year of ten percent. The nominal value of the painting then will be $1210—it’s new real value of $1100, inflated by an additional ten percent to reflect the change in the value of the currency. If the taxpayer now sells the painting, the taxpayer will have taxable income of $210: the amount realized of $1210 minus the basis of $1000. Assuming the tax rate remains unchanged at twenty-five percent, the taxpayer will owe a tax of $52.50. Inflation of only ten percent thus increases the taxpayer’s liability by more than 100 percent, from $25 to $52.50.

This distortion arises from the anomaly of measuring the amount realized in nominal, inflated currency units, while measuring the taxpayer’s cost in pre-inflation currency units. This procedure is no more valid theoretically than would be an attempt to measure the amount realized in Italian lire and the taxpayer’s cost in French francs. Proper measurement of the taxpayer’s income requires that the Code measure both the taxpayer’s gross receipts (the amount realized) and the taxpayer’s costs of earning income (the amount the taxpayer originally paid for the capital asset) in the same unit of currency.

Although it is perhaps natural to view inflation as a problem of importance only over the long term, inflation can seriously distort the measurement of gain even from assets held for only short periods of time. During the course of a single year, for example, the real increase in an asset’s value might amount to only six percent, while inflation might reach ten percent. Most of the apparent gain from the asset over this short period actually would be the result of inflation.\textsuperscript{17} Indeed, if both the

\textsuperscript{16} The increase might result, for example, from changing critical perceptions of the artist’s work.

\textsuperscript{17} If, for example, the taxpayer purchased the asset at the beginning of the year for $100, its total nominal value at the end of the year would be $116,
asset's real increase in value and the rate of inflation remain constant over the asset's life, the proportion of the apparent gain from an asset attributable to inflation actually is greater the shorter the asset's holding period.\textsuperscript{18}

The tax laws can remove the distortion of inflation by indexing the asset's tax basis\textsuperscript{19}—that is, by increasing the basis each year to account for inflation, so that at any given time the basis reflects up-to-date currency units. The painting considered above would have an indexed basis of $1100 at the time of reflecting both the real growth of six percent and the inflation of ten percent. Ten-sixteenths (more than sixty percent) of the "gain" would be illusory.

\textsuperscript{18} For formal proof of this proposition, see Brinner, \textit{supra} note 15, at 127 n.7.

As an example, consider two assets that the taxpayer purchased originally for $100. The taxpayer holds one for one year and the other for five years. Throughout the holding periods of both assets, the annual rate of growth in the assets' real value is four percent and the annual rate of inflation is six percent. The asset held for one year will produce an apparent capital gain of ten dollars, of which six dollars—sixty percent—results from the distortion of inflation. The owner of the asset held for five years will have an apparent capital gain of $61.05, that is, the asset's new value of $100 \times 1.10^5$, or $161.05$, minus the taxpayer's original cost of $100. Of this amount, the inflationary gain, that is, the increase in the asset's price attributable solely to inflation, equals $100 \times 1.06^5 - 100$, or $33.82$, which is 55.3% of the apparent gain of $61.11$. While the distortion arising from inflation remains serious for the asset held for five years, it is proportionally more serious for the asset held for only one year.

This phenomenon can be understood intuitively by observing that inflation's magnification of apparent capital gain arises from a failure to adjust the asset's basis from year to year for inflation. If an asset is experiencing real growth as well as inflationary growth, the asset's basis—even if adjusted for inflation—will comprise a progressively smaller proportion of the asset's market value each year. As basis becomes a progressively smaller fraction of the asset's value, a failure to adjust basis for inflation becomes relatively less significant.

The author is grateful to Charlotte Crane for discussion of this point.

\textsuperscript{19} See 2 U.S. TREASURY DEP'T, \textit{supra} note 2, at 178-88.

The problem of inflation arises not only with respect to "capital" assets, which taxpayers typically hold for appreciation over the relatively long term, but also with respect to inventory assets that taxpayers purchase for sale in the ordinary course of a trade or business. The Code generally addresses the problem of inflation accounting for inventory by permitting taxpayers to use a "last in first out" ("LIFO") method of inventory accounting. I.R.C. § 472 (West 1989). The use of LIFO helps to offset the effects of inflation when the taxpayer maintains a steady schedule of inventory accumulation and sales. LIFO, however, is far from precise, a situation that has prompted suggestions for reform. See, \textit{e.g.}, 2 U.S. TREASURY DEP'T, \textit{supra} note 2, at 189-92. This Article does not address the problem of inflation indexation of inventories, although the principles raised in the discussion of capital gains are applicable to the problem of inventories. \textit{Cf. id.} at 191-92 (proposing more precise method of indexation for inventories).
sale—the original basis of $1000 multiplied by 1.10 to reflect the inflation of ten percent. Gross income from the sale of the painting would be $110, the difference between the amount realized of $1210 and the indexed basis of $1100. The tax would be $27.50, twenty-five percent of $110—ten percent more than the pre-inflation tax of $25.00, which is exactly the result required to place the seller in a position equivalent to that of the taxpayer who earns income from wages.

2. Factors Other Than Inflation Affecting Capital Gains Policy

In fact, the situation is much more complicated than the simple example used above might suggest. Leaving aside for the moment the difficulties that arise when taxpayers finance capital assets with debt, the most serious complication results from the taxpayer's ability to defer taxation under the rule of realization. Although a true accretion system would impose a tax each year on increments in an asset's value as those increments accrue, the rule of realization permits the asset-owner to postpone tax on all increments of value until the taxpayer chooses to sell the asset. Moreover, under provisions that often are criticized, but which to date have withstood attempts at repeal, if the taxpayer holds an asset until death the asset receives a new, market-value basis, commonly called a "stepped up" basis, in the hands of the taxpayer's successor. Thus, the Code effectively forgives taxes on capital gains accrued during the taxpayer's lifetime.

The benefits from deferring taxation of accrued capital gains generally will increase the longer the taxpayer holds the asset. Ultimately, the benefits from deferral will outweigh the negative effects of inflation on the taxpayer, although the taxpayer probably will reach this point only after a very long holding period. The value of deferral is, of course, much greater if

20. See supra text accompanying notes 11-12.
22. Suppose, for example, that a taxpayer purchased corporate stock in 1932 for $1000 and holds the stock until the taxpayer's death in 1989, when the stock is worth $100,000. The taxpayer's successor would take the stock with a new basis of $100,000, thereby obtaining forgiveness of taxation on the $99,000 of unrealized gain. See, e.g., 2 B. Bittker, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS A 41.4 - 41.5 (1981 & Supp. 1988); Note, Carryover Basis: The Case for Repeal, 57 Tex. L. Rev. 204, 214-24 (1979).
23. A comparison of the amounts that a taxpayer would retain after tax at the ends of holding periods of varying lengths, on the sale of an asset purchased originally for $100, under accrual taxation with inflation adjust-
the taxpayer dies before selling the asset, so that capital gain taxes are forgiven. Despite the high value of deferral in many circumstances, it is very unlikely that, in the aggregate, the benefits of deferral compensate taxpayers for the detriment of inflation. Nevertheless, the existence of deferral makes it impossible to obtain a truly “neutral” result simply by indexing asset basis for inflation.24

ments and under realization taxation without inflation adjustments, illustrates this point. The following table assumes that the asset’s value increases in real terms at a constant five-percent annual rate, that inflation also occurs at a constant five-percent annual rate, and that all gains are subject to taxation at the rate of 25%:

<table>
<thead>
<tr>
<th>Holding Period (Years)</th>
<th>Taxpayer Retains Under Accrual Taxation With Inflation Adjustments</th>
<th>Taxpayer Retains Under Realization Taxation Without Inflation Adjustments</th>
</tr>
</thead>
<tbody>
<tr>
<td>5</td>
<td>$152</td>
<td>$121</td>
</tr>
<tr>
<td>10</td>
<td>231</td>
<td>195</td>
</tr>
<tr>
<td>15</td>
<td>352</td>
<td>313</td>
</tr>
<tr>
<td>20</td>
<td>535</td>
<td>505</td>
</tr>
<tr>
<td>25</td>
<td>814</td>
<td>813</td>
</tr>
<tr>
<td>30</td>
<td>1,238</td>
<td>1,309</td>
</tr>
</tbody>
</table>

This taxpayer would reach the “break-even” point—when the benefits of deferral outweigh the effects of inflation—after holding the asset for between 25 and 30 years, with the break-even point occurring between the 25th and 26th years.

In the table, the amount the taxpayer retains under accrual taxation with inflation adjustments is computed according to the formula $X = A \cdot \left(1 + \frac{p + (1-t)r}{n}\right)^n$, where $X$ equals the amount retained by the taxpayer, $A$ equals the asset’s original value, $p$ equals the rate of inflation, $t$ equals the rate of taxation, $r$ equals the asset’s real rate of growth, and $n$ equals the length of the holding period. The amount the taxpayer retains under realization taxation without inflation adjustments is computed according to the formula $X = A \cdot \left(1 - t\right) \cdot \left(1 + p + r\right)^n$, using the same definitions.

For more extensive discussions of the relative magnitudes of the effects of inflation and deferral, under various assumed rates of inflation and real interest rates, see Brinner, Inflation, Deferral and the Neutral Taxation of Capital Gains, 26 Nat’l Tax J. 565, 565-74 (1973); Congressional Budget Office, supra note 15, at 72-81.

24. The need to take account of losses, as well as gains, further complicates the task of achieving truly neutral taxation. Just as increases in an asset’s value, under the accretion model, should increase the taxpayer’s income subject to taxation, declines in the value of an asset diminish the taxpayer’s net worth and should lessen the taxpayer’s income subject to tax. The Code applies the rule of realization to losses as well as to gains, so that just as the taxpayer must include realized gains in gross income, I.R.C. § 61 (West 1989), the taxpayer may deduct realized losses, I.R.C. § 165 (West 1989).

Strict adherence to this system would give the taxpayer an enormous advantage, because the taxpayer would be free to defer taxation of gains indefinitely by delaying asset dispositions, while disposing of assets promptly to
The competing effects of inflation and deferral are not the only factors that have affected the formulation of capital gains policy. Commentators and policymakers have raised many arguments for taxing capital gains more leniently than a simple application of the accretion model suggests, and several of these arguments continue to exert a strong influence on policymaking.\(^2\)

First, under the rule of realization, very large unrealized capital gains—with correspondingly high potential tax liabilities—can accrue over time. These potential tax liabilities can deter investors from adjusting their portfolios to take account of changing economic conditions. This “lock-in” will more seriously affect assets held for relatively long periods of time.\(^2\) The lock-in effect is simply a by-product of a realization regime

realize any accrued losses. To limit this opportunity, the Code permits taxpayers to deduct capital losses during a year only to the extent of the taxpayer's capital gains during that year, plus an additional $3000 allowance for noncorporate taxpayers. I.R.C. § 1211 (West 1989). The taxpayer generally can carry unused losses forward to a subsequent year in which the taxpayer has capital gains. I.R.C. § 1212 (West 1989).

These capital loss disallowance rules do not wholly eliminate the advantages that taxpayers can enjoy by pursuing a policy of realizing losses currently but deferring gains indefinitely. At least to the extent that the taxpayer's total gain over time exceeds the taxpayer's losses, the taxpayer is able to realize substantial tax benefits from capital losses, by using these losses to offset any capital gains that the taxpayer chooses to realize, while deferring indefinitely the taxation of any remaining net gains. The $3000 “free allowance” further enhances the taxpayer's ability to benefit from a policy of realizing losses promptly while deferring realization of gains.

25. For a useful historical summary of arguments in favor of preferential treatment of capital gains, see Blum, *A Handy Summary of the Capital Gains Arguments*, 35 TAXES 247, 247-66 (1957). Some of the early arguments appear spurious by contemporary standards and no longer affect policymaking significantly: for example, the argument that capital gains should be classed as accretions to “capital” rather than as “income.” Cf. id. at 248-49. This Article limits discussion to arguments that continue to figure prominently in policy deliberations. For brief summaries of these arguments, see STAFF OF THE JOINT COMM. ON TAXATION, 101ST CONG., 1ST SESS., TAX TREATMENT OF CAPITAL GAINS AND LOSSES 18-29 (Jt. Comm. Print 1989) [hereinafter STAFF OF THE JOINT COMM. ON TAXATION]; M. GRAETZ, FEDERAL INCOME TAXATION 675-79 (2d ed. 1988).

26. An investor will choose to dispose of an asset when an alternative investment offers the prospect of greater return over time. The investor will make the change, however, only when the additional value of the proposed new investment exceeds the tax cost of disposing of the old investment. See Gravelle & Lindsey, *Capital Gains*, 38 TAX NOTES 39T, 402-03 (1988); see also infra text accompanying notes 171-77 (discussing pending legislative debate over capital gains policy). At least when increases in asset value tend to outweigh decreases over time, the tax cost of disposing of the old investment will tend to increase the longer the taxpayer holds the asset.
that offers substantial incentives to hold capital assets by offering opportunities for deferral. Nevertheless, a concern that lock-in might cause market stagnation has, over the years, lent support to the argument that Congress should provide some relief from taxation at the time a taxpayer sells an asset, especially when the owner has held the asset for a relatively long period of time.27

Additional support for relief from capital gains taxation historically has arisen from an explicitly stated desire to promote savings and investment by lowering the burden of taxation on income from capital assets.28 While income taxation probably poses some disincentive to participation in any income-producing activity, the rate of taxation arguably affects the decision whether to save more than it affects the decision whether, for example, to adjust the level of one’s participation in the labor force.29 Thus, considerations of economic growth often have motivated arguments for lighter taxation of capital gains.

A related motivation for preferential taxation of capital gains has arisen from the special concerns of investors in relatively risky, “venture capital” operations. The venture capitalist is likely to invest in a large number of unsuccessful businesses, but also will have a few extremely profitable investments. The appreciation in value of the successful investments typically will be very large in relation to the investor’s out-of-pocket outlay for the business. In tax terms, the investor’s basis in the investment will be very small compared to the invest-

27. See, e.g., S. REP. NO. 1263, 95th Cong., 2d Sess. 192 (1978) (referring to lock-in effect to justify lowering tax rate on capital gains in 1978). The lock-in effect continues to figure heavily in current debates over capital gains policy. See, e.g., Gravelle & Lindsey, supra note 26, at 401-03 (reviewing background and consequences of lock-in effect).

In addition to lock-in effect, the tendency for the rule of realization to “bunch” capital gains into a single taxable year has lent support to arguments for preferential taxation of capital gains. See, e.g., STAFF OF THE JOINT COMM. ON TAXATION, supra note 25, at 19-20. This argument has figured less prominently in policy debate since the 1986 Act’s general “flattening” of the rate structure. Id. at 20.


29. The extent to which this is true remains among the most controversial questions in tax policymaking. For a relatively recent study of views on this question and their implications for economic policy, see B. Bosworth, TAX INCENTIVES AND ECONOMIC GROWTH 177-204 (1984). The literature on this question is extensive and continues to grow rapidly. See, e.g., TAXES AND CAPITAL FORMATION (M. Feldstein ed. 1987).
ment's appreciation. Indexation of asset basis therefore will have little effect, in periods of inflation, on the level of gain recognized upon disposition of the investment.\(^\text{30}\)

The accretion model generally does not require that gain from the disposition of venture capital investments be adjusted for inflation. The venture capitalist's income from a successful endeavor, which the investor enjoys in the form of increases in the value of the investment, arises largely from the investor's personal services in identifying and promoting promising ventures at an early stage.\(^\text{31}\) Congress arguably should tax the venture capitalist's income, like other income from personal services, at the time the income accrues. The rule of realization, however, permits the venture capitalist to delay taxation until the investment is sold.

To the extent that the increase in value of a venture capital investment represents deferred income from personal services, it is appropriate under the accretion model to permit that increase to grow over time with inflation, until the taxpayer sells the investment. This will ensure that when an investor chooses to dispose of an investment, the gain properly will be stated in the currency units of the year of disposition, instead of the prior year in which the gain was accrued. Assume, for example, that a taxpayer makes a speculative investment of $032 in a research and development enterprise in Year 1. Suppose also that the enterprise immediately develops a valuable patent, giv-

\(^{30}\) A principal author of the Treasury Department's 1984 proposal for capital gains indexation described the reaction of those concerned with venture capital investments:

Those concerned with entrepreneurship and venture capital investment took little solace from [the indexation proposal]. . . Essentially, the argument was that many entrepreneurs who begin successful new ventures have little basis in their companies. They also argued that venture capitalists have relatively little basis in investments that are highly successful. Thus, . . . inflation adjustment is of little benefit to either of these groups. Those who were concerned about this problem took little comfort from the fact that the portfolios of most venture capital investors are sufficiently diversified that historical rates of return on them vary little from those of more mundane investment portfolios.


\(^{31}\) The income of the conventional investor, unlike that of the venture capitalist, tends to derive primarily from the value of the material resources committed to the investment.

\(^{32}\) It is unlikely that a taxpayer actually would have a basis of zero in a venture capital investment. The current example uses a basis of zero as an approximation of the situation in which a taxpayer places very little capital outlay into an investment in comparison to the gains that are likely if the investment is successful.
ing the investment a value of $1,000,000. If the taxpayer sells the investment immediately, the taxpayer will have a gain of $1,000,000, resulting in a tax, assuming a marginal tax rate of twenty-five percent, of $250,000.

Assume now that the taxpayer holds the investment for an additional year, during which the real value of the enterprise does not increase further, but during which inflation occurs at a rate of ten percent. At the end of the second year, the taxpayer sells the investment at its inflated value of $1,100,000. This will result in a gain of $1,100,000, yielding a tax of $275,000—an amount that is equivalent in purchasing power to the tax the investor would have paid had he or she sold the investment one year previously. If the tax laws reduced the gain for inflation, resulting in a gain of only $1,000,000, the investor's tax bill would be only $250,000 in new, "inflated" dollars, resulting in a real tax burden that is lower than the burden the investor would have faced had he or she sold the investment a year earlier. Adjusting the gain for inflation therefore would permit the investor's real tax burden to shrink.

Despite the absence of a need to adjust venture capital gains for inflation under the accretion model, venture capital arguably plays an especially important role in economic growth. Arguments for tax relief on gains from venture capital—typically in the form of exclusion from taxable income of a portion of realized gains—historically have enjoyed a high level of support. Conceptually, the arguments for some relief from taxation of venture capital gains are unrelated to those for inflation adjustment of asset basis. Politically, however, venture capitalists apparently have feared that if Congress did adopt a comprehensive system of indexation, many policymakers would think they had "solved" the "capital gains problem" and would not take measures to address the special concerns associated with venture capital.

Considerations involving the distribution of wealth make the formulation of capital gains policy even more complicated. Income from capital, virtually by definition, is concentrated among taxpayers with accumulated wealth. An increase in the level of capital gains taxation therefore could serve as an indi-

33. See McLure, supra note 30, at 1655-56.
rect mechanism for augmenting the tax code’s progressivity.\textsuperscript{35} A policy of permitting the effective rate of taxation on capital gains to grow as a result of anticipated increases in inflation may prove attractive to those who favor increased progressivity, if an explicit policy of more steeply progressive tax rates seems politically impracticable.

Many of the factors that bear on the formulation of a policy toward capital gains taxation defy quantitative measurement. Economists disagree sharply, for example, over the significance of the economic distortions occasioned by “lock-in,”\textsuperscript{36} as well as over the magnitude and economic importance of any disincentive to saving that taxes on income from capital might pose.\textsuperscript{37} The merits and relative significance of distributional concerns are even less susceptible of quantification. Any resolution of policy toward capital gains taxation, including the role of indexation, ultimately must reflect a reconciliation of competing concerns through the political process. An understanding of the potential role of inflation adjustment nevertheless can contribute to a more disciplined and constructive debate.

3. The Code’s Historical and Current Approaches to Capital Gains

Historically, the federal tax laws generally have resolved the capital gains question by allowing a preferentially low rate of taxation on income from “long-term” capital gains.\textsuperscript{38} Thus,
for example, before the 1986 Act, Congress permitted individual taxpayers to deduct from their gross incomes sixty percent of their net gain from capital assets held for longer than six months. This resulted in a maximum effective tax rate on long-term capital gains of twenty percent—forty percent of the maximum rate of fifty percent on "ordinary" income. Congress subjected corporations to a tax rate of twenty-eight percent on their net long-term capital gains, compared to a maximum corporate rate of forty-six percent on ordinary income.

Inflation seems to have played little, if any, role in the congressional decision to implement the partial exclusion of long-term capital gains in the early 1920s. Legislators justified the policy largely on the basis of lock-in, and by concern over the bunching effect of the rule of realization under a progressive rate structure.

The mechanisms for computing long-term capital gains under prior law were complex and could result in some anomalies. For example, the Code applied the preferential rate to long-term gains net of all losses, both short- and long-term. Under this regime, a long-term capital gain might reduce the taxpayer's ability to deduct short-term losses, which taxpayers generally could deduct at the ordinary income rate, so that the marginal rate on the taxpayer's long-term capital gain effectively equaled the ordinary income rate. See M. Chirelstein, Federal Income Taxation 292-93 (5th ed. 1988) (briefly describing mechanics of pre-1986 capital gain computations).

