CHAPTER 9

ADJUSTMENTS FOR EFFECTS OF INFLATION

Current law is woefully inadequate in making allowances for the effects of inflation. Provisions designed to compensate for inflation create further distortions and rarely achieve their goal with any degree of accuracy. In other cases, such as the taxation of interest income and expense, current law makes no adjustment for inflation.

Even at moderate inflation levels, the failure to reflect inflation in the measurement of capital income significantly distorts decisions regarding capital investment. This Chapter discusses Treasury Department proposals that, together with the rules for indexing depreciation allowances discussed in Chapter 8, would adjust the tax system for inflation on a relatively comprehensive basis.

INDEX CAPITAL ASSETS

General Explanation

Chapter 9.01

Current Law

Gains or losses from the sale or exchange of capital assets held for more than six months (one year for assets acquired before June 23, 1984) are treated as long-term capital gains or losses. Long-term capital gains receive preferential tax treatment. For individuals and other noncorporate taxpayers, 60 percent of net capital gain is excluded from income, with the balance of 40 percent taxable at ordinary rates. Thus, a taxpayer in the maximum 50 percent tax bracket has a marginal tax rate on net capital gain of 20 percent. For corporations, the regular maximum tax rate of 46 percent is reduced to 28 percent on net capital gain if the tax computed using that rate is lower than the corporation's regular tax.

A taxpayer determines net capital gain by first netting long-term capital gain against long-term capital loss and short-term capital gain against short-term capital loss. The excess of any net long-term capital gain over any net short-term capital loss equals net capital gain entitled to the preferential tax rate.

Capital losses are deductible under different rules for corporate and noncorporate taxpayers. For corporations, any net short-term or long-term capital loss is offset against any net long-term or short-term gain. Excess capital losses are not deductible but may generally be carried back for three taxable years and forward for five taxable years as a short-term capital loss in the carryover year.

Individuals and other noncorporate taxpayers also deduct any net short-term or long-term capital loss first against any net long-term or short-term gain. In addition, a noncorporate taxpayer with an excess net capital loss may generally take up to $3,000 of such loss as a deduction against other income. For this purpose, only one-half of net long-term capital loss is usable. Net capital loss in excess of the deduction limitations may be carried forward indefinitely, retaining its character in the carryover year as either a short- or long-term loss.

A capital asset is defined generally as property held by a taxpayer other than (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) rights to literary or artistic works held by the creator of such works, or

acquired from the creator in certain tax-free transactions, (4) accounts and notes receivable, and (5) certain publications of the government.

Special rules apply to gains and losses with respect to "section 1231 property" and "section 1256 contracts." Section 1231 property is defined as (1) depreciable or real property held for more than six months and used in a taxpayer's trade or business, but not includible in inventory or held primarily for sale in the ordinary course of a trade or business, (2) property subject to compulsory or involuntary conversion, and (3) special industry property, including timber, coal, domestic iron ore, certain livestock and certain unharvested crops. Gains and losses from all transactions involving section 1231 property are netted for each taxable year. If there is a net gain from section 1231 property, all gains and losses from section 1231 property are treated as long-term capital gains and losses and are combined with the taxpayer's other capital gains and losses. If there is a net loss from section 1231 property, all transactions in section 1231 property produce ordinary income and ordinary loss.

Section 1256 contracts are defined to include (1) any regulated futures contract, (2) any foreign currency contract, (3) any nonequity option, and (4) any dealer option. Gain or loss with respect to a section 1256 contract generally is treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss.

Subject to certain exceptions, capital gains and losses are taken into account when "realized," generally by sale, exchange or other disposition of the property. Section 1256 contracts generally are treated as if sold on the last business day of the taxable year in which held and accrued gains or losses are realized upon such deemed sales. Certain dispositions of capital assets, such as transfers by gift, are not realization events for tax purposes. Thus, in the case of gifts, no gain or loss is realized by the donor, and, in general, the donor's basis in the property carries over into the hands of the donee. Gain or loss also is not realized on transfer at death, even though the transferee's basis in the property is stepped-up to fair market value at the time of death.

The amount of a seller's gain or loss is equal to the difference between the amount realized by the seller and the seller's adjusted basis (i.e., the cost or other original basis adjusted for items chargeable against basis). Under various nonrecognition provisions, however, realized gains and losses in certain transactions are deferred for tax purposes. Examples of such nonrecognition transactions include certain like-kind exchanges of property, involuntary conversions followed by an acquisition of replacement property, corporate reorganizations, and the sale of a principal residence within two years of the

acquisition of a new principal residence. Generally, nonrecognition treatment defers gain or loss for tax purposes by providing for a substitution of basis from the old property to the new or for a carryover basis from the old holder to the new holder.

Reasons for Change

Measurement of Income. Tax liabilities should be imposed on the basis of real economic income. During periods of inflation, nominal gains or losses on sales of capital assets will reflect inflationary increases in the value of property which do not represent real changes in economic value. Current law, however, computes capital gains and losses by reference to historic investment cost, unadjusted for inflation, and thus overstates capital gains or understates capital losses to the extent of inflation during the period property is held before sale.

