PREFERENTIAL TREATMENT OF CAPITAL GAINS
IN A PROGRESSIVE TAX SYSTEM:
THE DEBATE CONTINUES INTO A NEW POLITICAL ERA

An Overview of Modern Tax Reform

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INTRODUCTION

Even before the inception of the first income tax under the Sixteenth Amendment of the United States Constitution in 1913, economists, scholars and politicians debated the arguments in favor of and against a progressive rate tax system, and the treatment of capital gains within that system. For more than a century the ideal of equity in the tax system and the role of government in the distribution of wealth have been central issues in the debate. In his "Wealth of Nations," Adam Smith set forth four elements that have been universally accepted by tax scholars, economists and politicians as necessary to an acceptable system of taxation. Those elements are equity, simplicity, certainty and fiscal responsibility. [FN1] Although these elements are universally accepted as necessary, it is the definition of each, and the manner in which the tax structure seeks to achieve them that continues to inspire debate and controversy.

Illustrative of the quest for equity in the tax system, economist Elmer Fagan wrote in 1938, "[a]lthough there are numerous arguments in favor of progressivity... in the end, equity is the only justification worth seriously considering." [FN2] Sixty-one years later, Congressman Bob Archer, Chairman of the House Ways and Means Committee and long-time proponent of federal tax reform, echoed Fagan's conclusion when he said, "[w]e need a tax code that achieves six basic principles: promotes fairness; simplifies compliance; attacks the underground economy; encourages savings and investment; improves the balance of trade; and stimulates economic growth." [FN 3] Representative Archer supported both the Taxpayer Refund and Relief Act of 1999 (vetoed 9/23/99) which contained an indexing proposal for capital gain and progressive marginal rates, as well as the proposed Fair Tax Act (currently in committees) which seeks to eliminate progressivity by replacing the income tax with a national consumption tax. [FN4] Both proposals, one progressive and one regressive, are offered in the name
of equity. [FN5] It is clear that the meaning of what is fair, and to whom, will continue to be the subject of partisan and scholarly debate well into the 21st century.

The first income tax enacted under the Sixteenth Amendment was a progressive tax which also taxed capital gains. The history of preferential treatment of long-term capital gains has been a matter of controversy since the inception of that first tax. The debate has increased in intensity over the last twenty years as the tax code's reach and complexity has grown further and further from the ideal of simplicity, mostly in its attempt to achieve the other goal of an acceptable tax system: equity. In fact, as Archer points out in his July 1998 newsletter, "The tax code is so complex that...at 7 million words, it is ten times longer than the Bible." Whether simplicity and equity can coexist in the modern era is intensifying the century old debate surrounding preferential treatment of capital gains in the tax code as well.

This paper is an overview which correlates the debate over preferential treatment of capital gains with the controversy inherent in a system of progressive taxation. Part II begins with a condensed history of the progressive tax and the capital gains preference since 1913. Part III examines the arguments in favor of and against progressivity and analyzes proposed HR2525, the Fair Tax Act, which seeks to eliminate the federal income tax altogether and replace lost revenue with a nationwide federal consumption tax. Part IV looks at the capital gains preference in general, methods of incorporating a capital gains preference into a progressive tax system, and arguments in favor of and against the preference. Finally, in Part V, I discuss and explain the indexing proposal and tax reform proposed by The Taxpayer Refund and Relief Act of 1999 (HR2488), which was vetoed by President Clinton in September, 1999. I argue that a comprehensive indexing proposal for capital assets and liabilities along with a reduction in the progressive rate structure is a more equitable alternative to tax reform than HR2525, and that a revised version of HR2488 might provide the best hope for achieving simplicity,
equity, certainty and fiscal responsibility, and for easing the burden on an overtaxed citizenry.

II. HISTORICAL BACKGROUND: CONSTITUTIONALITY AND HISTORY OF THE PROGRESSIVE TAX STRUCTURE AND THE CAPITAL GAINS PREFERENCE

The current tax rate structure in 2000 is progressive, meaning that higher income individuals pay a greater percentage of their income to the government than do low income individuals.[FN6] The Internal Revenue Code for the year 2000 provides five marginal tax brackets for ordinary income, with rates from 15% to 39% for ordinary income, and rates for capital gains income from 10% to 28%.[FN7]

The first tax enacted under the Sixteenth Amendment imposed a tax of 1% on individuals with taxable incomes up to $20,000, with a top marginal rate of 7% on individuals with annual taxable income of more than $300,000. [FN8]. Capital gains were taxed at the same rates (up to 7%). [FN9] Between 1913 and 1915, less than 2% of the wage-earners were affected by the tax rates.[FN10]. Since its inception, the Federal Income Tax has continuously maintained progressive marginal rates. [FN11]

The constitutionality of a progressive tax was challenged in 1916 when the United States Supreme Court decided *Brushaber v. Union Pacific Railroad*, 240 U.S. 1 (1916). [FN12] The issue specifically addressed whether the progressive marginal rates were unconstitutional under the Fifth Amendment of the United States Constitution. The appellants argued that “the progressive tax and the exempted amounts...are based on wealth alone and the tax is therefore repugnant to the due process clause of the Fifth Amendment.” [FN13] The appeal arose from a stockholder’s derivative suit in which a stockholder of the Union Pacific Railroad Company sought to enjoin the corporation from complying with the first Income Tax provisions under the Tariff Act of
1913.[FN14] The Court held that there was no basis in the case for reliance upon the due process clause of the Fifth Amendment because, “the Constitution does not conflict with itself by conferring upon the one hand a taxing power and taking the same power away on the other by the limitations of the due process clause.” [FN15] The Brushaber Court held that the progressive tax system would most likely be constitutional even if “the act complained of was so arbitrary as to constrain to the conclusion that it was not the exertion of taxation but a confiscation of property...or, what is equivalent thereto, was so wanting in basis for classification as to produce such a gross and patent inequality as to inevitably lead to the same conclusion.” [FN16] In so writing, the Court left the limits of progressive tax rates to the economists and government.[FN17] The Supreme Court has not specifically revisited the issue of the constitutionality of progression.

[FN18] As a result, economists and tax reformers have argued in favor of and against progressivity through the years since 1916, but the constitutionality of progressivity itself is well accepted, although the opportunity for constitutional challenge remains in theory. [FN19] (The constitutionality argument is an interesting one with enormous economic and social ramifications, but this author reserves that analysis for another article, as the enormity of it is outside the scope of this paper.)

Since 1916, marginal tax brackets have risen and the total percentage of individuals affected by the Federal Income Tax has increased exponentially. In 1917, in response to World War I, the War Revenue Act represented a significant change in the purpose and distributive effects of the Federal Income Tax. [FN20] The act significantly increased the amount of revenue collected by the government as a result of the income tax, and affected a far greater percentage of individuals. At this time, the marginal rates began at 2% on income exceeding $1,000, and surtaxes of 50% and 67% were imposed on individual taxable incomes over $1 million, and in excess of $2 million, respectively. By 1919, progressivity was at an unprecedented high, with a 77% maximum marginal
rate, and 70% of all taxes paid by fewer than 1% of all taxpayers. The highest marginal rates were reduced to 24% following the war under the advocacy of Secretary of the Treasury, Andrew Mellon, but remained progressive nonetheless. [FN21]

In the meantime, owners of capital assets saw some relief in the form of preferential capital gains tax treatment. Capital gains were taxed with ordinary income when the income tax was imposed in 1913. [FN22] In 1921, at the same time the marginal rates were peaking, an alternative tax rate of 12.5% was allowed for capital gains. [FN23] In 1924 capital gains were, for the first time, excluded from taxation based on holding period. Throughout the 30’s, long-term capital gains were excluded on a sliding scale based on holding period (6 months to 2 years) and amount of gains, from a 15% exclusion for large gains taxpayers to 50% for the small gains taxpayer. [FN24] The Revenue Act of 1942 replaced the sliding scale with a 50% deduction or a maximum rate of 25% at a 6 month holding period. This treatment of capital gains remained relatively unchanged until the Revenue Act of 1978. [FN25] A historical overview correlating the treatment of capital gains with the progressivity of the marginal rates reveals that as tax brackets on ordinary income become excessive, the economic and political response is to increase the capital gains preference, thereby giving those taxpayers in the highest brackets incentive to reinvest income and sell assets rather than holding them and to create wealth by investing ordinary income in capital assets. As the House Report to the 77th Congress in 1942 noted, a tax on capital gains that is too high would “have the effect of discouraging taxpayers from investing in new or productive enterprises.” [FN26]

Marginal rates spanned a wide range over the next 60 years, with the highest brackets escalating to the height of 91% following the rewriting of the tax code in 1954. [FN27] By the 1960’s, tax reform and the progressivity debate were of increasing interest politically as more and more American taxpayers were affected by the income
tax rates. While the highest brackets decreased slightly in the 1970's, middle and lower income earners were beginning to feel the effects of the marginal rates as they were pushed into higher income tax brackets when their income increased, to some extent as a result of inflation. [FN28] Due in part to this phenomenon, known as "bracket creep," taxpayers began increasingly to demand tax reform from the government to offer some relief from the burden.

Possibly in response to bracket creep, in 1978 the capital gains exclusion was raised, for the first time in over twenty-five years, from 50% to 60%. The Tax Reform Act of 1986, however, eliminated all capital gains exclusions and preferential rates. Between 1986 and 1990, the only preferential treatment of capital gains was in the form of deferral of tax liability on gains until sale or other disposition of the asset, at which time capital gains were realized by the taxpayer and taxed at ordinary income rates. [FN29]

It is interesting to note the correlation between this time in the mid to late 1980's when capital gains were afforded no preferential treatment in the tax code and the sudden barrage of "Flat Tax" proposals which began to surface in mid-80's as well. [FN30] As capital gains preferences decrease or are eliminated, the cry for an end to progressivity and a proportional tax (flat percentage of income) is heard.

The Revenue Reconciliation Act of 1990 reinstated a capital gains preference by setting the maximum tax rate for long term capital gains at 28%, at a time when ordinary income was taxed at a high of 31%. [FN31]. Capital gains currently receive greater preferential treatment. While the maximum rate for long term capital gains remains 28%, the highest marginal rate for ordinary income has increased to 39.6% under the Clinton Administration, with the Revenue Reconciliation Act of 1993. [FN32].

In 1999, the House Ways and Means Committee, led by Chairman Bill Archer, proposed The Taxpayer Refund and Relief Act of 1999 (HR2488), which included
among its provisions a partial indexing proposal as well as across the board reductions in marginal rates. Indexing, simply stated, is adjusting the amount of capital gain subject to tax for inflation so that inflationary, or "phantom," gains do not get taxed. HR 2488 was well written and passed both the House and the Senate with only minor amendments. The bill was submitted to the President, but was vetoed on September 23, 1999. Among other objections, the President rejected the tax reform as a "tax reduction for those who need it the least." As Representative Rangel (R-NY) responded, Clinton's simplistic veto "fail(s) to relate to the facts of the situation." [FN33].

Following the veto of HR2488, Rep. Archer has thrown his support behind house bill 2525, The Fair Tax Act, which abolishes the Internal Revenue Service and enacts a national sales tax to be administered by the states. As explained in the following section, a consumption tax is highly unlikely to be considered a viable alternative to a progressive income tax structure, and the debate and search for a solution to the equity problem will continue into a new administration.

III. PROGRESSIVE INCOME TAXATION

1. In General: Progressivity in the Tax Code

Although creating an equitable system of taxation is generally the goal of policy-makers, measurements of distribution of the tax burden differ greatly making it difficult at best and impossible at worst to create a tax structure which is seen as fair to all. Progressivity, or placing a greater burden on those who, in theory, can afford it more, has been a part of the tax structure in the United States since the first income tax was enacted. Although the debate usually centers around how progressive the tax structure should be, for the past twenty years reformers have begun to challenge the fairness of progressivity. Proponents of a proportionate or flat tax argue that it is fair, while supporters of a consumption tax argue that it is fair. The concepts of horizontal and
vertical equity are generally used as guidelines in determining what level of progressivity is fair.

