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MEMORANDUM FOR DR. LAWRENCE A. HUNTER
EXECUTIVE VICE PRESIDENT, NATIONAL CHAMBER FOUNDATION

The Legal Authority of the Department of the Treasury To Promulgate a Regulation Providing for Indexation of Capital Gains

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TABLE OF CONTENTS

PAGE

I. INTRODUCTION AND SUMMARY 1

II. BACKGROUND 4

III. THE LEGAL AUTHORITY OF THE TREASURY TO INDEX CAPITAL GAINS 11

A. The Standard for Reviewing Administrative Interpretations -- The Chevron Doctrine 12

B. Treasury Interpretations of the IRC Are Entitled to Judicial Deference 16

C. The Treasury Has Discretion to Index Capital Gains For Inflation 21

1. The Term "Cost" Is Ambiguous and Amenable to a Construction that Accounts for Inflation 22

2. The Legislative and Regulatory History of the Capital Gains Provisions of the IRC Does Not Preclude an Interpretation of "Cost" that Accounts for Inflation 30

3. Case Law Under the IRC Supports the Treasury's Discretion to Interpret "Cost" to Account for Inflation 66

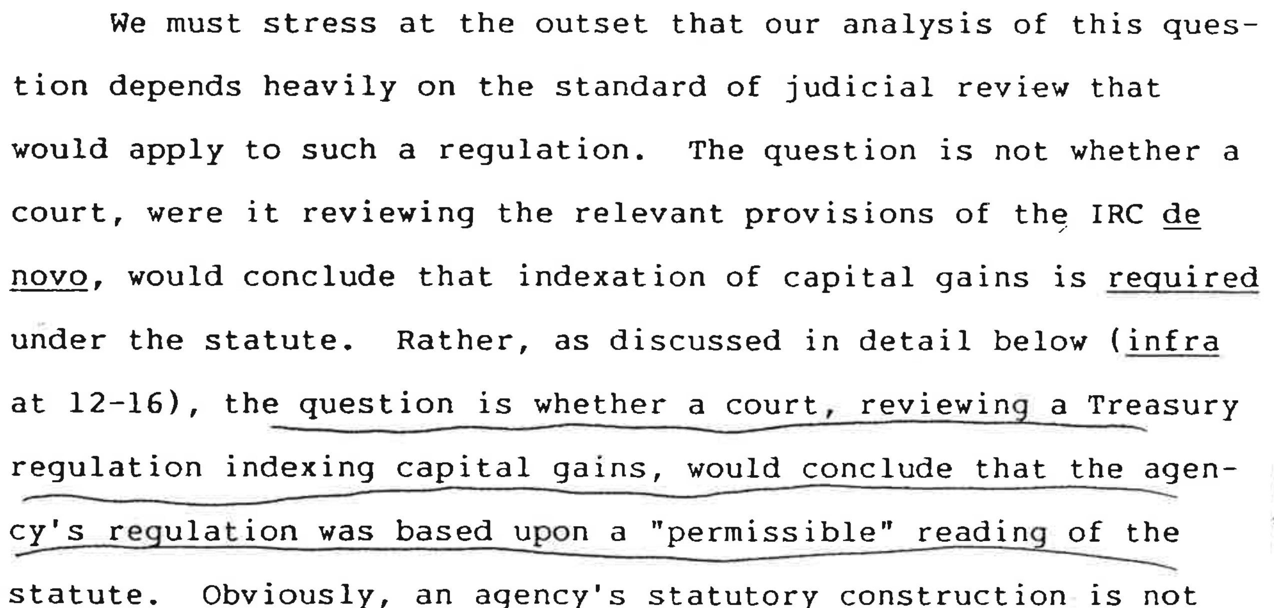
D. Adoption by Treasury of Capital Gains Indexing Is Not Foreclosed by Congress' Prior Reenactments of the IRC or by Its Failure To Enact Its own Indexing Measure 75

E. A Treasury Regulation Indexing Capital Gains Would Be Supported by a "Reasoned Analysis" 87

IV. CONCLUSION 90

I. INTRODUCTION AND SUMMARY

You have asked for our views on whether the Department of the Treasury ("Treasury) would have a solid legal foundation for promulgating a regulation under the Internal Revenue Code ("IRC") providing that the determination of taxable gain from the sale or exchange of a capital asset should be indexed to reflect the effect of inflation on the taxpayer's investment. In the pages that follow, we conclude that the legal basis for such a regulation is sound and would amply support its conscientious adoption by the Treasury. Indeed, we believe that a regulation indexing capital gains for inflation should and would be upheld judicially as a valid exercise of the Treasury's interpretative discretion under the IRC. This latter question is admittedly a close and difficult one, however.



We must stress at the outset that our analysis of this question depends heavily on the standard of judicial review that would apply to such a regulation. The question is not whether a court, were it reviewing the relevant provisions of the IRC *de novo*, would conclude that indexation of capital gains is *required* under the statute. Rather, as discussed in detail below (*infra* at 12-16), the question is whether a court, reviewing a Treasury regulation indexing capital gains, would conclude that the agency's regulation was based upon a "permissible" reading of the statute. Obviously, an agency's statutory construction is not

permissible if Congress has directly and unambiguously addressed the precise question at issue in a manner that forecloses the agency's interpretation. Apart from this obvious constraint on an administrative agency's interpretive discretion, however, a court must defer to the agency's reading of a statute that it administers if the reading is "plausible" and "reasonable," even if the court's own de novo construction of the statute would differ from the agency's.

At the heart of the inquiry is the statutory meaning of the word "cost" in the capital gains provisions of the IRC. The Treasury has consistently interpreted the "cost" of a capital asset to mean the asset's original purchase price and has measured the gain on the asset's sale as the difference (with certain adjustments not relevant here) between its purchase price and its selling price. The question is whether this definition of "cost" is required by the IRC. If it is not, the question becomes whether an administrative interpretation of "cost" to account for the effects of inflation is "plausible."

For the reasons discussed at length below, we believe that the Treasury has administrative discretion to reinterpret "cost" to take account of the economic reality that a "gain" attributable solely to inflation adds nothing to the taxpayer's real wealth or purchasing power. The term "cost" is ambiguous and is readily amenable to a construction that takes account of

inflation. And in neither the language nor the legislative history of the IRC has Congress clearly and directly addressed the "precise issue" of the meaning of "cost" or otherwise evidenced an intent to limit its meaning to original purchase price. Nor does the legislative history of the IRC contain persuasive evidence that Congress intended to deny the Treasury any interpretative discretion to take account of economic considerations other than original purchase price in calculating "cost" for purposes of determining capital gains. To the contrary, the legislative and regulatory history of the IRC's capital gains provisions affirmatively demonstrates that the Treasury has exercised, without objection from Congress, regulatory discretion in applying the concept of cost. The regulations promulgated by the Treasury -- especially under the Revenue Act of 1918, the statute which first incorporated the term "cost" in the capital gains provisions -- demonstrate that the Treasury did not view itself as confined to a definition of cost that was limited to original purchase price if use of such a definition would not truly and accurately measure the income of the taxpayer.

