

# What if Capital Gains Were Indexed to Inflation?

*Investors would be taxed less if this idea gets the green light.*

Provided by Charles D. Vercellone, ChFC

Recently, President Trump and Secretary of the Treasury Steven Mnuchin both voiced their support for an intriguing idea: the indexing of capital gains.<sup>1</sup>

The idea is not new; President George H.W. Bush's administration briefly considered it in the early 1990s. It is certainly appealing, especially for wealthy investors. (More than 75% of Americans who pay capital gains taxes earn \$1 million or more annually.) Secretary Mnuchin has claimed that this change could be made via an executive order or a new Treasury rule. How would it alter the capital gains tax picture?<sup>1,2</sup>

**Capital gains tax rates would not change, just the determination of cost basis.** That alone could hand investors a big tax break.

The cost basis is the amount that an investor originally pays to acquire an asset. Capital gains = sale price of the asset – cost basis + expenses. If capital gains were indexed, the cost basis would be adjusted upward with time.<sup>2</sup>

**Chances for arbitrage could also emerge.** An investor could purchase a capital asset using debt, positioning themselves for a tax deduction. The investor could then hold onto that asset for at least a year, sell it and pay nothing or next to nothing in capital gains tax, and yet claim a tax break from the interest on the loan.<sup>1</sup>

**This would be no small change.** Adherents of the idea cite its fairness, saying inflation should be factored into the calculation of investment gains. Detractors point to its potential for swelling the federal deficit: the Penn Wharton Budget Model projects that the alteration would cost taxpayers \$102 billion across the next ten years, with 63% of the tax benefits going to just the top 0.1% of earners. Brokerages, investment funds, and real estate investment trusts (REITs) might challenge the rule change with lawsuits, as it could affect a portion of their income generation and their favorable status under the Internal Revenue Code.<sup>1,2</sup>

The conversation on this topic will no doubt continue, and high net worth investors will want to keep track of it in the near term.

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**Citations.**

- 1 - bloomberg.com/news/articles/2018-08-31/trump-touts-benefit-of-capital-gains-break-experts-aren-t-sold [8/31/18]
- 2 - fool.com/taxes/2018/08/20/capital-gains-taxes-could-change-heres-what-you-ne.aspx [8/20/18]

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