Horizontal equity is based upon the principle that similarly situated taxpayers should be treated the same under the code. In theory, if two taxpayers have the same amount of income, they would be similar and should be treated the same. Although the principle seems straightforward, there are horizontal equity arguments even when, on the surface, two taxpayers seem to be similarly situated. As Marjorie Kornhauser points out in her article, "Equality, Liberty and a Fair Income Tax," there are many ways of treating people equally or "the same." [FN34]. For example, proponents of the consumption tax argue that taxing all citizens on spending is treating each similarly situated person similarly. This argument fails to take into consideration, however, the difference in the overall utility of each individual's income. A brief example illustrates the theory of horizontal equity: Assume a 10% sales tax on all goods. A has $10,000 and spends all $10,000 to maintain his lifestyle during the tax year. A pays $1,000 in taxes at a 10% rate. B has $1,000,000 and spends $100,000 during the year to maintain his lifestyle, and pays $10,000 in taxes. At first glance, the flat consumption tax rate appears to treat similarly situated taxpayers the same because B earns 10 times more than A, and B pays 10 times more in taxes than A. Upon closer examination of the economic reality of the situation, however, it becomes clear that A and B are not similarly situated at all: A has spent 100% of his earnings, because he had to based on the cost of living, and was therefore taxed on 100% of his earnings. A's actual earnings are taxed at 10%. B spent $100,000, based on his lifestyle, and paid $10,000 in taxes. B's earnings were $1,000,000, so he had 900,000 left. B's actual tax was .01% of his total earnings. In this example, A and B are economically dissimilar, and yet they are treated the same, which violates the principle of horizontal equity.
The foregoing example, also has ties to the principle of vertical equity. Vertical equity is the more controversial and subjective principle of the two, and yet it has been used to justify progressivity since the original income tax was enacted in 1913. Vertical equity provides that higher income individuals should pay more in taxes than lower income individuals. In other words, individuals in dissimilar economic circumstances should be treated differently. Vertical equity is grounded in the idea that the wealthier person ought to pay more than the poor person for a variety of economic, moral and social reasons. [FN35] The controversy inherent in a progressive income tax is usually not whether a tax should achieve vertical equity, but rather, how much greater a burden should the higher-income taxpayer bear in order to achieve vertical equity. As illustrated in the horizontal equity example, vertical equity attempts to take into consideration that each dollar earned has a different marginal utility depending on the wealth of the person who earns it. In other words, each dollar is more critical to the subsistence of a poor person than it is to a wealthier person. [FN36] Opponents of the progressive tax system have historically argued that extremely progressive tax rates would penalize hard work and violate the capitalist principle of wealth maximization. [FN37] The struggle in the modern era is to achieve a balance; where equity takes into consideration the differing economic circumstances of all individual taxpayers, and yet does not unduly burden or discriminate against higher-income individuals who, in the modern era, are not just the very wealthy, or the "robber barons," but also hard working, educated professionals and small business owners.

2. The Fair Tax Act: Arguments For and Against a National Consumption Tax

HR2525, The Fair Tax Act was introduced and referred to House Committee on Ways and Means on July 14,1999. Its official title as introduced is: "To promote freedom, fairness, and economic opportunity by repealing the income tax and other taxes, abolishing the Internal Revenue Service, and enacting a national sales tax to be
administered primarily by the states.” [FN38] Representative Bob Archer, who supported the Taxpayer Refund and Relief Act of 1999, has now thrown his support behind the seemingly radical consumption tax proposal. The Fair Tax Act contains three titles. Title I amends the Internal Revenue Code to repeal the income tax, estate and gift taxes, and employment taxes. Title II enacts a sales tax of 23% for the year 2001 on the use or consumption in the United States of taxable property or services.

Under sec. 101 of HR2525, the Fair Tax Act would impose a tax of 23% of the gross payments for taxable property or services. Section 2(a)(14)(A) defines “taxable property or service” as:

(i) any property (including leaseholds of any term or rents with respect to such property) but excluding –
   (I) intangible property, and
   (II) used property, and
(ii) any service (including any financial intermediation services as determined by section 801).

The code defines “Service” under section 2(a)(14)(B) as basically any service performed by an employee for which the employee is paid wages or salary, with exceptions for employees performing business functions for their employers, non-profit organization employees, government employees and employees directly providing education and training.

Under the consumption tax provision, any person purchasing goods, services, or renting or purchasing a residence will pay an additional 23% of the cost of that product or service in national sales tax. This tax would be in addition to any state imposed sales tax. The current tax in Michigan on most products would be a total of 29%. Therefore, in the state of Michigan, if this proposal was enacted, a pair of jeans with a price of $50.00 would actually cost the consumer $64.50. A new car with a sticker price of $25,000 would cost $32,250 in 2001 under the consumption tax.

Proponents of the consumption tax argue the income tax is unfair because it fails to take into consideration assets beyond income. [FN39] The equity argument is
untenable under a pure consumption tax such as the Fair Tax Act. Horizontal equity is violated because people in dissimilar economic situations are treated similarly. Everyone needs goods and services, and there is a subsistence level under which no one can live without serious hardship. Assume for the purpose of this example, that the amount for goods and services required to live at the subsistence level is $25,000 for a family of three. Family A earns $28,000, and has not incurred income tax liability in the past and has thus been able to accumulate a small savings account. (2 yrs. x 3000 = 6000). In 2001, Family A spends $25,000 and incurs $5,750 in tax liability. Family A's tax liabilities and expenditures would require income of $30,750, or $2,750 more than the family earned. In order to continue buying food, shelter and clothing, Family A will have to take $2,750 out of savings to meet their tax liability. Family A is effectively taxed on more than 100% of total earnings with a consumption tax. Clearly, the consumption tax creates economic and social problems. Family A, which previously was able to accumulate savings will be pushed into greater and greater hardship as savings are depleted. Family B, on the other hand, earns $500,000 per year and spends $50,000 during 2001. Family B would pay $11,500 in taxes. Family B spent twice as much as Family A and pays twice as much in tax. Family A incurred an effective tax liability of 20.5% of earnings, and Family B paid 2.3% of annual income in taxes. The consumption tax severely violates principles of horizontal and vertical equity. Under this proposal, lower-income taxpayers would actually carry a heavier tax burden than higher-income taxpayers, creating a regressive tax system. In a regressive tax system, lower-income individuals pay a greater percentage of income in taxes than higher-income individuals. Most economists and tax policy-makers agree that a regressive system is undesirable for economic, social and moral reasons. In fact, most proponents of proportionate or flat taxes exempt the poor in order to maintain at least a minimum level of vertical equity. This type of provision is not included in The Fair Tax Act.
The Fair Tax Act should not be passed because it would create serious hardship for the middle and lower income earners and would significantly bifurcate the classes by pushing middle income taxpayers into poverty while those who are slightly well off would be able to increase their wealth by choosing savings or investment rather than spending. The middle or low income individual does not have that choice. There is historical precedent for the belief that the consumption tax proposed by the Fair Tax Act would be create a steeply regressive tax system in which the poor are made worse off while the slightly wealthy would become richer. In the late 1900's, Congress used a system of tariffs and commodity taxes rather than an income tax. Populist social reformers who fought against the inequity of the regressive system were a great impetus to the reform of the tax system in 1913. The commodity taxes had the same effect and purpose as a consumption tax would have in 2001. In the late 19th century, Congress ensured that each taxpayer would pay the same amount on each purchase. The result, of course, was serious vertical inequity, because it did not take into consideration the divergent economic circumstances. Because the poor spent a greater percentage of their wealth on consumption than did the rich, the result was that the poor were paying a significantly higher percentage of income in taxes. The Populists influenced the legislature to achieve greater social justice in the tax system by incorporating principles of vertical and horizontal equity into the law. [FN40]

IV. THE CAPITAL GAINS PREFERENCE

1. In General: The Capital Gains Preference and Methods of Incorporating

Capital gains preference refers to the beneficial treatment of capital gains. When an asset is sold, capital gain is the difference between the taxpayer’s basis in the property and the amount realized. [FN41] The capital gains preference is an effective tool to reduce some of the tax burden on those individuals who are paying the greatest
percentage of total tax revenue, while still maintaining principles of vertical and 
horizontal equity in a progressive tax system. Capital gains preferences also have the 
advantage of increasing economic efficiency.

There are three types of preferential capital gains treatment: deferral, exclusion or 
preferential tax rates. The preference is an exclusion when at least some portion of the 
gain is excluded from taxation, as IRC §1202 pre-1986 amendments allowed. 
Preferential rates exist when the tax rate on capital gains is less than the rate for ordinary 
income, as the current tax code allows under IRC section 1h, where capital gains are 
taxed at a maximum of 20% or 28%, depending on the type of capital asset disposed of, 
and ordinary income is taxed at a maximum rate of 39.6%. [FN42] Deferral of taxation 
exists whenever long term assets are held, because although the asset may be 
appreciating each year, until the disposition of an asset creates a realization event 
whereby the taxpayer has an actual accession to wealth, the increased value of the asset is 
not taxed. Deferral, exclusion and preferential rates may be combined or only one may 
be used to create a capital gains preference. Currently, the tax code provides a 
combination of the three methods of preferential treatment.

The capital gains preference may be the best way to ease the severity of a 
progressive tax system for those taxpayers who are most affected by high marginal tax 
rates while still maintaining vertical and horizontal equity.

2. Arguments in Favor of and Against the Capital Gains Preference

There are economic and equitable arguments for and against the capital gains 
preference. The broadest and most politically effective argument against capital gains 
preferences, in terms of gaining anti-capital gains support on an equitable basis, is that it 
is simply another tax reduction for the rich, or as President Clinton called it in his veto of 
the Taxpayer Refund and Relief Act of 1999, “tax reduction[s] for those who need [them]
As Representative Rangel pointed out, however, upon closer examination, the facts of the situation are not so absolute. Although higher income individuals tend to own more capital assets which give rise to capital gains, Treasury Department statistics in 1990 showed that of all taxpayers with capital gains, 65% had taxable ordinary incomes of less than $50,000, and 25% had ordinary income of $20,000 or less. The same study indicated that 74% of the capital gains dollars were owned by individuals with incomes over $100,000, or less than 5% of all taxpayers. These statistics show, first, that although higher income individuals tend to own more capital assets, a significant number of taxpayers in the lowest tax brackets benefit from the deferral of income and lower tax rates for their earned capital gains, and thus benefit from a capital gains preference. Opponents argue that these lower income individuals do not generally incur great tax liability under the progressive marginal rate structure, and therefore do not benefit to any significant extent from a capital gains preference. On the contrary, the capital gains preference provides a benefit to those 65% of taxpayers with income under $50,000 who will suffer the effects of bunching in the year in which the asset is sold.

A capital gains preference alleviates the problem of “bunching.” Bunching occurs when a taxpayer is pushed into a higher income tax bracket in a single tax year because of the realization of gain from disposition of an asset which has appreciated and accrued gain over a number of years. For example, an unmarried individual with taxable ordinary income in 1999 of $49,000 would be in the 28% bracket, with tax liability of 15% on the first $29,600, or $3,315, plus 28% of $9,400 (the difference between $49,000 over $29,600), or $5,432, for a total tax liability of $8747 before deductions. If this individual’s ordinary income is based on wages from employment, for example, he or she will find him or herself in a relatively similar position from year to year. If a bunching situation occurs, the individual’s tax liability changes drastically in
one year due to the disposition of a capital asset. If the individual in year 2000 disposes of a capital asset and realizes $100,000 in gain, the taxpayer’s liability would change drastically without a capital gains preference. With no capital gains preference, his or her income would jump to $149,000 which, at current rates, would cause the taxpayer to be pushed up two brackets. The individual, whose tax burden is normally in the middle income bracket is now pushed up to the second highest bracket (36% marginal rate), and in 2000, without a capital gains preference would have tax liability of $54,885. The individual’s tax liability would be higher than his or her annual salary! A capital gains preference in the form of an exclusion or preferential rate helps to alleviate the bunching problem. This situation creates serious economic problems as well, as the taxpayer has a disincentive to dispose of capital assets due to the tax ramifications, and therefore money is “locked in” to the investments.

