DOES TREASURY HAVE AUTHORITY TO INDEX BASIS FOR INFLATION?

by Lawrence Zelenak

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In this article he examines the claim, which has been publicized in recent months, that the Treasury Department could unilaterally index the capital gains tax for inflation by a new regulation interpreting code section 1012. He concludes, in light of more than seven decades of administrative, judicial and legislative history, that such unilateral action would be invalid.

Introduction

Does the Treasury Department have the authority to index the basis of capital assets for inflation by regulation, without the need for congressional action? This possibility was first suggested in print by economist Paul Craig Roberts in a column in the *Washington Times* on January 22, 1992.¹ According to Roberts, "If Mr. Bush consulted his lawyers, he would find that the word 'cost' in calculating capital gains at the Internal Revenue Service is not defined by statute, but by regulation. The president can cut the capital gains tax rate simply by exercising his authority to change the regulatory definition to index capital gains for inflation." The idea was endorsed less than a week later by a *Wall Street Journal* editorial, which reported that Robert's proposal had "emanated out of the Justice Department's policy shop."² The editorial observed that "the procedures for measuring gains are determined by regulation, not by law," and that "Congress ... never said that capital gains must be defined as inflated gains (the reasons for its reluctance to say so explicitly are fairly obvious)." The editorial also noted that the same analysis "could be used to index depreciation schedules."

On March 5, White House Chief of Staff Samuel Skinner was quoted by *USA Today* as stating that regulatory indexation was under serious consideration.³ The story indicated that Budget Director Richard Darman favored regulatory indexing, but that Treasury Secretary Nicholas Brady and White House Counsel C. Boyden Gray were opposed, with Gray arguing that

the administration lacked the authority to take such unilateral action. Skinner again indicated the administration's interest in regulatory indexing in a March 18 speech to the National Association of Manufacturers.⁴ Skinner remarked that President Bush felt indexing was an option he should consider, but that the president was concerned about the legal limitations on his authority.⁵

Does the Treasury Department have the authority to index the basis of capital assets for inflation by regulation, without the need for congressional action?

The purpose of this article is to examine whether regulatory indexation of basis for the purpose of computing capital gains would be a valid exercise of the Treasury Department's authority to interpret the Internal Revenue Code.⁶ The crucial statutory provision is code section 1012, which provides that "[t]he basis of property shall be the cost of such property." After considering the relevant regulatory and judicial interpretations, and legislative history, the article concludes that regulatory indexing of basis would be an impermissible interpretation of section 1012.

Despite the invalidity of regulatory indexing, indexing would probably be immune from judicial challenge. A taxpayer would be disadvantaged by indexing only in the unlikely event that deflation caused a downward basis adjustment, thus increasing the taxpayer's capital gain (or decreasing capital loss). Absent deflation, indexing could work only to the advantage of particular taxpayers,⁷ and without a disadvantaged taxpayer there would almost certainly be no one with

¹Roberts, "Instant Way to Cut Capital Gains Tax," *Washington Times*, January 22, 1992, at F1.

²Editorial, "Presidential Indexation," *Wall Street Journal*, January 28, 1992, at A14.

³Lee, "Bush May Try End Run on Capital Gains Tax Cut," *USA Today*, March 5, 1992, at 4A.

⁴Hubbard, "Bush May Act Without Hill OK on Capital Gains, Skinner Warns," 54 *Tax Notes* 1449 (March 23, 1992).

⁵*Id.*

⁶Code section 7805(a) gives the Secretary of the Treasury the authority to "prescribe all needful rules and regulations for the enforcement" of the Internal Revenue Code.