The current preferential tax rate for capital gains has often been justified as an allowance for the overstatement of capital gains caused by inflation. The preferential rate actually serves this purpose only sporadically. The effects of inflation accumulate over time, yet the preferential tax rate does not vary with the holding period of an asset (beyond the minimum 6 months or one year) or with the actual rates of inflation during such period. As a result, the preferential rate undertaxes real income at low rates of inflation and overtaxes capital gains at higher rates of inflation; for any inflation rate, the longer an asset is held the greater is the undertaxation of real income. Moreover, the preferential rate does not prevent taxation of inflation-caused nominal gains in circumstances where the taxpayer has in fact suffered an economic loss.

Because the preferential tax rate does not account accurately for the effects of inflation, investors currently face substantial uncertainty regarding the eventual effective rate of tax on their investments. Such uncertainty poses unnecessary and incalculable risks for investors and thus impairs the capital formation needed for economic growth.

Neutrality. The preferential tax rate for capital gains also distorts investment decisions by providing a potentially lower effective rate of tax on assets that offer a return in the form of asset appreciation rather than current income such as dividends or interest. Along with other provisions that establish special tax treatment for particular sources and uses of income, the preferential tax rate for capital gains is one of an elaborate series of tax incentives for particular businesses and investments. These incentives impede the efficiency of an economy based on free market principles. This undeclared

government industrial policy largely escapes public scrutiny, yet it increasingly controls the form and content of business and investment activity.

Simplification. The sharp distinction in tax rates under current law between capital gains and ordinary income has been the source of substantial complexity. Application of different tax rates to different sources of income inevitably creates disputes over which assets are entitled to the preferential rate and encourages taxpayers to mischaracterize their income as derived from the preferred source. A significant body of law, based both in the tax code and in judicial rules, has developed to deal with these matters. Its principles are complicated in concept and application, typically requiring careful scrutiny of the facts in each case. The taxpayer and Internal Revenue Service resources consumed in this process are substantial, yet there is little basis for confidence that the results derived in particular cases are even roughly consistent.

Proposal

The preferential tax rate for long-term capital gains would be repealed. Gains and losses from sales of property would no longer be classified as either capital gains and losses (i.e., gains and losses from sales of capital assets) or ordinary gains and losses. Thus, net capital gain as defined under current law would be fully includible in taxable income and subject to tax at regular rates. Moreover, the holding period of property would no longer affect the tax treatment of gains or losses from sales.

Repeal of the preferential tax rate for capital gains would be coupled with inflation adjustment for realized gains from sales or other dispositions of property. For property other than inventory assets or debt instruments, a taxpayer's original cost basis would be indexed for inflation during the period a taxpayer holds the property. Computation of the basis adjustment for inflation is explained below. Assets required to be inventoried would not be indexed under the rules proposed here, but would be subject to inflation adjustment under the method of inventory accounting elected by the taxpayer. See Chapter 9.02. Inflation adjustment for bonds, notes and other debt instruments would be accomplished by indexing interest payments rather than the basis in the indebtedness. See Chapter 9.03. The above rules for indexing of basis would in general be available not only for U.S. taxpayers but also for property held by nonresident aliens and foreign corporations. In addition, conforming changes would be made in the current rules governing taxation of nonresident aliens and foreign corporations to take account of the elimination of the current law capital asset concept.

As applied to tax-favored retirement plans, the proposal would permit indexing of basis with respect to nondeductible employee contributions for purposes of determining the taxable

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portion of distributions from such plans. No indexing would be permitted with respect to tax deductible contributions by an employee or employer not included in income.

Losses from sales of investment property would remain subject to limitations. Excluding personal use property, losses from sales of property other than investment property could be deducted without limitation. In general, investment property would be defined as all nonpersonal use property other than (1) property used in a trade or business, (2) inventory property and property held primarily for sale to customers in the ordinary course of business, (3) a general partnership interest, or (4) an interest in an S corporation in which the holder actively participates in management of the entity. For purposes of these loss limitation rules, investment property would generally include notes, bonds and other debt instruments. For noncorporate taxpayers, losses from sales of investment property would offset gains from such property, with any excess loss deductible up to a maximum of $3,000 in each taxable year. Investment property losses in excess of this limitation could be carried forward indefinitely. For corporate taxpayers, investment property losses would offset gains from such property, but would not be otherwise deductible. Excess losses from sales of investment property by a corporation also could be carried forward indefinitely.

The proposal would not alter the basic realization and nonrecognition rules of current law. Thus, a taxpayer would take inflation-adjusted gains and losses into account only when realized upon a sale, exchange or other disposition of property. Current law rules regarding taxable realization events would be retained. Thus, a taxpayer would generally recognize gains or losses at year-end on section 1256 contracts, but would not recognize gain or loss upon gratuitous transfers of property, whether inter vivos or upon death. As under current law, the donor's basis and holding period for purposes of inflation adjustment would carry over in the case of inter vivos gifts. In the case of transfers of property at death, the donor's basis would be stepped-up to fair market value and the transferee would start anew the holding period for indexing such basis.

Nonrecognition provisions of current law, which require realized gains or losses to be deferred, would also generally be retained. In particular, homeowners would be permitted, subject to existing rules, to roll over gain on the sale of a principal residence, if a new principal residence is acquired within 2 years of the sale of the prior principal residence. Moreover, subject to existing rules, homeowners who are age 55 or older would exclude permanently the first $125,000 of inflation adjusted gain upon the sale of a principal residence.