The code attempts to deal with this problem by excluding gain from the sale of a taxpayer’s principle residence if certain requirements are met. [FN49] Prior to 1997, the taxpayer’s only solution to tax relief from large gains due to the sale of a principle residence was to “roll over” the gain within a prescribed period of time. However, because of inflation, the buying power of each dollar originally used to acquire the asset was reduced and the taxpayer was forced to either pay an inflated amount for an equivalent home or invest more money to upgrade. There was obviously no incentive to unlock the investment to repurchase an equivalent home, which created fewer realization events, and many taxpayers ended up in homes they could not afford simply to avoid the bunching effect and significant tax liability which occurred upon realization of the gain. Savings were thereby reduced and debt increased. The capital gains exclusion on principle residences has alleviated this problem, and empirical studies have shown that middle-income taxpayers benefit significantly from this provision because, unlike the
higher-income taxpayers, they are likely to earn more capital gains from the sale of a principle residence than from other capital assets.

Many opponents of the capital gains preference argue, nonetheless, that bunching is not a significant problem because the distribution patterns show that most capital gains taxes are concentrated among high income individuals who are already in the highest tax bracket. However, as the statistics show, individuals in the lower tax brackets would be seriously affected by the bunching problem in the absence of favorable capital gains treatment. Although research shows that those with earnings over $200,000, who constitute the top 1.8% of income, account for 78.6 percent of capital gains taxes, this statistic represents the amount of money paid in taxes by those taxpayers who realize capital gains rather than the number of taxpayers affected by the tax on capital gains. [FN50] In a 1999 Congressional Research Service report, tax analyst Jane Gravelle concedes that lower gains rates “may also enhance horizontal equity by treating taxpayer[s] in different circumstances more evenly.” [FN51]

Moreover, data from the Internal Revenue Service, Statistics of Income, show that the top 1% of taxpayers (those in the highest marginal bracket of 39.6%) includes not only the very wealthy - “[F]ortune 500 CEO’s, leading entertainers and athletes, Wall Street Investment Bankers and lawyers, but hundreds of thousands of successful professionals and business owners all across the country.” [FN52] This data tends to rebut the argument that capital gains preferences benefit “only the wealthy” and those who “need the reductions the least,” because of the disparity of the economic situations of the individuals who make up the top 1-5% of all taxpayers. [FN53]

The capital gains preference also provides an effective solution to the problem of “lock-in,” by increasing realization events, stimulating the economy and encouraging greater efficiency in investments. [FN54] The lock-in effect occurs when a taxpayer is reluctant to “unlock” investments by selling them because a disposition of the asset
would be a realization event and the gain realized would be subject to taxation. Where capital gains are taxed at ordinary income rates, the taxpayer has disincentives not only because he or she will suffer tax consequences from the realization of the gain, but also because the taxpayer may be affected by the bunching problem discussed above, in which case he or she would end up paying higher taxes on the amount realized than that taxpayer would normally pay on his or her ordinary income. This result is made worse when there has been inflation during the time the asset was held. In the case of inflation, the taxpayer who is pushed into a higher bracket because of realization of capital gain is realizing only "illusory gain" because the amounts realized from the sale of the assets are "inflated dollars with less buying power than the unit basis of the disposed asset."[FN55] (The indexing proposal helps to eliminate this disastrous effect to the taxpayer and will be discussed at length later in this paper). Thus, bunching, the lock-in effect and inflation can all work together to create a disincentive to investment.

Where the asset remains "locked," the taxpayer receives a tax benefit in the form of deferral of tax liability, and if the asset can be held until the taxpayer's death, the gain will not be taxed at all. "An investor who is not taxed until realization and who can avoid tax altogether by holding an asset until death, tends not to change investments, even though he may believe that higher returns are available elsewhere." [FN56] This effect occurs because the code currently provides for a step-up in basis for assets held at death, which means that the person who receives the property will have a basis in that property equal to the fair market value of the property on the date of the testator's death. [FN57] The code does not treat the bequest or devise as a realization event, therefore the appreciation of the property (the difference between the testator's basis and the fair market value) is never taxed. The economic effect of lock-in is fewer realization events, less incentive to diversify investments, and "inefficiency that impedes the flow of capital to its most productive uses." [FN58] In other words, a tax system which taxes capital
gains in the same manner as ordinary income in combination with its treatment of the taxpayer's death as a non-realization event will encourage taxpayers to retain assets as long as possible, thereby avoiding taxes that would normally result from a realization event. Proponents argue that giving capital gains preferential treatment encourages more efficient investment behavior because a lower tax burden will insures that financial decisions are motivated less by tax consequences and more by economic reality. [FN59]
As a result, the economy benefits, as capital is unlocked and available for investment.

Opponents argue that other remedies to the lock-in problem are available, such as taxing gains as they are accrued, or a rollover provision where gains are not taxed on the disposition of an asset if those gains are reinvested within a specified period of time. [FN60] The rollover provision is problematic because it does not take into account phantom gain due to inflation. The indexing proposal includes a provision which would repeal the step up in basis at death provision. If the stepped up basis provision were repealed in combination with lower capital gains tax rates which are indexed for inflation, the lock in effect could be greatly eliminated as the tax code would create economic incentive to reinvest capital assets rather than holding them until death.

Another argument in favor of a capital gains preference is that beneficial treatment of capital gains provides a savings incentive. The theory is that a preference increases the after-tax return on savings, attracting taxpayers more to saving and investment than to consumption. [FN61] Government benefits because where investment is encouraged through a capital gains preference, realization events are increased, thereby spurring the economy and increasing revenue (except in the case of outright exclusions, revenue is derived from each realization event). [FN62] Opponents argue that the most direct way to increase savings is by reducing the federal budget deficit. [FN63] In the current economy, some argue, the overall effect of capital gains rate cuts could be detrimental to the economy in the long run, because the increases in domestic investment
spurred by additional realization events would not offset the long term loss of revenue which would, in turn, actually increase the deficit. [FN64] Economists disagree as to this point, however, and although the specifics of revenue implications are beyond the scope of this paper, the current proponents of tax reform argue that there is a significant "on-budget surplus generated purely from higher income tax revenues," which will be used in part to fund tax cuts. [FN65]

Finally, it can be argued that to a certain extent, capital gains are not accessions to wealth because the gains are in large part inflationary, and as such do not represent "income." [FN66] This argument stems from the fact that inflation actually fosters an increase in the value of an asset during the time it is held. [FN67] This is the primary argument set forth by proponents of indexing as a solution. Indexing, as opposed to an outright exclusion of capital gain, eliminates that portion of capital gain that is due to inflation, and leaves only that amount which represents true income. Opponents argue that the advantage of deferral of income over the period of time during which the asset is held offsets the problem of inflation, because while the inflationary portion of the gain would become less over time, the advantage of deferral increases over time. Therefore, the argument goes, if the asset is held long enough, deferral advantages would balance the inflation detriment. [FN68] This argument presupposes that assets will be held for extremely long periods of time. If assets are held too long, the lock-in effect would be exacerbated to the detriment of the economy.

Another argument against the capital gains preference is an equity argument. Opponents argue that beneficial treatment of capital gains gives an inequitable advantage to higher income individuals. These individuals are more likely to own the assets that generate capital gain, and will therefore benefit more than lower income individuals who do not own capital assets. However, as illustrated previously, many recent studies confirm that lower- and middle-income taxpayers would be significantly affected by a
failure to treat capital gains preferentially, because they do own capital assets. Although they do not realize as much income from each capital asset disposed of, relative to total income, the person in the lower- or middle-income range could suffer more adverse tax consequences than the person in the higher income range upon realization of gain because the amount of gain is a larger percentage of his or her total income. Furthermore, empirical studies have shown that these taxpayers are paying more tax on phantom gain due to inflation than are higher-income taxpayers. [FN69] Additionally, the preference creates incentives to convert ordinary income to capital gain in order to take advantage of the preferential treatment. [FN70]

Many proponents of the capital gains preference advocate indexing of capital assets for purposes of determining gain. The Taxpayer Refund and Relief Act of 1999, which was vetoed by President Clinton on September 23, 1999, contained an indexing provision, Section 1022 of H.R. 2488, which would have amended the Internal Revenue Code (IRC) to include indexing of certain assets for purposes of determining gain.

Indexing is a process by which the basis of a capital asset is adjusted to take into account gain realized solely as a result of inflation when the asset is disposed of after a period of time. The general purpose behind indexing is to eliminate "illusory gain," or that portion of the capital gain which is the result of inflation rather than an actual accession to wealth. [FN71] Proponents argue that adopting a capital gains preference in the form of an indexing proposal allows for a more accurate measurement of a taxpayer's accretion to wealth, because (unlike an outright exclusion), "the indexing concept does not tax real economic gain; it simply excludes illusory profits derived solely from inflation." [FN72] Opponents, on the other hand, argue that indexing increases the already preferential treatment (deferment of income, favored rates) of capital gains by increasing the basis of certain capital assets to reflect inflation.
V. THE INDEXING PROPOSAL

1. In general: How the Code would work:

Proposed §1022 is a Code provision for determining gain when certain capital assets are sold or otherwise disposed of in a transaction constituting a realization event. The indexing proposal provides that an indexed basis, which reflects an adjustment for inflation, will be substituted for the adjusted basis of a qualified long-term capital asset only for purposes of determining gain. Sections 1022(a)(1)(2) and (3) provide the general rules for determining which assets will qualify as indexed assets under this proposal:

(1) INDEXED BASIS SUBSTITUTED FOR ADJUSTED BASIS- Solely for purposes of determining gain on the sale or other disposition by a taxpayer (other than a corporation) of an indexed asset which has been held for more than 1 year, the indexed basis of the asset shall be substituted for its adjusted basis.

(2) EXCEPTION FOR DEPRECIATION, ETC.- The deductions for depreciation, depletion, and amortization shall be determined without regard to the application of paragraph (1) to the taxpayer or any other person.

(3) EXCEPTION FOR PRINCIPLE RESIDENCES- Paragraph (1) shall not apply to any disposition of the principal residence (within the meaning of section 121) of the taxpayer.


This particular indexing proposal, therefore, only applies to individual taxpayers whose realization from the disposition of certain long-term capital assets constitutes a gain. Losses and liabilities are not to be adjusted for inflation through use of the indexing proposal. Further, gains from the sale of a taxpayer's principle residence, which qualifies for exclusion from gain under IRC §121, are not included. Indexing and exclusion are basically two sides of the same capital gains preference coin. Gains from the sale of a principle residence which are already entitled to preferential treatment in the form of an exclusion would receive double preference if also accorded indexing treatment. Proposed §1022 also excludes deductions for depreciation, depletion and
amortization from indexing, thereby insuring that only that gain which is due to inflation is excluded under the indexing provision. If income is defined as an "accession to wealth," then inflationary gains are not income, and should not be taxed. [FN73]

In order to determine the indexed basis of a capital asset, the individual taxpayer must first determine that the asset qualifies as an "indexed asset." In general, §1022(b)(1) defines an indexed asset as:
(A) Common stock in a C corporation (other than a foreign corporation), and
(B) Tangible property which is a capital asset or property used in the trade or business (as defined in §1231(b)).

