"Should capital gains be inflation adjusted?"

By Tommy Williams, CFP®

Capital gains tax reform comes with a big price tag: $100 billion over 10 years. A capital gain is any increase in the value of an asset, such as an investment, a home, land, etc., between its purchase and its sale. Simply put, the amount of a gain is determined by subtracting the purchase price from the sale price.


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Last week, the White House proposed capital gains be adjusted or 'indexed' for inflation before they are taxed. Princeton Professor Alan Blinder explained the idea in The Wall Street Journal:

"Why index gains? Suppose you own a stock for many years, during which time overall prices have doubled because of inflation. Over the holding period, the value of your stock also has doubled. When you sell, the proceeds have precisely the same purchasing power as the original purchase. There's no gain, no loss. But under current tax law, you owe taxes on the phantom 'gain.' Worse, if your stock went up by less than the cumulative inflation, you'll still get taxed despite your loss. This is unfair and dysfunctional."

While the suggestion is appealing to many investors, it's not without controversy. For example, the White House suggested the Treasury Department change the tax code without Congressional approval by modifying enforcement regulations. However, the legislative branch – Congress – is constitutionally responsible for tax law.

In addition, adjusting capital gains for inflation without doing the same for interest expense and depreciation may allow some taxpayers to be able to generate significant losses on paper. Current tax law includes provisions that limit this kind of tax strategy, but indexing capital gains would reopen the door, reported the Tax Policy Center.

Another consideration is the impact of the change on the deficit and the national debt. The Congressional Budget Office estimates suggest 2017 tax reform will *increase "…the total projected deficit over the 2018-2028 period by about $1.9 trillion."* Adjusting capital gains for inflation could increase the shortfall by about $100 billion over a decade, reported Naomi Jagoda for The Hill.

Proposals like this are commonplace in Washington. It's a little harder to figure out that the rich will get more benefit than the poor compared to other tax legislation. Tampering with tax tables is pretty obvious, sort of like the standard deduction and child care credits. It's very obvious who gets the benefit there and it really does spread the benefit all up and down the socioeconomic spectrum. It's not nearly so obvious that the rich are getting richer while the poor are getting poorer when you're indexing capital gains for inflation.

Also I'd like to see how they handle indexing gains. It seems to me like it would be pretty complicated. For example do we simply use the Consumer Price Index - a figure released monthly by the Bureau of Labor Statistics which calculates the cost to buy a fixed bucket of consumer goods and services that most people tend to use with frequency? It might be more appropriate to use Core Inflation – a measure of price changes that excludes transitory or temporary price volatility that often occurs with commodities such as food items, energy products, etc. Those wild price swings can really cloud the inflation picture sometimes.

In other words, there's a case to be made that being taxed on gains without consideration for inflation and purchasing power is unreasonable. However, it would be one more complicated thing added to the tax code – when many taxpayers would like one less thing. We'll see what happens. I'm guessing that there may be some issues of greater priority and political sensitivity that will get addressed first.

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