⁷At least this author, and several tax experts he consulted, could think of no situation in which a taxpayer would be disadvantaged by an upward adjustment in the basis of a capital asset. Anyone aware of such a situation is encouraged to contact the author or this publication.

standing to challenge the new regulation.⁸ The Supreme Court has stated that, to have standing, "A plaintiff must allege personal injury fairly traceable to the defendant's allegedly unlawful conduct and likely to be redressed by the requested relief."⁹ In two cases, the Supreme Court has ruled that plaintiffs lacked standing to challenge the Internal Revenue Service's grant of tax-exempt status to certain organizations.¹⁰ The plaintiffs argued that they had standing because of the adverse effects the organizations' exemptions had on the plaintiffs, but the Court ruled that the assumptions concerning the influence of the IRS grants on the activities of the organizations was too speculative to support standing.¹¹ The cases demonstrate a level of Supreme Court hostility to third-party standing to challenge favorable administrative treatment of taxpayers, sufficient to make it highly unlikely that anyone would have standing to challenge the legitimacy of an upward basis adjustment provided for by regulation.¹²

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The probable judicial unreviewability of regulatory indexing should not, however, lead the administration to disregard the legal limitations on its authority. Regulatory indexing may be attractive to members of the administration, because they believe it is good tax policy, because they believe it would have the political advantage of impaling Congress on the horns of a dilemma, or both. As tempting as that course may be, the administration should remember that an illegal activity is still an illegal activity, even when you are sure

you will not be caught. It is the official policy of the Internal Revenue Service "to determine the reasonable meaning of various code provisions in light of the congressional purpose in enacting them."¹³ That should also be the policy of the Treasury Department, and it should apply whether or not a particular determination is subject to judicial review.¹⁴

The Basis Statute and Its Interpretation

The simple statement that the basis of property is its cost, which now appears in code section 1012, first appeared in the Revenue Act of 1918,¹⁵ and in all subsequent legislation, Congress has declined to elaborate.¹⁶ The proponents of regulatory indexing are correct in claiming that the word cost is not completely self-defining, and that there would be nothing inherently illogical in interpreting cost to mean inflation-adjusted cost. At times there is more than one reasonable interpretation of a statute, and in such cases the choice among reasonable interpretations is for the administrative agency.¹⁷ Moreover, the fact that an agency has adopted one interpretation does not automatically preclude it from later adopting a different interpretation, if the new interpretation is reasonable.¹⁸

This argument for the permissibility of administrative indexing is, of course, premised on the assumption that indexing is a reasonable interpretation of section 1012. That assumption may seem correct as a matter of logic, but this is a situation in which "a page of history is worth a volume of logic."¹⁹ The interpretation which would satisfy the demands of logic fails the test of history.

The first regulation under the basis-equals-cost statute was issued in 1919. It repeated the statutory statement that basis is cost, without mentioning the possibility of indexing cost to reflect inflation or defla-

⁸The *Wall Street Journal* editorial, note 2, mentioned that it was "unlikely that anyone would have standing to sue to block indexing."

⁹*Allen v. Wright*, 468 U.S. 737, 751 (1984).

¹⁰*Id.*; *Simon v. Eastern Kentucky Welfare Rights Org.*, 426 U.S. 26 (1976). In *Allen*, parents of black public school children claimed that the Internal Revenue Service's standards and procedures for insuring that tax-exempt schools did not engage in racial discrimination were inadequate. In *Eastern Kentucky*, several indigents challenged the grant of tax-exempt status to a hospital that denied services (other than emergency room treatment) to indigents.

¹¹*Allen*, 468 U.S. at 756-61; *Eastern Kentucky*, 426 U.S. at 40-46.

¹²Concurring in *Eastern Kentucky*, Justice Stewart noted that he could not "now imagine a case, at least outside the First Amendment area, where a person whose own tax liability was not affected ever could have standing to litigate the federal tax liability of someone else." 426 U.S. at 46. The Second Circuit followed *Allen* and *Eastern Kentucky* in *United States Catholic Conference v. Abortion Rights Mobilization, Inc.*, 885 F.2d 1020 (2d Cir. 1989), cert. denied 495 U.S. 918 (1990) (holding that various pro-choice individuals and organizations lacked standing to challenge the tax-exempt status of the Roman Catholic Church in the United States).

¹³Statement of Principles of Internal Revenue Tax Administration, 1991-1 CB ii. This statement is published at the beginning of every *Internal Revenue Bulletin* and *Cumulative Bulletin*.