Although §1022(b)(1)(A) excludes foreign corporation stock, §1022(b)(2) includes stock in certain foreign corporations; primarily common stock from those foreign corporations which are traded on an established securities market.

After the taxpayer determines that he has realized gain from the disposition of a qualified capital asset held for more than one year, the taxpayer must then determine the indexed basis of the asset, which is substituted for the adjusted basis and included in the taxpayer's gross income.

Sections 1022(c)(1)(2) and (3) provide the rule for calculating the indexed basis:
( c) INDEXED BASIS- for purposes of this section
   (1) GENERAL RULE: The indexed basis for any asset is
       (A) the adjusted basis (AB) of the asset, increased by
       (B) the applicable inflation adjustment (IA).

Section 1022(c)(1) therefore, gives us the formula: Indexed Basis = AB + IA.
Next, the taxpayer must calculate the applicable inflation adjustment set forth in §1022(c)(2):
(2) APPLICABLE INFLATION ADJUSTMENT – The applicable inflation adjustment for any asset is an amount equal to
       (A) the adjusted basis (AB) of the asset, multiplied by
       (B) the percentage (if any) by which
the chain-type price index for GDP for the last calendar quarter ending before the asset is disposed of, exceeds
(ii) the chain-type price index for GDP for the last calendar quarter ending before the asset was acquired by the taxpayer.


In order to complete the calculation, the taxpayer would determine the GDP price index for the last calendar quarter before the sale or other disposal of the asset, and also the GDP price index for the last calendar quarter ending before the taxpayer acquired the asset. The percentage by which the GDP price index at the time the asset is disposed of exceeds the GDP price index from the time when the asset was acquired by the taxpayer will reflect inflation during the years the asset was held. When this percentage is applied to the adjusted basis of the asset, the basis will then reflect actual gain, having eliminated the portion of gain that is solely due to inflation.

The remainder of proposed §1022 includes sections dealing with various specific capital asset transactions. These remaining provisions are designed to counter and protect against many of the arguments set forth by opponents of indexing, and by opponents of the capital gains preference in general, such as arbitrage and other tax motivated transactions.

2. Arguments in Favor of and Against the Indexing Proposal

By allowing taxpayers with gain from capital assets to adjust otherwise taxable income for inflation when ordinary income is not entitled to the same adjustment, the indexing proposal constitutes a capital gains preference. Supporters of an indexing method of preferential capital gain treatment argue that the indexing proposal will make the tax system more equitable because inflation causes the mismeasurement of income for tax purposes. Indexing allows the taxpayer to eliminate that part of the gain which is solely attributable to inflation. Currently, capital gains enjoy preferential tax treatment in
the form of lower rates and deferral of gain. Indexing will give the taxpayer increased accuracy in determining inflationary gain, and therefore the taxpayer will be taxed on true accessions to wealth.

Opponents to the original indexing proposal argued that it would increase complexity, create the potential for tax arbitrage problems, and would lead to a further tax bias in favor of capital gains as well as create inequity between taxpayers with different types of capital assets. Further, selective indexing of gains but not liabilities will result in under-measurement of real income and could actually exacerbate the lock-in problem.

A major argument against indexing is that it will further increase the preferential treatment for capital gains as opposed to ordinary income. Opponents argue that the indexing proposal would violate the principle of horizontal equity because taxpayers are treated differently depending on the type of income they have. Because of the realization requirement, capital gains receive favored treatment before any other preference is applied. This argument fails, however, because the indexing proposal only seeks to eliminate gains which are not true accessions to wealth, and are therefore not income. The indexing proposal would significantly increase favorable treatment, but only for those individuals who are already paying more than their fair share of the tax burden because they are paying taxes not only on true income, but also on inflationary gain. The taxpayer with capital gains is, in effect, punished for investing and reinvesting. Under the indexing provision, the taxpayer will pay a lower rate of tax on his capital gain, which is justified because of the benefit of investment to the overall good, but will only be taxed on the actual gain, because the basis of the asset will be adjusted for inflation. [FN74] Where capital gains are not adjusted for inflation, capital gain income is actually penalized because many of the gains subject to taxation arise from inflation. [FN75].
Opponents argue that adding the indexing proposal to an already complex area of the IRC would increase the complexity of administration and application. First, any taxpayer with capital gains would be likely to require assistance in applying §1022. This argument fails to consider the fact that those taxpayers who own capital assets already generally require assistance in using the depreciation tables, and in itemizing deductions. If a taxpayer, on the other hand, is proficient in using the complex depreciation schedules, he or she should not find the few calculations required by the indexing proposal overly difficult. Presumably, if the indexing proposal were enacted, the IRS would include a list of GDP factors available within the indexing forms, and the calculations would be no more difficult than any other required calculations.

Another argument citing the complexity of the provision was that taxpayers would be required to keep precise records of acquisition dates, in order to know which GDP index to use. [FN76] Where taxpayers own capital assets, however, they must already keep accurate records in order to utilize the depreciation schedules, and for non-tax purposes relevant to the investment.

Opponents also argue that eligibility requirements for indexing are likely to create numerous disputes between taxpayers and government, which will lead to increased litigation and uncertainty for taxpayers. [FN77] Finally, substituted basis transactions, improvements and subsequent capital investments will be subject to scrutiny by the IRS and extreme complexity in application by the taxpayer. [FN78] The indexing proposal, however, covers most areas in which complexity would arise, and provides rules for areas which may be questionable, such as where there is a diminished risk of loss or short sale. [FN79]

Indexing will provide significant economic and social benefits which will justify any increase in complexity. First, indexing will reduce the lock-in effect, thereby increasing economic efficiency. By reducing the amount of capital gain,
reduces the lock-in effect and creates an incentive to sell assets. [FN80] Taxpayers who own capital assets will have great incentive to invest and reinvest, creating more realization events and, as a result, more actual revenue to the government. On the other hand, because §1022 fails to index liabilities, proponents argue that this indexing proposal actually exacerbates the lock-in problem because taxpayers with losses will be encouraged to hold the asset until the indexation benefit can be used. [FN81] Also, where a taxpayer borrows to finance the purchase of an indexed asset, the indexing proposal would result in undermeasurement of real income. [FN82] This argument is easily overcome by modifying the proposal to index liabilities as well as assets. This is called comprehensive indexing. The following example, from Reed Shuldiner’s article, “Indexing the Tax Code,” (48 Tax L. Rev. 537, 642 (1993)) will illustrate how comprehensive indexing would create an accurate measurement of real indexing:

**Example 39:** Margot buys an asset for $100, fully financing the purchase with debt. The debt bears a 15% nominal interest rate and the inflation rate is 10%. One year later, Margot sells the asset for $120, repays the debt with $115, and is left with $5.

(Margot’s basis = $100, Amount Realized = $120, Capital Gain subject to tax without indexing = $20)

**No Indexing** (Note: Shuldiner’s 1993 example shows an interest deduction. In 1997 interest deductions are phased out at higher incomes, and Margot’s situation would be as above): Without indexing, Margot has a gain of $20, a $15 interest deduction, and net income of $5.

**Partial Indexing (Indexing Assets, but not liabilities):** If only the asset were indexed for inflation, Margot would have a gain of $5, and an interest deduction of $15, and therefore a net loss of $10.

**Comprehensive Indexing (Indexing Assets and Liabilities):** If both the debt and the asset were indexed, Margot would have gain on the sale of the asset of $10, and an interest deduction of 5%. Her net income again would be $5.

If Margot cannot take the interest deduction, her indexed capital gain would be $10, and she would be taxed on that gain.
As example 39 illustrates, indexing assets without also indexing liabilities can create an inaccurate measurement of net income, however with the combination of comprehensive indexing and the phase-out of interest deductions, net income is measured the most accurately as Margot will not be taxed on the gain which was solely due to inflation.

Selective indexing can create the additional problem of tax arbitrage. Arbitrage occurs when taxpayers structure their affairs to receive favored tax treatment. [FN83] While indexing assets can accomplish certain goals, such as taxing only real gain, encouraging savings and investment, and reducing the lock-in effect, indexing becomes less attractive when liabilities are unindexed. [FN84] Where a taxpayer enters into an entirely debt-financed transaction, correcting for inflation on the asset side while failing to correct for inflation on the liability side causes net income to be seriously understated. Comprehensive indexing avoids this problem, as the example above illustrates.

Furthermore, although indexing assets without indexing liabilities would present arbitrage opportunities, similar problems are presented by any capital gains preference, and rules already exist to deal with and prevent arbitrage transactions. [FN85] The indexing proposal contains provisions to deal with arbitrage concerns by specifically addressing pass-through entities and transfers made to increase the indexing adjustment in §1022(f), (g) and (h).

VI. CONCLUSION

It is clear that the debate concerning progressivity of the income tax system will continue well into the new millennium. In the new political era, as they have in the last 20 years since the barrage of flat tax proposals began in the 1980's, politicians, tax scholars and economists will continue to debate what is "fair" and to whom. As this paper has demonstrated, progressivity seems to be the most fair of the alternatives, because a proportionate or consumption tax, like H.R. 2525, will create a regressive tax system
which is clearly unfair. The remedy which prevents a progressive tax system with no constitutional limits on the level of progressivity from placing too great a burden on taxpayers in the middle and upper marginal tax brackets is a capital gains preference. However, a capital gains preference is illusory if inflationary gains are not taken into account. Although selective indexing, such as indexing for purposes of determining gain only, may exacerbate some of the problems capital gains preferences are designed to remedy, such as the lock-in effect, these problems are resolved in a comprehensive indexing scheme. Section 1022 of The Taxpayer Refund and Relief Act, H.R.2488, already takes into account some of the difficulties in complexity and administration and offers statutory guidelines which will avoid such problems as arbitrage and uncertainty. Congress, and tax reformists such as Representative Archer, should revise The Taxpayer Refund and Relief Act, section 1022, and resubmit a proposal for comprehensive indexing for capital gains. Moreover, taxpayers should not be swayed by the political spin on the so-called “Fair Tax.” If such a “Fair Tax” were to somehow pass into law, there would be no winners, and the losers would be democracy, the economy and our wallets as we pull out more and more dollars each time we buy gas, a pair of shoes or a new car.
ENDNOTES


[FN4] *Taxpayer Relief and Relief Act of 1999*, H.R. 2488, Enrolled Bill (Sent to the President), Vetted by President Bill Clinton, September 23, 1999 (106th U.S. Congress, 1999)


[FN8] Howard, supra note 1, at 47.


[FN10] Id.


[FN13] Id., at 24

[FN14] Id., at 1

[FN15] Id., at 24
[FN16] Id. at 25

[FN17] Howard, supra notes 1, 7, 10 at 45; see also, Staudt, Nancy, *The Hidden Costs of the Progressivity Debate*, 50 Vand. L. Rev. 919, 931-934 (1997)

[FN18] Id.

[FN19] Id.

[FN20] Id.

[FN21] Id. at 50


[FN23] Id.


[FN25] Id. at 34

[FN26] Id. at 35

[FN27] Howard, supra note 1, at 55

[FN28] Id.

[FN29] Lee, supra note 24 at 34, 35, and Howard, supra note 1 at 56. See also, C.R.S. Report to Congress, supra note 9 at 2.


[FN32] Id.

[FN34] Kornhauser, Marjorie E., *Equality, Liberty, and a Fair Income Tax*, 23 Fordham Urb. L.J. 607, 613 (1996). "Certainly, the fairness of requiring everyone to donate a kidney to the organ transplant bank is questionable when A has two healthy kidneys and B has only one."


[FN36] Id. at 117


[FN40] Staudt, supra note 37 at 933, 934.

[FN41] CRS Report for Congress, supra note 9 at 1.


[FN43] Taxpayer Refund and Relief Act of 1999 -- Veto Message from the President of the United States, supra note 33.


[FN45] Id.

[FN46] Lee, supra note 24 at 40-45.

[FN47] Id.

[FN48] Id. at 5.