Nor does Congress' failure to enact any of the legislative indexation measures proposed in recent years reflect congressional "acquiescence" in the Treasury's existing definition of "cost." To the contrary, the legislative history of Congress' consideration of such proposals reveals, if anything, that Congress *favors* the concept of indexing capital gains. Indeed,

indexation measures have passed at different times in recent sessions of both the Senate and the House.

Finally, the case law relating to the Treasury's interpretative discretion in the capital gains and analogous contexts supports the conclusion that the concept of "cost" is ambiguous and that the Treasury has administrative discretion to reinterpret it in a manner that better accords with economic reality and with the principles underlying the taxation of income. Such an administrative reinterpretation, even though it would constitute a change from the agency's long-standing view, would be entitled to substantial judicial deference, since it would clearly be both "reasonable" and supported by a "reasoned analysis."

Before proceeding to a detailed discussion of each of the foregoing conclusions, we turn first to a general outline of the background of the proposal to index capital gains for inflation.

II. BACKGROUND

The Sixteenth Amendment granted Congress "power to lay and collect taxes on incomes, from whatever source derived . . . ." U.S. Const., amend. XVI. In Eisner v. Macomber, 252 U.S. 189, 207 (1919), the Supreme Court defined the term "income" as "'the gain derived from capital, from labor, or from both combined,' provided it be understood to include profit gained through a sale or conversion of capital assets . . . ." In elaborating further

on the meaning of income in the context of a sale of a capital asset, the Court described it as "a gain, a profit, something of exchangeable value, proceeding from the property . . . and . . . received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal." Id. (emphasis omitted).[1/]

The IRC provides that "[t]he gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis." IRC § 1001(a). The "[a]mount realized from the sale or other disposition of property" generally is equal to the sum of any money received plus the fair market value of any property (other than money) received. Id. § 1001(b). The "basis" of property is defined generally as "the cost of such property." Id. § 1012. The IRC provides for a number of adjustments to basis for items such as depletion, depreciation, amortization, and certain expenses. See, e.g., id. § 1016. This basic structure for the determination of gain or loss on the sale of property has not changed since 1918.

1/ In a later decision upholding the constitutionality of the taxation of capital gains, the Supreme Court did not consider the question whether a gain attributable solely to inflation comports with the constitutional meaning of "income" and thus can be taxed under the Sixteenth Amendment. See Merchants' Loan & Trust Co. v. Smietanka, 255 U.S. 509 (1921). You have not requested that we examine this constitutional issue.

The Congress has never defined the term "cost" in the IRC, and the regulations issued under the IRC ("Treasury Regulations") did not define it until 1957. The Treasury Regulations issued in 1957 defined cost as "the amount paid for . . . property in cash or other property." Treas. Reg. § 1.1012-1.(a). This regulatory definition of cost remains in place today.

Until 1986 Congress had consistently accorded some form of tax preference to capital gains. For example, from 1922 until 1934, capital gains were fully included in taxable income, but were taxed at a preferential rate. From 1934 until 1986, the preference took the form of a partial exclusion of capital gains from taxable income. Throughout this period, the amount of the capital gains exclusion and the length of time an asset had to be held in order to qualify for exclusion was statutorily adjusted from time to time, but the tax preference for capital gains was always substantial. With the passage of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986), however, the capital gains preference was virtually eliminated. Capital gains are now fully includible in taxable income, and are taxed at substantially the same rates as ordinary income.

One of the express congressional justifications for the preferential treatment of capital gains has been the adverse effect of inflation on the calculation of capital gains. During periods of high or even moderate inflation, nominal gains

realized upon the sale of property may not reflect a true increase in the value of the property at all. Thus, the taxpayer is taxed on the sale even though, in real terms, he has not received any income in the sense of an increase in wealth or purchasing power.

Consider the example of a taxpayer who bought a capital asset for $100,000 in 1982. In 1992, he sells the asset for $200,000. Under the current regime, the taxpayer will be taxed on his "gain" of $100,000. If, however, inflation has caused the general price level to double between 1982 and 1992, the taxpayer has not realized any increase in wealth -- that is, an increase in the value of the asset. The $200,000 that he has in 1992 represents the same purchasing power that the $100,000 represented in 1982. The value of the asset has not increased; it has merely kept pace with inflation. In fact, the taxpayer is now worse off than if he had never bought the asset at all, since the tax on the sale of the asset will eat into the nominal gain he received. It is even possible that inflation will have the effect of creating a tax liability for what is in truth a loss. If, for example, the taxpayer had sold the asset in 1992 for $180,000, in real terms he has suffered a ten percent loss in purchasing power. It is thus difficult to view the $80,000 increase as "a profit, something of exchangeable value, proceeding from the property . . . and . . . received or drawn by . . . (the taxayer) for his separate use, benefit and disposal." Eisner, 252 U.S. at

207. Yet, the taxpayer will nevertheless be taxed on $80,000 of "gain."

This capital gain taxing scheme not only artificially inflates the profit or "income" being taxed, it also leads to differential taxation of similarly situated taxpayers. According to Nobel Prize winning economist James M. Buchanan, "[o]ne of the most widely accepted principles or norms for the distribution of taxes among individuals states that individuals in similar situations should be treated similarly, or in other words, equals should be treated equally." 2/ Richard and Peggy Musgrave, two of the most widely recognized experts on taxation and public finance, define in practical terms precisely what it means to "treat equals equally": "The requirement of equal taxes for people in equal positions is also referred to as 'horizontal' equity. Taxpayers are said to be treated equally if their tax payments involve an equal sacrifice or loss of welfare." (Emphasis added) 3/

Taxing inflationary capital gains clearly violates this basic principle. If, for example a taxpayer bought $1,000 of stock invested in the Standard and Poor's 500 index in 1970, that stock would have sold for $3,677 in late 1990. This would have

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2/ James M. Buchanan, The Public Finances 165 (1960).