¹⁴In an analogous area, commentators have noted that members of Congress have an obligation not to vote in favor of what they believe are unconstitutional laws, even if the laws might not be subject to judicial invalidation. L. Tribe, *American Constitutional Law* 16-17 (2d ed. 1988) (constitutional issues should be "taken seriously [by legislators] whether or not judges threaten to offer binding answers of their own"); Brest, "The Conscientious Legislator's Guide to Constitutional Interpretation," 27 *Stan. L. Rev.* 585, 587 (1975) ("[L]egislators are obligated to determine, as best they can, the constitutionality of proposed legislation"); Linde, "Judges, Critics, and the Realist Tradition," 82 *Yale L.J.* 227, 252 (1972) ("[T]here is a constitutional law directly binding on government even without judicial review").

¹⁵Revenue Act of 1918, ch. 14, section 202(a), 40 Stat. 1057, 1060.

¹⁶B. Bitter and L. Lokken, *Federal Taxation of Income, Estates and Gifts*, para. 41.2.1 (2d ed. 1990).

¹⁷*Chevron U.S.A. Inc. v. Natural Resources Defense Council*, 467 U.S. 837, 842-45 (1984).

¹⁸"An initial agency interpretation is not instantly carved in stone." *Id.* at 863.

¹⁹*New York Trust Co. v. Eisner*, 256 U.S. 345, 349 (1921).

tion.²⁰ The basis regulations were amended periodically over the years, but no version of the regulations has so much as mentioned the possibility of inflation or deflation adjustments to basis. By the time of the regulations under the 1939 Internal Revenue Code, the relevant sentence read exactly as it reads today: "In general, the basis of property is the cost thereof."²¹

Thus, despite the consistent administrative practice of not adjusting basis to reflect changes in the value of the dollar, the regulation writers have never felt the need expressly to negate the possibility of indexing. The tax administrators have never considered indexing under the basis-equals-cost statutes to be a sufficiently plausible interpretation to merit refutation.

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Moreover, despite the tendency of *pro se* tax litigants to suggest every conceivable taxpayer-favorable interpretation of the tax laws, there is a paucity of reported opinions addressing the indexing question. In fact, there is no reported opinion in which a taxpayer claimed the right to an inflation adjustment to basis in computing the amount of capital gain. The nearest thing to such a claim appeared in the 1987 case of *Ruben v. Commissioner*,²² in which the taxpayer claimed that his adjusted basis, for purposes of computing a casualty loss for damage to his home, should be determined by his replacement cost. The Tax Court stated that the effect of this claim was to "seek a deduction based upon losses due to inflation and the decreased value of the dollar," and the court ruled that no such deduction was allowable.²³ The court also noted that "there is no statutory provision which allows for an upward adjustment to basis to reflect inflation or loss of the purchasing power of the dollar."²⁴ Finally, the court upheld the imposition of a negligence penalty on the taxpayer, characterizing his position on the casualty loss issue as frivolous.²⁵ A handful of other cases have rejected related taxpayer claims, such as a deduction for loss of purchasing power of the dollar,²⁶ the computation of depreciation deductions based on replace-

ment value,²⁷ and the nontaxability of interest income which is inadequate to keep pace with inflation.²⁸

In short, the idea of interpreting the tax laws to provide for indexation of the basis of capital assets for inflation has been considered so outlandish as to be not worthy of refutation by the Treasury and not worthy of assertion in litigation by taxpayers. And the Tax Court ruled that the taxpayer who came closest to making that argument deserved to be penalized for his frivolous conduct. In light of this history, the argument that the statute can be interpreted to permit an inflation adjustment to basis is without merit, regardless of what logic, uninformed by history, might suggest.

Legislative History of the Capital Gains Provisions

From 1921 to the Tax Reform Act of 1986,²⁹ capital gains were taxed more favorably than ordinary income.³⁰ A small capital gains preference was reintroduced by the Omnibus Budget Reconciliation Act of 1990, which raised the top stated rate on ordinary income to 31 percent, while leaving the top rate on capital gains at 28 percent.³¹

Over the years, the committee reports have offered a number of different (but compatible) explanations for the favorable treatment of capital gains. The 1921 act's legislative history noted that favorable rates were needed to deal with the problems of bunching (the imposition of high marginal tax rates when income accrued over a number of years is realized in a single year) and lock-in (the tendency of taxpayers not to realize gains on capital assets when capital gains tax rates are high).³² As early as 1934, however, a Ways and Means Committee Report offered the problem of inflation-produced artificial capital gains as a justification for favorable capital gains tax rates: "In many instances, the capital-gains tax is imposed on the mere increase in monetary value resulting from the depreciation of the dollar instead of on a real increase in value."³³ Similarly, the Senate Finance Committee Report accompanying the Revenue Act of 1978³⁴ stated:

[A]n increased capital gains deduction will tend to offset the effect of inflation by reducing

²⁷*Advocate Publishing Co. v. Commissioner*, 6 B.T.A. 780 (1927).

