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Getting Inflation Loss out of Capital Gains Taxation Is Fair - and Might Help Reach a Deal on Dunning the Dead

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My intent here is not to prove any prowess as a tax policy analyst. That would be impossible. As Congress debates major tax and spending changes, it is to put ideas on the table that might result in fairer taxation and increased incentives to invest savings. Such proposals also might serve as a bargaining chip as pressure builds for reforms that reduce wealth concentration in order to pay for higher standards of living for middle- and lower-income households.

For the record, I think that political economic systems that celebrate capitalism should include all workers as owners of working assets, which could be done through a universal retirement savings system. In my view, capital gains taxes should be progressive, neutral compared with taxes on labor income, and crafted to leave a fair rate of return. Policymakers are now debating many reforms that touch on these issues, including raising capital gains taxes for the wealthiest, broadening the reach of the estate tax, and taxing capital gains in a way that more closely reflects changes in real market value ("mark to market").

Inflation erodes asset value

Most income-related taxes are indexed for inflation, but not taxes on capital gains. They are applied to the difference between the nominal cost of acquiring an asset and the proceeds from selling it. If the time interval between purchase and sale is long and rate of inflation high, distortions caused by the current tax system can be large. Investors often end up paying taxes on paper profits that are not real and even can be dunned for taxes on large losses.

Under current rules, if an investor buys shares in a company for $100 and 10 years later sells them for $110, he or she will be taxed on the $10 difference. Though capital gains taxes vary by income, most people would end up paying $2 in this example – at a tax rate of 20%. If inflation averaged 3% over that decade, however, the real value of the $100 investment would have dropped by more

than one quarter, thereby leaving the investor having to pay the tax on a real dollar loss of roughly $25.

An inflation rate of 6% in the same example would see the investor paying tax on a loss of about half the investment's value. Periods of high inflation and deflation happen. Prices in the U.S. doubled between 1915 and 1920 during World War I. At the other extreme, prices tumbled between 1927 and 1933. If someone sold an asset for a bit less than its purchase price during the Great Depression, they might have turned a profit in terms of real buying power.

Erosion of an asset's value from inflation is harder to notice when rates are historically low as they have been since the Great Recession, but it still has an impact. We now may be headed for higher inflation rates due to a number of economic factors including federal monetary and fiscal stimulus policies, as well as increased competition for workers and supply constraints stemming from the Covid-19 pandemic.

Economists and policymakers considered indexing capital gains for inflation toward the end of the 1970s when the cost of living was rising rapidly. Inflation ran in 6%-13% range from 1973 to 1982. But indexing didn't happen.

"Mark to market"

Under current law, the IRS collects capital gains taxes when assets are sold. Sen. Ron Wyden (D-OR) and others seek to break the link between capital gains taxation and the time of sale. They would tax equities and other assets annually based on assessed market value. Annual taxation of unsold assets would blunt the impact of inflation. Of course, hyperinflation of the magnitude seen during Germany's Weimar Republic and the U.S. Civil War would still create issues in such system. But those occurrences are relatively rare.

Wyden, who is chairman of the Senate Finance Committee, has introduced a series of proposals in anticipation of an upcoming budget reconciliation process. His proposals to change the tax treatment of financial services -- derivatives and carried interest -- could be a precursor to broader taxation of capital gains on a mark-to-market basis.

Annually assessing the value of complex financial transactions may be a particularly difficult starting point for the introduction of "mark to market"

taxation. According to the conservative-leaning Tax Foundation: “Policymakers should approach the construction of a mark-to-market system within financial services carefully, as it can entail a new set of complexities and compliance costs for taxpayers and subject them to tax on unrealized (or phantom) income, ultimately reducing saving and investment to the detriment of the broader economy.”

I’m not sure exactly how I would pay taxes on shares of stock under a “mark to market” system. It sounds similar to how counties levy taxes on our vehicles. We get a bill each year based on an estimate what they might sell for. For cars, the amount typically declines as they age (except perhaps if there’s a protracted shortage of used cars). Taxes are relatively high on new cars. You don’t pay much tax to drive a piece of junk.

This type of taxation conceptually seems more like a wealth tax than a capital gains tax…I’ll have to check with an accountant who keeps up to date on tax law should a “mark to market” system become law. The fact that the prices of equities move up and down, often rapidly, might complicate assessment and payment.

Wyden’s efforts to make capital gains taxation fairer and more consistent falls within a broader campaign by some Democrats to close loopholes benefitting wealthy investors. “The constant theme running through our tax code is paying taxes is mandatory for working people…,” he says in a recent Finance Committee press release. “Raising more than $172 billion for priorities like childcare and paid leave by closing off these loopholes is a no-brainer.”

Deflating and taxing capital gains at death

A more practical and equitable place to begin taxing capital gains based on real accrued value might be during estate settlements. Under current law, capital gains are already assessed in a “mark to market” fashion after the owner’s death for the purposes of bequeathing tax-free wealth to heirs. Under an arrangement widely considered to be a tax dodge for the rich and a driver of growing wealth inequality, accrued capital gains aren’t taxed at death. Heirs receiving the assets also don’t have to pay capital gains unless they sell them.

The potentially taxable value of assets being inherited is re-set on a “stepped-up” basis, meaning at the market value at the time of death instead of the original purchase price. So, heirs only pay taxes for capital gains accrued while they own the assets, not before. In this way tax dollars that might have been collected from the departed capitalist disappear into a sort of tax purgatory.

Assets like shares of stock can multiply in value and be passed from one generation to the next without the government ever collecting a dollar in capital gains tax. This feature of the tax code enables the growth of dynastic wealth and widens the distance between ordinary working people who own no working capital and those in the top economic strata who own a lot of it.

Taxing capital gains during their transfer from the deceased to heirs offers Sen. Wyden and other proponents an opportunity for a test run of “mark to market” reforms while moderating wealth inequality. Revaluations are already performed under current law. All that needs to be done is to apply a tax.

If Congress considers taxing capital gains at death, adjusting nominal gains for inflation could serve many purposes. For one thing, taxation would be fairer. Heirs might object vehemently if they had to pay taxes on paper gains or real losses that might occur as described above.   It would be a lot simpler to apply a new valuation method to assets typically held for many years rather than to derivatives and other complex financial instruments involving myriad transactions with attendant tracking and accounting issues.

If Democrats in Congress take aim at taxing capital gains at death, inflation adjustment also could be a useful bargaining chip and give market-based economists and the owners of capital something in return for enduring the pain of posthumous taxation.

As of this writing, Democrats on Capitol Hill are reported to have bowed to political opposition and dropped President Biden’s proposal to tax capital gains of the dead while they continue considering raising taxes on the highest income filers and corporations in other ways. But debate over spending and tax bills is far from over. Democrats likely face a long and winding road before they can agree about what they want, much less what they might negotiate with Republicans or force in law through reconciliation.

Remember the truism?: “You can’t take it with you.”   Or can you?

Washington Post politics and culture columnist Kathleen Parker points out: “Dead is dead, you say, but one of my dead friends showed up in a dream of mine one night to my immense delight. ‘You’re not dead!’ I exclaimed. But there he was, nonetheless, and this is what he said: ‘As it turns out, it’s not that easy to leave. I needed to take care of some things.’”

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