3/ Richard A. Musgrave and Peggy B. Musgrave, Public Finance in Theory and Practice 216 (2d ed. 1976).

resulted in a taxable capital gain of $2,677. At the current 28 percent tax rate, the taxpayer would have paid $750 in tax. However, inflation since 1970 has been over 218 percent. This means the taxpayer's real gain was only $257. He was taxed $750 on a real gain of $257 for a tax rate of 292 percent. In short, he sacrificed almost three times his real gain or purchasing power to the government in taxes. Another individual who purchased $1,000 of stock in 1989 and sold it one year later for $1,268 also would have realized a real gain of $257 since inflation, as measured by the Gross Domestic Product price deflator, was 4.1 percent in 1990. At the current 28 percent tax rate, this taxpayer would have paid $75 in taxes. The first taxpayer, who realized an identical increase in his income sacrificed in taxes 10 times the purchasing power compared to the second taxpayer, a clear violation of the principle of horizontal equity.

The most direct way to counter the impact of inflation is to index capital gains.[4/] The indexation of capital gains would involve adjustment of the basis of the asset to reflect changes

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4/ Section 1012 of the IRC supplies a basis rule for all property, not just capital assets. The indexation of basis in section 1012 could therefore affect the determination of gain or loss for some types of ordinary income, such as gain on the sale of real estate lots held by a real estate developer. Unlike most types of ordinary income, such as salaries and wages, inflation affects this type of income in exactly the same way as it affects capital gains.

in the general price level due to inflation (or deflation).[5/] To use the first example discussed above, when the 1982 purchaser sold his asset in 1992 for $200,000, his basis in the asset, which was $100,000, would be adjusted to reflect the cumulative rate of inflation over the previous ten years (i.e., 100%). Thus, his new basis would be $200,000, and he would have no gain for federal income tax purposes, because he would have no real increase in wealth. If he had sold the asset for $250,000, he would have recognized a $50,000 capital gain.

The IRC currently provides for the indexation of tax brackets for individuals as well as for the indexation of the standard deduction and personal exemptions for individual taxpayers. See, e.g., IRC §§ 1(f), 1(g). In recent years, there have been several proposals in Congress to provide for the indexation of capital gains, and while such proposals have passed at different times in both the House and Senate, none has been enacted.

5/ We have not examined the merits of various indexing schemes. Past proposals have suggested the use of the Consumer Price Index or a GNP deflator.

III. THE LEGAL AUTHORITY OF THE TREASURY TO INDEX CAPITAL GAINS

In general terms, Treasury's legal authority to index capital gains turns on the scope of its administrative discretion under the IRC. As previously noted, the IRC's measurement of capital gains revolves around the concept of "basis," which is in turn defined as "cost." The Treasury has interpreted "cost" to refer to historical or original cost only -- i.e., the actual amount paid for the asset. The issue is not whether the Treasury's interpretation of "cost" for measuring capital gains is a permissible exercise of its regulatory discretion. The issue, rather, is whether the Treasury's "purchase price" understanding of "cost" is required -- that is, whether it is the only permissible means of measuring capital gains income consistent with the IRC. If it is not, the question becomes whether there is a "reasoned and lawful basis" for reinterpreting cost to reflect the effect of inflation.

Over the last 20 years, the Supreme Court has made clear that an agency is entitled to wide latitude in interpreting and construing the provisions of the statute it administers. There is also ample precedent for the proposition that such an agency interpretation is entitled to strong deference even when it represents a change from a previous interpretation. Indeed, numerous judicial decisions have upheld Treasury regulations that have reinterpreted IRC provisions in circumstances analogous to those

present here. The framework for analyzing the issue under study is provided by the Supreme Court's landmark Chevron decision.

A. The Standard for Reviewing Administrative Interpretations -- The Chevron Doctrine

In Chevron, U.S.A., Inc. v. Natural Resources Defense Council, 467 U.S. 837 (1984), the Supreme Court announced a rule of judicial deference to agency constructions of statutes. The Chevron analysis involves a two-step inquiry:

> First, always, there is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress. If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute.

Id. at 842-843.

The Chevron doctrine is premised on the simple and unremarkable proposition that the agency, rather than a court, is the appropriate body to "'fill any gap left, implicitly or explicitly, by Congress.'" Id. at 843 (quoting Morton v. Ruiz, 415 U.S. 199, 231 (1974)). This standard allows the agency -- which, after all, has the congressionally delegated

responsibility to administer the terms of the statute based upon the agency's technical and policy expertise -- to administer its organic statute in the manner that best fulfills its statutory mandate and the policies reflected in the law. Whether a reviewing court, were it examining the issue de novo, would agree with the agency's interpretation is not the issue. "The court need not conclude that the agency construction was the only one it permissibly could have adopted to uphold the construction, or even the reading the court would have reached if the question initially had arisen in a judicial proceeding." Chevron, 467 U.S. at 843 n.11.[6/] Rather, the agency's construction "may not be disturbed as an abuse of discretion if it reflects a plausible construction of the plain language of the statute and does not otherwise conflict with Congress' expressed intent." Rust v. Sullivan, 111 S. Ct. 1759, 1767 (1991). In short, then, the Treasury's construction of ambiguous IRC terms is entitled to "substantial deference." Id. at 1767.

Nor does the fact that indexing capital gains would represent a change in the Treasury's long-standing interpretation of the IRC eliminate the deference due to the agency's new construction, as the Supreme Court's recent decision in Rust makes clear.

6/ See also Pauley v. BethEnergy Mines, Inc., 111 S. Ct. 2524, 2534 (1991) ("When Congress, through express delegation or the introduction of an interpretive gap in the statutory structure, has delegated policymaking authority to an administrative agency, the extent of judicial review of the agency's policy determinations is limited.").

In that case, the Court upheld regulations of the Department of Health and Human Services ("HHS") which limited the ability of fund recipients to engage in abortion-related activities. The petitioners argued "that the regulations are entitled to little or no deference because they 'reverse a longstanding agency policy . . .' and thus represent a sharp break from the Secretary's prior construction of the statute." 111 S. Ct. at 1768. The Court rejected this argument, holding that the agency's interpretation was entitled to judicial deference under Chevron despite its "sharp break" with prior interpretations of the statute. Id. at 1769. See also Cross-Sound Ferry Serv., Inc. v. ICC, 873 F.2d 395, 398 (D.C. Cir. 1989) (agency "has great latitude in determining the scope of [statutory term] and in modifying it from time to time as the [agency] sees fit").

Indeed, Chevron itself involved a change in an agency interpretation. In Chevron, a new presidential administration took office and initiated the change in the interpretation of the statutory term ("stationary source") at issue. 467 U.S. at 857-58. Nevertheless, the Supreme Court accorded the new interpretation deference:

> The fact that the agency has from time to time changed its interpretation of the term "source" does not, as respondents argue, lead us to conclude that no deference should be accorded to the agency's interpretation of the statute. An initial agency interpretation is not instantly carved in stone. On the contrary, the agency, to engage in informed rulemaking, must consider

varying interpretations and the wisdom of its policy on a continuing basis.