²⁸*Stelly v. Commissioner*, 804 F.2d 868, 870 (5th Cir. 1986), cert. denied 480 U.S. 907 (1987). The court agreed with the IRS that the taxpayers' argument was frivolous for purposes of section 6702. *Id.*

²⁹Pub. L. No. 99-514, 100 Stat. 2085.

³⁰B. Bittker and L. Lokken, note 16, at para. 3.5.7. The first provision for favorable taxation of capital gains was enacted in 1921. Revenue Act of 1921, Pub. L. No. 98, 67th Cong., 1st Sess., section 206, 42 Stat. 227, 232-33.

³¹Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, section 11101, 104 Stat. 1388, 1388-403. The provision limiting the capital gains rate to 28 percent is code section 1(h).

³²H. Rep. No. 350, 67th Cong., 1st Sess. 10-11 (1921); S. Rep. No. 275, 67th Cong., 1st Sess. 13 (1921).

³³H. Rep. No. 704, 73d Cong., 2d Sess. 31 (1934), relating to the Revenue Act of 1934, Pub. L. No. 216, 73d Cong., 2d Sess., ch. 277, 48 Stat. 680.

³⁴S. Rep. No. 1263, 95th Cong., 2d Sess. (1978).

²⁰Regulation 45, Article 1561 (T.D. 2831, April 16, 1919), amended by T.D. 3206 (July 28, 1921).

²¹Reg. 118, section 39.113(a)-2, 18 F.R. 5771 (Sept. 26, 1953). The same sentence now appears as the first sentence of Reg. section 1.1012-1(a), which adds that "[t]he cost is the amount paid for such property in cash or other property."

²²T.C. Memo 1987-277, para. 87, 277 PH Memo TC.

²³*Id.* at 87-1357.

²⁴*Id.*

²⁵*Id.* at 87-1359.

²⁶*Sibla v. Commissioner*, 68 T.C. 422, 431 (1977), *aff'd on other issues* 611 F.2d 1260 (9th Cir. 1980); *Crossland v. Commissioner*, T.C. Memo 1976-59.

the amount of gain which is subject to tax. Thus, by increasing the deduction, taxable gain should be reconciled more closely with real, rather than merely inflationary gain. However, since the deduction is constant, unlike the automatic adjustments generally provided for in various indexation proposals, it should not tend to exacerbate inflationary increases.³⁵

This statement was made in the context of the Senate's (and ultimately Congress') rejection of a provision in the House bill which would have indexed the basis of capital gains for inflation.³⁶

This legislative history is decisive. Congress has indicated, in authoritative Committee reports, that special capital gains rates are appropriate because (among other reasons) the law does not permit basis adjustments to reflect inflation. The history of the 1978 act could not be clearer: Congress seriously considered allowing an inflation adjustment to basis (so seriously that the House bill permitted the adjustment), but ultimately explicitly rejected such an adjustment.³⁷

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Given these clear indications by Congress, there is simply no room — at least after 1978 — for a serious argument that section 1012 can be interpreted to permit regulatory indexing of basis for purposes of the capital gains tax. The temporary repeal of special capital gains rates by the 1986 Tax Reform Act does not change this result, for two reasons. First, the history discussed above indicates that Congress considered the absence of indexing an argument for special capital gains rates, but it does not indicate that the absence of indexing was dependent on the existence of special capital gains rates. Rather, the code did not permit indexing, and Congress might or might not respond to that fact with special capital gains rates. There is nothing in the legislative history of the 1986 act to indicate that the repeal of favorable treatment of capital gains called for revisiting the question of the definition of cost under section 1012.³⁸ Second, even if there were any force to the ar-

³⁵*Id.* at 192.