[FN49] Lathrope, supra note 6, IRC section 121.

[FN51] Id.


[FN54] Lee, supra note 24 at 5.

[FN55] Safavian, supra note 31 at 114.


[FN57] Lathrop, supra note 6, IRC section 1014.

[FN58] Cunningham and Schenk, supra note 56 at 345.

[FN59] Safavian, supra note 31 at 121.

[FN60] Internal Revenue Code, pre-1997 section 121.

[FN61] Cunningham and Schenk, supra note 55 at 377.

[FN62] Id.

[FN63] Lee, supra note 23 at 79.


Where the government is running a deficit in a closed economy, domestic investment equals private savings minus the amount of the deficit, or $I = S - D$ (where D is the deficit). Thus, a savings incentive that increased private savings (for example, the capital gains preference) would result in an increase in domestic investment only to the extent it was not offset by an increase in the deficit. To illustrate, suppose the enactment of the capital gains preference increased private savings of $100. If the preference paid for itself through increased realizations, this also would result in an increase in domestic investment by $100. On the other hand, if realizations did not increase sufficiently and the incentive resulted in an
increase in the deficit, that increase would offset the increase in domestic investment on a dollar for dollar basis.


[FN68] Cunningham and Schenk, supra note 55, 65, at 338.

[FN69] Lee, supra note 23, at 35.


[FN71] Safavian, supra note 30, at 121.

[FN72] Id.

[FN73] Lee, supra note 24, at 45-49.

[FN74] Law, Iris J., and Greenstein, Robert, Center on Budget and Policy Priorities, Tax Bill No Winner For Middle Class, 1999 TNT 182-10 (Sept. 21, 1999).


[FN76] Law and Greenstein, supra note 74.


[FN79] Lathrope, supra note 7, IRC section 1022(d).

[FN80] Shuldiner, supra note 77 at 640.

[FN81] Handler, supra note 78 at 17

[FN82] Id.

[FN83] Id. at 42.
[FN84] Shuldiner, supra note 77 at 640, see also: Handler, supra note 78 at 28.

[FN85] Id. at 644.
H.R.2525

Fair Tax Act of 1999 (Introduced in the House)

TITLE I—REPEAL OF THE INCOME TAX, PAYROLL TAXES, AND ESTATE AND GIFT TAXES

SEC. 101. INCOME TAXES REPEALED.

Subtitle A of title 26 of the Internal Revenue Code of 1986 (relating to income taxes and self-employment taxes) is repealed.

SEC. 102. PAYROLL TAXES REPEALED.

(a) IN GENERAL- Subtitle C of title 26 of the Internal Revenue Code of 1986 (relating to payroll taxes and withholding of income taxes) is repealed.

(b) FUNDING OF SOCIAL SECURITY- For funding of the Social Security Trust Funds from general revenue, see section 201 of the Social Security Act (42 U.S.C. 401).

SEC. 103. ESTATE AND GIFT TAXES REPEALED.

Subtitle B of title 26 of the Internal Revenue Code of 1986 (relating to estate and gift taxes) is repealed.

SEC. 104. CONFORMING AMENDMENTS; EFFECTIVE DATE.

(a) CONFORMING AMENDMENTS- The Internal Revenue Code of 1986 is amended--

(1) by striking subtitle H (relating to financing of Presidential election campaigns), and
(2) by redesignating—

(A) subtitle D (relating to miscellaneous excise taxes) as subtitle B,

(B) subtitle E (relating to alcohol, tobacco, and certain other excise taxes) as subtitle C,

(C) subtitle F (relating to procedure and administration) as subtitle D,

(D) subtitle G (relating to the Joint Committee on Taxation) as subtitle E,

(E) subtitle I (relating to the Trust Fund Code) as subtitle F,

(F) subtitle J (relating to coal industry health benefits) as subtitle G, and

(G) subtitle K (relating to group health plan portability, access, and renewability requirements) as subtitle H.

(b) REDESIGNATION OF 1986 CODE-

(1) IN GENERAL- The Internal Revenue Code of 1986 enacted on October 22, 1986, as heretofore, hereby, or hereafter amended, may be cited as the 'Internal Revenue Code of 1999'.

(2) REFERENCES IN LAWS, ETC- Except when inappropriate, any reference in any law, Executive order, or other document—

(A) to the Internal Revenue Code of 1986 shall include a reference to the Internal Revenue Code of 1999, and

(B) to the Internal Revenue Code of 1999 shall include a reference to the provisions of law formerly known as the Internal Revenue Code of 1986.

(c) ADDITIONAL AMENDMENTS- For additional conforming amendments, see section 202 of this Act.

(d) EFFECTIVE DATE- Except as otherwise provided in this Act, the amendments
made by this Act shall take effect on January 1, 2001.

TITLE II--SALES TAX ENACTED

SEC. 201. SALES TAX.

(a) IN GENERAL-- The Internal Revenue Code of 1999 is amended by inserting before subtitle B (as redesignated by section 104(a)(2)(A)) the following new subtitle:

'Subtitle A--Sales Tax

'Sec. 1. Principles of interpretation.

'Sec. 2. Definitions.

'CHAPTER 1. Interpretation; definitions; imposition of tax; etc.

'CHAPTER 2. Credits; refunds.

'CHAPTER 3. Family consumption allowance.

'CHAPTER 4. State and Federal cooperative tax administration.

'CHAPTER 5. Other administrative provisions.

'CHAPTER 6. Collection; appeals; taxpayer rights.

'CHAPTER 7. Special rules.

'CHAPTER 8. Financial intermediation services.


'SECTION 1. PRINCIPLES OF INTERPRETATION.

(a) IN GENERAL-- Any court, the Secretary, and any sales tax administering authority shall consider the purposes of this subtitle (as set forth in subsection (b)) as the primary aid in statutory construction.

(b) PURPOSES-- The purposes of this subtitle are as follows:

'(1) To raise revenue needed by the Federal Government in a manner consistent with the other purposes of this subtitle.
(2) To tax all consumption of goods and services in the United States once, without exception, but only once.

(3) To prevent double, multiple, or cascading taxation.

(4) To simplify the tax law and reduce the administration costs of, and the costs of compliance with, the tax law.

(5) To provide for the administration of the tax law in a manner that respects privacy, due process, individual rights when interacting with the government, the presumption of innocence in criminal proceedings, and the presumption of lawful behavior in civil proceedings.

(6) To increase the role of State governments in Federal tax administration because of State government expertise in sales tax administration.

(7) To enhance generally cooperation and coordination among State tax administrators; and to enhance cooperation and coordination among Federal and State tax administrators, consistent with the principle of intergovernmental tax immunity.

(c) SECONDARY AIDS TO STATUTORY CONSTRUCTION- As a secondary aid in statutory construction, any court, the Secretary, and any sales tax administering authority shall consider--

(1) the common law canons of statutory construction;

(2) the meaning and construction of concepts and terms used in the Internal Revenue Code of 1986 as in effect before the effective date of this subtitle; and

(3) construe any ambiguities in this Act in favor of reserving powers to the States respectively, or to the people.

SEC. 2. DEFINITIONS AND SPECIAL RULES.

(a) IN GENERAL- For purposes of this subtitle--

(1) AFFILIATED FIRMS- A firm is affiliated with another if 1 firm owns 50
percent or more of—

'(A) the voting shares in a corporation, or

'(B) the capital interests of a business firm that is not a corporation.

'(2) CONFORMING STATE SALES TAX - The term 'conforming State sales tax' means a sales tax imposed by a State that adopts the same definition of taxable property and services as adopted by this subtitle.

'(3) DESIGNATED COMMERCIAL PRIVATE COURIER SERVICE- The term 'designated commercial private courier service' means a firm designated as such by the Secretary or any sales tax administering authority, upon application of the firm, if the firm—

'(A) provides its services to the general public,

'(B) records electronically to its data base kept in the regular course of its business the date on which an item was given to such firm for delivery, and

'(C) has been operating for at least 1 year.

'(4) EDUCATION AND TRAINING- The term 'education and training' means tuition for primary, secondary, or postsecondary level education, and job-related training courses. Such term does not include room, board, sports activities, recreational activities, hobbies, games, arts or crafts or cultural activities.

'(5) GROSS PAYMENTS- The term 'gross payments' means payments for taxable property or services, including Federal taxes imposed by this title.

'(6) INTANGIBLE PROPERTY-

'(A) IN GENERAL- The term 'intangible property' includes copyrights, trademarks, patents, goodwill, financial instruments, securities, commercial paper, debts, notes and bonds, and other property deemed intangible at common law. The Secretary shall, by regulation resolve differences among the provisions of common law of the several States.
"(B) CERTAIN TYPES OF PROPERTY- Such term does not include tangible personal property (or rents or leaseholds of any term thereon), real property (or rents or leaseholds of any term thereon) and computer software.

"(7) PERSON- The term 'person' means any natural person, and unless the context clearly does not allow it, any corporation, partnership, limited liability company, trust, estate, government, agency, administration, organization, association, or other legal entity (foreign or domestic).

"(8) PRODUCE, PROVIDE, RENDER, OR SELL TAXABLE PROPERTY OR SERVICES-

"(A) IN GENERAL- A taxable property or service is used to produce, provide, render, or sell a taxable property or service if such property or service is purchased by a person engaged in a trade or business for the purpose of employing or using such taxable property or service in the production, provision, rendering, or sale of other taxable property or services in the ordinary course of that trade or business.

"(B) RESEARCH, EXPERIMENTATION, TESTING, AND DEVELOPMENT- Taxable property or services used in a trade or business for the purpose of research, experimentation, testing, and development shall be treated as used to produce, provide, render, or sell taxable property or services.

"(C) INSURANCE PAYMENTS- Taxable property or services purchased by an insurer on behalf of an insured shall be treated as used to produce, provide, render, or sell taxable property or services if the premium for the insurance contract giving rise to the insurer's obligation was subject to tax pursuant to section 801 (relating to financial intermediation services).

"(D) EDUCATION AND TRAINING- Education and training shall be treated as services used to produce, provide, render, or sell taxable property or services.

"(9) REGISTERED SELLER- The term 'registered seller' means a person registered pursuant to section 502.

"(10) SALES TAX ADMINISTERING AUTHORITY- The term 'sales tax administering authority' means--
(A) the State agency designated to collect and administer the sales tax imposed by this subtitle, in an administering State, or

(B) the Secretary, in a State that is neither--

(i) an administering State, nor

(ii) a State that has elected to have its sales tax administered by an administering State.

(11) SECRETARY- The term 'Secretary' means the Secretary of the Treasury.

(12) TAXABLE EMPLOYER-

(A) IN GENERAL- The term 'taxable employer' includes--

(i) any household employing domestic servants, and

(ii) any government except for government enterprises (as defined in section 704).

(B) EXCEPTIONS- The term 'taxable employer' does not include any employer which is--

(i) engaged in a trade or business,

(ii) a not-for-profit organization (as defined in section 706), or

(iii) a government enterprise (as defined in section 704).

(C) Cross reference-

For rules relating to collection and remittance of tax on wages by taxable employers, see section 103(b)(2).

(13) TAX INCLUSIVE FAIR MARKET VALUE- The term 'tax inclusive fair market value' means the fair market value of taxable property or services plus the
tax imposed by this subtitle.

'(14) TAXABLE PROPERTY OR SERVICE-

'(A) GENERAL RULE- The term 'taxable property or service' means--

'(i) any property (including leaseholds of any term or rents with respect to such property) but excluding--

'(I) intangible property, and

'(II) used property, and

'(ii) any service (including any financial intermediation services as determined by section 801).