For a discussion of the historical motivations for implementing preferential treatment of capital gains see generally Wells, supra note 38; 2 B. Bittker, supra note 22, 50.1; see also Halperin & Steuerle, Indexing the Tax System for Inflation, in Uneasy Compromise: Problems of a Hybrid In-
By the mid-1970s, however, rapidly accelerating price increases had drawn a great deal of attention to the tendency of inflation to magnify the effective rate of taxation on capital gains.\textsuperscript{43} Growing political attention to questions of “capital formation” increased concern with lock-in and with the level of investment in high-risk enterprises, and added support for reductions in the taxation of income from capital.\textsuperscript{44} The House of Representatives responded by passing a plan for indexing capital asset basis.\textsuperscript{45} Congress ultimately rejected the House plan, however, choosing instead to increase the “exclusion ratio” for long-term capital gains from fifty to sixty percent.\textsuperscript{46} Several years later, in the Economic Recovery Tax Act of 1981, Congress reduced the maximum marginal tax rate from seventy percent to fifty percent, and retained the 1978 Act’s sixty percent exclusion ratio.\textsuperscript{47} This resulted in a maximum rate of taxation on long-term capital gains of twenty percent.

The Treasury Department’s 1984 tax reform proposals (“Treasury I”),\textsuperscript{48} which provided much of the foundation for the 1986 Act, rejected the use of tax relief as a means of encouraging particular economic activities, relying instead on a
policy of lower marginal tax rates on income from all sources. The Treasury plan's goal of measuring real income as precisely as possible, however, gave rise to a policy of explicit adjustment for the effects of inflation. Accordingly, Treasury I proposed the elimination of the capital gains preference, coupled with the indexation of asset basis to reflect changes in the consumer price index.\textsuperscript{49} Explicit indexation, the Treasury argued, would adjust for price changes much more precisely than the rough approach of the "exclusion ratio,"\textsuperscript{50} thereby lessening variations in the effective rate of taxation on income from assets having differing ratios of real to inflationary gains.\textsuperscript{51}

The Reagan Administration accepted the Treasury Department's proposals only in modified form, and submitted to Congress a revised plan ("Treasury II"),\textsuperscript{52} which retained the policy of encouraging capital investment by means of tax preferences to a substantially greater degree than did Treasury I. Treasury II retained an "exclusion ratio" for long-term capital gains of noncorporate taxpayers.\textsuperscript{53} In proposing retention of the exclusion ratio, the Administration probably acted, at least in part, in deference to the concerns associated with venture capital. In addition, to guard against the possibility that unanticipated high inflation might increase the tax burdens of other taxpayers, Treasury II offered noncorporate taxpayers, beginning in 1991, the option of electing indexation as a substitute for the exclusion ratio.\textsuperscript{54} For corporate taxpayers, Treasury II retained the prior law's maximum rate on long-term capital gains of twenty-

\textsuperscript{49} Id. at 100-05; id. at 178-88.
\textsuperscript{50} Id. at 101-05.
\textsuperscript{51} Id. at 100-03. The Treasury argued that, in view of its proposed across-the-board reduction in maximum marginal rates, the "rule of realization," with its attendant deferral of taxation of income from capital gains, offered sufficient incentive for capital accumulation:

\textquoteleft\textquoteleft[\text{The Treasury Department believes that with inflation indexing, reduced tax rates, and a rate structure with only a few wide income brackets there is no need for preferential tax treatment of realized capital gains, beyond that provided by the substantial benefits of deferral of tax until gains are realized and the exemption of gains on assets transferred at death.}\textquoteright\textquoteright

\textit{Id.} at 102.
\textsuperscript{52} THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY (May 1985) [hereinafter TREASURY I].
\textsuperscript{53} Id. at 164-73. The exclusion ratio was reduced from 60\% to 50\%, in deference to the overall reduction in marginal tax rates envisioned in the Administration plan. The maximum individual rate under the Administration proposal therefore was 35\%, yielding a maximum rate on long-term capital gains of 17.5\%.
\textsuperscript{54} Id. at 169.
eight percent, as opposed to a proposed maximum corporate rate on ordinary income of thirty-three percent.\textsuperscript{55} The plan did not afford corporate taxpayers an "indexation option."\textsuperscript{56}

The House version of the 1986 Act followed Treasury II's approach of retaining the exclusion ratio for noncorporate taxpayers.\textsuperscript{57} Unlike Treasury II, the House bill did not offer individual taxpayers the opportunity to elect explicit indexation in the event of high inflation in future years.\textsuperscript{58} In another departure from Treasury II, the House bill eliminated entirely the preferential rate on capital gains of corporations.\textsuperscript{59}

The Senate version of the 1986 Act extended the House bill's cutback of the capital gains preference by eliminating the preference for individual taxpayers as well as for corporations.\textsuperscript{60} The Finance Committee report again expressed the view that the proposed lowering of maximum marginal rates—to twenty-seven percent for individuals and thirty-three percent for corporations, under the Senate bill\textsuperscript{61}—rendered prefer-

\textsuperscript{55.} Id. at 168.
\textsuperscript{56.} Id.
\textsuperscript{57.} The House bill provided for an exclusion ratio of 42%, which, coupled with the bill's maximum individual tax rate of 38%, resulted in a maximum rate of tax on long-term capital gains of 22.04%. See H.R. REP. No. 426, 99th Cong., 1st Sess. 196-97 (1985).
\textsuperscript{58.} In explaining the House bill's retention of a preference for long-term capital gains of noncorporate taxpayers, the Ways and Means Committee's report referred to the lock-in and capital formation arguments that policymakers traditionally have used to support a capital gains preference, but made no mention of the role of inflation. The House report's "Reasons for Change" in support of the capital gains proposal states in its entirety:

Reduced rates on long-term capital gains of individuals have historically been viewed as alleviating the impact of high individual tax rates on dispositions of assets that have appreciated in value over time. The reduced rates may contribute to the efficient allocation of capital by minimizing the possible "lock-in" effect of higher regular rates, and may also serve as an incentive to investment.

The committee believes it is desirable to retain a reduced rate for net capital gains of individuals. In the context of the general reduction of regular individual tax rates under the bill, however, the committee does not believe that it is necessary to retain the same degree of differential between regular rates and capital gains rates as is afforded under present law.

\textit{Id.} at 196.

\textsuperscript{59.} In explanation of this proposal, the House report stated only: "The committee is of the view that corporate capital gain should not be taxed at preferential rates. Thus, the bill conforms the corporate capital gains rate with the regular tax rate for large corporations." \textit{Id.} at 232.
\textsuperscript{61.} \textit{Id.} at 220.
Emphasizing that the elimination of the capital gains preference was to serve as a “trade-off” for lower rates, the Senate bill provided that the maximum rate on long-term capital gains for individuals would remain at twenty-seven percent, even if Congress increased maximum marginal rates in the future. Like the House bill, the Senate bill provided no mechanism for indexing capital gains for inflation.

As finally enacted, the capital gains provisions of the 1986 Act conformed closely to those of the Senate bill. The 1986 Act eliminated the long-term capital gains preference for individuals as well as for corporations. Thus, the maximum rate on both long- and short-term capital gains is equal to the maximum marginal rate on ordinary income—twenty-eight percent for individuals and thirty-four percent for corporations. The revised Code contains provisions indicating that the rates on long-term capital gains are not to rise, even if maximum marginal rates generally increase in the future. Congress provided no indexation for inflation.

In approving the 1986 Act, Congress recognized that the trade-off of a capital gains preference for lower maximum marginal rates constituted a fragile political accommodation. Indeed, the 1986 Act retains the network of technical provisions that in the past have implemented the preference for long-term capital gains, “to facilitate reinstatement of a capital gains rate

62. The committee said:

The committee believes that as a result of the bill’s reduction of individual tax rates on such forms of capital income as business profits, interest, dividends, and short-term capital gains, the need to provide a reduced rate for net capital gain is eliminated. This will result in a tremendous amount of simplification for many taxpayers since their tax will no longer depend upon the characterization of income as ordinary or capital gain. In addition, this will eliminate any requirement that capital assets be held by the taxpayer for any extended period of time (currently six months) in order to obtain favorable treatment. This will result in greater willingness to invest in assets that are freely traded (e.g., stocks).

Id. at 169.

The Senate Finance Committee eliminated the capital gains preference late in its consideration of the 1986 Act, as committee members increasingly became convinced that drastically reduced marginal rates constituted the only political “engine” capable of bringing about successful passage of a reform act. See J. Birnbaum & A. Murray, Showdown at Gucci Gulch: Lawmakers, Lobbyists, and the Unlikely Triumph of Tax Reform 226-27 (1987).


64. I.R.C. §§ 1(j), 11 (West 1989).

65. I.R.C. §§ 1(j), 1201(a) (West 1989) (setting forth maximum marginal capital gain rates for individuals and corporations, respectively).
differential if there is a future tax rate increase.\textsuperscript{66}

Absent from the conference committee report—and indeed from any of the congressional reports on the 1986 Act—is explicit mention of accelerating inflation as another possible source of breakdown of the economic and political accord on which Congress based the 1986 Act. The 1986 Act eliminated the long-term capital gains preference at a time when inflation was much lower than it had been during the 1970s and early 1980s.\textsuperscript{67} The trade-off of the elimination of the capital gains preference, in return for lower marginal rates, may have been attractive to asset holders on the assumption that price levels would continue to rise at relatively modest rates. Should inflation increase markedly, however, effective rates of taxation on many taxpayers' capital gains would increase dramatically. This could lead to economic burdens and political demands that the drafters of the 1986 Act did not foresee, contributing to the reopening of the tax revision process once again.\textsuperscript{68}

B. DEPRECIATION

1. Inflation's Magnification of the Tax Burden on Income from Depreciable Assets

Under an accretion-model system, the tax laws would permit the taxpayer to deduct all of the economic costs of earning

\textsuperscript{66} H.R. CONF. REP. No. 841, 99th Cong., 2d Sess. II-107 (1986). Even if the possibility of reinstating a long-term capital gains preference in the future had not concerned Congress, it would have needed to retain many “capital gain” provisions to facilitate the continued limitations on the deductibility of capital losses. \textit{See supra} note 24; \textit{cf.} Note, \textit{Capital Loss Deduction Limits After the Tax Reform Act of 1986}, 66 TEX. L. REV. 159, 179-80 (1987) (suggesting revisions to current rules limiting capital losses). The 1986 Act, however, retains many provisions aimed solely at distinguishing between long-term and short-term gains. These provisions are of little current importance, but would be essential if Congress were to reinstate the pre-1986 capital gains preference. \textit{But see} I.R.C. § 170(e)(1) (West 1989) (continuing to distinguish between long-term capital assets and other property in limiting deductions for certain assets contributed to charitable organizations).


\textsuperscript{68} \textit{See infra} notes 146-84 and accompanying text.
gross income. When a taxpayer generates income with the assistance of plant or equipment, the purchase price of the asset does not constitute a "cost" at the time the taxpayer acquires it, because at that time the taxpayer simply exchanges one valuable asset, the cash used to purchase the productive asset, for another of equal value. This transaction in itself results in no reduction of the taxpayer's net wealth. Instead, the taxpayer's true cost of asset ownership consists of the decline in the asset's value from year to year—the asset's "economic depreciation."

Depreciation allowances at the "economic" rate have become a hallmark of tax neutrality in an accretion system. Depreciation deductions at a faster-than-economic rate provide deductions before the taxpayer actually incurs costs. This gives the taxpayer the equivalent of an interest-free loan from the government and effectively taxes income from the depreciable asset at a rate lower than that imposed on income from other sources. Similarly, depreciation allowances at a slower-than-economic rate deprive the taxpayer of timely recovery of actual economic costs and thus subject income from the depreciable asset to an effective rate of taxation higher than that imposed on income from other sources. Congress explicitly based the tax code's current depreciation allowances, established in the 1986 Act, on estimates of economic depreciation.

Traditionally, the tax laws have allowed depreciation deductions according to schedules that permit a taxpayer to de-

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69. See supra notes 10-11 and accompanying text.
70. See M. GRAETZ, supra note 25, at 391.
71. For the leading demonstration of the neutrality of economic depreciation, see Samuelson, Tax Deductibility of Economic Depreciation to Insure Invariant Valuations, 72 J. POL. ECON. 604, 605-06 (1964).
72. See infra notes 108-16 and accompanying text.

Economists Jeremy Bulow and Lawrence Summers argue that, because an asset's actual economic depreciation will vary from the estimates set forth in the tax law's depreciation schedules, the effective rate of tax on income from depreciable property will vary. Bulow and Summers argue that this uncertainty as to effective tax rates can place holders of depreciable assets at a disadvantage with respect to taxpayers who earn income from other sources, whose effective tax rates can be predicted with more confidence. To compensate for this effect, Bulow and Summers argue that deductions exceeding true economic depreciation are necessary to promote investment neutrality. Bulow & Summers, The Taxation of Risky Assets, 92 J. POL. ECON. 20, 21-22 (1984); cf. Durst, The Depreciation Debate: Have Bulow and Summers Suggested a Viable Compromise?, 30 TAX NOTES 259, 260-62 (1986) (interpreting and commenting on Bulow and Summers' study in connection with legislative discussions leading to 1986 Act). But cf. Gordon & Wilson, Measuring the Efficiency Cost of Taxing Risky Capital Income, 79 AM. ECON. REV. 427 (1989) (suggesting modifications to Bulow-Summers methodology).
duct a stated percentage of an asset's original purchase price each year until the taxpayer has fully recovered the asset's original cost. Over the course of an asset's life, however, the value of the dollar may change, and a deduction based on the asset's price in the year of purchase may no longer provide an adequate measure of the owner's economic loss during a later year.\textsuperscript{73} Because gross income from a depreciable asset; typically, the amount earned from selling goods or services produced with the help of the asset, will rise naturally with inflation, but in the absence of specific legal authorization depreciation allowances will not, taxable income from the asset will rise by more than the rate of inflation, resulting in an artificially high tax.\textsuperscript{74}

Reference to the economic depreciation of an automobile, as estimated by the Treasury Department in its 1984 proposal, illustrates this effect.\textsuperscript{75} Assuming that the automobile has an initial purchase price of $10,000, the economic depreciation of the asset, as well as gross income and taxable income from the asset, are as depicted in Table 1:

<table>
<thead>
<tr>
<th>Year</th>
<th>Gross Income\textsuperscript{76}</th>
<th>Depreciation\textsuperscript{77}</th>
<th>Taxable Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$4,491</td>
<td>$3,491</td>
<td>$1,000</td>
</tr>
<tr>
<td>2</td>
<td>3,118</td>
<td>2,467</td>
<td>651</td>
</tr>
<tr>
<td>3</td>
<td>2,175</td>
<td>1,771</td>
<td>404</td>
</tr>
<tr>
<td>4</td>
<td>1,524</td>
<td>1,297</td>
<td>227</td>
</tr>
<tr>
<td>5</td>
<td>1,071</td>
<td>974</td>
<td>97</td>
</tr>
</tbody>
</table>

\textsuperscript{73} See 2 U.S. TREASURY DEP'T, \textit{supra} note 2, at 154-55.

\textsuperscript{74} Portions of the following discussion are based on H. Calkins & M. Durst, Inflation and Capital Recovery—A Proposal for a Safety Valve 3-7 (Oct. 1985) (unpublished memorandum) (available in \textit{TAX NOTES} Microfiche Data Base, Doc. No. 85-9659; also available in LEXIS, Fedtax library, TNT file); see \textit{infra} notes 113-14 and accompanying text.


\textsuperscript{76} Gross income from the asset is estimated on the assumption that the asset generates enough income each year to compensate the owner for the asset's decline in value during the year, and to provide the owner with a before-tax rate of return of ten percent on the undepreciated value of the asset as of the beginning of the taxable year. For example, the undepreciated value of the asset as of the beginning of Year 1 is its original purchase price of $10,000. Gross income during Year 1 is estimated at $4491—the amount required to compensate the owner for the asset's depreciation of $3491 during
Assuming that inflation causes gross income to increase by five percent each year, but Congress does not adjust depreciation for inflation, taxable income will be computed as follows:

Table 2—Taxable Income When Gross Income Rises With Inflation But Depreciation Does Not

<table>
<thead>
<tr>
<th>Year</th>
<th>Gross Income</th>
<th>Depreciation</th>
<th>Taxable Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$4,716</td>
<td>$3,491</td>
<td>$1,225</td>
</tr>
<tr>
<td>2</td>
<td>3,438</td>
<td>2,467</td>
<td>971</td>
</tr>
<tr>
<td>3</td>
<td>2,518</td>
<td>1,771</td>
<td>747</td>
</tr>
<tr>
<td>4</td>
<td>1,852</td>
<td>1,297</td>
<td>555</td>
</tr>
<tr>
<td>5</td>
<td>1,367</td>
<td>974</td>
<td>393</td>
</tr>
</tbody>
</table>

Taxable income in Year 1 ($1,225) is now twenty-two and one-half percent higher than taxable income in the absence of inflation ($1,000), although prices generally have increased by only five percent.

The disparity increases over the asset’s life, as inflation continues to run its course. In Year 5, taxable income after inflation ($393) is approximately 400% of taxable income before inflation ($97), although prices generally have risen by only about twenty-eight percent from Year 1 to Year 5. Focusing on the high percentage changes in the later years of the asset’s life risks magnifying the overall effects of inflation, because both gross income and taxable income are lowest in the later years, when the effect of inflation is greatest. Nevertheless, the overall effect is very large. Inflation at a rate of only five percent, in the example, has increased the present value of the investor’s tax burden, computed as of the time the investor purchased the asset, by more than forty percent over the life of the asset. Even moderate inflation can have a “devastating

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77. Under the Treasury proposal, automobiles would have been depreciable over a period of five years, using a “declining balance” rate of 32% per year—that is, each year the asset-owner could deduct 32% of the asset’s remaining undepreciated cost. 2 U.S. TREASURY DEP’T, supra note 2, at 161. The Treasury report noted that, under a pure declining-balance system, the taxpayer never reduces the basis of an asset entirely to zero, and that legislation implementing the Treasury proposal would need to modify the schedules to force them to “zero out” in the desired “close-out” year. Id. at 158. For purposes of the table in the text, the author has modified the asset’s declining-balance depreciation schedule slightly to achieve the desired close-out in the fifth year.

78. In the absence of inflation, and assuming a tax rate of 25% and a discount rate of 7.5% per year, reflecting both the 25% tax rate and the investor’s before-tax rate of return from the asset of 10%, the discounted present value


impact . . . on the present value of historical-cost depreciation."  

The effects of inflation on depreciation are not uniform among different categories of assets, a fact which compounds the economic distortion caused by inflation. Inflation will most seriously magnify the tax burden on relatively long-lived depreciable assets. The taxpayer purchasing a long-lived asset must "live with" the asset's original, indexed basis for a relatively long time. Shorter-lived assets are exhausted and repurchased more frequently, each time giving the owner a new depreciation basis reflecting the new price level at the time of purchase. The overall effect is that inflation not only creates a general bias against investment in depreciable assets, but also distorts the investor's choice among different categories of depreciable assets.80

2. Methods of Adjusting Depreciation Allowances for Inflation

Congress can remedy the distortions of inflation by allowing the owner of a depreciable asset to increase depreciation allowances each year to reflect changes in the value of the dollar. Because the Code currently states depreciation allowances as a percentage of the asset's remaining undepreciated basis, Congress can accomplish the adjustment by increasing the asset's remaining basis each year to reflect inflation.82 This adjustment will permit the asset owner to measure the deduction allowed for the costs of asset ownership (that is, the decline in the asset's value during the year) in the same currency unit that is used to measure gross income.

of the investor's expected tax bill is $514.08. (The tax bill is computed by reference to the "taxable income" figures from Table 1). If inflation occurs at a rate of 5% per year, however, as Table 2 illustrates, but no adjustments are made to depreciation allowances, the discounted present value (employing a discount rate of 12.5%—the previous rate of 7.5% increased to reflect the 5% inflation) of the investor's expected tax bill from the asset is $736.33. Introducing inflation at a rate of 5% thus has increased the investor's effective tax burden over the life of the asset by approximately 43%.

82. See 2 U.S. TREASURY DEP'T, supra note 2, at 158.
Table 3 indicates the effectiveness of this adjustment based on the example of the five-year asset employed above, when depreciation allowances, as well as gross income, increase with inflation:

**Table 3—Taxable Income When Both Gross Income and Depreciation Allowances Rise with Inflation**

<table>
<thead>
<tr>
<th>Year</th>
<th>Gross Income</th>
<th>Depreciation</th>
<th>Taxable Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$4,716</td>
<td>$3,666</td>
<td>$1,050</td>
</tr>
<tr>
<td>2</td>
<td>3,438</td>
<td>2,720</td>
<td>718</td>
</tr>
<tr>
<td>3</td>
<td>2,518</td>
<td>2,050</td>
<td>468</td>
</tr>
<tr>
<td>4</td>
<td>1,852</td>
<td>1,577</td>
<td>275</td>
</tr>
<tr>
<td>5</td>
<td>1,367</td>
<td>1,243</td>
<td>124</td>
</tr>
</tbody>
</table>

Here, taxable income in Year 1 ($1050) is five percent higher than it was in the absence of any inflation ($1000, as indicated in Table 1, above)—an appropriate result in view of the general price inflation of five percent. Similarly, taxable income in Year 5 ($124) is twenty-seven and eight-tenths percent higher than was taxable income in the absence of inflation ($97), a result that again is consistent with the assumption of five percent inflation over a period of five years.\(^3\) The indexing of depreciation allowances therefore results in a tax on income from depreciable property equivalent to that on income earned on a current basis, for example, on income from labor.\(^4\)

The explicit indexation of an asset’s basis is not the only means by which Congress might adjust depreciation allowances for inflation. As an alternative, Congress might simply provide increased depreciation allowances, on an *ex ante* basis, to reflect inflation anticipated over the life of an asset.\(^4\) As will be seen, Congress historically has favored this method of adjustment.\(^5\) This approach should prove satisfactory if inflation conforms to the assumptions incorporated in the predetermined schedules. Inflation, however, like many other economic variables, cannot be forecast with certainty, and depreciation schedules that incorporate estimates of future inflation will, over time, either overcompensate or undercompensate for actual price changes. If the schedules undercompensate, the tax system will provide

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3. In other words, five percent inflation occurring over a five-year period will increase prices generally by 27.8%.