³⁶"The bill also includes an exclusion for capital gains to the extent that the gain reflects inflation. For the purposes of determining capital gain or loss on a taxable transaction, taxpayers will be allowed to adjust upward their cost or other basis by the rate of inflation between the date of purchase and the date of sale." H. Rep. No. 1445, 95th Cong., 2d Sess. 7 (1978).

³⁷In 1982, Senator Armstrong complained that the Finance Committee had rejected, by a vote of 11 to 9, his amendment (identical to the 1978 House proposal) to index the capital gains tax for inflation. S. Rep. No. 494, 97th Cong., 2d Sess. 423 (1982).

³⁸The relevant void is the discussion of the repeal of special capital gains rates in S. Rep. No. 313, 99th Cong., 2d Sess. 169-70 (1986).

gument that indexing of basis is forbidden only as long as capital gains are not taxed at a favorable rate, that argument would now be without force, because of the reintroduction of favorable taxation of capital gains by the 1990 act.³⁹

The Reenactment Doctrine

Congress has reenacted section 1012 and its predecessors a number of times, with awareness of the administrative practice of not indexing cost for inflation, and has not changed the simple statutory equation of basis and cost. This raises the question of what significance, if any, these reenactments have on the correctness of the administrative practice. In *Helvering v. R.J. Reynolds Tobacco Co.*,⁴⁰ a 1939 opinion, the Supreme Court suggested in dictum that when the statute underlying a long-standing regulation had been repeatedly reenacted, any subsequent change in the regulation might be invalid (even as to prospective application) unless confirmed by another reenactment of the statute.⁴¹

However, the Court quickly repudiated the idea that reenactment of a statute automatically confers the force of statutory law on administrative interpretations existing at the time of the reenactment. In the 1941 opinion of *Helvering v. Reynolds*,⁴² the Court stated that the reenactment doctrine is "no more than an aid in statutory construction," which may be "useful at times in resolving statutory ambiguities, [but which] does not mean that the prior construction has become so embedded in the law that only Congress can effect a change."⁴³ The wisdom of this result is suggested by Judge Learned Hand's observation that "[t]o suppose that Congress must particularly correct each mistaken construction under penalty of incorporating it into the fabric of the statute appears to us unwarranted; our fiscal legislation is detailed and specific enough already."⁴⁴

³⁹Regulatory indexing of the basis of depreciable assets, also suggested by the *Wall Street Journal*, note 2, is subject to the same objection. Congress indicated in 1981 that accelerated depreciation was justified, in part, as a correction for the effects of inflation: "Inflation reduces the tax savings from depreciation deductions because the value of the dollar is less when these deductions are claimed than it was when the investment was originally made. As a result, the current system of depreciation reduces the incentive to invest." Senate Comm. on Finance, Economic Recovery Tax Act of 1981, S. Rep. No. 144, 97th Cong., 1st Sess. 13 (1981). This indication that accelerated depreciation is a substitute for indexing the basis of depreciable assets negates the possibility of such indexing by regulation. Although the current cost recovery allowances under code section 168 are not as generous as those provided by the 1981 act, the fact remains that Congress has clearly indicated that the law does not permit the adjustment of depreciation deductions to reflect inflation.

⁴⁰306 U.S. 110 (1939).

⁴¹*Id.* at 116-117. The actual holding in the case was that the regulation could not be *retroactively* amended by the Treasury.

⁴²313 U.S. 428 (1941).

⁴³*Id.* at 432. The Court also remarked that *Reynolds Tobacco* "turned on its own special facts." *Id.*

⁴⁴*F.W. Woolworth Co. v. United States*, 91 F.2d 973, 976 (2d Cir.), cert. denied, 302 U.S. 768 (1973).

More recently, in the 1974 case of *NLRB v. Bell Aerospace Co.*, the Court stated that "where Congress has re-enacted the statute without pertinent change . . . congressional failure to revise or repeal the agency's interpretation is persuasive evidence that the interpretation is the one intended by Congress."⁴⁵ Thus reenactment is important evidence of the meaning of the statute, although it is not necessarily conclusive.

