The Justice Department's 1992 memo does not prove that Treasury cannot index capital gains to inflation by regulation

In its 1992 memo, the Justice Department concluded that the Treasury Department could not issue a regulation indexing capital gains to inflation because the term "cost" in the Revenue Act of 1918 unambiguously means actual price paid. The Department's evidence includes dictionary definitions of the term cost, court cases, the Code, and legislative history. However, Congress never defined cost, and Congress and the courts have never said that Treasury did not have the authority to issue a regulation.

The authors of the memo first argue that dictionaries at the time the Revenue Act of 1918 was passed define cost as the price paid for a thing or service. They, therefore, conclude that Congress must have meant to define cost as price paid. The memo cites *Webster's New International Dictionary of the English Language* (1917), *Bouvier Law Dictionary* (1914), and *A New English Dictionary on Historical Principles* (1893). The memo also mentions that current dictionaries, such as *Black's Law Dictionary* (1990), give the same definition and that Treasury has since defined cost as "actual price paid."

Congress, however, has never defined the term "cost" in the Code, and Treasury Regulations did not define the term until 1957. The Supreme Court did rule though in *Rust v. Sullivan*, 500 U.S. 173 (1991) that an agency's interpretation was entitled to deference even if it reversed longstanding policy by the agency. Further, like the dictionaries that the memo mentions, the Random House Dictionary defines cost broadly as a sacrifice, loss or penalty, in addition to the price paid. Given the differences in definitions of cost and the standard economic analysis of cost, it is reasonable for the Treasury to determine that inflation is part of the cost.

The authors next argue that because courts have ruled that cost means "actual price paid," Treasury cannot interpret cost to include inflation. The memo cites *Ruben v. Commissioner*, 53 T.C.M. (CCH) 992 (1987), *Crossland v. Commissioner*, 35 T.C.M. (CCH) 262 (1976), Vandenberge v. Commissioner, 147 F.2d 167 (5th Cir. 1945), and *Hawke v. Commissioner*, 35 B.T.A. 784 (1937).

These cases, however, aren't entirely on point. For example, in *Ruben*, the Rubens' house was damaged by a fire, and they claimed a casualty loss on their Federal income tax return. The IRS commissioner challenged their casualty loss deduction, and the Rubens argued that an "inflationary economy replacement cost" was the true measure of basis. The Court ruled though that there was no statutory provision allowing for this adjusted basis. The Court, however, did not discuss whether Treasury could change its interpretation of cost. Similarly, in *Crossland*, the Crosslands wanted to include an inflation loss as a miscellaneous deduction. The Court ruled that the Crosslands couldn't create a deduction that didn't exist. While the Court did mention that Congress hasn't indexed capital gains for inflation, the Court did not discuss whether Treasury could do this. Interestingly, in *Hawke*, the Court used a Treasury regulation to determine the definition of cost.

Since these cases were decided though, there have been more recent cases that have included inflation in cost. For example, the Eleventh Circuit Court of Appeals in *Mercy Community Hospital v. Heckler*, 781 F.2d 1552 (1986) required the Department of Health and Human Services to account for inflation when reimbursing for "reasonable costs." Likewise, in *Amusement & Music Operators Association v. Copyright Royalty Tribunal*, 676 F.2d 1144 (1982), the Seventh Circuit ruled that the automatic inflation adjustment by the Copyright Royalty Tribunal was supported by the copyright act, even though other parts of the law required adjustments for inflation. Finally, the Supreme Court in *Verizon Communications Inc. v. FCC*, 535 U.S. 467 (2002), ruled that the term cost in the Telecommunications Act of 1996 was not unambiguous and could be interpreted by the FCC to include different definitions of cost. Although a telecommunications case, this case has direct applicability to the term cost in the Code.

The memo's third argument is that other parts of the Code require that cost be defined as the purchase price. The memo uses the deduction for depreciation as an example and states that if the definition of cost included inflation, taxpayers wouldn't have a basis to calculate this deduction. In addition, the memo notes that inflation isn't included in Section 1016's list of "Adjustments to basis," but inflation is included in other sections of the Code. The memo argues that this means Congress did not want to index capital gains to inflation.

As stated above though, the Seventh Circuit in *Amusement & Music Operators Association v. Copyright Royalty Tribunal*, 676 F.2d 1144 (1982), ruled that the automatic inflation adjustment by the Copyright Royalty Tribunal was supported by the copyright act, even though other parts of the law required adjustments for inflation. In addition**,** before Congress added many of these adjustments to the basis to the Code, Treasury had provided for many of these adjustments, such as depreciation and improvements added to property.

The memo's fourth argument is that the legislative history proves that Congress meant purchase price when it wrote cost into the Revenue Act of 1918. Specifically, the memo cites Representative Hardy's amendment to Section 201 "Basis for Determining Gain or Loss" and argues that Congress discussed and rejected including inflation in cost.

Representative Hardy's amendment, however, wasn't about indexing capital gains to inflation. Hardy was concerned that gains from prior years would be taxed when the property was sold. He believed requiring taxpayers to keep track of every sale of personal, real or mixed property would be burdensome and reduce trade. He was also concerned that this provision would lead to inequality in the tax code. He mentioned that an individual who sold his property would have to pay tax on an unearned increment, while someone who didn't sell wouldn't pay taxes. Further, he found it unfair that an individual with a larger income would have to pay a larger percent of the alleged profit. While there are some references to inflation in the legislative history, nothing in the legislative history suggests that Treasury cannot index capital gains for inflation.

The authors of the memo finally argue that Congress has chosen to lower the rate of the tax on capital gains to reduce the effect of inflation, rather than index capital gains for inflation. The memo says that this choice suggests that Congress defined cost as price paid. As evidence, the memo cites the Finance Committee's explanation for the increased capital gains deduction in the Revenue Act of 1978.

However**,** while Congress has been clearly aware of inflation and reduced the capital gains tax to reduce its effect, Congress never clearly defined cost, nor did it ever prevent Treasury from issuing a regulation indexing capital gains to inflation.