Id. at 863-864 (emphasis added).

A central premise of the Court's decision in Chevron is that the popularly elected executive (or his designate) may adopt and implement reasonable policy choices within the discretion the statute entrusts to him, and that changes in such policy choices is the natural and predictable outgrowth of the political process. The judiciary is not to interfere with such legitimate policy choices:

> Judges are not experts in the field, and are not part of either political branch of the Government. Courts must, in some cases, reconcile competing political interests, but not on the basis of judges' personal policy preferences. In contrast, an agency to which Congress has delegated policymaking responsibilities may, within the limits of that delegation, properly rely upon the incumbent administration's views of wise policy to inform its judgments. While agencies are not directly accountable to the people, the Chief Executive is, and it is entirely appropriate for this political branch of the Government to make such policy choices -- resolving the competing interests which Congress itself either inadvertently did not resolve, or intentionally left to be resolved by the agency charged with the administration of the statute in light of everyday realities.
>
> When a challenge to an agency construction of the statutory provision, fairly conceptualized, really centers on the wisdom of the agency's policy, rather than whether it is a reasonable choice within a gap left open by Congress, the challenge must fail. In such a case, federal judges -- who have no constituency -- have a duty to respect legitimate policy choices made by those who do.

Id. at 865-866. See also Michigan Citizens for an Indep. Press v. Thornburgh, 868 F.2d 1285, 1283 (D.C. Cir.), aff'd without opinion by equally divided Court, 493 U.S. 38 (1989).

Of course, the fact that the agency interpretation represents a change from a previous interpretation is not irrelevant. The agency must provide a "reasoned analysis" of the change in policy or interpretation. Rust, 111 S. Ct. at 1769; Motor Vehicles Mfrs. Ass'n v. State Farm Mut. Auto Ins. Co., 463 U.S. 29, 42 (1983). See also Black Citizens for a Fair Media v. FCC, 719 F.2d 407, 417 n.25 (D.C. Cir. 1983), cert. denied, 467 U.S. 1255 (1984). But so long as the agency's new policy is supported by a "reasoned analysis," it is entitled to no less judicial deference then the policy it replaces.7/

B. Treasury Interpretations of the IRC Are Entitled to Judicial Deference

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7/ The Supreme Court has not been entirely consistent on this issue. For example, in Pauley the Court stated in dictum that "[a]s a general matter, of course, the case for judicial deference is less compelling with respect to agency positions that are inconsistent with previously held views." 111 S. Ct. at 2535. The fact that this dictum was announced within a month of the contrary holding in Rust does not make the analysis of this issue any simpler. The cryptic Pauley dictum does not require, however, that there be no deference or less deference accorded to changes in agency interpretations; the statement that the case for deference in such situations is "less compelling" may be read to mean that the agency has a burden to explain the reasons for its change, but once explained, the interpretation is entitled to deference under Chevron. See State Farm, 463 U.S. at 42.

Section 7805(a) of the IRC provides a general delegation of rulemaking authority to the Secretary of the Treasury:

> Except where such authority is expressly given by this title to any person other than an officer or employee of the Treasury Department, the Secretary shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.

IRC § 7805(a).

It is clear that deference is to be accorded to regulations promulgated by the Treasury pursuant to section 7805(a). The extent and scope of this deference, however, has not been consistently expounded by the courts. There is authority to the effect that interpretive regulations promulgated pursuant to section 7805(a) are entitled to less deference than "legislative" regulations promulgated pursuant to a specific grant of rulemaking authority.[8/] See Rowan Co.'s, Inc. v. United States, 452 U.S. 247, 253 (1981); United States v. Vogel Fertilizer Co., 455 U.S. 16, 24 (1982); Water Quality Ass'n v. United States, 795 F.2d 1303, 1305 (7th Cir. 1986). Other cases, however, have not distinguished between legislative and interpretive rules with respect to this issue. See Borris I. Bittker and Lawrence Lokken, Federal Taxation of Income, Estates and Gifts, Volume IV,

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8/ For example, the IRC specifically authorizes the Secretary of the Treasury to promulgate regulations governing the use of consolidated returns. IRC § 1502.

§ 110.4.2 (2d ed. 1992) ("the distinction between legislative and interpretive regulations is often blurred in practice, and the supposedly diverse standards of judicial review tend to converge and even to coalesce") (citations omitted). Of course, *Chevron* itself announced a rule of strong deference to agency regulations *interpreting* a statute. 467 U.S. at 842-43.

Regardless of the amount of deference accorded to legislative regulations, it is nonetheless clear that considerable deference is due interpretive regulations. In a recent case reviewing Treasury Regulations interpreting the realization requirements of the IRC with regard to gains and losses on dispositions of property, *Cottage Sav. Ass'n v. Commissioner*, 111 S. Ct. 1503, 1508 (1991), the Supreme Court deferred to interpretive IRS regulations issued under section 7805(a).[9] In upholding the regulation, the Court observed:

> Because Congress has delegated to the Commissioner the power to promulgate "all needful rules and regulations for the enforcement of [the Internal Revenue Code]," 26 U.S.C. § 7805(a), we must defer to his regulatory interpretations of the Code so long as they are *reasonable*.

Cottage Savings, 111 S. Ct. at 1508 (emphasis added).

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[9] These regulations defined a statutory term -- "disposition" of property -- to include a requirement that the property be exchanged for cash or for "materially different" property. This requirement was recognized in neither the language or the history of the statutory term. *Cottage Savings*, 111 S. Ct. at 1508.

This statement is merely the latest in a long line of judicial pronouncements according deference to interpretive regulations promulgated under section 7805(a). In Bob Jones University v. United States, 461 U.S. 574, 596 (1983), the Court noted that "ever since the inception of the [IRC], Congress has seen fit to vest in those administering the tax laws very broad authority to interpret those laws . . . . This Court has long recognized the primary authority of the IRS and its predecessors in construing the Internal Revenue Code." The Bob Jones University Court characterized the agency's rulemaking authority under section 7805(a) as "essential to efficient and fair administration of the tax laws." Id. See also Bingler v. Johnson, 394 U.S. 741, 750 (1969) (Treasury Regulations "'must be sustained unless unreasonable and plainly inconsistent with the revenue statutes,' and 'should not be overruled except for weighty reasons.'"), quoting Commissioner v. South Texas Lumber Company, 333 U.S. 496, 501 (1948); Lykes v. United States, 343 U.S. 118, 127 (1952) (Treasury Regulation "entitled to substantial weight"); Brewster v. Gage, 280 U.S. 327, 336 (1930) ("It is the settled rule of practice that an interpretation of an ambiguous or doubtful statute that has been acted upon by officials charged with its administration will not be disturbed except for weighty reasons.").