The proper weight to give to reenactment or continuation of a provision depends on the circumstances of the particular case.

Since the codification of the income tax (in 1939), continuation of the relevant statutory provision without change, when Congress has reason to be aware of the disputed administrative interpretation, has legal effect similar to reenactment of the provision.⁴⁶ The proper weight to give to reenactment or continuation of a provision depends on the circumstances of the particular case. The critical issue is the level of congressional awareness and scrutiny of the administrative interpretation. Where the level of scrutiny and awareness is high, reenactment or continuation of the statute is strong evidence that Congress has adopted the interpretation.⁴⁷

There is probably no administrative interpretation, in the tax field, of which Congress has been more thoroughly aware, over a longer period of time, than the interpretation of cost as not permitting indexing of basis for inflation.⁴⁸ The only Supreme Court case involving an arguably equal level of legislative awareness of an administrative interpretation of the tax laws is *Bob Jones University v. Commissioner*,⁴⁹ in which the Court noted that Congress had been "acutely aware" for a dozen years of the IRS rulings denying tax exemptions to racially discriminatory schools.⁵⁰ The

Court concluded that "[i]n view of its prolonged and acute awareness of so important an issue," Congress' failure to reverse the rulings provided significant support "for concluding that Congress acquiesced in the IRS rulings."⁵¹ With equally acute congressional awareness of the administrative interpretation of section 1012, there is equally strong support for the conclusion that Congress has accepted the interpretation.⁵²

Conclusion

The choice among reasonable interpretations of a statute belongs to the agency charged with administering the statute, and an agency may move from one reasonable interpretation to another.⁵³ Thus, Treasury may unilaterally index the basis of capital assets for inflation — if indexing is a reasonable interpretation of section 1012. Devoid of historical context, the word "cost" might reasonably be interpreted to mean inflation-adjusted cost. But there is an historical context — more than seven decades of administrative, judicial, and legislative agreement that cost does *not* mean inflation-adjusted cost. In light of this history, indexing is not a reasonable interpretation of section 1012, and thus the administration lacks the authority to index basis.

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It has now been more than three months since the idea of regulatory indexing was first made public, and the administration still has not acted. This inaction gives reason to hope that key members of the administration realize they lack the authority to index basis, and that they have sufficient respect for the rule of law not to take unauthorized action merely because it would probably not be subject to judicial review.

⁴⁵416 U.S. 267, 275 (1974).

⁴⁶*Bob Jones University v. United States*, 461 U.S. 574, 599-602 (1983) (attaching great significance to the failure of Congress to modify the Internal Revenue Service's position that schools practicing racial discrimination are not eligible for tax-exempt status); B. Bittker, *Federal Taxation of Income, Estates and Gifts*, para. 110.4.2 (1981).

⁴⁷"[T]he degree of scrutiny Congress has devoted to the regulation during subsequent reenactments of the statute" is an important consideration in applying the reenactment doctrine. *National Muffler Dealers Assoc. v. United States*, 440 U.S. 472, 477 (1979). In *Peoples Federal Savings and Loan Association of Sidney v. Commissioner*, 948 F.2d 289 (6th Cir. 1991), the court rejected the taxpayer's argument that reenactment of the statute gave statutory force to the taxpayer-favorable regulation in existence at the time of reenactment, so that Treasury could not later adopt a different interpretation. In the course of its opinion, the court cited the above language from *National Muffler Dealers*, but noted that "[t]he apparent degree of scrutiny [of the regulation by Congress] in this case is zero." *Id.* at 301.

⁴⁸See text accompanying notes 33-37.

⁴⁹461 U.S. 574 (1983).

⁵⁰*Id.* at 599.

⁵¹*Id.* at 601.

⁵²Like basis indexing, *Bob Jones* involved the question of whether the administration would have the power to change an interpretation following reenactment or continuation of the relevant statute. The Reagan administration took the position before the Court that the IRS did not have the authority to issue the key revenue ruling embodying the antidiscrimination interpretation of the tax exemption provision. *Id.* at 585, n. 9. The Court's conclusion that the revenue ruling's interpretation of the statute was the proper interpretation thus foreclosed a later administrative change of position.

⁵³Text accompanying notes 17-18.