'(B) SERVICE- For purposes of subparagraph (A), the term 'service'--

'(i) shall include any service performed by an employee for which the employee is paid wages or a salary by a taxable employer, and

'(ii) shall not include any service performed by an employee for which the employee is paid wages or a salary--

'(I) by an employer in the regular course of the employer's trade or business,

'(II) by an employer that is a not-for-profit organization (as defined in section 706),

'(III) by an employer that is a government enterprise (as defined in section 704), and

'(IV) by taxable employers to employees directly providing education and training.

'(15) UNITED STATES- The term 'United States', when used in the
geographical sense, means each of the 50 States, the District of Columbia, and any commonwealth, territory, or possession of the United States.

'(16) USED PROPERTY- The term 'used property' means--

'(A) property on which the tax imposed by section 101 has been collected and for which no credit has been allowed under section 203, and

'(B) property that was held other than for a business purpose (as defined in section 102(b)) on December 31, 2000.

'(17) WAGES AND SALARY- The terms 'wage' and 'salary' mean all compensation paid for employment service including cash compensation, employee benefits, disability insurance, or wage replacement insurance payments, unemployment compensation insurance, workers' compensation insurance, and the fair market value of any other consideration paid by an employer to an employee in consideration for employment services rendered.

'(b) Cross References-

'(1) For the definition of business purposes, see section 102(b).

'(2) For the definition of insurance contract, see section 206(e).

'(3) For the definition of qualified family, see section 302.

'(4) For the definition of monthly poverty level, see section 303.

'(5) For the definition of large seller, see section 501(e)(3).

'(6) For the definition of hobby activities, see section 701.

'(7) For the definition of gaming sponsor, see section 701(a).

'(8) For the definition of a chance, see section 701(b).

'(9) For the definition of government enterprise, see section 704(b).

'(10) For the definition of mixed use property, see section 705.

'(11) For the definition of qualified not-for-profit organization, see section 706.

'(12) For the definition of financial intermediation services, see section 801.
CHAPTER 1--INTERPRETATION; DEFINITIONS; IMPOSITION OF TAX; ETC.

Sec. 101. Imposition of sales tax.

Sec. 102. Intermediate and export sales.

Sec. 103. Rules relating to collection and remittance of tax.

SEC. 101. IMPOSITION OF SALES TAX.

(a) IN GENERAL- There is hereby imposed a tax on the use or consumption in the United States of taxable property or services.

(b) RATE-

(1) FOR 2001- In the calendar year 2001, the rate of tax is 23 percent of the gross payments for the taxable property or service.

(2) FOR YEARS AFTER 2001- For years after the calendar year 2001, the rate of tax is the combined Federal tax rate percentage (as defined in paragraph 3) of the gross payments for the taxable property or service.

(3) COMBINED FEDERAL TAX RATE PERCENTAGE- The combined Federal tax rate percentage is the sum of--

(A) the general revenue rate (as defined in paragraph 4), and

(B) the old-age, survivors and disability insurance rate, and

(C) the hospital insurance rate.

(4) GENERAL REVENUE RATE- The general revenue rate shall be 14.91 percent.

(c) COORDINATION WITH IMPORT DUTIES- The tax imposed by this section is in addition to any import duties imposed by chapter 4 of title 19. The Secretary shall provide by regulation that, to the maximum extent practicable, the tax imposed by this section on imported taxable property and services is collected and
administered in conjunction with any applicable import duties imposed by the United States.

'(d) LIABILITY FOR TAX -

'(1) IN GENERAL- The person using or consuming taxable property or services in the United States is liable for the tax imposed by this section, and except as provided by subsection (e) of this section.

'(2) EXCEPTION WHERE TAX PAID TO SELLER- A person using or consuming a taxable property or service in the United States is not liable for the tax imposed by this section if the person pays the tax to a person selling the taxable property or service and receives from such person a purchaser's receipt within the meaning of section 510.

'SEC. 102. INTERMEDIATE AND EXPORT SALES.

'(a) IN GENERAL- For purposes of this subtitle--

'(1) BUSINESS AND EXPORT PURPOSES- No tax shall be imposed under section 101 on any taxable property or service purchased for--

'(A) a business purpose in a trade or business, or

'(B) export from the United States for use or consumption outside the United States, if, the purchaser provided the seller with a registration certificate, and the seller was a wholesale seller.

'(2) INVESTMENT PURPOSE- No tax shall be imposed under section 101 on any taxable property or service purchased for an investment purpose and held exclusively for an investment purpose.

'(3) STATE GOVERNMENT FUNCTIONS- No tax shall be imposed under section 101 on State government functions that do not constitute the final consumption of property or services.

'(b) BUSINESS PURPOSES- For purposes of this section, the term 'purchased for a business purpose in a trade or business' means purchased by a person engaged in a
trade or business and used in that trade or business—

'(1) for resale,

'(2) to produce, provide, render, or sell taxable property or services, or

'(3) in furtherance of other bona fide business purposes.

'(c) INVESTMENT PURPOSES- For purposes of this section, the term 'purchased for an investment purpose' means property purchased exclusively for purposes of appreciation or the production of income but not entailing more than minor personal efforts.

'SEC. 103. RULES RELATING TO COLLECTION AND REMITTANCE OF TAX.'

'(a) LIABILITY FOR COLLECTION AND REMITTANCE OF THE TAX - Except as provided otherwise by this section, any tax imposed by this subtitle shall be collected and remitted by the seller of taxable property or services (including financial intermediation services).
H.R.2488

Taxpayer Refund and Relief Act of 1999 (Enrolled Bill (Sent to President))

SEC. 202. INDEXING OF CERTAIN ASSETS ACQUIRED AFTER DECEMBER 31, 1999, FOR PURPOSES OF DETERMINING GAIN.

(a) IN GENERAL- Part II of subchapter O of chapter 1 (relating to basis rules of general application) is amended by inserting after section 1021 the following new section:

'SEC. 1022. INDEXING OF CERTAIN ASSETS ACQUIRED AFTER DECEMBER 31, 1999, FOR PURPOSES OF DETERMINING GAIN.

'(a) GENERAL RULE-

'(1) INDEXED BASIS SUBSTITUTED FOR ADJUSTED BASIS- Solely for purposes of determining gain on the sale or other disposition by a taxpayer (other than a corporation) of an indexed asset which has been held for more than 1 year, the indexed basis of the asset shall be substituted for its adjusted basis.

'(2) EXCEPTION FOR DEPRECIATION, ETC- The deductions for depreciation, depletion, and amortization shall be determined without regard to the application of paragraph (1) to the taxpayer or any other person.

'(3) EXCEPTION FOR PRINCIPAL RESIDENCES- Paragraph (1) shall not apply to any disposition of the principal residence (within the meaning of section 121) of the taxpayer.

'(b) INDEXED ASSET-

'(1) IN GENERAL- For purposes of this section, the term 'indexed asset' means--
(A) common stock in a C corporation (other than a foreign corporation), and

(B) tangible property,

which is a capital asset or property used in the trade or business (as defined in section 1231(b)).

(2) STOCK IN CERTAIN FOREIGN CORPORATIONS INCLUDED- For purposes of this section--

(A) IN GENERAL- The term 'indexed asset' includes common stock in a foreign corporation which is regularly traded on an established securities market.

(B) EXCEPTION- Subparagraph (A) shall not apply to--

(i) stock of a foreign investment company (within the meaning of section 1246(b)),

(ii) stock in a passive foreign investment company (as defined in section 1296),

(iii) stock in a foreign corporation held by a United States person who meets the requirements of section 1248(a)(2), and

(iv) stock in a foreign personal holding company (as defined in section 552).

(C) TREATMENT OF AMERICAN DEPOSITORY RECEIPTS- An American depository receipt for common stock in a foreign corporation shall be treated as common stock in such corporation.

(c) INDEXED BASIS- For purposes of this section--

(1) GENERAL RULE- The indexed basis for any asset is--

(A) the adjusted basis of the asset, increased by
(B) the applicable inflation adjustment.

(2) APPLICABLE INFLATION ADJUSTMENT- The applicable inflation adjustment for any asset is an amount equal to—

(A) the adjusted basis of the asset, multiplied by

(B) the percentage (if any) by which—

(i) the chain-type price index for GDP for the last calendar quarter ending before the asset is disposed of, exceeds

(ii) the chain-type price index for GDP for the last calendar quarter ending before the asset was acquired by the taxpayer.

The percentage under subparagraph (B) shall be rounded to the nearest 1/10 of 1 percentage point.

(3) CHAIN-TYPE PRICE INDEX FOR GDP- The chain-type price index for GDP for any calendar quarter is such index for such quarter (as shown in the last revision thereof released by the Secretary of Commerce before the close of the following calendar quarter).

(d) SUSPENSION OF HOLDING PERIOD WHERE DIMINISHED RISK OF LOSS; TREATMENT OF SHORT SALES-

(1) IN GENERAL- If the taxpayer (or a related person) enters into any transaction which substantially reduces the risk of loss from holding any asset, such asset shall not be treated as an indexed asset for the period of such reduced risk.

(2) SHORT SALES-

(A) IN GENERAL- In the case of a short sale of an indexed asset with a short sale period in excess of 1 year, for purposes of this title, the amount realized shall be an amount equal to the amount realized (determined without regard to this paragraph) increased by the applicable inflation adjustment. In applying
subsection (c)(2) for purposes of the preceding sentence, the date on which the property is sold short shall be treated as the date of acquisition and the closing date for the sale shall be treated as the date of disposition.

(B) SHORT SALE PERIOD- For purposes of subparagraph (A), the short sale period begins on the day that the property is sold and ends on the closing date for the sale.

(e) TREATMENT OF REGULATED INVESTMENT COMPANIES AND REAL ESTATE INVESTMENT TRUSTS-

(I) ADJUSTMENTS AT ENTITY LEVEL-

(A) IN GENERAL- Except as otherwise provided in this paragraph, the adjustment under subsection (a) shall be allowed to any qualified investment entity (including for purposes of determining the earnings and profits of such entity).

(B) EXCEPTION FOR CORPORATE SHAREHOLDERS- Under regulations--

(i) in the case of a distribution by a qualified investment entity (directly or indirectly) to a corporation--

(I) the determination of whether such distribution is a dividend shall be made without regard to this section, and

(II) the amount treated as gain by reason of the receipt of any capital gain dividend shall be increased by the percentage by which the entity's net capital gain for the taxable year (determined without regard to this section) exceeds the entity's net capital gain for such year determined with regard to this section, and

(ii) there shall be other appropriate adjustments (including deemed distributions) so as to ensure that the benefits of this section are not allowed (directly or indirectly) to corporate shareholders of qualified investment entities.
For purposes of the preceding sentence, any amount includible in gross income under section 852(b)(3)(D) shall be treated as a capital gain dividend and an S corporation shall not be treated as a corporation.

'(C) EXCEPTION FOR QUALIFICATION PURPOSES- This section shall not apply for purposes of sections 851(b) and 856(c).

'(D) EXCEPTION FOR CERTAIN TAXES IMPOSED AT ENTITY LEVEL-

'(i) TAX ON FAILURE TO DISTRIBUTE ENTIRE GAIN- If any amount is subject to tax under section 852(b)(3)(A) for any taxable year, the amount on which tax is imposed under such section shall be increased by the percentage determined under subparagraph (B)(i)(II). A similar rule shall apply in the case of any amount subject to tax under paragraph (2) or (3) of section 857(b) to the extent attributable to the excess of the net capital gain over the deduction for dividends paid determined with reference to capital gain dividends only. The first sentence of this clause shall not apply to so much of the amount subject to tax under section 852(b)(3)(A) as is designated by the company under section 852(b)(3)(D).

'(ii) OTHER TAXES- This section shall not apply for purposes of determining the amount of any tax imposed by paragraph (4), (5), or (6) of section 857(b).

'(2) ADJUSTMENTS TO INTERESTS HELD IN ENTITY-

'(A) REGULATED INVESTMENT COMPANIES- Stock in a regulated investment company (within the meaning of section 851) shall be an indexed asset for any calendar quarter in the same ratio as--

'(i) the average of the fair market values of the indexed assets held by such company at the close of each month during such quarter, bears to

'(ii) the average of the fair market values of all assets held by such company at the close of each such month.