This principle was perhaps most forcefully stated in United States v. Correl, 389 U.S. 299 (1967). In Correl the Supreme Court upheld a longstanding Treasury rule requiring that in order

to deduct the cost of meals, a taxpayer traveling on business must stop for sleep or rest during his trip. In upholding this rule, the Court expressed the principles of deference governing its review in language remarkably similar to that used by the Chevron Court seventeen years later:

> Alternatives to the Commissioner's sleep or rest rule are of course available. Improvements might be imagined. But we do not sit as a committee of revision to perfect the administration of the tax laws. Congress has delegated to the Commissioner, not to the courts, the task of prescribing "all needful rules and regulations for the enforcement" of the Internal Revenue Code. 26 U.S.C. § 7805(a). In this area of limitless factual variations, "it is the province of Congress and the Commissioner, not the courts to make the appropriate adjustments." Commissioner v. Stidger, 386 U.S. 287, 296 . . . . The rule [sic] of the judiciary in cases of this sort begins and ends with assuring that the Commissioner's regulations fall within his authority to implement the congressional mandate in some reasonable manner.

Correl, 389 U.S. at 306-07.

Thus, it is well established that interpretive regulations promulgated pursuant to section 7805(a) are entitled to substantial judicial deference.[10/]

10/ There have been cases refusing to accord deference, or according less deference, to Treasury Regulations interpreting statutory provisions for which the IRC already provides a detailed statutory definition of the term. See, e.g., Vogel Fertilizer, 455 U.S. at 24; Thomas Int'l Ltd. v. United States, 773 F.2d 300, 303 (Fed. Cir. 1985), cert. denied, 475 U.S. 1045 (1986). This principle has little application here, however, since "cost" is not defined in the IRC, and "basis" is defined only by reference to cost.

Footnote continued on next page.

C. The Treasury Has Discretion to Index Capital Gains for Inflation

In applying the foregoing principles to the proposed indexation regulation, the initial inquiry is whether the Treasury has express or implied interpretive discretion regarding the statutory terms at issue. In the terms of the Chevron doctrine, the question is whether Congress has explicitly (by express delegation) or implicitly (by failing to speak directly and clearly to the precise question at issue) delegated authority to the Treasury to interpret the statute. See Chevron, 467 U.S. at 843-44. We believe that the Treasury has interpretive discretion in this case.[11]

Footnote continued from previous page.

There have also been a number of cases refusing to defer to statutory constructions that are unreasonable or impermissible. See, e.g., Commissioner v. Engle, 464 U.S. 206 (1984); United States v. Cartwright, 411 U.S. 546, 550 (1973) (The deference "principle is to set the framework for judicial analysis; it does not displace it. We find, that the contested regulation is unrealistic and unreasonable."); City of Tucson v. Commissioner, 820 F.2d 1283, 1290 (D.C. Cir. 1987); Water Quality Ass'n, 795 F.2d at 1309, 1313. To be sure, neither the Chevron principle nor the Correl line of cases according deference to interpretive regulations under section 7805(a) can be entirely successful in divorcing the predilections of judges from the standard of review. Nonetheless, these deference principles are designed to ensure that such occurrences are the exception and not the norm.

11/ There are several points in the Chevron analysis that are elastic enough to leave room for judicial maneuvering. One of these is the question of statutory ambiguity. The Supreme Court has not conclusively clarified just how ambiguous a statute must be in order for the agency construction

Footnote continued on next page.

The Random House Dictionary defines cost as follows: "1) the price paid to acquire, produce, accomplish, or maintain anything . . . 2) an outlay or expenditure of money, time, labor, trouble, etc.: What will the cost be to me?, 3) a sacrifice, loss or penalty: to work at the cost of one's health." Random House Dictionary of the English Language, (2d ed. 1987). Accordingly, under a standard definition of "cost," the IRC directs that capital gains are to be measured by determining the difference between the taxpayer's "loss," "sacrifice," or "expenditure" represented by the asset and the money he has realized through its sale. Any such "loss," "sacrifice," or "expenditure" needs to be ascribed a monetary value in order to determine the gain realized. The issue, then, is whether Congress specifically intended that a taxpayer's cost be measured solely by the nominal dollars expended at the time of purchase or, rather, whether the monetary value of the expenditure represented by the asset may be assessed at the time the asset is sold and the taxable event occurs. We can discern nothing in the standard definition of "cost," or in any other language of the IRC, suggesting that the historical "purchase price" measurement of monetary value must be used in preference to a measurement that coincides with the sale of the asset. Both methods of measurement are straightforward assessments of the taxpayers "cost"; they differ only in the time at which such "cost" is measured, and the language of the statute

provides no indication that one method must be used rather than the other.

Nor can we discern any reason that a historical measurement of cost is somehow more appropriate or reasonable than measuring cost at the time the asset is sold. To be sure, measuring the monetary value of cost at the time of purchase is a more convenient and readily discernible basis for assessing cost since it looks to the actual purchase price. This simple and administratively convenient measurement of cost, however, has the significant drawback of not accurately assessing the taxpayer's true cost and, as a result, the true income or "gain" realized by the sale of the capital asset. Focusing on the nominal dollars expended as the measurement of cost, rather than on what the dollars would purchase at the time the capital gains are measured, falsely understates the genuine cost to the taxpayer and falsely inflates the "gain" being taxed.

Under standard economic analysis, the assessment of financial "sacrifice," "loss," or "cost" is the extent to which the taxpayer's purchasing power has been diminished. See, e.g., John Eatwell, Murray Milgate, and Peter Newman, The New Palgrave - A Dictionary of Economics at 343-45 (1987). Returning to our prior hypothetical, a buyer of a $100,000 capital asset in 1982 has expended his purchasing power by $100,000 in 1982 terms. But ten years later, the purchasing power represented by that same

capital asset (assuming 100% cumulative inflation over ten years) is now $200,000. The financial "cost" to the purchaser in 1982 has doubled by 1992, and a sale of the asset increases the taxpayer's purchasing power only if, and to the extent, he realizes more than $200,000 in return for it. Equating cost with purchase price ignores this economic reality, and thus yields capital "gains" that are wholly fictional -- that do not truly represent, in the Supreme Court's words, "a profit, something of exchangeable value." Eisner, 252 U.S. at 207. Obviously, measuring the cost of an asset at the time of sale more accurately assesses the taxpayer's true income or gain. Moreover, this more accurate measurement of cost eliminates differential taxation of short-term and long-term holders of capital assets, which results from treating a sum expended in 1982 for a capital asset as if it were no less valuable than the same sum expended in 1992.

