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Capital Gains Could be Indexed to Inflation

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Treasury Proposes Bold Maneuver to Index Capital Gains

By Ken Berry

Under a proposal being contemplated by the Trump administration that would change the way capital gains are taxed, "the rich could get richer," or at least those investors who realize sizeable gains from sales of assets they've owned a long time. If the president pulls the trigger on this maneuver, it would bypass the usual legislative process for tax law changes.

As reported by various media sources, U.S. Treasury Secretary Steven Mnuchin, one of the early architects of the massive Tax Cuts and Jobs Act (TCJA), recently revealed that his department is studying a provision taking inflation into account for capital gain purposes. By doing so, the amount of taxable gain would be reduced when assets like securities or real estate are sold a profit.

"If it can't get done through a legislation process, we will look at what tools at Treasury we have to do it on our own and we'll consider that," said Mnuchin, acknowledging that it's not clear if his department has the authority to act on its own. "We are studying that internally, and we are also studying the economic costs and the impact on growth."

Typically, capital gains are calculated by subtracting the basis (i.e., the initial price) of an asset from its sales price. Certain allowable adjustments, such as improvements to a home, may increase the basis for tax purposes. For example, if you bought a home for $250,000 and added a swimming pool costing $50,000 before you sold it for $500,000, your gain would be $200,000 ($500,000 sales price – $300,000 adjusted basis).

If the Treasury proposal goes through, the taxable gain would be similarly adjusted for inflation occurring during the time you owned the asset. Going back to our example, if the initial $250,000 cost of the home was adjusted to $350,000 for inflation, the taxpayer's gain would be only $100,000 ($500,000 sales price – $400,000 adjusted basis).

Keep in mind that capital gains already receive preferential tax treatment under current law. As opposed to a top 37% rate on most income (lowered from 39.6% by the TCJA), long-term capital gains on assets held longer than one year are taxed at a maximum 15% rate or 20% for upper-income investors. In addition, long-term gains for lower-income taxpayers are taxed at the 0% rate. The TCJA includes a provision that keeps the income thresholds that were effective for 2017 in place.

Proponents of the proposed Treasury change contend that indexing for inflation would reflect the real value of assets that you've owned for years. Otherwise, they say you're effectively overpaying tax on a gain. In fact, you might argue that, in some situations, you're actually sustaining a loss when you're forced to report a gain.

But detractors claim that the proposal is just another tax break that favors the rich oat the expense of other taxpayers. " At a time when the deficit is out of control, wages are flat and the wealthiest are doing better than ever, to give the top 1 percent another advantage is an outrage and shows the Republicans' true colors," said Senator Chuck Schumer (D-NY). "Furthermore, Mr. Mnuchin thinks he can do it on his own, but everyone knows this must be done by legislation."

Putting aside the debate of whether the change is warranted or not, if the conservative majority can't push legislation through Congress, or the balance of power shifts after the mid-term elections, the authority for such an executive action would certainly be challenged. Therefore, any indexing of capital gains might be short-lived.

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