5. See *infra* notes 93-116 and accompanying text.
inadequate capital recovery and will discourage capital investment. If the schedules overcompensate, the tax system will provide an unintended investment subsidy. Moreover, as the example immediately above shows, the resulting distortions might be large.\textsuperscript{86}

A third and relatively novel method of adjusting depreciation for inflation, advocated by economists Alan Auerbach and Dale Jorgenson, is to allow a single depreciation deduction in the year in which a taxpayer purchases an asset, equal to the discounted present value of depreciation expected over the asset's useful life.\textsuperscript{87} Because the asset purchaser would receive deductions equal in present value to those that Congress would allow under a policy of periodic deduction of economic depreciation, such an approach would preserve investment neutrality. Moreover, because the taxpayer would take the first-year deduction in full at the time the taxpayer purchases the asset, the real value of the deduction would be immune from the effects of inflation.

As was true with respect to capital gains, economic and political factors other than a desire for a neutral measure of net income may influence the choice of a depreciation policy. Most importantly, policymakers often argue that to encourage capital investment, Congress should shield income from depreciable assets from the full effects of the income tax, as it historically has shielded capital gains. This view has led, during the past three decades, to policies of explicitly "accelerated" depreciation schedules—schedules set deliberately to provide deductions at rates faster than estimated economic depreciation.\textsuperscript{88}

One form of accelerated depreciation that has attracted a good deal of attention consists of the immediate deduction, or "expensing," of the complete cost of an asset at the time the taxpayer purchases the asset.\textsuperscript{89} Expensing conforms to a con-

\textsuperscript{86} For a quantitative review of likely distortions, see Feldstein, supra note 84, at 36-39; Gann, Taxation of Capital Income Under Three Tax Reform Plans, 26 TAX NOTES 187, 188-90 (1985); Jorgenson & Sullivan, supra note 80, at 226.

To the extent that the use of \textit{ex ante} inflation adjustments increases the taxpayer's uncertainty as to the prospective effective tax rate on income from an asset, it raises the concern identified by Bulow and Summers, supra note 72.


\textsuperscript{88} See infra notes 97-103 and accompanying text.

\textsuperscript{89} The Code currently permits a limited amount of expensing, up to
sumption tax model of the tax base, under which a taxpayer is allowed to deduct all amounts saved or invested during the year.\textsuperscript{90} The outstanding feature of the consumption-tax model, for current purposes, is that it produces a result which is economically equivalent to the complete exemption from taxation of income from all forms of investment, including investment in depreciable assets.\textsuperscript{91}

Expensing therefore not only insulates investment in depreciable assets from the disincentive effects of income taxation, but by providing an effective tax rate of zero on income from all investments, it avoids distorting the choice among different depreciable assets. Moreover, because the taxpayer takes the entire deduction under expensing in a single instant, changes in the price level over time will not affect the deduction's real value.\textsuperscript{92}

\begin{table}[h]
\centering
\begin{tabular}{|c|c|c|}
\hline
\textbf{Year} & \textbf{Gross income (1-1/3 times amount in Table 1)} & \textbf{After-tax income (75\% of gross income)} \\
\hline
1   & $5,985 & $4,491 \\
2   & 4,157 & 3,118 \\
3   & 2,900 & 2,175 \\
4   & 2,032 & 1,524 \\
5   & 1,428 & 1,071 \\
\hline
\end{tabular}
\caption{Gross income and after-tax income for an investment of $10,000 per year, for purchases of equipment by small businesses. I.R.C. § 179 (West 1989).}
\end{table}

\begin{itemize}
\item $10,000 per year, for purchases of equipment by small businesses. I.R.C. § 179 (West 1989).
\item See Andrews, supra note 9, passim; Bradford, The Case for a Personal Consumption Tax, in WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE? 77-80 (J. Pechman ed. 1980). Under a consumption tax, amounts withdrawn from savings or investment during the year and not reinvested are included in gross income.
\item Using a format employed by Alvin Warren, this feature of expensing can be demonstrated by reference to the example of a five-year asset with an initial purchase price of $10,000 depicted in Table 1. See Warren, Accelerated Capital Recovery, Debt, and Tax Arbitrage, 38 TAX LAW. 549, 552 (1985).
\item If taxpayers are permitted to expense assets, an investor facing a marginal tax rate of 25\% can, with an out-of-pocket investment of $10,000, make an investment of $13,333 in the depreciable asset—$10,000 of the investor's own money, plus the tax savings of $3333 from the deduction of the $13,333 invested (that is, 0.25 \times 13,333 = 3,333). With a total investment of $13,333, gross income from the asset each year will be 1.3333 times the gross income from the $10,000 asset employed in Table 1. In view of the assumed tax rate of 25\%, gross and after-tax income from the asset will be as follows:
\item The resulting pattern of after-tax income from the $10,000 out-of-pocket investment under consumption-tax rules is identical to the pattern of before-tax gross income, indicated in Table 1 in the text, from the $10,000 investment under accretion-tax rules. Thus, the effect of consumption-tax treatment; that is, expensing, is to provide complete exemption from taxation of income earned by the taxpayer on the $10,000 out-of-pocket investment.
\item See Bradford, supra note 90, at 88.
\end{itemize}

The tax code could combine expensing with inflation-adjusted economic
3. The Code's Historical and Current Approaches to Depreciation Allowances

The tax laws never have sought explicitly to index depreciation allowances for inflation. From the earliest days of the federal income tax until 1981, however, the statutes and applicable administrative guidelines permitted increasingly accelerated depreciation schedules. For most of this period, policymakers seem to have based the acceleration more on the belief that accelerated schedules more accurately portray the true economic depreciation of assets in a technologically changing environment, and a desire to provide investment incentives, than on a desire to adjust for the effects of inflation. Additionally, in 1962, Congress augmented the accelerated depreciation schedules with an investment tax credit. This credit gave a purchaser of depreciable business equipment a tax rebate, in an amount ranging from seven to ten percent of the asset's cost, in the year in which the taxpayer purchased the asset—a move explicitly designed to provide an incentive, beyond economic

depreciation, or with its economic equivalent, the Jorgenson-Auerbach first-year capital allowance, see supra text accompanying note 87, in order to provide an inflation-proof recovery system with any desired level of incentive for capital investment. The tax laws might, for example, permit the taxpayer to expense a given percentage of the asset's cost, and to claim economic depreciation, or the equivalent Jorgenson-Auerbach deduction, on the rest. See Harberger, Tax Neutrality in Investment Incentives, in THE ECONOMICS OF TAXATION 299 (1980). If applied consistently, this form of incentive depreciation should provide equal effective tax rates on income from all categories of assets. There need be no conflict, therefore, between a desire to provide a moderate level of incentive through accelerated, but not instantaneous, depreciation and a desire to insulate depreciation allowances from the effects of inflation.


For example, in significantly accelerating depreciation allowances in 1954, the congressional tax-writing committees argued that the new schedules would result “in a timing of allowances more in accord with the actual pattern of loss of economic usefulness,” and referred to “[t]he incentives resulting from the changes.” H.R. REP. No. 1337, 83d Cong., 2d Sess. 23-24 (1954), reprinted in 1954 U.S. CODE CONG. & ADMIN. NEWS 4017, 4048; S. REP. No. 1622, 83d Cong., 2d Sess. 25-26, reprinted in 1954 U.S. CODE CONG. & ADMIN. NEWS 4621, 4656; see also Announcement 71-76, 1971-2 C.B. 503, 512-17 (announcing acceleration of depreciation allowances by administrative action in 1971, a period of both high inflation and economic slowdown, and emphasizing needs to provide better reflection of economic depreciation and to place United States industries in a more competitive posture).

depreciation, for capital investment.96

The rapid acceleration of inflation in the mid-1970s, however, coupled with persistently slow economic growth, brought the effects of inflation on depreciation closer to center stage. Business groups argued that high inflation tended to erode the value of the depreciation deductions over time and that, even beyond mere inflation adjustment, faster-than-economic allowances were needed to encourage an adequate level of capital investment.97 Aided by the change in the political environment symbolized by the landslide election of Ronald Reagan in 1980, Congress enacted depreciation allowances of unprecedented acceleration. Under the Accelerated Cost Recovery System (ACRS) enacted in 1981, asset owners could “write off” the value of most items of equipment over five years, a period far shorter than the actual estimated useful lives of most categories of equipment, and of buildings over fifteen years.98 The 1981 Act additionally raised the level of the investment tax credit from seven to ten percent for many assets.99

As the political storm of 1981 subsided, academic and government studies showed that, under reasonable expectations of inflation, the ACRS allowances, in combination with the investment tax credit, would offer investors negative effective tax rates on income from many assets.100 Thus, the allowances could provide investors with positive after-tax returns from in-

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96. The Senate Finance Committee report on the institution of the investment tax credit said, “Realistic depreciation alone . . . is not enough to provide . . . essential economic growth. In addition, a specific incentive must be provided if a high rate of growth is to be achieved.” S. REP. No. 1881, 87th Cong., 2d Sess. 11, reprinted in 1962 U.S. CODE CONG. & ADMIN. NEWS 3304, 3314.


100. For an early discussion of the negative tax rates that were projected under ACRS, see Gravelle, Depreciation Policy Options, 5 STUD. IN TAX’N, PUB. FIN. & RELATED SUBJECTS 126, 131 (1981). The 1982 Annual Report of the President’s Council of Economic Advisers highlighted the negative tax rates under ACRS. ECONOMIC REPORT OF THE PRESIDENT 122-27 (1982); see CEA Sees Negative Tax Rates on Some New Investment, 14 TAX NOTES 426, 426-28 (1982).
vestments that, on a before-tax basis, actually were unprofitable. Moreover, the ACRS allowances would generate widely varying effective tax rates on income from different depreciable assets.

In response to these concerns, Congress lengthened depreciation schedules slightly and adjusted the investment tax credit in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). Congress intended, under TEFRA, for the discounted present value of capital allowances on equipment, at projected rates of inflation, to approximate the immediate deduction, or expensing, of the asset's purchase price. If successful, this policy would have avoided negative effective tax rates, yielding instead effective tax rates of zero, and would in the process have eliminated the problem of varying effective tax rates across asset classes.

Inflation, however, fell sharply below the levels Congress had assumed when it established revised ACRS schedules in 1982. The attempt to simulate immediate expensing therefore failed. Strongly negative effective tax rates persisted on income from many categories of assets, and effective tax rates continued to vary widely across asset classes. This phenomenon—which arose directly from Congress's decisions in 1981 and 1982 to compensate for inflation by ex ante adjustments—helped fuel calls for “comprehensive” tax reform which gained special prominence in the presidential campaign of 1984, and resulted in the Treasury I study in November of that year.

Treasury I proposed the allowance of economic depreciation, based on statistical estimates of the rates at which assets of various kinds have tended to decline in value over time. The Treasury plan established an office to revise these estimates periodically in response to changes in the technological

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103. See supra notes 90-92 and accompanying text.
104. See supra note 67.
105. See 2 U.S. TREASURY DEP'T, supra note 2, at 156.
106. The Treasury I report pointed out, for example, that “[s]ince current [1984] rates of inflation are significantly lower than those prevailing when the ITC and ACRS were enacted, current law allows investment in depreciable assets to be recovered far more rapidly than under a neutral system of income taxation.” 1 id. at 105.
107. 2 id. at 152-76.
and economic environment.\textsuperscript{108} Most importantly for present purposes, Treasury I substituted explicit indexation of depreciation allowances for the previous attempt to compensate for inflation by \textit{ex ante} acceleration.\textsuperscript{109} Treasury I also eliminated the investment tax credit.\textsuperscript{110}

The Administration's revised reform plan, Treasury II, retained Treasury I's approach of basing depreciation schedules on statistically derived estimates of true economic depreciation, but superimposed an acceleration on the estimated economic allowances as an explicit incentive for capital investment.\textsuperscript{111} The Administration designed the Treasury II schedules to provide roughly equal effective tax rates across asset classes. Like Treasury I, Treasury II indexed asset basis for inflation.\textsuperscript{112}

The House version of the 1986 Act returned to an apparent policy of \textit{ex ante} adjustments for inflation through the acceleration of depreciation schedules. The House bill offered allowances that were roughly equivalent to the "economic" deductions of Treasury I, apparently based on an assumed inflation rate of four percent.\textsuperscript{113} As an important innovation, how-

\begin{footnotesize}
\textsuperscript{108} \textit{Id}. at 160-62. This proposal was retained in subsequent legislative proposals, and in the 1986 Act itself, but was eliminated from the Code in 1988. From 1986 until late 1988, § 168(i)(1) of the Code gave the Treasury authority to alter depreciation lives for particular classes of assets, based on studies of assets' actual declines in value. In the Technical and Miscellaneous Revenue Act of 1988, Congress repealed this authority, while continuing to instruct the Treasury to "monitor and analyze actual experience with respect to all depreciable assets." Pub. L. No. 100-647, § 6253, 1989 U.S. CODE CONG. & ADMIN. NEWS (102 Stat.) 3342, 3753 (amending I.R.C. § 168(i)(1)).

\textsuperscript{109} \textit{2 U.S. TREASURY DEP'T}, \textit{supra} note 2, at 158.

\textsuperscript{110} \textit{Id}. at 173-75. This proposal was retained in subsequent reform plans and in the final version of the 1986 Act. Pub. L. No. 99-514, § 211, 100 Stat. 2085, 2166-70.

\textsuperscript{111} \textit{TREASURY II, \textit{supra} note 52, at 132-63.}

\textsuperscript{112} \textit{Id}. at 164-73.

\textsuperscript{113} For a comparison of the depreciation allowances of the Treasury I and House plans, see Durst, \textit{supra} note 72, at 262 (using methodology employed in \textit{STAFF OF THE JOINT COMM. ON TAXATION, 99TH CONG., 1ST SESS., TAX REFORM PROPOSALS: TAXATION OF CAPITAL INCOME 85-90 (Comm. Print 1985)}). The Ways and Means Committee described its proposed depreciation schedules as providing a moderate level of investment incentive, see H.R. REP. No. 426, \textit{supra} note 57, at 146, although the analysis in Durst, \textit{supra}, suggests that if anticipated inflation is taken into account, the House allowances conformed closely to estimated true economic depreciation.

The House committee report explicitly rejected the notion of employing highly accelerated depreciation as an economic incentive: "Proponents of massive tax benefits for depreciable property have theorized that these benefits would stimulate investment in such property, which in turn would pull the entire economy into more rapid growth. The committee perceives that nothing of this kind has happened." H.R. REP. No. 426, \textit{supra} note 57, at 145-46.
\end{footnotesize}
ever, the House bill contained a “safety valve” provision, which allowed investors limited adjustments to depreciation deductions if inflation significantly exceeded anticipated levels in the future. The House bill permitted taxpayers to increase depreciation allowances by one-half of the extent to which inflation exceeded five percent in any given year. Thus, although the House bill did not provide full indexation of depreciation allowances, it partially mitigated the distortions that would arise if inflation were substantially to exceed the levels incorporated in the ex ante depreciation schedules.

In an avowed attempt to provide stronger incentives for capital formation, the Senate version of the 1986 Act provided allowances substantially more accelerated than those of the House bill. The Senate bill dropped the House proposal for “safety valve” inflation adjustments and instead relied entirely on ex ante acceleration to compensate for the anticipated effects of inflation.

Ultimately, the 1986 Act incorporated depreciation allowances that apparently are designed to afford “economic,” as opposed to accelerated, depreciation. Congress did not adopt any explicit indexation mechanism; rather it incorporated into the depreciation schedules an apparent ex ante adjustment for inflation at an assumed annual rate of slightly more than three percent, approximately the rate prevailing when Congress considered the legislation leading to the 1986 Act. The 1986 Act

114. See H.R. Rep. No. 426, supra note 57, at 154-55. The House apparently based the “safety valve” approach on a proposal by Hugh Calkins, then head of the American Bar Association Tax Section, but acting in his personal capacity, who, with the assistance of the author of this Article, offered the proposal to the Ways and Means Committee and other policymakers in the fall of 1985. See H. Calkins and M. Durst, supra note 74. The Calkins proposal was similar in structure to that adopted by the House, although the Calkins proposal would have allowed somewhat more generous inflation adjustments, permitting the taxpayer to adjust allowances by 80%, as opposed to 50%, of the extent to which inflation exceeded the specified “trigger” rate. Id. at 11-12; cf. infra note 181 (describing recently introduced bill to provide “safety valve” indexation of capital gains).

115. See S. Rep. No. 313, supra note 60, at 97-106. The Senate Finance Committee said in its report:

The committee believes some . . . acceleration in the rate of recovery of depreciation deductions should be provided to compensate partly for the repeal of the investment tax credit. The committee is cognizant that other nations heavily subsidize business investments through tax and other policies, and the committee does not believe such policies can be completely ignored.

Id. at 96.

116. Economist Alan Auerbach has estimated that assuming an inflation
thus leaves open the possibility that substantially accelerated inflation will diminish the real value of depreciation allowances, raising both economic and political pressures for revision of the current system.

C. THE EFFECTS OF INFLATION ON THE TAX CONSEQUENCES OF INTEREST PAYMENTS

1. The Basic Effects of Inflation on the Tax Burdens of Lenders and Borrowers

Consider first the very simple situation of a person, whether or not an asset holder, who borrows $100 for a period of one year. In the absence of anticipated inflation, the lender will charge the borrower annual interest equivalent to the lender's "time value of money"—the price the lender will demand for forgoing alternative uses of the borrowed funds during the year. For example, in the absence of anticipated inflation, the annual interest rate charged to a reasonably creditworthy borrower might amount to five percent.

Adding inflation to the equation complicates the picture. The lender will demand, in addition to compensation for the time value of money, compensation for the erosion that inflation will cause in the value of the borrower's repayment obligation during the course of the year. If inflation occurs during the year at an annual rate of ten percent, the real value of the borrower's repayment obligation would shrink at the rate of ten percent during the year, a result that would enrich the borrower at the expense of the lender. To compensate for this enrichment and to make the lender "whole," the parties must find some way of effectively increasing the amount of the repayment obligation during the year.119

rate of three percent, the 1986 allowances would result in effective tax rates on income from most categories of depreciable assets that are slightly higher than the statutory rate. See Auerbach, The Tax Reform Act of 1986 and the Cost of Capital, 1 J. ECON. PERSP. 73, 74-77 (1987). This result implies that the 1986 allowances generally approximate economic depreciation at inflation rates slightly lower than three percent.

117. The discussion in this subsection follows, in substance, the analysis in 1 U.S. TREASURY DEP'T, supra note 2, at 77, and 2 id. at 193-200.

118. For a general discussion of factors affecting the determination of interest rates, see R. BREALEY & S. MYERS, PRINCIPLES OF CORPORATE FINANCE 543-73 (3d ed. 1988).

119. Assuming an initial repayment obligation of $100, the real value at the end of the year, computed in "old," uninflated dollars, would be $100 / 1.10, or $90.90.

120. In the example, the amount of the repayment obligation must increase
To accomplish this adjustment in practice, lenders commonly require that interest payments include compensation for the time value of money (as well as for any risk of default), and an additional amount designed to compensate for the erosion of the value of the loan principal anticipated from inflation. Thus, in the above example, if the parties expected inflation to occur at a rate of ten percent per year, the borrower would be responsible for interest not of five but of fifteen percent: five percent to compensate the lender for the time value of money, plus ten percent to compensate the lender for the erosion in the value of the borrower’s repayment obligation. Interest thus commonly includes two components: a “real” component designed to compensate the lender for the time value of money and for bearing any risk of nonpayment, and an “inflation” component designed to offset the effects of inflation on the value of the principal.

To measure net income properly under an accretion-model tax system, Congress should permit a borrower who uses loan proceeds for income-producing purposes to deduct the true economic cost of maintaining the loan. In periods of inflation, the borrower’s economic cost of maintaining the loan is the difference between the borrower’s total interest expense (including both the time value of money and inflation components of interest, as well as any risk premium charged by the lender) and the economic benefit the borrower receives from the erosion of the real value of the repayment obligation. Thus, under a pure accretion system, if Congress permitted the borrower of a loan for income-producing purposes to deduct in full all interest paid on the loan, Congress also should require the borrower to include in gross income the amount by which inflation lowers the real value of the borrower’s repayment obligation.

The proper tax treatment of the lender, under an accretion-model system, mirrors that of the borrower. Congress should require the lender to include in gross income all interest payments received from the borrower. In addition, as the borrower receives an economic benefit from inflation’s erosion of the real value of the repayment obligation, the lender suffers an economic detriment. Congress should permit the lender to deduct the amount of this detriment.