'(B) REAL ESTATE INVESTMENT TRUSTS- Stock in a real estate investment trust (within the meaning of section 856) shall be an indexed asset
for any calendar quarter in the same ratio as--

'(i) the fair market value of the indexed assets held by such trust at the close of such quarter, bears to

'(ii) the fair market value of all assets held by such trust at the close of such quarter.

'(C) RATIO OF 80 PERCENT OR MORE- If the ratio for any calendar quarter determined under subparagraph (A) or (B) would (but for this subparagraph) be 80 percent or more, such ratio for such quarter shall be 100 percent.

'(D) RATIO OF 20 PERCENT OR LESS- If the ratio for any calendar quarter determined under subparagraph (A) or (B) would (but for this subparagraph) be 20 percent or less, such ratio for such quarter shall be zero.

'(E) LOOK-THRU OF PARTNERSHIPS- For purposes of this paragraph, a qualified investment entity which holds a partnership interest shall be treated (in lieu of holding a partnership interest) as holding its proportionate share of the assets held by the partnership.

'(3) TREATMENT OF RETURN OF CAPITAL DISTRIBUTIONS- Except as otherwise provided by the Secretary, a distribution with respect to stock in a qualified investment entity which is not a dividend and which results in a reduction in the adjusted basis of such stock shall be treated as allocable to stock acquired by the taxpayer in the order in which such stock was acquired.

'(4) QUALIFIED INVESTMENT ENTITY- For purposes of this subsection, the term 'qualified investment entity' means--

'(A) a regulated investment company (within the meaning of section 851), and

'(B) a real estate investment trust (within the meaning of section 856).

'(f) OTHER PASS-THRU ENTITIES-

'(1) PARTNERSHIPS-
(A) IN GENERAL- In the case of a partnership, the adjustment made under subsection (a) at the partnership level shall be passed through to the partners.

(B) SPECIAL RULE IN THE CASE OF SECTION 754 ELECTIONS- In the case of a transfer of an interest in a partnership with respect to which the election provided in section 754 is in effect--

(i) the adjustment under section 743(b)(1) shall, with respect to the transferor partner, be treated as a sale of the partnership assets for purposes of applying this section, and

(ii) with respect to the transferee partner, the partnership's holding period for purposes of this section in such assets shall be treated as beginning on the date of such adjustment.

(2) S CORPORATIONS- In the case of an S corporation, the adjustment made under subsection (a) at the corporate level shall be passed through to the shareholders. This section shall not apply for purposes of determining the amount of any tax imposed by section 1374 or 1375.

(3) COMMON TRUST FUNDS- In the case of a common trust fund, the adjustment made under subsection (a) at the trust level shall be passed through to the participants.

(4) INDEXING ADJUSTMENT DISREGARDED IN DETERMINING LOSS ON SALE OF INTEREST IN ENTITY- Notwithstanding the preceding provisions of this subsection, for purposes of determining the amount of any loss on a sale or exchange of an interest in a partnership, S corporation, or common trust fund, the adjustment made under subsection (a) shall not be taken into account in determining the adjusted basis of such interest.

(g) DISPOSITIONS BETWEEN RELATED PERSONS-

(1) IN GENERAL- This section shall not apply to any sale or other disposition of property between related persons except to the extent that the basis of such property in the hands of the transferee is a substituted basis.

(2) RELATED PERSONS DEFINED- For purposes of this section, the term
related persons' means—

'(A) persons bearing a relationship set forth in section 267(b), and

'(B) persons treated as single employer under subsection (b) or (c) of section 414.

'(h) TRANSFERS TO INCREASE INDEXING ADJUSTMENT- If any person transfers cash, debt, or any other property to another person and the principal purpose of such transfer is to secure or increase an adjustment under subsection (a), the Secretary may disallow part or all of such adjustment or increase.

'(i) SPECIAL RULES- For purposes of this section—

'(1) TREATMENT OF IMPROVEMENTS, ETC- If there is an addition to the adjusted basis of any tangible property or of any stock in a corporation during the taxable year by reason of an improvement to such property or a contribution to capital of such corporation—

'(A) such addition shall never be taken into account under subsection (c)(1)(A) if the aggregate amount thereof during the taxable year with respect to such property or stock is less than $1,000, and

'(B) such addition shall be treated as a separate asset acquired at the close of such taxable year if the aggregate amount thereof during the taxable year with respect to such property or stock is $1,000 or more.

A rule similar to the rule of the preceding sentence shall apply to any other portion of an asset to the extent that separate treatment of such portion is appropriate to carry out the purposes of this section.

'(2) ASSETS WHICH ARE NOT Indexed ASSETS THROUGHOUT HOLDING PERIOD- The applicable inflation adjustment shall be appropriately reduced for periods during which the asset was not an indexed asset.

'(3) TREATMENT OF CERTAIN DISTRIBUTIONS- A distribution with respect to stock in a corporation which is not a dividend shall be treated as a disposition.
'(4) ACQUISITION DATE WHERE THERE HAS BEEN PRIOR APPLICATION OF SUBSECTION (a)(1) WITH RESPECT TO THE TAXPAYER - If there has been a prior application of subsection (a)(1) to an asset while such asset was held by the taxpayer, the date of acquisition of such asset by the taxpayer shall be treated as not earlier than the date of the most recent such prior application.

'(5) COLLAPSIBLE CORPORATIONS- The application of section 341(a) (relating to collapsible corporations) shall be determined without regard to this section.

'(j) REGULATIONS- The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section.'.

(b) CLERICAL AMENDMENT- The table of sections for part II of subchapter O of chapter 1 is amended by inserting after the item relating to section 1021 the following new item:

'Sec. 1022. Indexing of certain assets acquired after December 31, 1999, for purposes of determining gain.'.

(c) EFFECTIVE DATES-

(1) IN GENERAL- The amendments made by this section shall apply to the disposition of any property the holding period of which begins after December 31, 1999.

(2) CERTAIN TRANSACTIONS BETWEEN RELATED PERSONS- The amendments made by this section shall not apply to the disposition of any property acquired after December 31, 1999, from a related person (as defined in section 1022(g)(2) of the Internal Revenue Code of 1986, as added by this section) if--

(A) such property was so acquired for a price less than the property's fair market value, and

(B) the amendments made by this section did not apply to such property in the hands of such related person.
(d) ELECTION TO RECOGNIZE GAIN ON ASSETS HELD ON JANUARY 1, 2000- For purposes of the Internal Revenue Code of 1986--

(1) IN GENERAL- A taxpayer other than a corporation may elect to treat--

(A) any readily tradable stock (which is an indexed asset) held by such taxpayer on January 1, 2000, and not sold before the next business day after such date, as having been sold on such next business day for an amount equal to its closing market price on such next business day (and as having been reacquired on such next business day for an amount equal to such closing market price), and

(B) any other indexed asset held by the taxpayer on January 1, 2000, as having been sold on such date for an amount equal to its fair market value on such date (and as having been reacquired on such date for an amount equal to such fair market value).

(2) TREATMENT OF GAIN OR LOSS-

(A) Any gain resulting from an election under paragraph (1) shall be treated as received or accrued on the date the asset is treated as sold under paragraph (1) and shall be recognized notwithstanding any provision of the Internal Revenue Code of 1986.

(B) Any loss resulting from an election under paragraph (1) shall not be allowed for any taxable year.

(3) ELECTION- An election under paragraph (1) shall be made in such manner as the Secretary of the Treasury or his delegate may prescribe and shall specify the assets for which such election is made. Such an election, once made with respect to any asset, shall be irrevocable.

(4) READILY TRADABLE STOCK- For purposes of this subsection, the term 'readily tradable stock' means any stock which, as of January 1, 2000, is readily tradable on an established securities market or otherwise.

SEC. 203. CAPITAL GAINS TAX RATES APPLIED TO CAPITAL GAINS OF DESIGNATED SETTLEMENT FUNDS.
(a) IN GENERAL- Paragraph (1) of section 468B(b) (relating to taxation of designated settlement funds) is amended by inserting '(subject to section 1(h))' after 'maximum rate'.

(b) EFFECTIVE DATE- The amendment made by this section shall apply to taxable years beginning after December 31, 1999.

SEC. 204. SPECIAL RULE FOR MEMBERS OF UNIFORMED SERVICES AND FOREIGN SERVICE, AND OTHER EMPLOYEES, IN DETERMINING EXCLUSION OF GAIN FROM SALE OF PRINCIPAL RESIDENCE.

(a) IN GENERAL- Subsection (d) of section 121 (relating to exclusion of gain from sale of principal residence) is amended by adding at the end the following new paragraphs:

'9) MEMBERS OF UNIFORMED SERVICES AND FOREIGN SERVICE-

'(A) IN GENERAL- The running of the 5-year period described in subsection (a) shall be suspended with respect to an individual during any time that such individual or such individual's spouse is serving on qualified official extended duty as a member of the uniformed services or of the Foreign Service.'
TAXPAYER REFUND AND RELIEF ACT OF 1999—VEETO MESSAGE FROM THE PRESIDENT OF THE UNITED STATES (House of Representatives - September 23, 1999)

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The SPEAKER pro tempore laid before the House the following veto message from the President of the United States; which was read and, without objection, referred to the Committee on Ways and Means:

To the House of Representatives:

I am returning herewith without my approval H.R. 2488, the 'Taxpayer Refund and Relief Act of 1999,' because it ignores the principles that have led us to the sound economy we enjoy today and emphasizes tax reduction for those who need it the least.

We have a strong economy because my Administration and the Congress have followed the proper economic course over the past 6 years. We have focused on reducing deficits, paying down debt held by the public, bringing down interest rates, investing in our people, and opening markets. There is $1.7 trillion less debt held by the public today than was forecast in 1993. This has contributed to lower interest rates, record business investment, greater productivity growth, low inflation, low unemployment, and broad-based growth in real wages—and the first back-to-back budget surpluses in almost half a century.

This legislation would reverse the fiscal discipline that has helped make the American economy the strongest it has been in generations. By using projected surpluses to provide a risky tax cut, H.R. 2488 could lead to higher interest rates, thereby undercutting any benefits for most Americans by increasing home mortgage payments, car loan payments, and credit card rates. We must put first things first, pay down publicly held debt, and address the long-term solvency of Medicare and Social Security. My Mid-Session Review of the Budget presented a framework in which we could accomplish all of these things and also provide an affordable tax cut.

The magnitude of the tax cuts in H.R. 2488 and the associated debt service costs would be virtually as great as all of the on-budget surpluses the Congressional Budget
Office projects for the next 10 years. This would leave virtually none of the projected on-budget surplus available for addressing the long-term solvency of Medicare, which is currently projected by its Trustees to be insolvent by 2015, or of Social Security, which then will be in a negative cash-flow position, or for critical funding for priorities like national security, education, health care, law enforcement, science and technology, the environment, and veterans' programs.

The bill would cause the Nation to forgo the unique opportunity to eliminate completely the burden of the debt held by the public by 2015 as proposed by my Administration's Mid-Session Review. The elimination of this debt would have a beneficial effect on interest rates, investment, and the growth of the economy. Moreover, paying down debt is tantamount to cutting taxes. Each one-percentage point decline in interest rates would mean a cut of $200 billion to $250 billion in mortgage costs borne by American consumers over the next 10 years. Also, if we do not erase the debt held by the public, our children and grandchildren will have to pay higher taxes to offset the higher Federal interest costs on this debt.

Budget projections are inherently uncertain. For example, the Congressional Budget Office found that, over the last 11 years, estimates of annual deficits or surpluses 5 years into the future erred by an average of 13 percent of annual outlays--a rate that in 2004 would translate into an error of about $250 billion. Projections of budget surpluses 10 years into the future are surely even more uncertain. The prudent course in the face of these uncertainties is to avoid making financial commitments--such as massive tax cuts--that will be very difficult to reverse.

