Ok, let's reassess the taxation of capital gains

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But inflation adjusting is only one of several possible changes

The current tax cut proposal to **adjust capital gains for inflation** sent me scurrying back to stuff I wrote in the 1970s when all sorts of proposals were being considered to deal with high inflation. What was true then, and remains true today, is that some aspects of capital gains taxation – such as no inflation adjustment – hurt holders of capital assets, but other aspects of capital gains taxation are enormously beneficial to those who get their income through the appreciation of asset values.

Capitals gains are treated favorably under the tax code in three ways:

1. *Lower rate*: The maximum tax rate on capital gains is 20 percent (with an additional 3.8 percent tax on investments as part of the Affordable Care Act), compared to 37 percent for ordinary income.
2. *Deferral*: Gains are not taxed when they accrue but rather the tax is deferred until gains are realized. Postponing tax payments provides individuals with an interest-free loan from the Treasury.

3. *Escape through bequests*: capital gains escape income tax completely if they are passed from one generation to another through bequests, because the heirs can step-up their basis for future tax calculations to the value at death.

If the tax treatment of capital gains is being reconsidered, all the provisions should be put back on the table.

In 1974, my solution was fourfold:

- *Inflation adjust gains*. That means inflating the purchase price of the asset to current dollars and including the adjusted value of the gain in income.
- *Tax at same rate as ordinary income.* If taxes are levied in accordance to ability to pay, then income should be broadly defined to include all sources of accretion.
- *Introduce an interest charge to eliminate the benefits of deferral*: The interest charge would equalize the tax treatment of capital gains to that of wages, which are taxed annually as they are received.
- *Eliminate the bequest loophole*. Tax accrued gains at death as if they were realized; this procedure is referred to as "constructive realization." If constructive realization is too dramatic, require the heir to use the original costs when computing gains on future realizations.

Since 1974, economists have argued about the optimal tax rates for capital versus earned income, so using the same tax rate may be controversial. But I would still basically stick with the 1974 package.

The bottom line is if policymakers want to review the tax treatment of capital gains, let's have a full review of all the provisions. It makes no sense to focus only on the one provision that disadvantages investors without considering the other provisions that work to their advantage.