In actual operation, the tax laws depart radically from the

from $100 to $110 dollars, the year-end equivalent, in terms of purchasing power, of the $100 in “old” dollars that the borrower received at the inception of the loan.
accretion model in their treatment of debt. Although the tax code does not include in gross income the economic benefit the borrower enjoys from the erosion in the value of the repayment obligation, the Code generally does allow the taxpayer to deduct the entire amount of interest payments made, including the inflation premium. As a result, the borrower can deduct inflation-related costs without paying an offsetting tax on inflation-related benefits. Conversely, the lender must include all interest payments in gross income, but does not receive any deduction for inflation's erosion of the value of the repayment obligation.

These imperfections in the tax treatment of debt would have no significant consequences if the borrower and lender shared the same marginal tax rate. The Code's undertaxing of the borrower as a result of inflation then would match precisely the overtaxing of the lender. In a competitive market for loans, lenders would pass their tax costs to borrowers in the form of additional interest, so that the cost of borrowing would be the same as it would be under a tax system that adjusted both interest deductions and receipts for inflation. The borrower and lender would be left in the same economic positions they would occupy if the Code conformed to the accretion model.

Borrowers and lenders, however, often do not face the same marginal tax rates. In many loan transactions, the lender faces an unusually low marginal rate or is entirely tax-exempt.

121. See Hickman, Interest, Depreciation, and Indexing, 5 VA. TAX REV. 773, 802 (1986). A taxpayer's "marginal tax rate" is the rate the taxpayer would pay on an additional dollar of income received. See D. MOFFAT, supra note 14, at 189.

122. One analyst has estimated that almost one-half of all interest payments are received by tax-exempt entities such as pension funds, or otherwise are received in tax-exempt form. See C. STEUERLE, TAXES, LOANS, AND INFLATION 48-49 (1985). The marginal tax rates of other interest recipients are difficult to determine. Historically, the Code has taxed banks and other financial institutions at relatively low rates, owing largely to generous rules for deducting anticipated loan losses, but the 1986 Act reduced this and other advantages. See generally O'Brien & Gelfand, Effects of the Tax Reform Act of 1986 on Commercial Banks, 34 TAX NOTES 597 (1987) (estimating effect of major changes in 1986 Act on bank profitability); O'Brien & Gelfand, Corrigendum: The Impact of the Tax Reform Act of 1986 on Commercial Banks, 34 TAX NOTES 1323 (1987) (concluding that 1986 Act might have moderately adverse effect on banks). The tax advantages accruing when a borrower is in a high bracket and a lender is in a low bracket almost certainly have caused disproportionate representation by low-bracket entities among the economy's lenders. The Treasury has noted:
from deducting the inflation component of interest will not match the corresponding tax detriment to the lender and inflation will result in an overall tax reduction.\textsuperscript{123}

In keeping with Treasury I's policy of adhering closely to the accretion model, the proposal would have implemented for the first time a system of explicit indexation for debt.\textsuperscript{124} On grounds of feasibility, Treasury I rejected the theoretically exact approach of computing the outstanding balance of each loan on an annual basis, and of including in the borrower's gross income, and excluding from the lender's gross income, the amount by which inflation had caused the real value of the loan principal to decline during the year.\textsuperscript{125} Treasury I instead employed the admittedly rough assumption that the "real" component of interest on long-term debt averages approximately six percent per year, and that interest paid in excess of six percent constitutes an inflation premium.\textsuperscript{126} Treasury I would have used this assumption to estimate the proportion of interest payments and receipts during the year that was attributable to inflation.

\footnotesize{[I]n a progressive tax system, overstatement of interest expense and income accentuates the existing incentive for lower tax-bracket taxpayers (including tax-exempt institutions) to be net creditors and higher tax-bracket taxpayers to be net borrowers. This so-called "clientele effect" occurs because the tax savings from interest deductions is greater for high-bracket borrowers than is the increased tax liability from interest income to low-bracket lenders. This clientele effect is aggravated during times of high inflation and corresponding high nominal interest rates.}

\textsuperscript{2} U.S. TREASURY DEP'T, supra note 2, at 194.
\textsuperscript{123} See infra notes 136-40 and accompanying text.
\textsuperscript{124} See 1 U.S. TREASURY DEP'T, supra note 2, at 77; 2 id. at 193-200.
\textsuperscript{125} Treasury I did not follow the conceptually correct approach of excluding from income or disallowing deduction of an amount of interest equal to the product of the inflation rate and the outstanding principal of debt. This procedure was viewed as inordinately cumbersome from an administrative standpoint, since in principle it would involve applying an inflation adjustment factor to the principal (calculated on the annualized basis) of every credit arrangement in the economy; compliance would have been difficult except on loans involving financial institutions or other sophisticated borrowers or lenders. In practice it would likely have resulted in "indexed" and "unindexed" classes of loans which would have been somewhat arbitrary, difficult to monitor, and subject to abuse.


\textsuperscript{126} 2 U.S. TREASURY DEP'T, supra note 2, at 194-98. "The formula's use of 6 percent—a rate that is high relative to historical real interest rates—was chosen to err on the side of a smaller than appropriate disallowance of interest deductions (although this decision also implied a relatively small interest income exclusion)." McLure & Zodrow, supra note 125, at 52.
For example, if the average long-term interest rate in the economy during the year was thirteen percent, Treasury I would have assumed that six percent represented real interest, and seven percent represented an inflation component. Based on this assumption, Treasury I would have permitted borrowers to deduct only six-thirteenths of any interest payments made during the year, and would have excluded from gross income an equivalent proportion of lenders' interest receipts.127

The Administration dropped Treasury I's debt-indexation proposal from the Treasury II reform plan, thus rendering interest indexation an early casualty of the legislative process that led to the 1986 Act. In large measure, the failure of the interest indexation proposal resulted from its sheer novelty to many participants in the tax reform process, as well as from opposition from the real estate industry, which relies heavily on debt financing.128 In addition, as the authors of Treasury I have acknowledged, the restricted time period within which they drafted Treasury I prevented them from addressing some important technical features of the plan.129

A concern over prospective revenue losses also contributed to the rejection of interest indexation in the 1986 Act.130 A sig-

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128. "The proposal for interest indexing was strongly opposed by those in the real estate and tax shelter industries." McLure & Zodrow, supra note 125, at 52.
129. Most notably, Treasury I's rough method of interest indexation reached inappropriate results for those taxpayers, such as banks, engaged in the business of borrowing and relending money:

Suppose, for example, that a bank borrows at 8% and lends at 10% at a time when the inflation rate is 4%. Under an ideal system of indexing, taxable interest income and allowable interest deduction would, in effect, both be reduced by four percentage points, leaving unchanged the two percentage points spread between borrowing and lending rates. The Treasury I proposal, however, in effect applied a fractional exclusion to net interest income or expenses. Thus, it would reduce the spread representing the taxable income of the bank by 40%. This illustration ... shows that the proposed technique of interest indexing would be defective for most net borrowers or lenders who are active as both creditors and debtors.

McLure, supra note 30, at 1630 n.28. Treasury I also implemented the interest indexation proposal under a transitional rule that the plan's principal author, in retrospect, acknowledged would pose hardships, especially for public utilities that recently had floated large issues of debt. Id. at 1655; see also Sunley, The Tax Challenge for the 1990s, 40 TAX NOTES 621, 624 (1988) (stating shortcut method was defective and stating need for further work on how interest paid and received should be adjusted for inflation).

130. See McLure, supra note 30, at 1655; McLure & Zodrow, supra note 125, at 52.
significant portion of interest paid consists of interest on federal government debt. The payer of this interest—the government—is tax-exempt, but the recipients comprise a mixture of taxable and tax-exempt entities. The indexation plan’s reduction of interest deductions therefore would not have raised tax revenue from this interest, but the exclusion from gross income of a portion of receipts would have reduced tax revenue. As the principal author of Treasury I subsequently has pointed out, the net effect on government revenues probably would have been limited, because the partial exclusion from gross income of receipts probably would have permitted the government to lower the rate of interest paid on its debt. Despite this argument, however, revenue concerns apparently helped to account for the rejection of Treasury I’s interest indexation proposals.


Many holders of depreciable assets and of assets held for capital gain finance the acquisition and holding of the assets through loans. As the discussion above suggests, these asset-holders experience two competing effects from inflation. First, inflation increases their effective tax burdens, either by magnifying the extent of apparent capital gain or by reducing the real value of depreciation allowances. At the same time, inflation decreases their effective tax burdens by increasing the value of the inflation component of interest, for which the Code allows deductions.

Historically, the offsetting nature of these competing effects has constituted a significant argument against providing any inflation adjustments at all. This argument, however, ignores the detrimental tax effects of inflation on holders of eq-

131. See McLure, supra note 30, at 1655; McLure & Zodrow, supra note 125, at 52 n.18.

132. Other factors contributing to the projected revenue losses of the Treasury I interest indexation proposals included the plan’s exemption of home mortgage interest payments, its de minimis rules, and its unintentionally generous treatment of financial institutions, supra note 126. See Halperin & Steuerle, supra note 42, at 372 n.34.

133. The recognition that inflation causes offsetting effects on the tax burden of holders of debt-financed assets has led to the belief “that you have to index the entire balance sheet if you do it at all.” Bristol, supra note 34, at 1028 (describing discussion at National Tax Association-Tax Institute of America conference on current tax policy issues); cf. STAFF OF THE JOINT COMM. ON TAXATION, supra note 25, at 28-29 (discussing partial indexation).
uity-financed assets. Moreover, the argument almost certainly overstates the inflation-related tax benefits accruing to holders of debt-financed assets. To recognize this, it is useful first to consider the competing effects of inflation on the tax burdens of holders of debt-financed depreciable assets, and then to consider the somewhat more complex situation of holders of debt-financed assets held for capital gain.

If the economic depreciation of a debt-financed asset occurs at the same rate as that at which the taxpayer amortizes the loan used to carry the property,134 the overstatement of taxable income from the decline in the value of depreciation allowances, and the understatement of taxable income from the allowance of a deduction for the inflation component of interest, will precisely balance in economic effect over the term of the loan.135 The aim of indexing depreciation allowances is to ensure that at the time the taxpayer takes each deduction, the amount of the deduction will be increased to account for the cumulative effects of inflation since the taxpayer purchased the asset. The aim of the lender in adding an “inflation premium” to interest is to reach an economic result similar to that which would result if, at the time the borrower repaid each increment of principal, that increment increased to account for the accumulated effects of inflation since the borrower purchased the asset. If the loan schedule calls for the borrower to repay the principal at the rate at which the asset depreciates, the total economic value of the inflation adjustments to depreciation and of the inflation component of interest should be identical over the term of the loan.

Of course, this balance between inflation’s overmeasurement and undermeasurement of taxable income will exist only for assets that the taxpayer finances entirely by debt. To the extent that the taxpayer has financed the asset in part from equity, inflation will impose a tax cost by reducing the real value of depreciation allowances without producing a countervailing

134. This congruence is likely, if it is assumed that the lender desires to extend financing as fully as possible without permitting the loan balance to exceed the remaining market value of the collateral, and that the borrower wishes to retain financing to the largest extent that the lender will permit. Under these assumptions, the lender will require repayments of principal at the rate at which the value of the capital erodes—that is, at the rate of the collateral’s true economic depreciation.

positive effect. Thus, for a very considerable class of depreciable assets,\textsuperscript{136} inflation poses an unmitigated tax detriment.

Even for assets that are entirely debt-financed, although inflation's undermeasurement and overmeasurement of taxable income should approximately balance, inflation's effects on the asset holder's overall tax burden probably will not balance. The taxpayer's ability to deduct the inflation component of interest is likely to provide a pure tax benefit only if the recipient of the interest faces no tax burden on its receipt. Otherwise, market mechanisms almost surely will shift some of the tax burden back to the borrower in the form of higher interest payments. Although many lenders are formally or effectively tax-exempt, many others are not, so that at least some of the apparent benefits borrowers enjoy as a result of inflation probably are illusory.

The mechanisms by which lenders can shift some of the tax burden of inflation back to borrowers are complex, and the magnitude of the shift almost certainly varies in different situations.\textsuperscript{137} The shift can occur in a straightforward fashion, as when lenders increase rates on adjustable-rate loans in periods of high inflation. In the case of a fixed-rate loan, the lender can shift the tax burden of inflation indirectly by increasing the rate demanded at the inception of the loan, to compensate for the risk that high inflation might impose an extra tax burden on the lender while the loan is outstanding.

The fact that the loan market consists of a mixture of taxable and tax-exempt lenders enormously complicates the market's response to accelerating inflation. The tax-exempt lender experiences no additional tax burden as a result of inflation, and thus has no immediate reason to shift any increased tax burden onto the borrower. The fully taxable lender will seek to pass along all of the increased tax burden. A likely result will be a partial shifting. Competitive pressure from tax-exempt lenders probably will constrain taxable lenders to some

\textsuperscript{136} Debt provides approximately 60% of total corporate financing in the United States. \textit{See} \textsc{National Bureau of Economic Research}, \textsc{The Taxation of Income from Capital} 237 (1984) [hereinafter \textsc{National Bureau of Economic Research}].

extent in their attempts to shift their tax burdens, while tax-
exempt lenders probably will raise their rates somewhat to
match the increases of taxable lenders.\footnote{Essentially, the ultimate effect of inflation on interest rates depends on the extent to which exempt lenders increase their lending in response to market demand, perhaps by shifting their portfolios from equity to debt. If exempt lenders can enter the market at will, taxable lenders will be constrained entirely from shifting their increased tax burdens to borrowers. This extreme result, however, is unlikely. \textit{See generally} Bossons, \textit{supra} note 137, at 954-57.} Moreover, on the as-
sumption that the market for loans is less than perfectly com-
petitive, the extent of the shift is likely to vary from loan to
loan.

The almost certain result is that most holders of debt-fi-
nanced assets will not enjoy the full tax benefits potentially
arising from inflation. Thus, these benefits will not fully com-
 pense for the negative effects of inflation on the real value of
depreciation allowances. Even holders of debt-financed assets
therefore should receive some measure of indexation of depre-
ciation allowances. Nevertheless, because lenders are unlikely
to pass their full inflation-related tax burden back to borrow-
ers, inflation should affect owners of debt-financed depreciable
assets less than holders of equity-financed assets, and Congress
should entitle the former only to partial indexation.

The situation with respect to debt-financed assets held for
capital gain is similar, but not identical. When an asset is fully
debt-financed, the principal amount of the loan financing the
asset will at all times equal the value of the asset.\footnote{See \textit{supra} note 134. When unrealized capital gains are present, full
debt-financing requires that the principal amount of the loan increase as the asset appreciates—a pattern from which parties typically will depart in practice.} Thus, if
the Code taxed capital gains on an accrual system, the asset
holder's detriment from inflation's illusory "increase" in the asset's value, would
precisely equal the benefit from inflation arising from the de-
cline in the real value of the asset-holder's repayment obliga-
tion. The result would be an exact tax "wash" to the asset
holder.

Because the Code taxes capital gains on a realization basis,
however, it defers the tax \textit{detriment} from inflation's magnifica-
tion of capital gains until the taxpayer disposes of the asset.\footnote{\textit{See V. Tanzi, \textit{Inflation and the Personal Income Tax} 45-46 (1980).}} The tax \textit{benefit} from deduction of the inflation component of interest accrues to the taxpayer immediately, because the Code
permits the taxpayer to deduct interest payments on a current
basis throughout the term of the loan.\textsuperscript{141} Overall, it is possible that because the taxpayer will enjoy the benefits of inflation currently and will suffer the detriment only on realization,\textsuperscript{142} inflation might pose a net benefit to the holder of the debt-financed asset.

Except when a taxpayer holds assets until the taxpayer's death,\textsuperscript{143} it is unlikely that inflation will pose a significant net benefit in practice. For the reasons described in the discussion above of debt-financed depreciable assets,\textsuperscript{144} higher interest charged by the lender is likely to offset some of the benefit to the taxpayer from deduction of the inflation component. Thus, while the net tax result to the holder of a debt-financed capital asset in times of inflation should be better than that to the holder of the debt-financed depreciable asset, it will probably not be so attractive as to constitute an overall tax benefit.\textsuperscript{145} At least as a theoretical matter, Congress should allow holders of debt-financed capital assets some level of capital-gains indexation, although the extent of the indexation should be less than that afforded holders of equity-financed assets.

II. POLITICAL CONSEQUENCES OF CONGRESS'S FAILURE TO ADJUST THE TAX BASE FOR INFLATION\textsuperscript{146}

The 1986 Act, like all tax legislation, represents a compro-

\textsuperscript{141} Section 163(d) of the Code may limit the taxpayer's ability to enjoy the tax benefits of inflation through immediate interest deductions. Section 163(d) generally limits a taxpayer's deductions of “investment interest” to the taxpayer's “investment income” for the year. I.R.C. § 163(d)(1) (West 1989). Taxpayers generally must carry unused interest deductions forward until they have investment income against which to deduct the interest. Id. § 163(d)(2). Thus, a taxpayer who has incurred a loan in order to finance the holding of a capital asset may not be able to deduct interest until the taxpayer sells the asset, generating investment income. If the taxpayer has investment income from other, equity-financed assets, however, § 163(d) may not prevent the current deduction of all of the taxpayer's loan interest.

\textsuperscript{142} By holding the asset until death, the asset holder would escape the tax detriment from inflation completely. See supra note 22 and accompanying text.

\textsuperscript{143} See id.

\textsuperscript{144} See supra notes 136-37 and accompanying text.

\textsuperscript{145} See supra note 23 and accompanying text (indicating that tax benefits from deferral generally are small compared to tax detriments arising from inflation, except over relatively long holding periods or if taxpayer holds asset until death).

\textsuperscript{146} This subsection considers whether an unanticipated acceleration of inflation is likely to bring about a substantial revision of the 1986 accommodation, and outlines legislative approaches designed to promote tax
misse among competing political and economic interests. Central to the 1986 Act was the acceptance by taxpayers earning income from capital of a significant cutback in depreciation allowances, and repeal of the capital gains preference, in return for the benefit of lower marginal rates. Presumably, the parties to this political accommodation had in mind some probable range of anticipated inflation rates at which the 1986 Act’s compromise seemed acceptable. Should inflation significantly exceed anticipated levels, however, effective rates of taxation on income from capital would increase markedly and the political accord underlying the 1986 Act could unravel.  

The very large extent by which the 1986 Act’s provisions cut back on previous levels of capital incentives underscores the new system’s vulnerability to inflation. Although pre-1986 depreciation allowances, along with the investment tax credit, permitted the effective “expensing” of assets in many circumstances, inflation at rates significantly above four percent generally will result in allowances under the 1986 Act that fail to recover even economic depreciation. Similarly, the 1986 Act cut back from a sixty-percent capital gains preference to no preference at all. Even comparatively low rates of inflation cause some overmeasurement of capital gain, and the magnification may become dramatic if inflation accelerates.

stability in an environment of uncertainty about future price changes. The discussion is motivated by the related beliefs that a marked acceleration of inflation would cause serious economic disruption that should be remedied, and that incentives for capital formation beyond those required by inflation adjustment would raise a significant possibility of undesirable revenue losses. The main purpose of the discussion, however, is not to advocate these views, but to explore the political feasibility of inserting some measure of inflation protection into the Code, in advance of any resurgence of inflation, to protect both the economy and the administrability of the tax code from the disruptions that could ensue if Congress did not provide inflation adjustment mechanisms. In view of the somewhat different political environments surrounding depreciation allowances and the capital gain provisions, the discussion treats these two portions of the Code separately.

147. Inflation could, conversely, prove to be lower than the levels anticipated by participants in the debates of 1986, causing effective tax rates on capital income actually to be lower than envisioned. This phenomenon occurred following the adoption of the Tax Equity and Fiscal Responsibility Act of 1982, when apparently excessive capital subsidies provided some of the impetus to the changes in 1986. See supra notes 104-06 and accompanying text. Congress passed the 1986 Act, however, at a time of relatively low inflation, at least within the comparative framework of the past twenty years. See supra note 106. At this writing, it seems more likely that in the relatively near term, inflation will exceed, rather than fall short of, the rates apparently assumed in drafting the 1986 changes.

148. See supra note 102 and accompanying text.
A. THE POLITICAL OUTLOOK FOR DEPRECIATION POLICY

By significantly increasing the tax burden on holders of equity-financed depreciable property, a resurgence of inflation would make the argument for tax revision both economically and politically compelling. The argument would be compelling economically as a consequence of the importance attached in recent years to the need to revitalize the manufacturing sector of the economy, a sector that relies disproportionately on equity finance. This economic concern would gain added political force owing to the relative ability of owners of equity-financed depreciable assets—a group that consists largely of the country's publicly held manufacturing corporations—to present their economic arguments in a politically effective manner.

Successful political pressure to augment depreciation allowances if inflation should accelerate need not lead inevitably to a large-scale disruption of the tax laws. Congress could respond to more rapid inflation by means of a “surgical” acceleration of depreciation allowances, leaving other elements of the tax structure relatively unaffected. This would recall previous congressional action on the investment tax credit, which Congress increased and decreased several times between 1962 and 1986 in response to changing perceptions of the macroeconomic need for a stimulus to investment.