In short, it is fully consistent with the normal understanding of the term "cost" to measure the asset in terms of the purchasing power it represents in real dollars at the time of the sale rather than in nominal dollars at the time of the purchase. Moreover, measuring costs and gain at the same time serves the general purposes of the IRC by more accurately assessing real income and by furthering the principle of horizontal equity, discussed above (supra at 8-9). See, e.g., IRC § 446(b) (accounting methods must clearly reflect income). Accordingly, the language and structure of the IRC supports a measurement of capital gains

that takes account of inflation on historical purchase price and the extent to which that inflation overstates the true "income" realized from a capital asset sale.

This conclusion is reinforced by the fact that "cost" or similar terms in other statutes have been construed to permit, or even require, taking account of inflationary effects. For example, in Mercy Community Hosp. v. Heckler, 781 F.2d 1552 (11th Cir. 1986), the Eleventh Circuit Court of Appeals applied a cost provision in such a way as to require the agency to take account of inflation in the Medicare context. Under the Medicare regime, health care providers are reimbursed their "reasonable costs" incurred in providing covered services to Medicare beneficiaries, including depreciation of hospital land and buildings. Id. at 1553. In Mercy, the provider sold the hospital's assets for an amount greater than their net book value, which reflected the depreciation expense reimbursed by HHS. Pursuant to its regulations, HHS argued that, because the provider recognized a gain over the net book value, it must necessarily have incurred fewer costs than it had calculated, and that it had therefore received excessive reimbursement. The Eleventh Circuit rejected HHS' view, stating:

> The subsequent sale of the unconsumed remainder of the depreciable assets at a price in excess of the depreciated book value does not necessarily imply, as the Secretary seems to argue, that the provider did not actually incur some portion of the cost it was reimbursed with the consumption of the asset before it was sold.

* * *

> The monetary value of depreciable assets may also increase as the assets are being consumed simply because of the effect on market values of inflation.

Id. at 1557 (emphasis added). Whatever the validity of the Mercy court's holding that the statute required the agency to take account of a factor such as inflation,[12/] the court's analysis certainly supports the view that the term "cost" may be so construed by the relevant enforcement agency.

Similarly, the Seventh Circuit upheld the Copyright Royalty Tribunal's creation of an automatic inflation adjustment mechanism for jukebox royalty rates pursuant to the Tribunal's statutory authority to establish "reasonable" rates. Amusement & Music Operators Ass'n v. Copyright Royalty Tribunal, 676 F.2d 1144 (7th Cir.), cert. denied, 459 U.S. 907 (1982). The Court upheld the reasonableness of this adjustment, reciting that "a cost of living or other inflation adjustment designed to maintain the real value of the fee set by the Tribunal is not prohibited but is instead affirmatively supported by the language of the Act." Id. at 1155. The Court came to this conclusion even though other portions of the copyright law covering different

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12/ A number of other cases have held that HHS did not act unreasonably in applying the recapture rules struck down in Mercy. See, e.g., Creighton Omaha Regional Healthcare v. Sullivan, 950 F.2d 563 (8th Cir. 1991), and cases cited therein. Of course, these cases cannot be read to hold that the agency would have acted unreasonably if it had taken inflation into account.

industries, such as cable television, specifically required adjustments for inflation and no such express requirement is contained in the part of the Act covering jukebox royalties. See id. at 1146-49. See also National Cable Television Ass'n v. Copyright Royalty Tribunal, 683 F.2d 1077 (D.C. Cir. 1982).13/

We believe, therefore, that there is sufficient room within the concept of "cost" to allow a reinterpretation of the term to account for inflation. Our view is strengthened by the fact that, as discussed in the next section, the Treasury has historically taken a flexible view toward its own interpretation of basis and cost, even if these interpretations have for the most part been tied to the concept of historical cost. Given the Treasury's undoubted power to interpret IRC provisions, and given the wide ambit agencies are accorded in interpreting their organic statutes under the Chevron doctrine, a Treasury interpretation of these provisions to account for the effects of inflation would be entitled to judicial deference. We turn next to an examination of whether the legislative and/or regulatory history of the relevant IRC provisions precludes such a course.

13/ Moreover, monetary damages awards, which are obviously designed to compensate for the financial worth of the victim's injuries, routinely take account of the effect of inflation when calculating lost future earnings. See, e.g., Jones & Laughlin Steel Corp. v Pfeifer, 462 U.S. 523 (1983). This is so even though such calculations must prospectively speculate about the rate of future inflation -- an administrative difficulty not present in the capital gains context.

2. The Legislative and Regulatory History of the Capital Gains Provisions of the IRC Does Not Preclude an Interpretation of "Cost" that Accounts for Inflation

It is generally not sufficient under the Chevron analysis to simply find a statutory ambiguity and then resolve it with an agency interpretation. The deference accorded to agency interpretations does not foreclose or obviate the need to review the legislative history of the statute that is being interpreted in order to determine whether Congress has spoken directly and clearly to the issue at hand. In Chevron itself the Court noted that, under the first prong of the deference analysis, "[i]f a court, employing traditional tools of statutory construction, ascertains that Congress had an intention on the precise question at issue, that intention is the law and must be given effect." 467 U.S. at 843. See also National Muffler Dealers Ass'n v. United States, 440 U.S. 472, 477 (1979) (examining legislative history of provision in determining whether the "regulation harmonizes with the plain language of the statute, its origin, and its purpose"); Central States Motor Freight Bureau, Inc. v. ICC, 924 F.2d 1099, 1105 (D.C. Cir.), cert. denied, 112 S. Ct. 87 (1991) (holding that "traditional tools of statutory construction" include relevant legislative history).[14]

14/ On some occasions the Supreme Court has not utilized legislative history in the Chevron analysis at all, or has used it only under the second prong of the analysis. See, e.g., Boston and Maine, 112 S. Ct. at 140-43; Young v. Community Nutrition Inst., 476 U.S. 974 (1986).