The proposal generally would retain current law rules relating to determination of the amount realized upon a sale,

exchange, or disposition of property. In particular, current law rules concerning the amount realized in respect of liabilities (recourse or nonrecourse) assumed or taken subject to upon disposition of property would be retained.

The Internal Revenue Service would implement the indexing proposal by publishing inflation tables using the Bureau of Labor Statistics' Consumer Price Index for Urban Households. These tables would contain inflation adjustment factors which would be applied to the original cost basis to determine the inflation adjusted basis. The tables would specify inflation adjustment factors by calendar quarters that an asset was held. Thus, a taxpayer who bought an asset in the third quarter of 1984 and sold the asset in the second quarter of 1990 would locate in the tables a single inflation adjustment factor to be applied to the original cost basis. The tables would contain inflation adjustment factors back to January 1, 1965. Assets obtained prior to that date would be indexed as if acquired on that date.

The inflation adjustment factors would be computed using a half-quarter convention, which would allow only half the applicable quarterly inflation rate regardless of when during a quarter an asset was acquired or sold. An asset would be required to be held for one full calendar quarter in order to qualify for indexing. Assets held only for one full quarter would obtain an inflation adjustment factor only for that full quarter, and not for the partial quarters in which acquired and disposed of.

If assets are used in a trade or business that employs a functional currency other than the U.S. dollar, the measure of inflation generally would be based on the inflation rate in the functional currency (as determined by the Internal Revenue Service).

Effective Date

The proposal would be effective on January 1, 1986 for all assets purchased on or after that date (other than assets purchased pursuant to a binding contract entered into before January 1, 1986). Thus, assets purchased on or after January 1, 1986 would be subject to indexing from the date of purchase; in addition, gains or losses from such assets, whenever recognized, would be taxed under the new rules of the proposal.

Different transition rules would apply to depreciable and nondepreciable assets purchased before January 1, 1986 ("old depreciable assets" and "old nondepreciable assets," respectively). For old nondepreciable assets, there would be a three year transition period, beginning on January 1, 1986, during which gain or loss would be computed without indexing of basis. In general, gains or losses during this period from old nondepreciable assets would be taxed under the principles and

effective tax rates of current law. Thus, net capital gain from such assets would be subject to partial exclusion, with the amount of exclusion calculated to produce approximately the same maximum rate under current law of 20 percent. Thus, if the maximum individual marginal tax rate during this period is 35 percent, the fractional exclusion for all taxpayers would be 43 percent. Similarly, corporations would be eligible for an alternative rate that, in relative terms, would approximate the available current law rate of 28 percent.

During the three year transition period, taxpayers holding certain old nondepreciable assets would be allowed an election to realize gain or loss without a sale or other disposition. This mark-to-market election could be exercised only with respect to assets which are regularly traded on an established market, such as a stock or commodity exchange. If the mark-to-market election is not exercised and the taxpayer holds old nondepreciable assets on January 1, 1989, the basis of those assets is indexed as of that date (for post-1964 inflation).

The one-time mark-to-market election would permit taxpayers to determine at any time during the transition period whether they are better off realizing gain by applying the preferential tax rate to unindexed basis or by indexing historic basis (post-1964) and applying the uniform marginal tax rate. Thus, the transition period affords a taxpayer electability of tax treatment for readily marketable assets which would be retained after the transition period closes. Assets that were marked-to-market during the transition period would be indexed only from the date of the mark-to-market election.

Old nondepreciable assets sold on or after January 1, 1989, would be fully subject to the proposals. Thus, gain or loss from such assets would be determined by reference to an inflation adjusted basis (indexed for inflation back to the date of purchase, but not earlier than January 1, 1965). No mark-to-market election would be available on or after January 1, 1989.

Sales and other dispositions of old depreciable assets during the three year transition period would be taxed under current law principles. Thus, gains from the sale of old depreciable assets would be subject to recapture as ordinary income under current law recapture rules. Net capital gain from old depreciable assets sold during the transition period would be taxed in the same manner as net capital gain from old nondepreciable assets during the transition period. That is, net capital gain would be subject to partial exclusion at a rate calculated to maintain the same maximum tax rate of 20 percent for individuals. In general, net losses from sales of old depreciable assets during the transition period would be deductible in full, as under current law.

For sales of old depreciable assets after the transition period ends on January 1, 1989, gains would be taxed in two parts. First, all depreciation not in excess of realized gain (computed with respect to the asset's basis without adjustment for inflation) would be recaptured and subject to tax at regular tax rates. Second, the excess, if any, of such realized gain over the recapture amount would be adjusted for inflation by indexing the original cost basis of assets using the published inflation adjustment factors. Thus, the excess of the amount realized on the sale over the inflation adjusted original cost basis would be taxed at the regular tax rate. After the transition period, losses from the sale of old depreciable assets (computed with respect to the basis of assets unadjusted for inflation) would be deductible in full.

Analysis

Effect on Saving and Investment. Under most circumstances, the proposal would either hold roughly constant or reduce effective tax rates on realized capital gains; the proposal should thus either have no or a somewhat stimulative effect on saving and investment. At current rates of inflation (four percent in 1983 and 1984), most high-bracket taxpayers would be subject to roughly the same effective tax rate on long-term capital gains as under current law (i.e., a maximum rate of 20 percent on nominal gains). At rates of inflation experienced in recent years (an average annual rate of 7.9 percent between 1972 and 1982), the proposal would reduce significantly the effective tax rate on most real capital gains. This is shown by Table 1, which provides maximum effective tax rates on real capital gains under current law for various combinations of inflation rates, rates of real appreciation, and holding periods.