Several factors, however, could render it difficult for Congress to remedy the problem of resurgent inflation through “surgical” adjustments to the Code's current ex ante depreciation schedules. First, some time would elapse between the onset of higher inflation and the subsequent legislative adjustment. Affected taxpayers probably would seek not only “corrected” rules on a prospective basis, but also some form of compensation for past slippage. The variety of forms in which

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149. “By failing to consider indexing while fully including realized gains, the reform leaves a situation that may not prove viable, even with relatively modest inflation rates . . . .” Halperin & Steuerle, supra note 42, at 379; cf. McLure & Zodrow, supra note 125, at 51 (“It would not be surprising—particularly if inflation accelerates—to see reintroduction of a capital gains exclusion.”).

150. See NATIONAL BUREAU OF ECONOMIC RESEARCH, supra note 136, at 236-38 (indicating that ratio of debt to total financing for publicly held manufacturing corporations is approximately 20%, compared to ratio of approximately 40% for other publicly-held corporations).

151. See supra notes 95-96 and accompanying text.
Congress could provide this compensation would increase the indeterminacy of the tax revision process, thereby diminishing the likelihood of a simple and limited legislative change. In 1981, for example, owners of depreciable property obtained extremely generous depreciation allowances, in part almost certainly to compensate for the cumulative effects of inflation during the 1970s.\footnote{See supra notes 97-99 and accompanying text.} The 1981 allowances soon appeared excessively generous, a fact that contributed to tax instability during the succeeding five years.\footnote{See supra notes 104-06 and accompanying text.}

The mechanics of the tax legislative process also pose an obstacle to "surgical" solutions. Although the tax-writing committees of Congress maintain an ongoing schedule of hearings on various topics, and the analytical work of the congressional and Treasury legislative staffs never ceases, the tax legislative process is in many respects discontinuous. Given the competing demands on their attention, legislators can give close attention to questions of tax revision only for discrete and limited periods of time. Persons seeking significant changes to the tax laws always must cross the hurdle of placing tax revision on the legislative agenda as a general matter.\footnote{One commentator has stated: [An] important criter[on] for enactable significant Federal tax legislation is a sufficient "critical mass." This . . . implies that for the Congress to be willing to proceed with a major piece of Federal tax legislation . . . it is necessary that the package have a sufficient critical mass of provisions to justify proceeding. This explains the pattern of the chairmen of the tax-writing committees taking relatively few tax measures to the floor of either the House or the Senate in each Congress. The preferred method of operating is to package various components together in a single bill, thus making the job of voting on such measures less painful than if they were considered as separate pieces of legislation. Kies, The Current Political, Budgetary, and Tax Policy Environment Suggests the Possibility of Major Federal Tax Legislation in the 100th Congress, 35 TAX NOTES 179, 185 (1987).}

Once Congress responds to demands to place tax revision on the legislative agenda, it is unlikely that advocates for relief in other areas will forgo the resulting opportunity to press their causes. The resulting lobbying pressure is likely, at the least, to delay passage of even very limited tax legislation.\footnote{For example, interested parties attempted to insert "substantive" provisions into legislation designed to make technical corrections to the 1986 Act and substantially delayed passage of that legislation. See Jones, Finance Staff Continues Work on Technical Corrections Amendment, 40 TAX NOTES 886 (1988). Congress ultimately passed a technical corrections act in October 1988, approximately two years after passage of the 1986 Act. Technical and Miscel-}
does result, the introduction of additional topics for consideration could cause originally limited tax legislation to "mushroom" into a comprehensive tax revision, leading to a very unstable tax environment. Reliance on periodic legislative corrections as a substitute for indexation of depreciation allowances seems ill-advised.

It is possible that, even if inflation accelerates significantly, the political influence of adversely affected groups will not be sufficient to place the tax legislative process in motion. Indeed, while inflation apparently has contributed to the initiation of major tax legislation, including the Revenue Act of 1978 and the Economic Recovery Tax Act of 1981, these changes probably responded more to the Code's previous failure to index rate schedules for inflation than to the Code's lack of indexation of depreciation allowances and capital gains. Arguably, now that Congress has eliminated "bracket creep," inflation no longer poses a significant threat of tax instability.


156. The potential for tax legislation to "mushroom" almost certainly has increased in recent years, as tax lobby groups have increased their access to the political process through such means as more aggressive use of political contributions. See Doernberg & McChesney, On the Accelerating Rate and Decreasing Durability of Tax Reform, 71 MINN. L. REV. 913, 923-44 (1987); infra notes 237-41 and accompanying text.

157. See supra notes 43-47 and accompanying text.


159. Id.; see also supra note 14 and accompanying text (describing elimination of "bracket creep" in 1981 Act).

One commentator has observed:

"It is bracket indexing . . . that has sparked the most interest and congressional action. Most workers have incomes subject to the personal income tax, but a much smaller number (disproportionately those with high incomes) have substantial capital gain and interest income. Indexing the latter provisions might be seen as a tax break for the rich, giving them protection from inflation not enjoyed by other taxpayers. Moreover, bracket indexing is relatively simple to administer centrally, requiring only annual changes in tax tables. Indexing of savings and capital gains, on the other hand, would require complex calculations by taxpayers, opening up new potential for error and fraud.


The persistence of legislative interest in capital gains relief, see infra notes 169-76 and accompanying text, may indicate, however, that the tax concerns of holders of capital are more compelling politically than the immediately preceding view suggests."
While this argument may have force, it necessarily is speculative because there is no way to know how strong the pressure for change would have been in 1978 and 1981 if the concern for "bracket creep" had not contributed to it. It is prudent to assume that even with today's indexed rate schedules, the "capital formation" lobby would prove effective in the event of markedly accelerated inflation and would succeed in setting the tax revision process in motion, with potentially wide-ranging results. More than unadorned political power would back the lobbyists' arguments: the increase in effective tax rates on equity-financed capital, owing to inflation's effect on the real value of depreciation allowances, could have economic implications that would concern even the most disinterested legislator. A goal for policymaking should be to build appropriate mechanisms into the Code now to protect the real value of depreciation allowances on equity-financed property in the event of accelerating inflation, in order to forestall the less predictable results that otherwise might follow another round of rapid inflation.

Ironically, the largest impediment to the incorporation of an inflation-adjustment mechanism for depreciation allowances is the fact that inflation rates remain relatively low. Congress might be inclined to address the problem of inflation's erosion of depreciation allowances only after inflation already has substantially increased effective tax rates on income from depreciable property, at which point legislative action addressed only to the effects of further inflation may no longer be possible.\(^6\)

Currently, however, the political environment may be especially conducive to the adoption of measures to protect depreciation allowances from the possible effects of marked increases in inflation. The financial markets remain concerned over the possibility of resurgent inflation,\(^1\) and the currently pending legislative debate over capital gains policy has focused some legislative attention on inflation's effects on tax burdens.\(^2\) Moreover, concern over the level of the federal deficit remains high, which might make Congress responsive to fears that accelerating inflation, if left uncompensated by the tax code, would raise political pressure for capital incentives that would exceed the

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160. See supra text following note 151.
161. The level of concern over the possibility of resurgent inflation varies, as might be expected, from day to day. For a representative recent discussion, see Inflation Stages a Comeback, Bus. Wk., Apr. 1989, at 32.
162. See infra notes 169-76 and accompanying text.
cost of limited indexation for inflation. In addition, leading tax legislators recognize the enormous strain that the magnitude of recent changes has placed on tax administration both in government and in the private sector. This concern for tax stability may make legislators especially averse to sweeping tax changes such as those that could result from renewed calls for capital incentives in the foreseeable future. In sum, congressional leaders may be willing to initiate some form of inflation "insurance" at the current time, as a relatively inexpensive means of forestalling expensive and structurally sweeping legislative changes if inflation accelerates in the future.

A safety-valve adjustment to depreciation allowances, similar to that the House proposed in its version of the 1986 Act, could serve the desired purpose effectively. The safety valve would compensate for the effects of inflation only to the extent that inflation exceeds the rate assumed in setting the 1986 Act's depreciation schedules. Thus, unless inflation accelerates to unforeseen levels, the safety-valve adjustment would have no revenue cost at all. The safety valve would have some revenue cost in periods of high inflation, but the revenue cost very likely would be lower than the costs of other measures that Congress would implement if high inflation were to recur and Congress had not previously set in place protections against its effects. Following the former House proposal, Congress could provide additional revenue protection by setting the "trigger" rate for implementing inflation adjustments somewhat higher than the rate of about four percent apparently assumed in setting schedules in the 1986 Act, and by indexing for only a

163. See Verdier, supra note 158, at 173-74 (discussing extent to which deficit pressures are likely to bring about significant tax legislation).

164. See, e.g., id. at 174-75.

165. See supra notes 113-14 and accompanying text; see also infra note 181 (describing recently introduced bill for safety-valve indexation of capital gains).

166. See H. Calkins & M. Durst, supra note 74, at 10; see also infra note 181.

167. Congress actively considered the 1986 Act throughout calendar year 1985, and until the early autumn of 1986. In early 1986, the Congressional Budget Office forecast inflation, measured by the Consumer Price Index for Urban Wage Earners and Clerical Workers, at a rate of 3.4% for the fiscal year ending September 30, 1986, and at rates between 4.2 and 4.4% for the following five fiscal years. The Administration's forecast was somewhat more optimistic, projecting a rate of 3.7% for fiscal year 1986, 4.1% for fiscal year 1987, and rates declining from 3.5% to 2.0% for the following four fiscal years. Office of Management and Budget, Budget of the United States Government Fiscal Year 1987 at 2-24 to 2-25 (1986). (Inflation actually has occurred at a
portion of the extent to which inflation exceeds the trigger rate. Moreover, by means of an election described below, Congress could substantially restrict the relief provided to holders of debt-financed capital.168

The proposed safety-valve adjustment in essence represents a compromise. It acknowledges the economic significance of "capital formation" arguments, and provides some measure of assurance against rising effective tax rates on income from depreciable capital if inflation increases. It minimizes revenue costs, however, by offering indexation only to the extent necessary to remove the effects of truly unanticipated inflation. The safety valve for depreciation would lend additional political stability to the Code, while protecting the economy from some of the more serious tax-related shocks that inflation might, in the absence of adjustments, inflict.

B. THE POLITICAL OUTLOOK FOR CAPITAL GAINS

The political outlook for capital gains taxation suggests even more strongly the potential utility of a safety valve inflation adjustment. The elimination of a capital gains preference in the 1986 Act, in return for lower marginal rates, remains among the most fragile compromises of the 1986 Act.

The Bush Administration recently has proposed reinstating a preferential rate for gains realized on a large group of capital assets.169 The Administration has based its proposal primarily on a desire to promote long-term investment, although the Administration also has expressed a desire to provide a rough correction for the effects of inflation.170

pace of 1.6% in calendar year 1986, 3.6% in calendar year 1987 and 4.0% in calendar year 1988. 112 Monthly Labor Review 87 (Mar. 1989)). In the author's view, a projected rate of 4% probably comports with most observers' expectations during the period when Congress actively considered the 1986 Act. Cf.

168. See infra notes 197-209 and accompanying text.


170. The Administration has stated:

   Restoring a capital gains tax rate differential is essential to promote savings, entrepreneurial activity, and risk-taking investments in new products, processes, and industries that will help keep America
The Administration has argued that reintroducing a capital gains differential would increase federal revenues, largely by encouraging realizations of capital assets, especially in the period immediately following the proposal's effective date.\textsuperscript{171} The Administration proposal generally limits the preference to investment assets such as corporate stock, realizations of which should be most sensitive to changes in tax rates.\textsuperscript{172} The proposal requires a holding period of only one year for assets sold through 1992 but increases the holding period to two years in 1993 and to three years in 1995, a feature that could enhance short-term revenue gains.\textsuperscript{173} Democratic policymakers in Congress have opposed the Administration proposal, based partly on skepticism over the Administration's claim that the proposal will raise revenue,\textsuperscript{174} and partly on a desire not to disturb the competitive and economically strong. At the same time, investors should be encouraged to extend their horizons and search for investments with long-term growth potential. . . . 

A capital gains differential will also provide a rough adjustment for taxing inflationary gains that do not represent any increase in real income.

\textit{Id.} at 3. The Administration proposal also states:

Although inflation has been kept low under policies of the past eight years, even low rates of inflation mean that individuals who sell capital assets at a nominal profit are paying tax on a "fictional" element of profit represented by inflation. High rates of inflation, such as those that existed in the mid and late 1970s, exacerbate the problem. An income tax should consider only "real" changes in the value of capital assets — after adjusting for inflation — in order to avoid unintended high effective rates of tax that actually lower the real after-tax value of assets. Current law taxation of nominal capital gains in full has the perverse result that real gains are overstated (and taxed too highly) and real losses are understated and, in some cases, actually converted for tax purposes from losses to gains. A partial exclusion for long-term capital gains provides a rough adjustment for the inflationary element of capital gains without creating the complexities and additional record-keeping that a precise inflation adjustment would require.

\textit{Id.} at 4. (For discussion of the potential complexities to which the statement refers, see infra notes 186-91 and accompanying text).

\textsuperscript{171} Id. at 10-14. The Administration has also indicated its expectation that the capital gains proposal would increase federal revenues by enhancing economic growth, although the Administration has not incorporated this effect in its formal revenue estimates. \textit{Id.} at 11.

\textsuperscript{172} Assets qualifying for the proposed preference would include "capital assets" as defined under § 1221 of the Code (generally, all investment assets) but would not include depreciable or depletable property. The proposal also denies preferential treatment to gains from the sale of collectibles (for example, rare coins and works of art), on the ground that investment in these items does not promote economic growth. \textit{Id.} at 5-6, 8-9.

\textsuperscript{173} Id. at 7, 13.

\textsuperscript{174} See, e.g., Jones, \textit{Taxwriters Greet Bush Proposals with Skepticism}, 42 \textit{Taxwriters} \textbf{42} at 1268.
political compromise of 1986.175

The ultimate resolution of the Administration’s capital gains proposal likely will depend on the outcome of the controversy over revenue effects. If the Administration prevails in arguing that reintroduction of a preference would raise revenue, Congress probably will adopt some form of exclusion ratio for capital gains, and further consideration of capital gains reform, including indexation for inflation, would be unlikely.176 If Congress does not accept to the Administration’s position on revenue effects, however, the dominant congressional view toward the capital gain provisions likely would remain that implied by the committee reports on the 1986 Act: Congress would view a capital gains preference as a potentially expensive measure that nevertheless may be justified if Congress should increase tax rates above their current levels.

In itself, that congressional view would imply a fairly modest “exclusion ratio” in the event of an overall increase in tax rates. If Congress were, for example, to increase the maximum marginal individual rate from twenty-eight to thirty-three percent,177 the exclusion ratio needed to keep the maximum rate

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175. For example, Robert J. Leonard recently reported that Committee Chairman Rostenkowski believes that “[r]educing the capital gains tax rate will destabilize the balance set in the 1986 Act.” 42 TAX NOTES 141, 141 (1989).


177. Currently, while the maximum statutory individual income tax rate is 28%, taxpayers generally must pay a surtax of five percent on income exceeding $43,150, or $71,900 for married couples filing joint returns, until the surtax has repaid to the Treasury the tax benefit that the taxpayer enjoys from the Code’s 15% rate on the taxpayer’s first $17,850 of taxable income ($29,750 for married couples filing joint returns), as well as the Code’s allowance of “personal exemption” deductions of $2000 each for taxpayers and their dependents. See I.R.C. § 1(g) (West 1989). (The dollar values indicated in the preceding sentence are to be indexed for inflation beginning in 1989. I.R.C. § 1(f), (g) (West 1989)). Many taxpayers therefore pay tax at a marginal rate of 33% until the surtax has fully paid back the benefits of the 15% rate and the personal exemptions, after which the taxpayer’s marginal rate reverts to 28%. To the extent that legislators are inclined to increase marginal rates, a possible means
on capital gains at twenty-eight percent would be \((33 - 28)/33\), or about fifteen percent.

A resurgence of inflation, however, could generate additional political pressures and lead to a much higher exclusion ratio. Historically, the interests of both "venture capitalists" (whose tax burdens generally are unaffected by inflation) and of those with more conventional investments, such as publicly traded stocks and bonds, (the taxation of which inflation can affect enormously) almost certainly have combined to influence policymaking for capital gains. Many policymakers probably have not differentiated consciously between the economic situations of venture capitalists and other investors, but have assumed that the same exclusion ratio that is appropriate to remedy the effects of inflation on the taxation of conventional investments also will provide an appropriate preference for venture capital. Because inflation typically represents a very high proportion of the capital gain on conventional investments, the apparent tendency to equate the "venture capital" and inflation problems probably has contributed to a policy of high exclusion ratios.

Much the same result could obtain if even a small increase in marginal tax rates were to coincide with a high level of concern over resurgent inflation. Congress then would encounter facially similar demands to reinstate a capital gains preference to maintain the political-economic compromise of 1986 and to provide some measure of compensation for the possible effects of resurgent high inflation. The outcome might be an exclusion ratio for capital gains far greater than a policy of restoring the 1986 compromise requires.

In essence, the accommodation of 1986 has different implications for venture capitalists and for more conventional investors. For venture capitalists, the accommodation is based on a congressional promise that marginal rates on realized capital gains will not exceed twenty-eight percent—a quid pro quo, the validity of which probably does not depend on any particular rate of inflation. For conventional investors, the implicit political accord was more complex. Essentially, conventional inves-

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178. See supra notes 31-34 and accompanying text.
179. See supra notes 13-19 and accompanying text.
tors "agreed" in 1986 to accept inflation's magnification of the effective rate of taxation on capital gains, provided that the maximum marginal rate remains fixed at twenty-eight percent and that inflation remains within the range anticipated in enacting the 1986 legislation.

Consequently, if an increase in marginal tax rates were to induce Congress to reinstitute a capital gains preference (and if Congress were not to view the reinstatement of a capital gains preference as a source of additional revenue), Congress could implement a preference at the lowest possible revenue cost through a two-tiered approach. First, Congress could implement a relatively low, across-the-board exclusion ratio, reducing the maximum rate on all capital gains to twenty-eight percent. In addition, Congress could implement a mechanism for safety-valve indexation of capital gains similar to that recommended above for depreciation allowances. The safety-valve indexation would permit the taxpayer, at the time of an asset's sale, to adjust gain to the extent that inflation, over the holding period of the asset, has exceeded a trigger rate based on expectations incorporated into the 1986 Act. In enacting safety-valve indexation, Congress would not seek to eliminate all of inflation's effects on the taxation of capital gains, but would seek instead to maintain the political-economic accommodation of 1986.

This approach would be similar to that of Treasury II, which employed an exclusion ratio as an across-the-board capital incentive, but allowed some taxpayers to elect indexation if the exclusion ratio did not provide ample protection against inflation.

180. Unfortunately, this would reintroduce to tax planning and enforcement the enormous complexity that previously accompanied a differential rate of taxation on long-term capital gains. This portion of the discussion, however, seeks to identify the most desirable course of action to follow if Congress should decide to reimplement some level of preference for long-term capital gains.

181. See supra notes 165-68 and accompanying text.

Recently, Senator Kasten has introduced legislation that would combine a 50% exclusion ratio for long-term capital gains with "safety-valve" indexation of asset basis. S. 171, 101st Cong., 1st Sess., 135 CONG. REC. S525, S527-29 (daily ed. Jan. 25, 1989). The Kasten bill would index asset basis for inflation to the extent that inflation exceeds four percent per year.

In support of the "safety valve" portion of the proposal, Senator Kasten has said: "The indexing of capital gains for inflation above 4 percent will result in no revenue loss whatsoever . . . . This is because the Congressional Budget Office's projected inflation rates for the next 5 years . . . are no higher than 4 percent." Id. at S526.
flation. The approach outlined here differs, however, in that the exclusion ratio would be somewhat less generous than the thirty-five-percent exclusion of Treasury II. In addition, in the belief that the political accord of 1986 incorporates acceptance of some level of increase in the tax burden on capital gains arising from inflation, the safety-valve adjustment would not provide full indexation, but would compensate for inflation only to the extent that it exceeds the “trigger” rate during the holding period of the asset.

The political environment surrounding capital gains taxation remains fluid, and a wide range of outcomes remains possible. In lieu of an exclusion ratio, Congress conceivably could adopt the Treasury I approach of indexation, thereby precluding the need for a safety-valve adjustment. Any resolution other than full indexation, however—whether the resolution incorporates a large exclusion ratio, small exclusion ratio, or no exclusion ratio at all—will remain desirable, economically and politically, only within some range of inflation rates. Especially if Congress implements its resolution at a time when inflation, and hence inflationary expectations, are comparatively low, Congress should consider preserving the stability of the Code through some measure of “safety-valve” inflation protection.

III. THE ROOTS OF THE DECISION TO FORGO INDEXATION IN THE PAST

Critics have offered numerous arguments against explicit indexation of the tax base and for relying instead on either ex ante attempts to accommodate inflation, for example, by accelerating depreciation allowances, or on no adjustments for inflation at all. In addition to normative arguments against explicit indexation, a number of political factors have blocked indexation. While many of the normative arguments against indexation...