To recognize the relevance of legislative history, however, is not to accord it substantial or controlling weight. In fact, at least one Justice of the Supreme Court has at times expressed great antipathy to reliance on legislative history in interpreting statutes. See Green v. Bock Laundry Mach. Co., 109 S. Ct. 1981, 1994 (1989) (Scalia, J., concurring in the judgment). And, while the Court does not appear to be on the verge of abandoning resort to legislative history altogether,[15] when it has looked

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15/ Courts, including the Supreme Court, have not consistently applied the Chevron analysis when it comes to resolving the proper scope and significance of legislative history. One commentator has suggested that at least two approaches have developed to this and other issues under Chevron. See Note, CERCLA, Natural Resource Damage Assessments and the D.C. Circuit's Review of Agency Statutory Interpretations Under Chevron, 58 Geo. Wash. L. Rev. 932, 951 (1990). An "activist" approach allows courts to closely examine legislative history to determine Congress' intent. A "deferential" approach focuses more on the statutory language and the agency's construction of it and places less reliance on ambiguous or imprecise statements in the legislative history. Id. Compare K Mart, 486 U.S. at 293 n.4, with Cardoza-Fonseca, 480 U.S. at 432 n.12. Even when not explicitly recognized, this difference in approaches has led different courts to vary in the precision they require in the statute's legislative history before they will refuse to defer to an agency interpretation. Compare Japan Whaling Ass'n v. American Cetacean Soc'y, 478 U.S. 221 (1986) (deferring to agency interpretation that it had discretion under statute to refuse to certify nations for violation of international whaling quotas even though legislative history contained statements from agency officials recognizing that agency had no such discretion), with Ohio v. Department of the Interior, 880 F.2d 432 (D.C. Cir. 1989) (examining broad statements of congressional purpose and history relating to different sections of statute in refusing to defer to agency interpretation).

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in recent cases to legislative history as part of the Chevron analysis, it has demanded a great amount of specificity before it will find that the legislative history supersedes and controls an arguably inconsistent agency interpretation. For example, in Rust v. Sullivan the Court noted that "[w]hile the petitioner's interpretation of the legislative history may be a permissible one, it is by no means the only one, and it is certainly not the one found by the [agency]. It is well established that legislative history which does not demonstrate a clear and certain congressional intent cannot form the basis for enjoining the regulations." 111 S. Ct. at 1770 (emphasis added). Similarly, in Chevron, the Court noted references in the legislative history that arguably were inconsistent with the agency's interpretation of the statute, but refused to accord the legislative history controlling significance because it did not speak to the "precise

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Similarly, the Supreme Court has stated in dicta that the Chevron deference rule applies only in cases of the application of law to fact and not to "pure" questions of law. Cardoza-Fonseca, 480 U.S. at 446. See Union of Concerned Scientists v. NRC, 824 F.2d 108, 113 (D.C. Cir. 1987) (same). But see Central States, 924 F.2d at 1102 (rejecting argument that Chevron deference is inappropriate for "purely legal" issues). Regardless of the validity of this dictum, which has been criticized, Cardoza-Fonseca, 480 U.S. at 454-55 (Scalia, J., concurring), the question of the application of "cost" to property whose value has been affected by inflation is probably not a pure question of law.

issue" before the Court. 467 U.S. at 862.[16/] The "general remarks" in the legislative history were entitled to little weight because they were not made "with this narrow issue in mind and they cannot be said to demonstrate a Congressional desire." Id. (quoting Jewell Ridge Coal Corp. v. United Mine Workers of America, 325 U.S. 161, 168-69 (1945)). See also Drummond Coal Co. v. Hodel, 796 F.2d 503, 507 (D.C. Cir. 1986), cert. denied, 480 U.S. 941 (1987). Thus, there is a rather high threshold for specificity before legislative history will be treated as superseding the agency's interpretation.

With these principles in mind, we have closely examined the legislative history of the capital gains provisions of the IRC

16/ The analysis of whether Congress has, through legislative history or otherwise, spoken to the "precise question at issue" is another facet of the Chevron analysis that is subject to manipulation. By defining the "precise question at issue" either narrowly or broadly, a reviewing court may influence its decision as to whether Congress has addressed it; Congress is more likely to have addressed broad issues than narrow ones. See Note, 58 Geo. Wash. L. Rev. at 948 n.12. Of course, the formulation of the inquiry -- has Congress spoken to the "precise" question at issue -- suggests that the question should be defined narrowly. As lower courts have recognized, see Ohio, 880 F.2d 432, 443 n.6, Chevron itself defined the precise question quite narrowly. Rather than ask whether Congress had defined "stationary source," the Court asked whether Congress had an expressed intent regarding the applicability of the concept espoused in the agency interpretation to the statutory program at issue. Chevron, 467 U.S. at 845. See also Ohio, 880 F.2d at 443 (asking whether Congress had addressed whether the agency was entitled to formulate specific definition at issue regarding measurement of damages rather than whether Congress had addressed the measurement of damages generally); Central States, 924 F.2d at 1099 ("precise question at issue" is "to be interpreted tightly").

dating back to 1913. We have given special attention to early revenue acts, particularly the Revenue Acts of 1918 and 1921, for it was in these acts that Congress first set forth the "cost" definition of basis and first established a preferential tax status for capital gains. We have also paid careful attention to the last 15 years of legislation in the income tax area, because in these years capital gains, and specifically, capital gains indexation, has been a recurring issue in Congress. We have found nothing in this legislative history that forecloses the Treasury's authority to index capital gains. That is, nothing in the legislative history speaks directly and clearly to this "precise issue."

a. 1913-1920. The Sixteenth Amendment, authorizing the taxation of incomes, became effective on March 1, 1913. The first income tax law passed under this statute was enacted on October 3, 1913. See Pub. L. No. 63-16, 38 Stat. 114 (1913). The most relevant guide to Congress' understanding of "cost," however, is the Revenue Act of 1918, for neither the 1913 Act nor the 1916 Revenue Act spoke to how to measure capital gains for property acquired after March 1, 1913.[17/]

17/ The language and legislative history of the 1913 Act neither differentiated between ordinary income and capital gains nor set up a mechanism for determination of the gains. Section 2(c) of the Revenue Act of 1916 provided that "for the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, acquired

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Section 202 of the 1918 Act provided that "for the purpose of ascertaining the gain derived or losses sustained from the sale or other disposition of property, real, personal, or mixed, the basis shall be . . ., [i]n the case of property acquired on or after [March 1, 1913] . . . the cost thereof." Revenue Act of 1918, Pub. L. No. 65-254, 40 Stat. 1062 (1919). This definition of basis is derived from the Treasury Regulations under the 1916 Act. Treas. Reg. No. 33, art. 90 (capital gain is "the difference between the price at which disposed of and the cost"). See also id. art. 101, 116.

