IRET Congressional Advisory

July 21, 1997 No. 64

CAPITAL GAINS, INDEXING, AND THE AMT

The House and Senate are now in conference to iron out the differences in their respective tax bills, and some accommodation will have to be made with the President on the outstanding issues. What features of the capital gains and alternative minimum tax (AMT) provisions are the most critical to keep?

The House and Senate versions of the tax bill would impose a cap on the tax rate on capital gains of 20% (10% for taxpayers in the 15% bracket). The House bill would also index the basis of stock and tangible business property for future inflation, post 2000. The President opposes indexing, and favors a 30% exclusion of capital gains from taxable income, resulting in a top rate of 27.72%, or virtually no reduction from the current 28% cap for upper income taxpayers.

The President opposes indexing, and favors a 30% exclusion of capital gains from taxable income, resulting in a top rate of 27.72%, or virtually no reduction from the current 28% cap for upper income taxpayers... [Depriving additional taxpayers of relief,] the President's proposal would probably regard the 30% exclusion as a "preference item" under the AMT...

The Congressional proposals would extend the capital gains rate reduction to taxpayers affected by the alternative minimum tax. The President's proposal would probably regard the 30% exclusion as a "preference item" under the AMT, imposing a 26% or 28% AMT rate on capital gains of affected taxpayers, which would be little or no tax relief.

The House version of the tax bill would reduce the number of corporations subject to the AMT, and reduce its burden, by substituting normal income tax depreciation for the far less generous depreciation currently allowed under the AMT. The bill would also provide a modest expansion of the AMT exemption for small corporations and individuals. The Senate has a less generous AMT exemption increase and no AMT depreciation relief. The President generally opposes AMT relief.

If the Congress must compromise on capital gains, it should insist on the Congress's rate caps for all taxpayers, including those subject to the AMT, rather than the far less effective exclusion proposed by the President. In exchange, it should leave indexation for another day.

Taxation of capital gains is double taxation. The correct rate of tax on all capital gains, whether real or inflation-induced, is zero. Indexing would reduce the taxation of inflated gains, but would do nothing to reduce the taxation of real gains.

The price of an asset, such as a share of stock or a piece of an unincorporated business, is the present value of the expected future earnings of the asset, after taxes. A rise in expected future earnings will boost the share price or value of the business today, producing a capital gain. If and when the higher earnings come to pass, they will be taxed as corporate income and/or personal business or dividend income. To tax the capital gain as well is to double-tax the additional earnings. This is true whether the earnings increase/capital gain is real or due to inflation.

Proponents of indexing often point out that, from the late 1960s through 1982, a period of high inflation, most reported capital gains were real losses. Even in the mid- to late-1980s, depressed farmland and other real estate made the majority of realized gains into real losses. Indexing the basis of capital assets would have eliminated the tax on those gains. But that was then, this is now. More recently, with very low inflation, gains should increasingly be real, especially on financial instruments, such as stock. Since 1982, for example, the S&P 500 stock index has risen over 600 percent, and the Dow Jones Industrial Average over 700 percent. The consumer price index (CPI) is only up by about 65 percent. It is now crucial to cut the tax rate on all gains, real as well as inflation-related.

There is a way for the Congress to have the best of both worlds. They could adopt the biggest possible capital gains tax rate reduction (for both ordinary and AMT taxpayers), and then urge the Federal Reserve to move to zero inflation, or as close to it as our imperfect inflation measures require. The inflation component of gains would then vanish as well, rendering indexing moot. This approach would maximize the "unlocking" of unrealized gains near term, giving the Treasury a burst of revenue. The President's proposal would do far less to encourage realizations, and indexing for inflation that has not yet occurred will not encourage trading of currently held assets.

The AMT tax treatment of depreciation is the single largest reason why businesses become subject to the punitive alternative tax system. The economically optimal treatment of investment is expensing, the immediate write-off of outlays for plant, equipment, structures, and inventory. Ordinary depreciation rules delay these write-offs for years, reducing their value. AMT depreciation is even worse, and constitutes a vicious deterrent to investment. The effect is to raise the cost of capital, requiring investment to earn a higher pre-tax return in order to leave investors with a satisfactory yield after replacement costs and taxes. Investment suffers, as do productivity growth, wages, and employment. Substituting regular income tax depreciation for AMT depreciation would be a big step toward eliminating this punitive, anti-growth feature of the tax system. The AMT provisions of the House bill should be kept.

Ultimately, the AMT and the separate taxation of capital gains should be completely eliminated through fundamental tax restructuring... An immediate capital gains rate cut and easing of the AMT, however, could boost the economy and near-term federal revenue, helping to pay for a restructured tax system incorporating a low tax rate.

Ultimately, the AMT and the separate taxation of capital gains should be completely eliminated through fundamental tax restructuring. The major tax restructuring proposals would eliminate the tax bias against saving, in part by moving to expensing and ending the double taxation associated with capital gains. Representative Archer and Senator Lott have promised fundamental tax restructuring within the next few years. If they are serious, and if inflation remains low until tax restructuring, then indexing gains now is unnecessary. An immediate capital gains rate cut and easing of the AMT, however, could boost the economy and near-term federal revenue, helping to pay for a restructured tax system incorporating a low tax rate. These steps would also lower the apparent "static" revenue cost of completing the move to a fully restructured tax system.

The Congress's options for removing the tax barriers to saving and investment have been unfairly limited because the costs of the proposals are overstated by the static scoring methods used by the Joint Committee on Taxation and the Treasury. These agencies grudgingly allow for some revenue reflow as people realize more existing capital gains at a lower tax rate, although they usually underestimate the effect. Neither agency, however, allows for the rise in the stock market and the amount of gains available to be taken that a capital gains rate cut would trigger. Neither assumes any additional economic growth and related revenues from the reduction in the cost of capital from capital gains and AMT relief. Other obstacles to meaningful tax changes include proposals for economically unproductive child credits and tuition credits, which would waste much of the money available for tax cuts, and the budget rule that prohibits the use of discretionary spending cuts to fund tax reduction. Dynamic revenue estimation and reform of the budget rules that impede tax reduction are important additional steps that should be taken forthwith.

Stephen J. Entin
Resident Scholar

Note: Nothing written here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before Congress.