182. See supra note 54 and accompanying text. It also is similar to Senator Kasten’s proposal to combine a 50% exclusion ratio with safety-valve indexation. See supra note 181.
183. Congress should consider limiting access to the safety valve to taxpayers who agree to relinquish a portion of their interest deductions. This would limit the full adjustment to sellers of equity-financed capital assets. See infra notes 197-209 and accompanying text.
185. Joseph Minarik, an economist and adviser to Senator Bradley, reports that in drafting the Bradley-Gephardt reform plan, an important predecessor to the 1986 Act, “[i]t was concluded that indexing . . . would cause prohibitive administrative and political difficulties, which later developments proved to
A. NORMATIVE ARGUMENTS AGAINST INDEXATION

1. Administrative Complexity

The most important normative argument that has been raised against indexation is that indexation would disproportionately add to the Code's administrative complexity. The potential complications arising from a comprehensive system of indexation are indeed significant. Capital gains indexation, for example, would require an adjustment to an asset's historical cost basis at the time a taxpayer sells the asset to reflect the effects of inflation since the taxpayer acquired the asset. In practice, however, many events might have occurred since the original purchase that would complicate computation of the asset's basis. Investors in stocks and mutual funds, for example, often arrange to "reinvest" their dividends. Consequently, the investment will have many different bases, reflecting reinvestments throughout the period of ownership. Although the calculations required to index these numerous separate bases are conceptually simple, they could be burdensome to a taxpayer seeking to complete a return without professional assistance. Changes to the tax basis of an investment asset during its holding period can result, moreover, from many additional factors, including the expenditure of legal fees incurred in a lawsuit to quiet title to stocks, bonds, or other investments, and engineering work performed to ready a parcel of land for development.

Despite these admitted complexities, however, critics probably have overstated the administrative difficulties of indexing asset basis. First, the complexities should not seriously affect the indexation of depreciation allowances. Taxpayers compute depreciation deductions annually, maintaining records of adjusted asset basis continuously. Adjusting allowances for inflation on a quarterly or annual basis, according to a table...
provided by the government, should require little additional effort.\textsuperscript{188}

The problems of indexing capital gains are more serious. Nevertheless, when “retail” investors participate in dividend reinvestment plans and similar arrangements, the investors in most cases deal with entities that keep computerized records of the amounts and dates of all reinvestments.\textsuperscript{189} These entities easily should be able to compute the proper indexation of asset basis for their customers, either at the time of sale or as part of the customer’s regular monthly or quarterly statement. The expense involved should be minimal. In other instances, in which the taxpayer has adjusted an asset’s basis during the holding period for reasons other than reinvestment plans, the taxpayer’s affairs almost certainly will be sufficiently complex that the taxpayer will employ professional assistance in preparing returns, and the computations required for indexation should be trivial to a trained accountant.

Any system of capital gains taxation, even one that offers neither price adjustments nor a long-term capital gains preference, involves considerable administrative complexity. In any system of capital gains taxation, taxpayers must maintain records of asset basis. Similarly, even without price indexation, a taxpayer who sells a portion of a block of assets accumulated over a period of time (a block accumulated gradually through a reinvestment program, for example) must follow complex rules to identify precisely which assets are being sold, in order to know which of many different asset bases to use.\textsuperscript{190} Indexation

\textsuperscript{188} Some minor complications might arise from the government’s frequent retroactive revisions of price indices. STAFF OF THE JOINT COMM. ON TAXATION, \textit{supra} note 25, at 8. Revisions in price indices tend to be minor, however, and an indexing plan should not require taxpayers to change depreciation allowances retroactively to reflect such revisions. If it desired, Congress could modify future inflation adjustments to account for revisions in previously reported price indices, in order to correct for revisions at least roughly over time.

\textsuperscript{189} Cf. Halperin & Steuerle, \textit{supra} note 42, at 359 (“One suspects . . . that in the large majority of . . . cases, individuals deal with financial institutions that have access to the technology to implement indexing without undue difficulty.”).

\textsuperscript{190} Assume, for example, that a taxpayer purchases one share of Acme Corporation stock in 1985 for $100 and then purchases an additional share in 1986 for $120. In 1989, the taxpayer sells one of the two shares of Acme stock for $150. The taxpayer must determine which of the two shares was sold—the share with a basis of $100, giving rise to a gain of $50, or the share with a basis of $120, giving rise to a gain of $30. United States tax law generally allows the shareholder significant latitude in selecting the particular shares deemed to be sold. \textit{See} Treas. Reg. § 1.1012-1(c) (as amended in 1980). Indexing capital gains
of capital gains will neither remove nor substantially magnify these complexities. Indexation might, however, reduce the need for frequent revisions of the tax code, thus lessening the likelihood of the administrative complexity and economic disruption that attends any substantial tax revision.¹⁹¹

2. The Argument That Indexation Is Impracticable Because of the Need to Take into Account Inflation’s Effects on Debt: The Problem and a Suggested Approach to a Solution

Although inflation represents an unmitigated tax detriment to the holder of an equity-financed depreciable or capital asset, the ability to deduct in full all interest payments, including the inflation component of interest, partially offsets the negative tax effects of inflation for holders of debt-financed assets. This has led many to suggest that the tax laws should offer indexation of depreciation allowances and capital gains only to holders of equity-financed assets.¹⁹² Policymakers sometimes assume, however, that limiting indexation only to equity-financed assets would require administratively complex “tracing” rules, or similar attribution rules to determine whether a

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¹⁹¹ The tax laws of the United Kingdom have indexed capital gains since 1982, offering a body of administrative experience useful for implementing indexation in the United States. See COMPARATIVE TAX SYSTEMS: EUROPE, CANADA, AND JAPAN 300-01 (J. Pechman ed. 1987) [hereinafter COMPARATIVE TAX SYSTEMS]; Note, Indexation of Capital Gains, 1982 BRIT. TAX REV. 131, 150-58 (describing implementation of capital gains indexation in 1982); Note, Capital Gains Tax, 1985 BRIT. TAX REV. 142, 154-57 (describing modification of indexation in 1985 that eliminated requirement that taxpayer hold assets for one year to qualify for indexation, and that permits indexation even if it would result in taxable loss on realization).

¹⁹² Much of the complexity of indexation in the United Kingdom seems to have arisen from difficulties in applying transitional rules, a topic that would require careful attention if Congress were to implement capital gains indexation, including the proposed safety-valve indexation, in the United States. See Gunn, The Overgrown Jungle, 1987 TAXATION 537, 537 (criticizing some administrative aspects of United Kingdom indexing rules). Almost certainly, Congress should offer safety-valve indexation only for inflation occurring after the date of enactment, and, following the example of the 1982 revisions to indexation in the United Kingdom, should offer the taxpayer the option of basing indexation for assets held on the effective date on either the historical cost basis of the asset or on the asset’s fair market value as of the effective date. Cf. Inland Revenue Press Release, Capital Gains Rebasing and Indexation (May 25, 1989) (describing recent administrative action dealing with assets held as of effective date of indexing plan).

¹⁹² See Gann, supra note 135, at 131-34.
taxpayer's depreciable and capital assets are, in fact, debt-financed. Indeed, some have suggested that the administrative problems of limiting indexation only to equity-financed assets are so severe, and the economic distortions that would arise from failing to limit indexation to equity-financed assets sufficiently troubling, as to render attempts to index the tax base for inflation inadvisable.

Indexing depreciation allowances and capital gains on both debt- and equity-financed assets, while leaving the taxation of interest payments and receipts unadjusted for inflation, would result in economic distortions for a number of reasons. This practice would result in higher after-tax rates of return on

193. See id. at 131 (stating that allowing indexation only for equity-financed portion of depreciable asset “raises practical problems of calculating the percentage of depreciable assets which are debt-financed”); id. at 134 (noting that “indexation could be limited to equity-financed capital assets, but such a limitation requires tracing rules to determine to what extent the indexed assets are debt-financed”). The likely administrative burdens of tracing rules and similar attribution rules are daunting. The simplest attribution rule, and the most defensible economically, consists of a presumption that all debt carried by the taxpayer “finances” the taxpayer’s depreciable or capital assets, except to the extent that the total outstanding principal of the debt exceeds the market value of the taxpayer’s depreciable or capital assets. Even this simple rule would require that the taxpayer estimate both the principal value of indebtedness and the total market value of depreciable and capital assets on a yearly basis.

The Code does have a number of rules limiting interest deductions that require some form of tracing. See, e.g., I.R.C. § 265(a)(2) (West 1989) (disallowing deduction of “[i]nterest on indebtedness incurred or continued to purchase or carry” tax-exempt bonds); id. § 163(h) (disallowing deduction of “personal interest,” except for “qualified residence interest”); Temp. Treas. Reg. § 1.163-8T (1987) (providing complex tracing rules to implement “personal interest” limitation of § 163(h)). These rules have been the source of enormous administrative complexity with apparently unsatisfactory results. For recent discussions of “tracing” and similar attribution rules, see, for example, Block, The Trouble with Interest: Reflections on Interest Deductions After the Tax Reform Act of 1986, 40 U. FLA. L. REV. 689, 716-75 (1988); Johnson, Is an Interest Deduction Inevitable?, 6 VA. TAX REV. 123, 170-82 (1986); Koppelman, Tax Arbitrage and the Interest Deduction, 61 S. CAL. L. REV. 1143, 1207-16 (1988); Shakow, Confronting the Problem of Tax Arbitrage, 43 TAX L. REV. 1, 26-32 (1987); see also Galvin, The Deduction of Nonbusiness Interest: An Exercise in Planned Confusion, 41 TAX LAW. 803, 820-24 (1988) (discussing application of Temp. Treas. Reg. § 1.163-8T); see generally M. GRAETZ, supra note 25, at 458-59 (raising general doubts concerning administrability of Code sections that currently require tracing rules).

194. Halperin & Steuerle, supra note 42, largely represents an attempt to confront this argument. The authors conclude that the merits of a partial indexation system must be evaluated on the basis of careful economic analysis. “[P]artial indexing is not necessarily worse than the alternatives. It depends upon the details.” Id. at 372.
debt-financed depreciable and capital assets than on similar assets that taxpayers finance with equity, thereby exacerbating the tax code’s tendency to favor debt over equity. Allowing taxpayers fully to index depreciation and capital gains even on debt-financed assets would offer an artificial inducement to purchase those particular depreciable and capital assets, such as buildings, that are especially amenable to debt-financing. Moreover, even leaving aside the question of economic distortion, allowing holders of debt-financed assets full indexation of depreciation and capital gains would impose an unwarranted revenue loss on the Treasury. In short, it seems advisable on a number of grounds to limit the extent to which inflation adjustments, including safety-valve indexation, are made available to holders of debt-financed assets.

Congress should consider limiting the inflation adjustments of holders of debt-financed assets without the need for tracing rules or similar mechanisms, by permitting the taxpayer to adjust depreciation allowances and capital gains for inflation only if the taxpayer agrees to the partial disallowance of interest deductions on all of the taxpayer’s indebtedness.

195. The tax laws already significantly favor debt over equity by permitting deductions under the corporate tax for interest paid to creditors, but not for dividends paid to shareholders. Concern over this problem, which has existed throughout the history of the income tax, is now especially acute, because of the recent spate of “leveraged buyouts” and similar transactions that substitute corporate debt for equity. See generally Staff of the Joint Comm. on Taxation, Federal Income Tax Aspects of Corporate Financial Structures (1989) (booklet prepared for members of House Ways & Means and Senate Finance Committees). It is unlikely that Congress would want to provide additional incentives for debt formation by permitting inflation indexation of depreciation or capital gains without requiring holders of debt-financed assets to relinquish some of the tax benefits arising from inflation.

196. Cf. Boskin, A Closer Look at Tax Neutrality Toward Investment, 29 Tax Notes 652, 653 n.41 (1985) (“A . . . conceptual problem is whether all types of assets, and investments in all industries, have equal access to debt as opposed to equity finance.”); Summers, A Fair Tax Act That’s Bad for Business, Harv. Bus. Rev., Mar.-Apr. 1987, at 53, 55 (observing that tax system historically has been biased in favor of investment in buildings, in part because buildings “can carry heavy tax-favored debt”). Prior to the 1986 Act, the Code implicitly took this advantage into account by providing more generous cost recovery rules, largely through the investment tax credit, for equipment than for buildings. The 1986 Act eliminated this practice. See Auerbach, supra note 116, at 77 (indicating that 1986 Act, unlike prior law, provides similar effective tax rates on income from industrial machinery and on income from industrial buildings).

197. Cf. C. Steuerle, supra note 122, at 196 (“Fractional exclusion of interest payments (in effect, partial indexing) could be applied to businesses and corporations that have high debt-to-equity ratios or make substantial use of other tax preferences.”).
Under the suggested approach, the “price” for electing indexation of depreciation or capital gains would be an agreement to forgo interest deductions to the approximate extent necessary to negate the tax advantage that the taxpayer otherwise would enjoy from the deduction of the inflation component of interest. Congress would base the percentage of interest deductions that it would require the taxpayer to forgo on economic estimates of the extent to which borrowers, on average, actually “keep” the tax benefits from deducting the inflation component of interest, as opposed to losing them as a result of lenders passing along their increased tax burdens from inflation. If it is estimated, for example, that borrowers retain sixty percent of the benefit from deducting the inflation component of interest, then as a condition for adjusting depreciation allowances or capital gains for inflation, Congress would require taxpayers to forgo deduction of sixty percent of the inflation component of interest, estimated by means similar to those of Treasury I.

Although it might seem that the proposed election would raise many of the disadvantages of Treasury I’s interest indexation proposal, the administrative difficulties of the proposal would be limited because only taxpayers with relatively low outstanding debt would “elect into” the proposed indexation system. For these taxpayers, the tax advantage of indexing depreciation allowances and capital gains would outweigh the tax cost of relinquishing a portion of the interest deduction. Taxpayers with relatively large outstanding debt would find that the tax costs of relinquishing a portion of the interest deduction would be greater than the tax advantages of indexing depreciation and capital gains, and these taxpayers would not

198. See supra notes 137-38 and accompanying text.

199. Casting the suggested approach in the form of an election helps to illustrate the proposal’s conceptual basis, but it may pose difficulties to the extent that policymakers have come to associate taxpayer elections, of various kinds, with administrative complexity. Congress could achieve a result virtually identical to that of the mechanism outlined here, without the need for an election, by allowing taxpayers inflation adjustments to depreciation or capital gains only to the extent that the adjustments exceed the estimated portion of the taxpayer’s interest deductions that results in an inflation-related benefit to the taxpayer; that is, the same portion of the interest deduction that the taxpayer would be required to forgo under the suggested election. Taxpayers with very large interest deductions relative to their depreciation deductions or capital gain realizations would essentially be rendered ineligible for inflation adjustments, just as would happen under the suggested election. The following discussion, and the technical comments toward the conclusion of this Article, should be adaptable readily to a system that does not involve a taxpayer election.
make the suggested election. Thus, the proposed system probably would not affect taxpayers, such as banks, that are in the business of borrowing and relending money.\textsuperscript{200}

A set of examples can illustrate the workings of the proposed election. The examples are based on Table 1 in Section I(B) of this Article,\textsuperscript{201} which depicts the economic depreciation, in the absence of inflation, of an automobile with an original purchase price of $10,000. The examples also incorporate the assumptions concerning the relationship between real and nominal interest rates on which the Treasury based its 1984 interest indexation proposal.\textsuperscript{202}

Table 1 indicates that during the first year of the automobile's life, it depreciates economically to the approximate extent of $3491. Assume now that inflation occurs at a rate of five percent during the year. If the taxpayer were to index depreciation for inflation, the proposal would permit the taxpayer to increase the depreciation deduction during the year by five percent, from $3491 to $3666.\textsuperscript{203}

Following the methodology of the 1984 Treasury proposal, the assumed inflation rate of five percent implies a total, nominal interest rate of eleven percent.\textsuperscript{204} The 1984 Treasury proposal thus would estimate that of all interest payments that the taxpayer makes, five-elevenths—45.5%—represents the inflation component.\textsuperscript{205} Assume further that, based on empirical ev-

\textsuperscript{200} See supra note 129. These taxpayers generally would have outstanding indebtedness substantially exceeding the value of their depreciable and capital assets, and therefore would not elect into the proposed system.

It might be argued that the suggested election would operate harshly with respect to asset holders who are both lenders and borrowers. These taxpayers receive tax benefits from inflation's effects on interest payments only to the extent of their net outstanding indebtedness. Arguably, then, the proposed election should require the partial disallowance only of net, not gross, interest payments.

Requiring the partial disallowance only of net interest payments, however, effectively would grant taxpayers who make the election an implicit indexation of their interest receipts—a benefit that would not be afforded to taxpayers generally, in the absence of comprehensive indexation such as that of Treasury I. Thus, if Congress chooses to make use of the election offered for consideration here, it probably should require the partial disallowance of the taxpayer's gross, as opposed to net, interest payments.

\textsuperscript{201} Supra text accompanying notes 76-77.

\textsuperscript{202} Supra notes 124-27 and accompanying text.

\textsuperscript{203} See supra Table 2, text following notes 76-77.

\textsuperscript{204} Supra notes 125-27 and accompanying text.

\textsuperscript{205} The suggested election's incorporation of the Treasury I approach of estimating a single fractional "inflation component" for all interest payments could pose some relative disadvantage for borrowers of risky debt. Interest
idence, it is estimated that borrowers on average “keep” sixty percent of the tax benefit from deducting the inflation component of interest. The proposed election thus would require the taxpayer to forgo deduction of sixty percent of the estimated inflation component of interest—that is, sixty percent of 45.5%, or 27.3%—on all of the taxpayer’s indebtedness, in return for the benefit of indexing depreciation allowances. (In actual practice, the taxpayer would not be required to make these calculations. Rather, the tax return and accompanying instructions simply would state that in return for claiming the benefit of indexing depreciation, the taxpayer would be required to reduce interest deductions by a specified percentage.)

Suppose now that the taxpayer, who has purchased a depreciable automobile for $10,000, and who has no other depreciable or capital assets, has $20,000 of total debt outstanding. Because the amount of the outstanding debt exceeds the value of the automobile, the taxpayer effectively has debt-financed the entire value of the automobile. Assuming a tax rate of twenty-five percent, the benefit to the taxpayer from indexing depreciation on the automobile, during the first year of the automobile’s useful life, would be twenty-five percent of the amount by which indexation increased the taxpayer’s depreciation allowance. As indicated immediately above, indexation would increase the taxpayer’s depreciation allowance from $3491 to $3666, an increase of $175. At a twenty-five-percent tax rate, indexation thus would decrease the investor’s tax bill by $43.75.

payments on relatively risky debt include not only an inflation component, but also a risk premium. Thus, the inflation component represents a smaller proportion of interest paid on risky debt than on other debt. An ideal indexation system would require borrowers of risky debt to forgo deduction of a smaller percentage of their interest payments than other borrowers.

The drafters of Treasury I apparently were willing to accept this distortion as a price for the overall benefits of indexing under the plan. Because the Treasury I plan involved not only the partial disallowance of interest deductions but the partial exclusion of interest receipts, the plan’s overtaxation of borrowers of risky debt was to some extent offset by an undertaxation of lenders of risky debt, a situation that would not exist under the suggested election. Nevertheless, under the suggested election, only taxpayers whose asset values are relatively high compared to their loan balances would elect into the indexation system. These taxpayers should, by and large, be those with relatively risk-free debt. Thus, any potential disadvantage to high-risk borrowers may be of limited practical significance. The significance might be still lower if Congress implements the election in connection with the partial exclusion of capital gains, a measure which, generally speaking, would tend to offer special advantages to speculative investments.
To benefit from this reduction, however, the taxpayer would need to forgo 27.3% of the otherwise allowable deduction for interest on the taxpayer's total indebtedness of $20,000. Based on the assumption of an eleven-percent interest rate, the taxpayer's total interest payments on the $20,000 of indebtedness would be $2200. As the price of indexing depreciation allowances the taxpayer would be required to forgo deduction of 27.3% of this amount, or $600.60. At a tax rate of twenty-five percent, forgoing the deduction of $600.60 would result in a tax cost of $150.15. The tax detriment from relinquishing a portion of the interest deduction thus would outweigh the tax benefit of $43.75 from indexing depreciation allowances, and the taxpayer accordingly would not elect to accept the benefits of indexation. Quite properly, this taxpayer—whose indebtedness is very large compared to the value of the taxpayer's depreciable assets—would not enjoy the benefits of depreciation indexation.

A different result would obtain if the taxpayer's total indebtedness were only $1000, rather than $20,000. Under this assumption, the taxpayer has financed the depreciable automobile primarily from equity. For this taxpayer, the tax benefit from indexing depreciation allowances would remain at twenty-five percent of $175, or $43.75. The taxpayer's total interest expense is $110 (eleven percent of $1000), and the taxpayer would be required to forgo indexation of 27.3% of this amount ($30.03), yielding a tax cost (at a tax rate of twenty-five percent) of $7.51. This cost is much less than the tax benefit of $43.75 from indexing depreciation allowances. The holder of the equity-financed asset therefore will “elect into” the indexation system. As a consequence of accepting indexation of depreciation allowances, however, the taxpayer will relinquish the inflation-related benefits associated with the taxpayer's $1000 of debt.206

206. As an additional example, it is useful to consider the operation of the proposed election with respect to a taxpayer who fully debt-finances the $10,000 depreciable asset, and who has no other debt outstanding. For this taxpayer, the benefit from indexing the depreciation allowance during the first year remains at $43.75. In order to receive this benefit, the taxpayer would be required to forgo deduction of 27.3% of $1100 in interest on the taxpayer's $10,000 indebtedness. Thus, the taxpayer would lose a deduction of $300.30, resulting in a tax cost (at a 25% tax rate) of $75.08. The holder of the fully debt-financed asset thus would not elect to index depreciation in the first year of the asset's life.