The bill relies on an implausible legislative assumption that many of its major provisions expire after 9 years and all of the provisions are repealed after 10 years. This scenario would create uncertainty and confusion for taxpayers, and it is highly unlikely that it would ever be implemented. Moreover, this artifice causes estimated 10-year costs to be understated by about $100 billion, at the same time that it sweeps under the rug the exploding costs beyond the budget window. If the tax cut were continued, its budgetary impact would grow even more severe, reaching about $2.7 trillion between 2010 and 2019, just at the time when the baby boomers begin to retire, Medicare becomes insolvent, and Social Security comes under strain. If the bill were to become law, it would leave America permanently in debt. The bill as a whole would disproportionately benefit the wealthiest Americans by, for example, lowering capital gains rates, repealing the estate and gift tax, increasing maximum IRA and retirement plan contribution limits, and weakening pension anti-discrimination protections for moderate- and lower-income workers.

The bill would not meet the Budget Act's existing pay-as-you-go requirements which
have helped provide the discipline necessary to bring us from an era of large and
growing budget deficits to the potential for substantial surpluses. It would also
automatically trigger across-the-board cuts (or sequesters) in a number of Federal
programs. These cuts would result in a reduction of more than $40 billion in the
Medicare program over the next 5 years. Starting in 2002, they would also lead to the
elimination of numerous programs with broad support, including: crop insurance,
without which most farmers and ranchers could not secure the financing from banks
needed to operate their farms and ranches; veterans readjustment benefits, denying
education and training to more than 450,000 veterans, reservists, and dependents;
Federal support for programs such as child care for low-income families and Meals on
Wheels for senior citizens; and many others.

As I have repeatedly stressed, I want to find common ground with the Congress on a
fiscal plan that will best serve the American people. I have profound differences,
however, with the extreme approach that the Republican majority has adopted. It
would provide a tax cut for the wealthiest Americans and would hurt average
Americans by denying them the benefits of debt reduction and depriving them of the
certainty that my proposals for Medicare and Social Security solvency would provide
as they plan for their retirement.

I hope to work with Members of Congress to find a common path to honor our
commitment to senior citizens, help working families with targeted tax relief for
moderate- and lower-income workers, provide a better life for our children, and
improve the standard of living of all Americans.

William J. Clinton.

Mr. ARCHER. Mr. Speaker, I yield the customary 30 minutes to the gentleman from New York (Mr. Rangel), the ranking minority member, pending which I yield myself such time as I may consume.

Mr. Speaker, I just listened to the veto message that has been read to the House; and I am stunned by the hyperbolic rhetoric and failure to relate to the facts of the situation. And I use the word stunned advisedly.

Simply translated, the President's message means I know better how to spend the money than you do. He said that in Buffalo, New York, the day after his State of the Union address this year when he commented to an assemblage of roughly 20,000 people: Now we have this interesting new situation of a surplus. What should we do with it? Well, one alternative would be to give the money back to you. But who would know if you would spend it right? That is quote/unquote from the President of the United States.

All of the verbiage that we heard in the veto message is simply cover to keep the money in Washington because he believes that Washington knows best how to spend the people's money.

He vetoed this tax relief plan today, a plan which would downsize the power of Washington and upsize the power of people. He vetoed a plan that protects Social Security and Medicare; pays down the debt by $2 trillion; improves education and gives taxpayers only a small portion of their money back.

Make no mistake, it is their money; not ours. We did not earn it here in Washington. In doing so, the President said no to new school construction. He said no to helping parents save for their children's education. He said no to marriage penalty relief for 42 million married Americans. He hurt baby-boomers who are saving for their retirement by blocking IRA expansions. By his veto, he has prolonged the confiscatory, unfair death tax.

He has made it especially tough on those caring for elderly relatives in their own homes who would get tax relief, by blocking health and long-term care tax relief for all American citizens. Since the President has vetoed this tax relief plan and said no to the American people, I challenge him to say no also to the special interests in Washington who cannot wait to get their hands on the people's money.

I have always said that if we do not get this tax overcharge out of Washington, Washington will most surely spend it; and now we are going to find out if I am right.

In fact, today I ask the American people to watch very closely what happens to their money over the next 60 days. What will happen to the projected $14.5 billion surplus in the general treasury next year? And that is the non-Social Security surplus.
Unfortunately, my guess is that Washington will spend the people's tax dollars like some Hollywood movie star on a Rodeo Drive spending spree, but unlike the movie stars who use their own money Washington will be using your credit card, your checkbook and your wallet, and, worse still, your Social Security money.

After this spending spree, Americans should ask themselves if they are happy with the way it was spent. Do they think the money was spent wisely or would they rather have had that extra $1,000 a year in their own family budget? Because in the end, that is what this debate is all about. Do the people trust Washington to know better how to spend their money as the President says, or do they feel that they know best how to spend the money in their own budgets?

Do they want their excess money going for $200 hammers or do they want it to go to their children's education and their own IRAs? We all know the answer to those questions, so I again ask the President to join with us and find a way to return this tax overcharge to the workers of the country.

President Clinton has once again put the needs of Washington above the needs of the American people, and I think that is sad. I think this is a sad moment for this country.

Republicans believe strongly that refunding excess tax dollars to American families and workers is a matter of principle. Taxes are too high. Government does not need all of the money that is coming in to pay government's bills, and the taxpayers should get a refund. Since President Clinton killed this reasonable tax relief plan, he has given himself a license to spend; and spend he will. Americans should know that the big blank check in Washington is drawn on their own checkbook, is coming out of their family's budget, is coming out of their opportunity to see investment to create better jobs; and they will get stuck with the bill.

I will fight the brewing explosion of government spending and instead use every chance available to cut taxes and create more opportunity for all Americans, because I continue to put my faith and trust in the hard work and values of the American people, and I believe that they know best how to spend their own hard-earned dollars.

Mr. Speaker, I reserve the balance of my time.

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Mr. RANGEL. Mr. Speaker, I yield myself such time as I may consume.

Mr. Speaker, the President of the United States has the right and obligation to veto any bill that an abusive Congress sends to his desk if he or she believes that the bill, the legislation, is not in the interest of the American people.

The President of the United States has reviewed this piece of Republican legislation
and has vetoed the bill.

Now, the Congress on the other hand, has the opportunity to override the veto. All they have to do is to indicate that they think the President is wrong and then ask for a vote and override the veto.

Now, the Republican majority obviously do not want a vote to override the veto. They would like to make a comment or two but they want to avoid having a debate on the floor and exercising their constitutional right to say that the President is wrong.

Now, why would they use this political or legislative tactic? One, it could be that they believe the President is right and they do not want a vote on this because they have changed their mind. They recognize the legislation was abusive. They went home. They tried to sell it to the American people, and the American people said they do not want it.

Or maybe it is two. Maybe they just counted the votes, and they found out that all of the Republicans really do not believe in this political rhetoric, so they do not have the votes to override the President. Maybe that is one of the reasons why they are not exercising their constitutional right.

Mr. Speaker, I really think that the reason that they do not want the override is because they never intended to have a legislative package. Why would they have worked so hard in the vineyards for a whole day among just Republicans in putting together this enormous $792 billion tax cut and not send it to the President? Why did they carry this bill throughout the hills and valleys of their congressional districts to try to sell this political document?

What they were saying is, we cannot vote for anything in the Congress. We do not have the ability to get a bill out for Social Security. We cannot get a bill out for Medicare, not for prescription drugs, not for patients' rights, not for school construction, not for gun safety. Listen, we just do not know how to shoot straight. But there is one thing we can say that we want to do and that is reduce your taxes. So, Mr. President, please veto the bill so that we can go home and say that you were the one that knocked down the Christmas tree that we put together in the House Republican leadership and the Senate Republican leadership.

[TIME: 1730]

All I am saying is this: Either you believe in the President by not wanting to override the veto, either you do not have the votes to override the veto, or either you do not believe in this document that you put together anyway.

Meanwhile, we will await to see what you want to do. We are here, and we are not in
the majority; and we laud your efforts to attempt to convince the American people that you are right. But believe me, the American people want legislation, they want it on the floor, and they want votes. If you do not like what the President did, for God's sake, show it, and let us get a vote and let us try to override. If you do like what he has done, but you do not have the guts to say that he has it right, sit there, let the hour pass, and then we will move on to something else. I hope it is Social Security. I hope it is Medicare. I hope it is prescription drugs, but then again, I hope for too much from the majority party.

Mr. Speaker, I reserve the balance of my time.

Mr. ARCHER. Mr. Speaker, I yield such time as he may consume to the gentleman from Arizona (Mr. Hayworth).

Mr. HAYWORTH. Mr. Speaker, I thank the chairman of the committee, and I thank the ranking member for offering a very interesting illustration: When one cannot talk facts and policy, let us return to process, and I welcome that attempt at rhetorical subterfuge.

I would say to the gentleman from New York, and to my colleagues on the left, we stand ready. Indeed, Mr. Speaker, I would remind this House that we have reserved H.R. 1 for a plan from the President of the United States to help save and strengthen Social Security, but a funny thing, and really a tragic thing, has happened down Pennsylvania Avenue.

Indeed, Mr. Speaker, I think it is important to remind this House that aside from certain budgetary measures required under the Budget Act, this administration has failed to send up any of its proposals in legislative language since the attempt to socialize medicine. Perhaps that is the reason why they have never sent anything back to us in detail.

So let me say to my colleague, in the best spirit of bipartisanship, we welcome you putting your plans on the table. We encourage you, as did our Democratic colleague, the gentleman from California (Mr. Matsui) to then Under Secretary of the Treasury Larry Summers, to have the President bring forth his plan to save Social Security; not rhetoric from the rostrum in a State of the Union message, but a true legislative plan.

So let me first respond to that.

Now, Mr. Speaker, let me explain why I must object in the strongest terms possible to the veto of our tax relief and tax fairness legislation by the President of the United States. First, Mr. Speaker, every Member of this House and every American should know that in wielding his veto pen, President Clinton today extinguished the hopes and dreams of small business owners for quality health insurance for themselves and their
employees in terms of 100 percent tax deductibility. Had this President signed the legislation into law, that would have taken effect. The President said no. And in essence, I say to my colleagues, what transpired, not content with the largest tax increase in American history foisted upon the American people in the 103d Congress when those who would claim to be such intrepid policymakers on this floor, gave us the largest tax increase in American history. Not content with that, today the President of the United States has, in essence, raised our taxes in excess of $790 billion over the next 10 years.

Mr. Speaker, he said 'yes' to a tax increase, 'no' to health care deductibility for small business. He said 'yes' to a tax increase, 'no' to reducing the marriage penalty. He said 'yes' to a tax increase and more spending, and 'no' to an end to the death tax. He said 'yes' to a tax increase and 'no' to families who sought tax relief to care for an elderly member of the family in their home. He said 'yes' to higher taxes, and he said 'no' to the American people.

No, you should be punished for succeeding, for investing. How dare we reduce the rate of capital gains taxation, even though a noted Democratic President earlier in this century said that a rising tide lifts all boats in terms of tax relief. This President said no to the American people. He said no to the people of rural America and the inner city.

Mr. Speaker, he said 'no' to the people of the inner city, with our American renewal package, incidentally, a bipartisan piece of legislation in stand-alone form that curiously was opposed once it became part of this overall plan.

The bottom line is, the President of the United States has again said 'no' to the American people, 'no' to their hopes and dreams and aspirations, and a resounding 'yes' to what is, sadly, flawed logic.

There are many honest disagreements we have in this chamber, and I delight and revel in the fact that as free people, we have a chance to continue to thoughtfully debate the different philosophical dispensations we may have.