Also, indexing would eliminate the current volatility in effective tax rates that accompanies inflation; the associated reduction in uncertainty should stimulate saving and investment. The "insurance" benefits of a tax system which guarantees an explicit inflation adjustment should not be minimized. For example, inflation averaged seven percent annually between 1971 and 1975. Over the same period, nominal capital gains on sales of corporate stock totaled $24.6 billion. Once adjusted for inflation, however, these sales actually represented a loss of $0.4 billion.

Finally, indexing capital gains for inflation would produce more accurate measurement of real losses; the associated increase in government risk-sharing should also stimulate saving and investment.

Effect on risk-taking. The effect of capital gains taxation on private risk-taking in the economy is of critical importance. The venture capital and associated high-technology industries seem particularly sensitive to changes in effective tax rates.

Shareholders in some ventures--those which are highly successful over short periods of time--would face higher effective tax rates under the proposal. Nevertheless, more accurate measurement of economic losses and the reduction of inflation caused variations in effective tax rates would stimulate investment generally. Moreover, a maximum marginal tax rate of 35 percent on indexed gains would produce effective rates that are not substantially above those experienced during the last two venture capital booms. (Tax rates of 25 percent during the 1960s and 28 percent from 1978-81 on nominal gains were actually higher effective rates due to inflation.) In addition, all investors would continue to benefit from the deferral of tax on accrued but unrealized gains.

Also, the increase in saving stimulated by reductions in individual marginal rates and expansion of IRAs, as well as the elimination of many industry-specific tax preferences and the enactment of measures to reduce the advantages of investment in unproductive tax shelters, should increase the supply of capital available to high technology industries.

Housing. The indexing proposal should not, on balance, significantly affect the housing industry or the desire of individuals to invest in their own homes. Most capital gains in the housing industry have been inflationary gains that would not be subject to tax under the indexing proposal. Moreover, the proposal retains the provisions of current law permitting taxpayers to roll over realized gains on the sale of a principal residence and granting a one-time exclusion of $125,000 on the sale of a principal residence by taxpayers over the age of 55. Indeed, the one-time exclusion would be more generous under the proposal since it would apply to inflation-adjusted rather than nominal gains.

Retention of Realization Requirement. The proposal would retain the realization requirement of current law, under which gains and losses generally are not taxed until realized by sale, exchange or other disposition. One of the consequences of the realization requirement is that tax on accrued but unrealized gains is deferred, except in the case of section 1256 contracts. The tax advantage of deferring gains creates an incentive for taxpayers to continue to hold appreciated assets in order to avoid realizing gain. This so-called "lock-in" effect impairs capital resource allocation to the extent taxpayers are deterred from reallocating investments by the tax costs of realizing accrued appreciation.

Indexing mitigates the lock-in effect of the realization requirement by ensuring that only real gains are taxed. Under current law, unrealized inflationary gains cause a lock-in effect as much as unrealized real gains. Moreover, although the proposal eliminates the preferential tax rate for capital gains, the Treasury Department proposals include a reduction in marginal

tax rates that reduces the current law distinction between capital gain and ordinary income. On balance, the relative significance of the lock-in effect under the indexing proposal versus current law depends on prospective rates of inflation. Since the lock-in effect cannot be eliminated fully in any system that retains the realization concept, the gains in certainty and measurement of income attributable to indexing and the distortions caused by a rate differential override concerns over the lock-in effect.

The proposal retains the mark-to-market accounting concept currently applicable to section 1256 contracts. The primary advantage of the mark-to-market concept in this limited context is that it negates the need to identify offsetting positions for purposes of the loss deferral rules applicable to straddles. Straddle transactions utilizing section 1256 contracts would provide numerous opportunities for abuse for taxpayers with large volumes of trades in such contracts absent retention of mark-to-market accounting for these assets.

Scope of Loss Limitation Rules. In general, the proposal would retain the capital loss limitation rules of current law for assets held for investment and not for use in a trade or business. Such limitations are appropriately applied to investors who may selectively realize gains and losses on investment assets.

Simplification. Repealing the preferential tax rate on capital gains and taxing all inflation-adjusted income at uniform tax rates would eliminate a source of substantial complexity in current law. Schemes to convert ordinary income to capital gain would be deprived of their principal tax motivation. For example, use of a so-called "collapsible corporation" as a device to convert ordinary income into capital gain from a sale or exchange of stock would no longer be abusive. Thus, current law's collapsible corporation provisions and related provisions concerning collapsible partnerships could be repealed.

Depreciation recapture has been necessary under ACRS and prior depreciation rules to prevent excessive depreciation deductions from being converted into capital gain. Indexing depreciation allowances and gains and losses from dispositions of property obviates the need for depreciation recapture provisions. Excessive depreciation would be "recaptured" as ordinary income, which (assuming no intervening change in the taxpayer's marginal tax rate) would substantially restore the tax benefit derived from the original deduction. Although the taxpayer would continue to receive a timing advantage where RCRS allowances exceed economic depreciation, taxing all recapture income as ordinary income would permit repeal of the recapture provisions for depreciable property acquired after the proposals become fully effective.