By the final (fifth) year of the asset's life, the result is different. In that year, by reference to Tables 1 and 3 in the text, the difference between the unindexed depreciation allowance ($974) and the indexed depreciation allow-
The mechanics of the election would differ to some extent, depending on whether taxpayers seek indexation of depreciation allowances or of capital gains. When taxpayers seek indexation only of depreciation allowances, they could make the election simply on a year-by-year basis; that is, for the particular year in which the taxpayer seeks to index depreciation allowances, the taxpayer would be required to accept partial reduction of the interest deduction only for that year. This relatively simple structure is possible because the Code allows depreciation deductions on a year-by-year "accrual" basis. Thus, a single year's depreciation allowances can be matched, as an eco-

ance ($1243) is $269. At a tax rate of 25%, deduction of this amount yields the taxpayer a tax savings of $67.25.

In the fifth year, the remaining fair market value of the taxpayer's depreciable asset will be $1243. This can be seen from Table 3, which sets forth the inflation-adjusted depreciation deductions. The table indicates that in inflation-adjusted terms, the asset depreciates by $1243 during the fifth year, at the end of which the asset's inflation-adjusted value is zero. This indicates that the asset's inflation-adjusted value as of the beginning of the year was $1243. Assuming that the remaining principal balance of the taxpayer's loan, as of the beginning of the year, is equal to the asset's fair market value, a result that is consistent with the underlying assumption of a fully debt-financed asset, the outstanding loan balance will be $1243. The taxpayer's interest payment for the year therefore will be 11% of $1243, or $136.73. Forgoing 27.3% of this deduction ($37.33) will impose a tax cost (at a 25% tax rate) of $9.33. Because this is less than the tax savings of $67.25 from indexing depreciation, the taxpayer will elect to index in the fifth year.

This example has several lessons for those who would design an election system such as that suggested here. First, a taxpayer whose depreciable asset is fully debt-financed will choose to enjoy some indexation of depreciation over the asset's life. This result is appropriate. For the taxpayer whose depreciable assets are exactly 100% debt-financed, inflation's detrimental effect on depreciation allowances should, in fact, outweigh the tax benefits accruing through inflation's effects on the interest deduction, because a portion of these benefits are likely to be "taken" from the taxpayer in the form of higher interest charges imposed by lenders. See supra notes 137-45 and accompanying text.

An additional lesson is that some taxpayers will, rationally, decide to opt into the indexation system in some years but not in others. This underscores the desirability of permitting taxpayers to elect depreciation indexation on an annual basis. See text immediately following this note. The rules generally should permit the taxpayer who opts into the system midway through an asset's life to index the depreciation allowance for the year in question on a cumulative basis, taking into account inflation from the point at which the asset was purchased. Otherwise, the taxpayer will not receive a full measure of inflation protection. The mechanics of providing this cumulative adjustment should be fairly simple for the taxpayer who, as would normally be the practice with respect to depreciable property, has maintained records of asset basis from year to year. Cf. S. 171, supra note 181, § 201, 135 CONG. REC. at S527-28 (setting forth similar cumulative adjustment mechanism for indexing capital gains).
nomic matter, against the interest deductions accruing to the taxpayer in that same year.

The election cannot be quite so simple when the taxpayer seeks indexation of capital gains. Under the rule of realization, the capital gains reported in a given year will reflect income accrued not only in that year, but throughout the asset's holding period. As a theoretical matter, Congress should require a taxpayer who elects indexation of capital gains on an asset disposed of in a given year to relinquish a portion of the interest deduction for each year during which the taxpayer held the asset.

Congress could provide this theoretically proper treatment by requiring taxpayers to elect, in the year in which they originally purchase an asset, whether to participate in the indexation program with respect to that asset. Such a requirement probably would be unfair; however, to taxpayers unable to predict the extent to which they would maintain debt balances during the asset's holding period. Alternatively, under a less exact but simpler election mechanism, the taxpayer would not be required to elect into the system at the time the taxpayer purchased an asset, but instead could elect indexation at the time the taxpayer sells the asset. As a condition to receiving indexation of the capital gain on sale, the Code would require the taxpayer to accept, retroactively, a partial reduction of interest deductions for a specified number of years (perhaps three years, corresponding to the normal statute of limitations for amending income tax returns), or for the holding period of the asset if shorter. (This simplified method could offer taxpayers an economic advantage when they hold assets for long periods of time.207 This advantage, although admittedly resulting in some distortion in favor of holding debt-financed assets, should be relatively minor. It also might be consistent with a legislative desire to mitigate "lock-in" by providing some advantage to assets with long holding periods.)

While this Article offers the proposed election as a component of a "safety valve" indexation plan, the election should be adaptable to any program of indexation of depreciation or capital gain, whether explicit or implicit. Congress could, for example, require the election as a condition of eligibility for any reinstated capital gain preference (which presumably would be

207. That is, a taxpayer holding an asset for longer than three years could enjoy indexation of gain that accrued in some years for which the taxpayer would not be required to reduce interest deductions.
intended, in part, as a substitute for indexation), or as a condition of eligibility for the Code's current, accelerated depreciation allowances (which apparently are intended to provide some \textit{ex ante} protection against inflation).\footnote{208} Alternatively, Congress might not require the proposed election as a condition to enjoying the benefits of the Code's existing \textit{de facto} indexation provisions, but might require the election as a condition to enjoying any additional indexation.\footnote{209}

The proposed coupling of indexation with an elective limitation of interest deductions inevitably would involve some level of imprecision. The determination of the portion of interest to be disallowed would rest on fairly rough estimates of the extent of the inflation component of interest, and of the portion of the tax advantages from inflation that borrowers lose in the form of higher interest charged by lenders. The resulting distortions, however, should be relatively small, and probably not sufficiently systematic, or measurable by the taxpayer, to raise opportunities for significant manipulation. Even if the distortions were fairly large, the election mechanism might well provide fewer distortions, and fewer opportunities for manipulation, than the Code's historical, and with respect to accelerated depreciation, current, approach of making available the full benefits of implicit indexation of inflation without requiring any "payback" from holders of debt-financed assets. Unless Congress introduces full indexation of debt into the Code (a remote possibility, given the administrative difficulties involved), it should consider an election mechanism along the lines suggested here in connection with any future proposals to index the income tax base, implicitly or explicitly, for inflation.

\footnote{208. \textit{But see} Bulow \& Summers, \textit{supra} note 72, \textit{passim} (suggesting that Code's current depreciation allowances may be lower than those necessary to bring about investment neutrality). The Bulow-Summers analysis implies that Congress should proceed with caution in limiting depreciation to estimated economic depreciation, even to holders of debt-financed assets.}

\footnote{209. If Congress employs the proposed election in connection with safety-valve indexation of depreciation or capital gains, it should not require the asset owner to relinquish the full inflation-related tax advantage associated with debt, but only the portion attributable to that component of inflation for which the taxpayer receives indexation under the safety valve. Thus, if a safety valve provides for indexation of depreciation allowances for only 75\% of the extent to which inflation exceeds 5\%, Congress should require taxpayers to relinquish only that portion of the interest deduction attributable to the same amount of inflation. It would be unrealistic to expect asset owners to forgo the full tax benefits associated with the inflation component of interest, in return for only limited inflation indexation of depreciation allowances and capital gains.}
3. Other Substantive Arguments Against Indexation

a. Revenue Considerations

Arguably, the Code's current lack of indexation mechanisms is desirable, because it permits the revenue yield of the tax system to grow over time to help "pay for" the relatively low marginal rates introduced by the 1986 Act.\(^{210}\) Apparently, because the increased tax collections (in real terms) from an unindexed system are likely to occur only gradually, and because the increased tax burden is to some extent uncertain, the prospect of increased tax collections poses a relatively low threat to those taxpayers who would be affected. Indexation thus becomes a relatively easy pawn to trade in return for more immediate or certain benefits, such as those accruing from lower rates.

The importance of this phenomenon in facilitating the resolution of legislative debates should not be underestimated. If those policymakers crafting the legislative compromise in 1986 had not relied on the tendency of some participants in the process to discount the tax burdens likely to arise from a lack of indexation, passage of a tax bill in 1986 might have been impossible. Nevertheless, the same tendency to discount the prospective tax effects of inflation that aids political compromise in the first instance may magnify the intensity of the political reaction if inflation should accelerate and the detrimental effects of inflation "suddenly" appear. A revenue-raising strategy that relies too heavily on the tendency to discount the potential effects of inflation is inherently prone to instability, as well as to distorted tax burdens on income from capital.

The proposed safety-valve indexation scheme may represent an attractive compromise between a desire to raise revenue by letting the real tax burden increase to some extent with inflation, and a desire to limit the extent to which inflation can inflict political instability and economic distortion on the tax system. So long as inflation remains within anticipated bounds, a safety-valve system will permit inflation to affect the real

\(^{210}\) McLure reports, for example, that some participants in the deliberations leading to the 1986 Act "were . . . concerned that indexing of depreciation allowances would create a revenue 'time bomb' that would explode sometime beyond 1990. That is, they feared that if inflation accelerated, depreciation allowances would increase accordingly and revenues would be lower than under an unindexed system." McLure, supra note 30, at 1654 (footnote omitted). The indexation of capital gains and its rough substitute, a capital gains exclusion ratio, also seem to have fallen prey to revenue concerns. See J. Birnbaum & A. Murray, supra note 62, at 225-27.
value of federal revenues. If inflation exceeds the “trigger” rate, however, the safety valve will limit the extent to which real tax burdens will increase, thus protecting the tax system against very profound economic distortions and very strong political pressures for tax restructuring.211

b. Arguments Relating to Progressivity

An additional normative argument against indexation relates to the tax system’s progressivity. Virtually by definition, beneficial interests in depreciable and capital assets tend to be held disproportionately by persons of relatively high wealth. An unindexed system may provide a politically attractive means of increasing the system’s progressivity over time, by increasing the real rate of taxation on income from wealth in periods of high inflation.212

Questions of income tax progressivity are intrinsically subjective, and it is difficult to evaluate the normative value of attempting to increase progressivity through the effects of inflation on the tax base. Nevertheless, even if a policy of fostering progressivity through the effects of inflation is desirable, it should be subject to limitations. As was true with respect to a policy of eschewing indexation to raise revenue, a policy of avoiding indexation of the tax base to enhance progressivity may be desirable within some range of possible inflation rates, but almost certainly will lead to excessive tax burdens on income from capital at higher rates.213 A desire for progressivity therefore may justify a decision not to adopt complete indexation, but it should not prevent Congress from adopting measures, such as the safety-valve system proposed here, to keep the effects of inflation within predetermined bounds.

211. Canada has employed a “safety valve” compromise in its indexation of rate brackets, a form of indexation for which the tradeoff between increased revenues and the distortion of tax burdens is especially acute. Since 1985, Canada has indexed rate brackets only for inflation exceeding three percent. See COMPARATIVE TAX SYSTEMS, supra note 191, at 348.


213. Cf. Bailey, supra note 212, at 323 (comments of Peter Diamond) (“In the end . . . , we are left with the simple fact that inflation results in a tax on wealth. A tax on wealth does not bother me, but its random size does.”).
c. The Argument That an Unindexed System Offers “Automatic Stabilizers” Against Inflation

Commentators often have argued that Congress should avoid indexing the tax system, because an unindexed system offers built-in correctives for inflation through both economic and political mechanisms. Economically, an unindexed system is said to offer an “automatic stabilizer” by increasing tax revenues in the event of inflation, thereby dampening aggregate demand. Politically, an unindexed system may counter inflation by giving important interest groups a strong economic incentive to favor policies that lessen the likelihood of inflation.

As an economic matter, the “automatic stabilizer” argument was more compelling prior to the indexation of the rate structure in the 1981 Act. Before the introduction of bracket indexation, Congress could expect inflation to “bump” a great many taxpayers into higher brackets, thereby accomplishing a broadly based tax increase that might have served a useful counter-cyclical purpose. Now that Congress has eliminated “bracket-creep,” however, inflation increases the real value of tax revenues by increasing specifically the tax burden on income from capital. At least in the recent “stagflationary” past, high levels of inflation have tended to coincide with rel-

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214. See, e.g., id. at 313-14 (describing “automatic stabilizer” argument). In 1978, the Senate Finance Committee favored an increase in the capital gains “exclusion ratio” rather than explicit indexation, based in part on the argument that “since the [exclusion ratio] is constant, unlike the automatic adjustments generally provided for in various indexation proposals, it should not tend to exacerbate inflationary increases.” S. REP. No. 1263, supra note 27, at 192.

215. See, e.g., STAFF OF THE JOINT COMM. ON TAXATION, supra note 113, at 8 (reporting fears that indexation “might reduce the public resolve to prevent inflation”); Wetzler, supra note 38, at 425 (reporting that Congress defeated indexation of capital gains in 1978 in part on basis of “the somewhat speculative argument that indexing, by cushioning people from the ill effects of inflation, would deplete the ranks of dedicated inflation fighters”).

216. See Halperin & Steuerle, supra note 42, at 379 (comments of Richard A. Musgrave); cf. R. WEAVER, supra note 159, at 191-92 (discussing role of “fiscal dividend” in congressional consideration of rate bracket indexation).

217. In addition, however, inflation eroded the value of the then-unindexed personal exemption and standard deduction, thereby increasing the burdens of taxpayers with very low incomes. This undesirable result undoubtedly helped to bolster the case for the Code’s current indexation of rate brackets, as well as the level of the personal exemption and the standard deduction.

218. “Stagflation” is “[a] word recently coined to describe the simultaneous occurrence of economic slowdown, with its concomitant increased unemployment (stagnation), and rising prices (inflation).” D. MOFFAT, supra note 14, at
atively low levels of capital investment. A policy of seeking, through “automatic stabilizers” in the tax code, to dampen aggregate demand by increasing the relative tax burden on income from capital thus seems questionable on macroeconomic grounds.219

A policy of reliance on automatic stabilizers may be more defensible on political grounds. By virtue of their relative political strength, groups earning income from equity-financed capital—including the nation's large manufacturing concerns—may prove especially influential in promoting anti-inflationary policies. The same groups, however, might also prove especially influential, in the event of high inflation, in changing the tax rules to lessen the burden on income from capital, thus raising a special danger of legislative instability in the absence of indexation. Even if Congress were to index the tax system fully, moreover, capital-owning groups probably would remain a significant lobby for anti-inflationary policies, as a result of inflation's tendency to induce restrictive monetary policies, thus dampening demand for the products of capital.

Some purely symbolic implications of indexing may strengthen the political stabilizer argument. Historically, policymakers probably have associated “indexing” as a generic concept with political systems in which traditional anti-inflationary policies have failed fairly spectacularly.220 The further introduction of indexation measures into the tax system might raise the view that the United States had weakened in its resolve to combat inflation. This perception apparently did not arise, however, following the 1981 Act's indexation of rate brackets, and it seems unlikely that the modest changes recommended in this Article would have a serious symbolic effect. In sum, although a desire for political automatic stabilizers may provide a reasonable argument against full indexation of the tax base, the strength of the argument probably is limited.


219. “If inflation occurs only when unemployment is low, [an unindexed] tax system may . . . moderate inflation by curtailing excessive demand. If inflation occurs during recession, however, the automatic rise in taxes aggravates rather than moderates declines in output and unemployment.” Bailey, supra note 212, at 313.

220. See, e.g., Bailey, supra note 212, at 314 (describing, but ultimately discounting, argument that “[t]o index the tax system has often been equated with a confession of defeat in the attempt to control inflation”); see also C. Steuerle, supra note 122, at 35 (attributing historical failure to index tax base for inflation, in part, on “a political fear of all issues of indexing”).
d. The Argument That an Unindexed System Results in More Frequent Improvements to the Code

At times, the idea has arisen that while a lack of indexation concededly breeds legislative instability, the instability serves a useful social function by providing legislators with frequent opportunities to improve the tax system. This argument implies a teleological view of the tax policy process, according to which successive changes can be expected to lead the tax system progressively toward a more nearly perfect state.

The teleological view seems questionable. Two quite different conceptions of a theoretically pure tax system have influenced tax policymaking in recent decades: an accretion model under which the Code subjects all income to taxation regardless of the use to which the taxpayer puts the income; and a consumption model, which subjects to tax only income that the taxpayer uses to finance consumption during the year. Contemporary tax legislation can be described most plausibly as an oscillation between these two polar models, with the tax system at any given moment showing features of both models. Even the 1986 Act, which in many ways represents a substantial triumph for the accretion model, incorporates some important consumption-tax elements, most notably continued generous deductions for retirement savings and the continued exemption from taxation of the economic returns from home ownership. It is conceivable that future tax changes may lead inexorably toward a system closely approximating either the accretion or consumption-tax ideals. It is also possible, however, that successive versions of the Code will represent various “hybrids” of the two models, with relative weights depending on prevailing economic and political circumstances.

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221. Aaron, for example, reports, but does not endorse, this argument: During inflation Congress ... must act periodically to offset the effects of rising prices, not only on taxes, but also on expenditures. The central issue ... is whether such periodic reexamination results in better or worse tax and expenditure policy than would result if automatic adjustment freed Congress from the need to reexamine these programs. Aaron, supra note 135, at 26.

222. For a recent collection of essays focusing on the tension between these models, see UNEASY COMPROMISE, supra note 42; cf. also supra notes 89-92 and accompanying text (describing absence of need for inflation adjustments in pure consumption-model system).

223. See Andrews, supra note 9, at 1128-40.

224. “It is not only the current tax that is a hybrid; the inclination of tax
minacy of this environment, a policy of deliberately building instability into the system, in the hope that this will lead to net improvement, is not compelling.

The teleological argument against indexation also understates the cost of instability in the tax laws as a problem in itself. Frequent changes to the Code can generate confusion and resentment among taxpayers, and can require a great deal of expensive reeducation among tax administrators and advisers in both the public and private sectors. Frequent changes make it impossible for the Treasury to provide current guidance to practitioners and taxpayers through regulations and rulings, thus magnifying uncertainty and administrative expense. Perhaps most importantly, frequent changes in the law deprive the congressional and Treasury staffs, as well as legislators, of the time needed to refine the details of legislative changes, a problem that almost certainly has contributed to shortcomings in recent legislation. For these reasons, the most frequent appeal by participants in the legislative process in recent years has been not for a more "perfect" tax system, but rather for greater stability in the tax code.

In short, it would seem counterproductive to leave the tax base unindexed for inflation as a means of inducing more frequent reexaminations of tax legislation. It seem far more desirable to build some automatic adjustments for inflation into the Code, to promote a greater measure of legislative stability than the Code has seen during the past decade.

B. PROCESS-ORIENTED CAUSES FOR THE ABSENCE OF INFLATION ADJUSTMENTS

In addition to the substantive concerns just addressed, the parochial interests of some participants in the legislative process may have contributed to the rejection of indexation mechanisms in the past. The existence of these parochial con-

policymakers is also mixed. They show little determination to go all the way in either direction toward a pure accretion or a pure consumption tax.” Andrews & Bradford, Savings Incentives in a Hybrid Income Tax, in Uneasy Compromise, supra note 42, at 269, 270 (footnote omitted).

225. See, e.g., Daily Tax Rep., July 14, 1988, at L-1, L-5 (testimony of IRS Commissioner Lawrence Gibbs before the Subcommittee on Commerce, Consumer and Monetary Affairs of the House Government Operations Committee) (“We have seen six major tax bills in the last eight years. It is time to give the IRS and the public a rest from substantial changes to the law that only add to the confusion.”); see also Leonard, Perspectives on the Tax Legislative Process, 38 Tax Notes 969, 977 (1988) (pointing to need for stability in tax system); Verdier, supra note 158, at 174-76 (focusing on need for tax stability).
cerns in no way detracts from the merits of the substantive arguments that critics have raised against indexation. Understanding the potential parochial interests nevertheless is useful for purposes of evaluating previous decisions on inflation adjustments, as well as for designing proposals that are likely to receive a favorable legislative reception.

The legislative system's bias against inflation-proof tax mechanisms seems stronger than substantive concerns alone can explain. In 1981, for example, legislators rejected a House Ways and Means Committee proposal for the “expensing” of many categories of depreciable assets—an inflation-proof method of providing asset-holders with effective exemption from taxation—226—in favor of a “front-loaded” system, highly susceptible to the effects of inflation, designed to achieve an approximately similar result.227 Even more remarkable is the legislative experience of 1982, when Congress, stating explicitly in the legislative history its goal of providing equipment purchases with the economic equivalent of “expensing,” nevertheless chose to accomplish this goal through the inflation-sensitive mechanism of front-loaded depreciation schedules.228 The pat-

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226. See supra notes 89-92 and accompanying text.
227. The House Ways and Means Committee adopted an explicit expensing proposal, H.R. REP. No. 201, 97th Cong., 1st Sess. 73-89 (1981), but Congress defeated it on the House floor: 127 CONG. REC. 18,092-18,188 (1981). Congress may have rejected expensing out of a desire to provide businesses with relief even beyond the zero effective tax rates associated with expensing, c.f. supra note 91, although Congress's prompt effort, in 1981, to correct the 1981 Act's negative effective tax rates, supra notes 100-03 and accompanying text, suggests that Congress did not seek deliberately, in 1981, to achieve a result more generous than expensing. Congress also may have been concerned, in 1981, that the Ways and Means expensing proposal was to be phased in only gradually. Cf. 37 CONG. Q. ALMANAC 99 (1981) (pointing to both absolute level of subsidy provided under Ways and Means plan, and its rate of phase-in, as factors influencing plan's defeat). Had Congress been concerned mainly with the rate of phase-in, however, it could have retained the expensing approach with a more rapid implementation. The roots of congressional decisionmaking always are complex, and this likely was especially true in the fast-changing environment of the early 1980s. Nevertheless, it remains worthwhile to consider why Congress was so resistant to the inflation-proof expensing proposal and, perhaps more to the point, why advocates of greater incentives for capital formation supported accelerated cost recovery rather than expensing.
228. See supra notes 101-03 and accompanying text.

