Summary of Main Points, 'Partiality of Indexing Capital Gains'
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Summary of main points, "Partiality of Indexing Capital Gains"

I. Who or what pays a tax on phantom income?

A. Ordinary inventories, each time they turn over.

B. Slow inventories, e.g. growing timber (second-growth, planted or seeded by man).

These also get real gains from two sources:

- biological growth
- rise of real price (i.e. price relative to other prices)

The above two gains are NOT phantom, but real income. Phantom income is just the extra monetary gain that comes from a rising general price level.

Taxwise, timber already gets favorable tax treatment as a "capital asset." The purported reason for this lower rate is to offset the phantom income element in its gains, so giving indexing in addition would be double compensation for the same thing.

C. Minerals in the ground, including hydrocarbons.

Taxwise, these already get percentage depletion and various other special tax favors, so indexing here, too, would be overkill.

D. Ordinary durable capital, e.g. buildings that yield cash flow.

Cash flow has two elements:

Part 1, a return ON the unrecovered capital (this part is taxable as income); and

Part 2, a return OF (a fraction of) the unrecovered capital (this part is not taxable, and is kept out of taxable income by by tax-depreciation of the initial or "historical" cost of building the structure).

Part 2 is like selling the building itself, one small fraction at a time, to its users. Call this fraction a "peel." Each peel yields a phantom income when the general price level rises.

E. How about land?

1. The ordinary income from land contains no phantom income because there is no depreciation. The

corpus or body of the land does not turn over. In chemical terms, land is like a catalyst that enters into a chemical reaction, but is not consumed by it, not incorporated in the product. Other material inputs are like reactants, that become part of the product.

2. When the whole *corpus* of land is sold from A to B, for a monetary gain, there may be phantom income in that.

Taxwise, such gains are well sheltered already by slow ownership turnover; by step-up of basis at time of death ("Angel-of-Death" provision); by dynastic holders (that never sell); by advance purchases in anticipation of appreciation; by expensing of holding costs well in advance of sale; by using appreciated land as collateral for loans; etc.

II. What real income is generated by inflation, but not taxed?

A. Decline in the real value of private debts.

Most private debts are secured by real estate, so equity owners are the big gainers.

B. Decline in the real value of deferred tax liabilities

- from early overdepreciation
- from untaxed early accruals of value
- from carrying costs that were deducted
- from sequential sales of homes

III. What real losses are not deductible?

A. Loss in value of money held, and of credits denominated in money, like loans, bonds.

IV. What cash flow contains no phantom income?

The ordinary income of land

V. What assets retain their tax "basis" over time?

- Land - it is not tax-depreciable
- Residences - they are not tax-depreciable
- Recreational holdings - they are not tax-depreciable
- Minerals - they get percentage depletion instead of depreciation
- Durables yielding imputed income

- Assets with stepped-up basis
  - Inherited property
  - Income property when sold