Beyond the benefits of repealing provisions rendered superfluous, repeal of the preferential tax rate would reduce the scope of disputes between taxpayers and the government and would inevitably curb or reverse the growth of rules -- legislative, judicial and administrative -- intended to confine the preferential treatment of capital gains within certain bounds. Although legal uncertainties would not be eliminated, the tax stakes in subsequent disputes would be substantially reduced, easing the pressures that have spawned complexity under current law.

INDEX INVENTORIES

General Explanation

Chapter 9.02

Current Law

In general, current law requires the use of inventory accounting methods where necessary to determine clearly a taxpayer's income. Treasury regulations implementing this rule generally require inventories to be maintained where the production, purchase or sale of merchandise is an income-producing factor. A taxpayer that keeps inventories for tax purposes must use the accrual method of accounting with respect to purchases and sales of inventory items.

Inventory accounting assists in accurately measuring income from the sale of goods; this measurement, in turn, depends on the value for tax accounting purposes of the goods on hand at the close of the taxable year. The cost of goods sold during the year is generally equal to the dollar value of beginning inventory, plus purchases and other inventoriable costs incurred during the year, minus the dollar value of ending inventory. Thus, a taxpayer with beginning inventory of $100, purchases and other inventoriable costs of $500, and ending inventory of $150, has a cost of goods sold for the year of $450 ($100 plus $500 minus $150 = $450). The measurement of income from the sale of goods changes with any change in the valuation of ending inventory. Thus, if ending inventory, in the preceding example, had a higher value, the cost of goods sold would have been lower, and gross income from sales would have been correspondingly higher. Conversely, a lower figure for ending inventory would have increased the cost of goods sold and reduced gross income.

Under Treasury regulations, inventories generally are valued at cost, although in certain cases the lower of cost or market value is permitted. In order to determine the cost of ending inventory the goods on hand at year-end must be identified. In making this determination, a taxpayer may identify each specific item of inventory and ascertain its actual cost or value. In most cases, however, this "specific identification" method is impractical because of the number and fungible nature of the goods on hand. The Code and regulations therefore permit alternative methods which employ simplifying assumptions regarding the flow of goods from inventory.

The first-in, first-out (FIFO) method assumes that the first goods purchased or produced are the first goods sold. Under FIFO the most recently produced goods are deemed on hand at year-end, and ending inventories are thus valued at the most recent purchase or production costs. The last in, first-out (LIFO) method assumes that the last goods purchased or produced are the first goods sold. Since LIFO accounting values ending inventory at the oldest purchase or

production costs, in periods of increasing purchase or production costs its use results in higher cost of goods sold and lower taxable income than FIFO.

Since 1939, taxpayers who use the LIFO method for tax purposes have been required to use LIFO in preparing annual financial statements for credit purposes and for reports to stockholders, partners, proprietors or beneficiaries (the "LIFO conformity requirement").

Reasons for Change

Taxes should be imposed on real economic income, not on increases that are attributable to inflation. Current inventory accounting methods depart from this principle by failing to reflect inflation in a consistent manner.

Because the LIFO method treats the most recently acquired goods as the first goods sold, LIFO accounting reflects income from inventory sales more accurately during periods of inflation than FIFO. Notwithstanding the advantages of the LIFO method in an inflationary economy, many businesses nevertheless use the FIFO method. Some businesses find that the use of LIFO for financial accounting purposes -- as required by the LIFO conformity requirement -- is unacceptable. Whatever the original reasons for the LIFO conformity requirement, it is not appropriate in a tax system designed to neutralize the effects of inflation. Many small firms are reluctant to use the LIFO method because they view LIFO as significantly more complex than FIFO.

Although LIFO better accounts for the effects of inflation than FIFO, it does not fully account for these effects. LIFO takes account only of price changes in the inventoried goods, which may or may not correspond to the effects of inflation on prices generally. Moreover, since LIFO represents only a flow of goods assumption rather than an adjustment of inventory costs in line with inflation, it results in only the deferral rather than the elimination of inflationary gains. When a firm that uses the LIFO method either liquidates or reduces inventories, it is taxed on previously deferred inflationary gains. This factor distorts business decisions and creates a tax bias in favor of transactions such as mergers and reorganizations which permit continued deferral of the inflationary gain.

Proposal

Taxpayers would be permitted to use an Indexed FIFO method in addition to the current LIFO and FIFO methods of accounting. Under the Indexed FIFO method, inventories would be indexed using inflation adjustment factors based on the Consumer Price Index. Indexing would be based on relatively simple computational methods, such as applying the percentage increase in the Consumer Price Index to the FIFO cost of the number of units in beginning inventory which does not exceed the number of units in ending inventory. Indexing would be permitted only with respect to inflation occurring after the effective date of

the proposal. The requirement under current law that the Internal Revenue Service consent to changes in accounting methods would be waived for taxpayers changing to LIFO or to Indexed FIFO accounting methods during an appropriate transition period. In addition, the LIFO conformity requirement would be repealed.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

About two-thirds of inventories in the United States are owned by firms which continue to use FIFO accounting, despite the resulting overstatement of income tax liability during inflationary times. Table 1 provides data on the use of FIFO by industry group. Repeal of the LIFO conformity requirement would permit such firms to switch to either Indexed FIFO or LIFO inventory tax accounting, while continuing to use the FIFO method for financial accounting purposes. It is expected that taxpayers that currently use the FIFO method would switch to the Indexed FIFO method or the LIFO method. An immediate switch by all firms that currently use FIFO to either Indexed FIFO or LIFO would result in a maximum aggregate annual tax saving to those firms of approximately $6 billion.