As was true in 1981, see supra note 227, simple hostility to inflation-proof tax measures was not the only political factor contributing to the rejection of expensing in 1982. Perhaps most importantly, Congress perceived the 1982 Act as a relatively limited, “incremental” corrective amendment to the 1981 legislation, and Congress may have been reluctant to reopen the 1981 decision to adopt ACRS rather than expensing. In addition, a simple move from ACRS to expensing in 1982 would have involved short-run revenue losses and required
tern continued in 1986 when business lobbyists failed to support Treasury I's proposal for indexed depreciation allowances and capital gains, although these proposals probably would have resulted in effective rates of taxation on income from capital that were quite generous, both by reference to historical standards and by comparison with the unindexed provisions that Congress ultimately adopted in the 1986 Act.

The motivations underlying legislative decisions are complex, and one should draw conclusions concerning the causes of legislative action only with caution. Nevertheless, the apparent aversion to inflation-proof mechanisms, even in 1981 and 1982 when "expensing" seemed a logical response to the prevailing political and economic environment, suggests the presence of a bias against inflation-proof mechanisms arising from more than solely substantive concerns.

carefully drawn transitional rules. Cf. Letter from James M. Verdier to Michael C. Durst (Jan. 19, 1989) at 3 (offering recollection that revenue concerns militated against adoption of expensing in 1982). Nevertheless, it was within the congressional staff's expertise to draft appropriate phase-in rules, and the congressional decision to forgo expensing in actuality, while acknowledging its economic desirability, is noteworthy.

229. See McLure, supra note 30, at 1652-56.

230. See McLure & Zodrow, supra note 125, at 51 ("In light of the outcry prompted by the Treasury I proposal to index capital gains against inflation and tax them at a maximum rate of 35 percent, the agreement under the 1986 Act to tax gains at a 33 percent maximum rate without indexing for inflation is quite amazing.").

With respect to the reaction to Treasury I's proposal for indexed, "economic" depreciation allowances, McLure has observed:

The argument that the real present value of depreciation allowances would be as great under [the Treasury I proposal] as under [prior law's accelerated allowances] carried less weight with many business executives than might have been expected. This can probably be traced to a variety of sources. First, some simply did not understand the purpose of indexing, which was to prevent the measurement of real income from being distorted by inflation. Second, even those who clearly understood the economics of [the Treasury I proposal] did not necessarily prefer it to [prior law]. This suggests that economists' models that focus attention on real present values and exclude consideration of up-front cash flow may fail to capture real-world decision making.

McLure, supra note 30, at 1654 (footnote omitted); see also Minarik, supra note 185, at 1387 (reporting that in response to Treasury I, "[t]he investment community railed against nonaccelerated indexed depreciation, asking for bigger up-front deductions that were not contingent upon inflation").

231. For a recent attempt to catalog factors influencing legislative decision-making on proposals for indexation, of spending programs as well as tax rules, see R. Weaver, supra note 159, at 1-37, 211-47.
1. The Possibility That Indexation May Limit Opportunities for Political Compromise

One source of bias against an inflation-proof tax system may be an aversion among participants in the legislative bargaining process to “economically” as opposed to “politically” determined policies.\(^\text{232}\)

Risk-averse policymakers (both legislators and lobbyists) almost certainly would prefer an environment in which they can conduct political battles along a continuum of possible outcomes, rather than one in which the only apparent possible outcomes are wholesale success or failure for their clients (and for themselves).\(^\text{233}\) Policymakers probably have viewed inflation adjustment as a discontinuous policy tool,\(^\text{234}\) in the sense that the institution or removal of indexation can lead to very large changes in the effective rate of taxation on income from capital. The same probably has been true with respect to indexation’s possible substitute, “expensing” of depreciable assets, especially if policymakers have perceived expensing as an alternative to economic depreciation in a universe admitting of only two possible solutions. Policymakers therefore may have tended to avoid indexation and expensing in favor of the more familiar expediants of the front-loaded depreciation schedule and the capital gains exclusion ratio, both of which policymakers probably perceive as “nontheoretical” policies admitting of gradual adjustment along a continuum.

The perception of inflation-proof structures as inconsistent with political compromise is, as an economic matter, patently erroneous. Congress can combine “expensing” with economic depreciation to provide any desired level of inflation-proof investment incentive—for example, by allowing expensing of half of an asset’s cost and economic depreciation of the rest.\(^\text{235}\) Similarly, Congress can provide any desired level of preference for capital gains in an inflation-proof manner, simply by applying a reduced tax rate to inflation-adjusted gains.\(^\text{236}\) Over time, tax

\(^{232}\) See infra note 239.

\(^{233}\) For example, proponents of generous depreciation deductions may have perceived the 1986 Act’s allowances, with their attempted \textit{ex ante} inflation adjustments, as less of a long-term political setback than an economically similar policy of economic depreciation with explicit indexation for inflation.

\(^{234}\) See, \textit{e.g.}, Bristol, \textit{supra} note 34, at 1028 (“Indexing, beyond that of brackets and exemptions, is seen as a complicated process requiring ‘all or none’ type decisions.”).

\(^{235}\) See \textit{supra} note 92.

\(^{236}\) For example, Congress might simply provide that \textit{after} adjustment for
policymakers may acquire a more sophisticated understanding of inflation adjustment, including an understanding of the flexibility of inflation-proof mechanisms. This economic education is likely to occur slowly, however, and a perception that inflation adjustment is largely inconsistent with political compromise may impede consideration of tax indexation measures in the foreseeable future.

To the extent that this is true, the safety-valve approach suggested in this Article may prove especially attractive. Under a safety-valve approach, policymakers would arrive at their underlying depreciation and capital gain policies through political compromise, without reliance on explicit inflation adjustments. The presence of the safety valve, however, would preserve the political result should inflation exceed the range political negotiators apparently assumed in reaching their original compromise.

2. Political Actors' Interest in Continuous Change Per Se

Recent discussions of “rent seeking” behavior by participants in the tax legislative process suggest an additional source of opposition to inflation adjustment mechanisms. These discussions focus on the fact that legislators and lobbyists derive their compensation—whether in the form of professional fees, campaign contributions, or political influence—from the process of legislative change, rather than from any particular political outcome. If this model is correct, these participants have an incentive to avoid legislative measures, such as inflation adjustments, that tend to insulate the tax code from potentially destabilizing influences.
The grounding of indexing and expensing directly in economic theory may in itself render these measures unattractive to the “rent seeking” participant in the political process. Policy tools based explicitly on economic models promote the image of a tax policy adhering closely to objectively applied external criteria. The alternative image is of a tax policy based on a continuous process of political “horse trading”—an image that may be attractive to professional horse-traders.

The rent-seeking model paints only a partial picture of the legislative process. Even if the model has only limited explanatory power, however, it suggests that the tax code has more built-in instability than purely normative considerations warrant. Recognition of the rent-seeking model therefore renders more attractive those measures that, like safety-valve indexation, might serve to limit occasions for legislative revision.

IV. SOME TECHNICAL ASPECTS OF THE PROPOSED SAFETY VALVE AND THE REQUIRED ELECTION

A. BASIC STRUCTURE OF THE SAFETY VALVE

This Article has suggested an approach to inflation adjust-

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239. Cf. Hulten & Wykoff, supra note 75, at 81-82 (contrasting notions of “economic” and “politically determined” depreciation allowances).

240. “The problem with all single-objective theories of politicians’ behavior is not that they are altogether wrong, but that they are incomplete.” R. Weaver, supra note 159, at 211.

241. In this sense, one can view inflation-adjustment mechanisms as “constitutional rules” of the kind advocated by Brennan and Buchanan. See G. Brennan & J. Buchanan, supra note 237, at 1-12.
ment consisting of three central elements. First, Congress would permit taxpayers to adjust depreciation allowances and capital gains to compensate for inflation, but only to the extent that inflation exceeds a "trigger" rate, set slightly higher than the rate assumed in drafting the underlying tax act. Second, to limit revenue costs and provide some level of "automatic stabilizer," Congress would permit adjustments for only a portion of the extent to which inflation exceeds the trigger rate. Third, the proposed indexation of depreciation and capital gains would be available only to taxpayers who accept a partial disallowance of the deduction for interest on all of their indebtedness.

The choice of a trigger rate, and the portion of inflation above the trigger rate for which Congress would provide adjustment, would be matters of economic and political judgment. The House proposal in 1985 would have permitted adjustments to depreciation allowances by half of the extent to which inflation exceeded five percent during the year—adjustments which arguably are too limited. For purposes of illustration only, the following discussion assumes that the Code would allow the taxpayer adjustment for seventy-five percent of the extent to which inflation exceeds a trigger rate of five percent.

Mechanically, with respect to depreciation, the system proposed in this Article would permit taxpayers to multiply the depreciation allowance otherwise permitted for the taxable year by the factor of one plus seventy-five percent of the extent to which the inflation rate (expressed in decimal form) exceeds five percent during the year. For example, if inflation were to occur during the taxable year at the rate of eight percent, the taxpayer would multiply the otherwise permitted allowance by a factor of $1 + [0.75 \times (0.08 - 0.05)]$, or 1.0225. Because the effects of inflation are cumulative throughout a depreciable asset's life, the proposed safety-valve adjustments also would be cumulative. Thus, if inflation in the first year of an asset's life were to occur at a rate of eight percent (resulting in an adjustment factor of two and one-quarter percent), and if infla-

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242. See supra notes 166-67 and accompanying text.
243. See supra note 168 and accompanying text.
244. See supra notes 197-209 and accompanying text.
245. See supra note 114.
246. That is, the taxpayer would be able to increase the allowance by 2.25 percent.
A safety-valve adjustment to capital gains would consist of a one-time increase in basis in the year in which the taxpayer sells the asset, which would reflect the extent to which “excess” inflation had occurred during the asset’s holding period. Assume, for example, that during an asset’s three-year holding period, inflation occurred at a rate of eight percent in the first year, five percent in the second year, and ten percent in the third year. In computing the asset’s adjusted basis for purposes of determining the gain on sale, the taxpayer would multiply the basis by a factor of 1.0225, reflecting the eight-percent inflation in the first year, and also by a factor of 1.0375, reflecting the ten-percent inflation in the third year. No adjustments would be allowed for the second year, in which inflation did not exceed five percent. The total adjustment factor thus would be 1.0225 X 1.0375 (reflecting the cumulative effect of inflation above the trigger over the asset’s life), or 1.0608. Therefore, if the asset had an adjusted basis in the year of purchase of $100, its inflation-adjusted basis at the end of the three-year holding period would be $106.08.

B. SOME ADDITIONAL MATTERS OF TECHNICAL DESIGN

Because the proposed safety-valve indexation of depreciation conforms depreciation deductions more closely to economic reality, the Code generally should treat the adjustments as additions to “depreciation” for purposes of those portions of the Code to which depreciation allowances are relevant. For example, Congress should allow the proposed safety-valve adjustments in computing depreciation for minimum tax purposes, as well as in computing a corporation’s “earnings and profits.” This extension of the proposed indexation is not essen-

248. This example retains the assumption that Congress would design the safety-valve indexation to compensate for 75% of the extent to which inflation exceeds five percent per year.

249. The adjustment factor for a year in which inflation occurs at a rate of 10% is 1 + [0.75 X (.10 − .05)], or 1.0375.

250. See H. Calkins & M. Durst, supra note 74, at 12.

251. Id. In computing alternative minimum taxable income, Congress generally allows taxpayers depreciation according to schedules somewhat less accelerated than those that apply in computing regular taxable income. I.R.C. § 56(g)(4) (West 1989).

252. Generally, a corporation’s “earnings and profits” represent a measure of the corporation’s retained earnings, the distribution of which will result in a
tial, however, and Congress might decide, for purposes of administrative simplicity, to limit the applicability of the proposed depreciation adjustments only to the computation of a taxpayer’s regular taxable income.253

The Code provides generally that a taxpayer must reduce an asset’s basis by the amount of any depreciation deduction allowed for the asset, to reflect that the taxpayer has “recovered” a portion of the asset’s original cost through depreciation.254 The reduction in basis can result in additional taxable gain if the taxpayer later sells the depreciable asset prior to its exhaustion.255 The question arises whether the additional depreciation deductions resulting from safety-valve indexation should, like regular depreciation deductions, result in reductions of the depreciable asset’s basis.

The answer should depend on whether gain on the sale of the depreciable asset is eligible for safety-valve indexation. If the additional depreciation deductions attributable to indexation result in reductions in the asset’s basis, but the taxpayer is not permitted to index gain on the sale of the asset, the taxpayer could face an unwarranted increase in taxable gain on the sale. If the taxpayer is permitted to index gain on the sale of the depreciable asset, however, the additional depreciation allowances resulting from safety-valve indexation should reduce asset basis. The 1985 House proposal did not subject gains on asset dispositions to indexation, and the 1985 proposal accordingly did not require the taxpayer to reduce asset basis by the additional depreciation deductions attributable to indexa-

dividend to the shareholder. I.R.C. § 316(a) (West 1989). In computing earnings and profits, the Code allows a corporation depreciation deductions less accelerated than those allowed in computing taxable income. I.R.C. § 312(k) (West 1989).

253. The 1985 House proposal did not allow safety-valve indexation in some circumstances in which the Code subjects assets to depreciation under special rules, for example, when assets are used outside the United States. See H.R. REP. No. 426, supra note 57, at 154. As a general matter, however, the House proposal treated its proposed inflation adjustments as additional “depreciation” deductions for purposes of all portions of the Code. Id. at 155.

254. I.R.C. § 1016(a)(2) (West 1989). In essence, the Code views the taking of a depreciation deduction as a “sale” of the worn-out portion of the asset for zero consideration, resulting in a deductible “loss”; that is, the amount of the depreciation allowance. Under traditional tax principles, the allowance of a deductible loss should result in a reduction of asset basis.

255. The taxable gain on the sale of a depreciable asset is equal to the difference between the amount received on sale of the asset and the asset’s adjusted basis. I.R.C. § 1001 (West 1989). Thus, a reduction in asset basis as a result of depreciation allowances can increase the amount of gain recognized on the asset’s sale.
For administrative simplicity, Congress probably should retain this approach.\textsuperscript{257}

Congress should not permit the proposed indexation of a capital asset's basis to the extent that it results in a capital loss.\textsuperscript{258} Allowing indexation even when it results in a capital loss could exacerbate the distortion currently arising from a taxpayer's ability to recognize capital losses at the taxpayer's discretion by disposing of assets with unrealized losses, while deferring, and perhaps avoiding entirely, the taxation of capital gains by retaining assets with unrealized gain.\textsuperscript{259}

The proposal to condition indexation on the taxpayer's election to limit interest deductions raises a need for rules addressing business entities under common control. It might be possible, for example, for a taxpayer to establish two corporations, one to hold and operate the taxpayer's depreciable assets and the other to serve as obligor on loans to finance the taxpayer's business operations. If the Code is to permit the asset-holding corporation to benefit from safety-valve indexation of depreciation or capital gains, it should require the debtor corporation to elect the partial disallowance of interest deductions.

Congress can address this and similar problems by permitting a taxpayer to participate in safety-valve indexation only if all related taxpayers, including entities related by common ownership, also elect into the system. The degree of common


\textsuperscript{257} The principles applied in reaching this decision also could help resolve some other technical problems of depreciation indexation. For example, depreciation allowances on assets of a partnership result in reductions of a partner's basis in the partner's partnership interest. A partner's basis in a partnership interest generally is referred to as an "outside" basis, to distinguish it from the partnership's "inside" basis in the assets held by the partnership. \textit{See} 1 A. Willis, \textit{Partnership Taxation} § 21.01 (2d ed. 1976). Similar situations can arise with respect to shareholders' interests in S corporations, and parent corporations' interests in the stock of subsidiaries. \textit{See generally} Staff of the Joint Comm. on Taxation, \textit{supra} note 113, at 64-65 (discussing problems of inflation adjustments for assets held by pass-through entities). As a general matter, Congress should keep indexing rules consistent for both inside and outside basis. For example, if the Code permits partnerships to index depreciation allowances, thereby resulting in larger reductions of "inside" asset basis each year than would occur in the absence of indexation, it should allow partners to index capital gains on the sale of partnership interests.

\textsuperscript{258} Cf. Staff of the Joint Comm. on Taxation, \textit{supra} note 113, at 39-40 (recommending that taxpayers not be permitted to index asset basis to extent indexation results in taxable loss). \textit{But cf.} \textit{supra} note 191 (describing recent legislative change permitting indexation to result in losses under British indexing system).

\textsuperscript{259} See \textit{supra} note 26 and accompanying text.
ownership required for entities to be deemed "related" for purposes of this rule should depend upon congressional judgment concerning the likelihood that safety-valve indexation would, in fact, induce tax avoidance transactions among related entities. The Code currently contains several models of "related entity" provisions on which Congress could rely.260

By requiring the partial disallowance of the taxpayer's total deductions for "interest," the election suggested here would pose an additional incentive for taxpayers to recharacterize interest expenses as some form of expenditure carrying another label but serving the same economic function as interest. The Code already poses substantial incentives of this kind by disallowing interest deductions in a number of contexts, and the tax law has adapted in response to this problem in a number of respects.261 The election suggested here might not add significantly to the incentives for recharacterization that already exist. Nevertheless, Congress should recognize that the election could raise the need for additional policing of attempts to classify debt transactions under some other label.

Congress could limit the potential administrative burdens of the proposed system by providing fairly generous de minimis exceptions.262 For example, Congress might permit taxpayers with capital gains not exceeding $5,000 to index these amounts without electing a partial disallowance of interest deductions.263 In addition, Congress almost certainly would exempt "qualified residence interest" (home mortgage interest)264

260. The Code defines "related" entities differently for different purposes. For example, §§ 267 and 318 provide that entities with 50% common ownership will be considered related for purposes of most of the Code's anti-avoidance rules. See I.R.C. § 267 (West 1989) (disallowing losses in transactions between related taxpayers); Id. § 318 (defining "constructive ownership of stock" for purposes of various rules aimed at curtailing tax avoidance schemes among related corporations). Section 168(f)(5), in contrast, considers entities with 10% common ownership to be related for purposes of preventing taxpayers from first selling and then reacquiring depreciable property in order to qualify that property for depreciation under liberalized rules. See I.R.C. § 168(f)(5) (West 1989).

261. Cf. supra note 193 (indicating some areas in which Code currently limits its interest deductions). For discussion of this topic, see Shakow, supra note 193, at 32-50; 2 U.S. TREASURY DEP'T, supra note 2, at 198-99.

262. Cf. 1 U.S. TREASURY DEP'T, supra note 2, at 114 (providing $5,000 de minimis exception to interest indexation proposal).

263. The Code's current allowance of a limited amount of "expensing" for small business taxpayers under § 179 might preclude the need for a similar de minimis rule for depreciation. See supra note 89.

from the partial disallowance.\footnote{Cf. 1 U.S. TREASURY DEP'T, supra note 2, at 114 (excluding personal residence interest from Treasury I interest indexation proposal).}

The current discussion cannot seek realistically to identify all potential complexities of safety-valve indexation, and it is likely that some unforeseen difficulties will arise after the program is implemented. As a general matter, however, the complexities the proposal raises are of familiar kinds, and Congress should be able to resolve them by following existing statutory models. The suggested election mechanism addresses the most daunting difficulty: the need to "trace" or otherwise attribute a taxpayer's debt to particular depreciable or capital assets. The complexities of safety-valve indexation, moreover, would very possibly be far less serious than the potential distortions, both political and economic, of leaving the Code entirely unprotected from a future resurgence of rapid inflation.

\section*{CONCLUSION}

Although analysts have long recognized that a failure to index the tax base for inflation can lead to large increases in the tax burden on income from capital, a number of concerns have stymied proposals to redress this defect. To some extent, these concerns reflect serious normative arguments against indexation, most notably including a recognition of the need to find some practicable means of limiting the indexation afforded holders of debt-financed assets. In addition to the normative concerns, a political aversion to explicit inflation protection, which has arisen partly from causes largely unrelated to indexation's intrinsic merits, has blocked consideration of inflation adjustment mechanisms.

This Article has argued that these historical impediments to inflation adjustment need not preclude the introduction to the Code of a useful degree of inflation protection. Congress can alleviate many of the complexities that critics have feared in the past by a straightforward election which effectively would limit full inflation adjustments to holders of equity-financed assets. Congress can address many of the other substantive and political barriers to indexing by limiting explicit indexation only to periods in which the tax effects of inflation pose an especially serious threat to both economic growth and legislative stability.

At the time of this writing, inflation remains relatively
low, but the possibility of resurgent inflation cannot be ruled out. The tax burden on capital remains a serious economic and political concern, and members of Congress, tax administrators, and practitioners are adamant in their desire for stability in the Code. The current environment therefore may present an excellent opportunity for placing in the Code inflation adjustments that would be of little consequence now, but which could prevent a great deal of needless dislocation should inflation accelerate in the future.