Firms that currently use LIFO, however, would be unlikely to change to Indexed FIFO, unless the economic advantages were sufficient to offset the associated administrative costs as well as the tax costs resulting from recapture of LIFO reserves. LIFO inventories would not be eligible for an inflation adjustment under the capital asset indexing proposal described at Chapter 9.01. Such an adjustment would generally be inappropriate because the LIFO inventory valuation merely reflects a flow of goods assumption; it does not purport to reflect the taxpayer's historic cost of the physical goods on hand. Moreover, those using LIFO have benefitted in the past relative to taxpayers using FIFO as a result of this flow of goods assumption. It would provide a further relative tax advantage to those using LIFO to permit their inventories to be indexed. For LIFO firms that do switch to Indexed FIFO, inventory stocks would thereafter be valued more accurately. Moreover, distortion of decision-making with respect to liquidations of firms and reductions in inventories would be reduced.

The proposal to index the FIFO method would improve the measurement of income for tax purposes since inflationary gains would be permanently removed from the tax base. The Indexed FIFO method also would be more consistent with the proposed system for indexing depreciation than other methods of inventory accounting. In particular, for firms that elected the Indexed FIFO option, economic gains and losses on inventory would be included in the tax base. This treatment would be analogous to the proposed treatment for depreciable assets, where depreciation allowances would be indexed for general inflation.

Finally, the current disincentive to entry into industries that have historically used the FIFO accounting system and thus borne an artificially high tax burden would be removed.

Table 1

Percentage of Ending Inventory Valued by the FIFO Method by Industry 1/

Industry	Value of Ending Inventory ($Billions)	Percentage FIFO (%)
Agriculture	4.6	97
Mining	8.2	81
Construction	23.1	97
Food	24.0	66
Tobacco	6.7	15
Textiles	5.8	50
Apparel	8.3	82
Lumber	6.0	77
Furniture	6.0	77
Pulp and Paper	6.5	60
Printing and Publishing	5.4	70
Chemicals	26.4	50
Petroleum	23.9	41
Rubber	5.1	63
Leather	2.1	74
Stone, Clay and Glass Products	5.9	58
Primary Metals	20.7	39
Fabricated Metals	20.7	39
Machinery	38.9	67
Electrical Equipment	30.1	68
Motor Vehicles	16.1	47
Instruments	8.2	57
Transportation Equipment	18.3	78
Transportation Public Utilities	31.9	92
Communications	6.5	99
Wholesale Trade	108.8	80
Retail Trade	102.2	69
Finance, Insurance, and Real Estate	12.8	89
Services	11.0	95
Total All Industries	594.2	70

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1/ Source: 1981 Corporation Income Tax Returns, computed by the Bureau of Economic Analysis

INDEX INDEBTEDNESS

General Explanation

Chapter 9.03

Current Law

As a general rule, a borrower can deduct all interest paid or accrued on indebtedness. Interest is ordinarily deductible by the borrower whether the indebtedness is incurred in the conduct of a trade or business, in connection with an income-producing investment, or in financing personal consumption. Interest incurred to carry or acquire tax-exempt bonds is not deductible, however, and limitations apply to the deductibility of interest incurred to produce investment income.

Corresponding to the general deductibility of interest incurred, interest received by or credited to a holder of indebtedness is fully includible in income and taxable at ordinary income rates. Interest received on certain obligations of State and local governments, however, is exempt from Federal income tax.

In general, the making of a loan and the satisfaction of indebtedness are not taxable events for Federal income tax purposes. Thus, a debtor does not have income upon the receipt of the principal amount of a loan or a deduction when such principal amount is repaid. Similarly, the principal amount of a loan is neither a deductible amount to the lender when the loan is made nor an item of income when it is repaid. If indebtedness is discharged at less than its face amount, the debtor may recognize discharge of indebtedness income and the lender ordinarily recognizes a loss.

Reasons for Change

Over time inflation erodes the value of a creditor's claim for repayment of an indebtedness with a fixed principal amount, and the debtor's liability to repay principal is correspondingly reduced. Debtors and creditors routinely take account of the anticipated effects of inflation on a lending transaction by adjusting the rate of interest charged. Thus, nominal interest rates typically include an inflation component which compensates the lender for the anticipated reduction in the real value of an obligation of a fixed dollar amount; as to the borrower, this payment is an offsetting charge for the inflationary reduction in the value of the principal amount of the borrowing.

Because the inflation component of nominal interest payments is, in effect, a repayment of principal, the current treatment of nominal interest payments as fully deductible by the debtor and fully taxable to the creditor mismeasures the income of each. These inaccuracies in the measurement of income distort a variety of investment decisions,

greatly increasing the significance of tax considerations in such matters as the allocation of investment funds between debt and equity and between long-term and short-term financing. Moreover, in 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.

The failure of the current tax system to recognize and measure the inflation component of nominal interest payments also accentuates the economic effects of variable inflation on debtors and creditors. If the rate of inflation increases unexpectedly, a creditor with fixed-interest indebtedness suffers an economic loss, and the debtor has a corresponding economic gain. These changes in economic position are compounded by the treatment of interest under current law, since the entire amount of nominal interest payments remains deductible or includible in income regardless of changes in the inflation rate. The resulting mismeasurement of income in an economy with variable inflation spawns economic uncertainty. Such uncertainty likely contributes to reduced levels of savings, investment and risk-taking.

Finally, the overstatement of interest under current law encourages borrowing for investments in which income is tax exempt or tax deferred. For example, the investment of borrowed funds in capital assets produces a current deduction for interest expense but no realization of the increase in value of the capital asset until its sale or disposition. This mismatching of income and expense from related transactions understates current income and thus permits the deferral of tax. Overstatement of interest expense thus increases the extent to which debt-financed tax shelter investments can be used to offset taxable income from other sources.

Proposal

Interest would be indexed for tax purposes by excluding a fractional amount of interest receipts from income and denying a deduction for a corresponding fraction of interest payments. For example, with a fractional exclusion rate of 25 percent, taxpayers would include in income only 75 percent of otherwise taxable interest receipts and deduct only 75 percent of otherwise deductible interest payments. The fractional exclusion rate would be based on the annual inflation rate, as explained below.

In general, the proposal would apply the fractional exclusion rate to a taxpayer's net interest income or net interest expense, subject to the following exceptions. First, an individual would deduct any mortgage interest on indebtedness secured by or allocable to his or

her principal residence. Qualifying mortgage indebtedness for this purpose could not exceed the fair market value of the principal residence. Next, an individual would net aggregate gross interest expenses (excluding home mortgage interest) against aggregate gross interest income (excluding tax-exempt interest). An individual with net interest expense would apply the fractional exclusion rate to the amount of interest expense in excess of $5,000 ($2,500 in the case of a married person filing a separate return). Interest expense, after any reduction by the fractional exclusion rate, would be deductible. See Chapter 16.01, however, relating to limitations on the deduction of investment interest. An individual with net interest income would apply the fractional exclusion rate to such net interest income. Interest income, after reduction by the fractional rate would be includible in income.

All of a corporation's interest income and expense would be subject to the fractional exclusion. Interest incurred by a partnership or other pass-through entity would be treated as incurred by the partner or other person to whom the payments are allocable.

Interest received by a partnership or other pass-through entity would be treated as received by the partner or other person reporting such payments.

Tax-favored retirement plans, such as an individual retirement account or qualified pension plan, which earn interest income would not be able to pass on the benefit of the fractional exclusion to the plan beneficiaries. Thus, the fractional exclusion rate could not be claimed with respect to distributions from tax-favored retirement plans. See Chapter 9.01 for application of the basis indexing rules to retirement plans.

The fractional exclusion rate would be modified annually to reflect changes in the rate of inflation, as measured by the Bureau of Labor Statistics' Consumer Price Index. The proposed relationship between fractional exclusion rates and inflation rates is set forth in Table 1. The proposed relationship set forth in Table 1 is based on an assumption of a constant six percent real, before-tax interest rate. Assumption of lower real interest rates would result in higher exclusion rates for any given inflation rate. The fractional exclusion rate for a taxpayer that uses a functional currency other than the U.S. dollar should be based on the inflation rate in the foreign currency.

Table 1

Fractional Exclusion Rate

Inflation Rate (Percent)	Fractional Exclusion Rates (Percent) 1/
0	0
1	14
2	25
3	33
4	40
5	45
6	50
7	54
8	57
9	60
10	62
11	65
12	67

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1/ Fractional exclusion rate is determined by assuming a constant, six percent real interest rate (rate of return).

The proposal would not alter the current law definition of interest. The current law rules which impute interest income in certain transactions would also be retained.

Effective Date

The proposal to index interest payments and receipts would become effective January 1, 1988 and would apply to all indebtedness regardless of when incurred. The delay in effective date would mitigate the effects of the change in the tax treatment of interest paid and received on existing loans.

Analysis

Indexing Interest Rather than Principal. An ideal measure of real economic income for tax purposes would recognize the inflationary reduction in principal on a loan as creating loss for the creditor and income for the debtor on an annual basis. That ideal system departs from the realization doctrine of current law, however, under which mere changes in the value of an asset, including a debt instrument, do not trigger income or loss. Abandonment of the realization doctrine in this context would introduce substantial costs in complexity and recordkeeping.

Inflation's impact on indebtedness may be indirectly accounted for, however, without departing from the realization doctrine. Instead of computing inflationary gain or loss on principal, the effects of inflation can be approximated by indexing interest payments and receipts through application of the proposed fractional exclusion rate.

For example, A borrows $100 from B on January 1, agreeing to pay back the principal plus ten percent interest on December 31. Over the course of the year, there is four percent inflation and the real, pre-tax rate of return is six percent. On December 31, A satisfies its indebtedness by repaying the $100 principal and $10 in interest. B's receipt of the $100 in principal actually represents a loss of $4 in real purchasing power. B's receipt of $10 in nominal interest, however, actually represents a $6 real return on the loan, plus a $4 inflationary component which offsets the reduction in the value of the $100 principal. Thus, in this example, a fractional exclusion rate of 40 percent would be appropriate.

The example demonstrates that, in theory, the effects of inflation on indebtedness may be reflected for tax purposes either by indexing principal or indexing interest. Indexing interest retains the realization rules of current law, and is a much more administrable system.

Determining the Fractional Exclusion Rate. In a world with but one nominal interest rate, real interest income and expense would be accurately measured by a fractional exclusion rate equal to the ratio of the inflation rate to the nominal interest rate. With such an

exclusion rate, the excluded interest payments and receipts would correspond to the inflationary component of nominal interest.

The proposal's single fractional exclusion rate for each inflation rate obviously oversimplifies the relationships between inflation and nominal interest rates in a diverse economy. The real rate of return earned on indebtedness will differ from lender to lender. The proposal's economy-wide fractional exclusion rate, however, allows a more accurate measurement of real economic income than does current law, which implicitly provides a zero fractional exclusion rate for all interest.

Effects on Nominal Interest Rates. The proposal would likely result in lower nominal interest rates than would prevail under current law for any given set of economic conditions. For any expected inflation rate, lenders would not demand as high an inflation premium since the inflation component of nominal interest receipts would not be taxed. Similarly, borrowers would be less willing to pay a high inflation premium, since the inflation component of nominal interest payments would not be tax deductible. Accordingly, nominal interest rates would likely fall, relative to levels that would prevail under current law for any given economic conditions. Whether interest rates would actually fall after enactment of the proposal would, of course, depend upon factors beyond the tax laws, such as monetary policy and international capital flows.

The proposal also likely would result in reduced volatility of interest rates with respect to changes in inflation. Under the proposal, a change in inflation should induce a smaller change in nominal rates than would occur under current law.

Effects of the Exceptions to Fractional Exclusion Rate. The proposal would not apply the fractional exclusion rate to all deductible interest payments, resulting in some asymmetric treatment of borrowers and lenders. Homeowners would be permitted full deduction of mortgage interest on a principal residence, while mortgagees would be entitled to apply the fractional exclusion rate to interest received on home mortgages. All individuals would be allowed full deduction (without indexing) of the first $5,000 of other net interest expense. Although these exceptions depart from theoretical symmetry for all interest payments and receipts, their retention facilitates the transition from an unindexed to an indexed tax system. The exception for home mortgages, however, would create an incentive for taxpayers both to mortgage the existing equity in their homes, and to disguise consumer, investment or business indebtedness as increases in home mortgages. These opportunities for tax arbitrage present serious revenue concerns, and it may be necessary to develop strict rules to prevent such schemes from circumventing the intent of the exception.

Characterization of Non-Interest Payments as Interest. Indexing interest receipts and excluding a portion of such receipts from income may lead taxpayers to try to characterize certain periodic payments as

partially excludable interest rather than fully taxable income such as rents or royalties. Some disincentive for mischaracterization exists, since treatment of payments as interest would limit the interest deduction available to the payor. Nevertheless, payors and payees in different tax brackets could produce a net tax savings by mischaracterizing payments as interest.

Current law has substantial experience with attempts to mischaracterize payments as interest, principally with regard to the characterization of corporate distributions as interest or dividends. No single, mechanical approach to such questions is likely to prove satisfactory, and it is contemplated that the response to abusive cases would evolve under current doctrines distinguishing between substance and form.

The interest exclusion could also encourage overstatement of interest rates in deferred payment transactions in order to characterize profit on the sale as excludable interest. Although similar incentives can exist under current law, for example, in deferred payment transactions involving nondepreciable property, much greater attention has been focused on transactions in which interest is understated in order to take advantage both of front-loaded ACRS deductions and of the current favorable treatment of capital gains.

In order to limit overstatement of interest, stated valuations and interest rates would be measured against comparable transactions and disregarded where unrealistic. Although not part of the proposal, it could eventually be appropriate to establish mechanical limits on maximum interest rates analogous to the imputed interest rules of current law.

Interaction with Other Proposals. Indexing interest receipts and payments is consistent with the Treasury Department proposals relating to inflation indexing for capital gains, RCRS property and inventories. Since both interest receipts and stock in a corporation holding interest-bearing assets would be adjusted for inflation, there might be some question of a potential for over-indexing or of double counting for inflation. In general, however, no such double counting would occur, since it is appropriate that the corporation's income and the shareholder's return on stock be separately adjusted for inflation.

Because the fractional exclusion rate is not a precise measure of inflationary effects, interest generally would not be excluded in the same proportion as a shareholder or partner would be allowed to index basis in stock or a partnership interest. Even though not precisely accurate, the fractional exclusion rate comes closer to achieving the appropriate correspondence between a shareholder's basis in a corporation's stock and the corporation's income from indebtedness than would a system that failed either to index the shareholder's stock basis or to apply the fractional exclusion to the corporation's interest income.

The variation between basis indexing and application of the fractional exclusion rate could in some cases be exploited by taxpayers if future variations could be known with sufficient certainty. Such exploitation seems to present the greatest likelihood of taxpayer manipulation in the case of pass-through entities holding a substantial proportion of interest bearing assets. In such cases, partners would be precluded from increasing basis in their partnership interests faster than at the rate implied by the fractional exclusion rate applied to the partnership's interest receipts. In other cases, similar limitations on indexing stock may be required to ensure that the relationship between indexing capital assets and indebtedness is not abused.