No Treasury Regulation prior to 1918 defined "cost," although several "Treasury Decisions" indicated that cost was equivalent to the original price paid for the property.18/

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before March first, nineteen hundred and thirteen the fair market price or value of such property as of March first, nineteen hundred and thirteen shall be the basis for determining the amount of such gain derived." Revenue Act of 1916, Pub. L. No. 64-271, 39 Stat. 756 (1916). This provision was apparently inserted to avoid the constitutional problems that might arise if the government attempted to tax gains that accrued prior to the effectiveness of the Sixteenth Amendment. The Act itself, however, provided no basis rule for property acquired after the effective date of the Sixteenth Amendment.

18/ See T.D. 2005, 16 Treas. Dec. 111 (1914); T.D. 2077, 16 Treas. Dec. 245 (1914); T.D. 2090, 16 Treas. Dec. 259 (1914). These Treasury Decisions are not dispositive of the meaning of "cost" as used in the 1918 Act. First, of course, these Treasury Decisions cannot be read as interpreting Congress' use of "cost," since "cost" was not used

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Although it thus might be argued that the 1918 Act incorporated these administrative interpretations of cost, this argument is not persuasive since Treasury Decisions do not have the interpretive significance of Treasury Regulations, the Decisions themselves are ambiguous, and there is nothing in the legislative history of the 1918 Act indicating that these Treasury Decisions were being adopted.

Moreover, the intent of the Treasury Regulations prior to 1918 is quite unclear. The 1916 regulations measured capital gain in terms of "cost," the predecessor regulations for the 1913 Act more narrowly defined capital gains as "the difference between the selling price and the buying price." Treas. Reg. No.

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in the IRC until the 1918 Act. Equally important, these Treasury Decisions do not represent a unitary or exclusive definition of "cost" for purposes of measuring gain. In fact, only T.D. 2090 is itself concerned with the measurement of gain; T.D. 2005 deals with business losses and T.D. 2077 deals with assets acquired before January 1, 1909. Moreover, T.D. 2077 continues to use "purchase price" rather than "cost." Furthermore, these Treasury Decisions also reflect that "cost" entailed something more than the original price for which the asset was purchased. For example, both T.D. 2005 and T.D. 2090 adjusted original cost for subsequent improvements made to the asset. Finally, as discussed, infra at 66-68, the Treasury also adjusted basis for depreciation and depletion under the early revenue acts. Thus, even if there were evidence, which there is not, that Congress meant in 1918 to adopt the Treasury's definition of "cost" as reflected in these Treasury Decisions, the exact contours of this definition are ambiguous.

33, Act of October 3, 1913 (January 5, 1914) art. 109.[19/] The regulation's shift from the narrower measurement of "buying price" to the broader term "cost" seems to reflect a more flexible administrative approach to measuring capital gains, and one which does not strictly equate "cost" with purchase price. In all events, this variation in the pre-1918 regulations would seem to refute any implication that the 1918 Act incorporated a prior administrative definition that equated "cost" exclusively with the purchase price or original cost of the asset.

More importantly, the regulations issued under the authority of the 1918 Act demonstrate that the Treasury considered itself to continue to have flexibility with respect to determining the basis of property under the "cost" rule. Throughout those regulations, the Treasury provided for adjustments to basis and to cost that differed from original cost, in order to more accurately represent the taxpayer's income. Most notable is the 1918 regulations' treatment of property acquired by gift or bequest. The original 1918 regulations provided that "in the case of property acquired by gift, bequest, devise or descent the basis for computing gain or loss on a sale is the fair market price or value of the property at the date of acquisition . . . ." Id.

19/ This regulation dealt with capital gain for assets acquired by corporations after January 1, 1909. The 1909 date is apparently significant because it refers to the effective date of a corporation tax law that was enacted prior to the effective date of the Sixteenth Amendment.

art. 1562. A later version of the 1918 regulations made clear that this basis rule was tied to the Treasury's conception of the meaning of cost: "the cost of . . . property [acquired by gift or bequest] to the person making the sale or other disposition thereof is the fair market value of the property at the date of acquisition . . . ." Id. art. 1562 (as amended July 28, 1921).

By equating "cost" with the fair market value of the property as of the date it was acquired by gift or bequest, the 1918 regulations expounded a conception of "cost" that was completely divorced from concepts of historical or original cost. By no measure could the taxpayer's "cost" as defined in these regulations be seen as representing the amount that the taxpayer had paid for the property -- the taxpayer himself paid nothing for the gift or bequest. And if the proper focus is on the donor or the testator, the regulation still was not tied to any concept of historical or original cost, because fair market value at the time of the gift or bequest is in no way related to the amount paid by the donor or testator for the property. Indeed, the 1921 Revenue Act (and subsequent Acts) rejected the fair market value rule for measuring capital gains on sales of property acquired by gift, adopting instead a rule that defined basis as the amount paid by the donor.[20] The Treasury in 1918 thus did not

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20/ The 1921 Act provided that in the case of property acquired by gift after December 31, 1920, the basis was to be the

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uniformly equate the statutory term "cost" with the original purchase price of the asset.

Similarly, the 1918 regulations provided that "[w]hen a partner retires from a partnership, or it is dissolved, he realizes a gain or loss measured by the difference between the price received for his interest and the cost to him . . . of his interest in the partnership, including in such cost . . . the amount of his share in any undistributed partnership net income earned since February 28, 1913, on which the income tax has been paid." Treasury Regulations under the Revenue Act of 1918 art. 1570

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same as it was in the hands of the donor. Id. § 202(a)(2). Thus, the donor's basis, usually the original cost, would be transferred to the donee. The congressional reports discussing these provisions noted that the Treasury's regulation was subject to abuse in that a taxpayer could get a substantial step-up in his basis by giving the property to a spouse or close relative, who could then sell the property immediately and effectively avoid taxation since the basis would be the fair market value of the property. The report noted that under the 1918 Act, "[n]o explicit rule is found in the present statute for determining gain or loss resulting from the sale of such property, but the Treasury Department has held that the proper basis for such determination is the fair market price or value of such property at the time of its acquisition by the donee." S. Rep. No. 275, 67th Cong., 1st Sess. 10 (1921). See also, H.R. Rep. No. 350, 67th Cong., 1st Sess. 9 (1921). Thus, not only did Congress recognize the Treasury's administrative discretion to interpret the "cost" basis rule of section 202 of the 1918 Act, it did not believe the Treasury's interpretation of the gift basis rule was necessary in order to be consistent with any other provision of the 1918 Act. The 1921 Act did not change the fair market value rule for property acquired by bequest, devise or descent; in fact, it codified these rules.

(1919) (emphasis added). Thus the regulations explicitly contemplated that "cost" would include not only the original cost of the partner's share in the partnership, but also his share in undistributed taxed partnership net income. Other provisions in the Treasury's 1918 regulations under section 202 reflected similar variations in the agency's definition of "cost." For example, the regulations provided that the original cost of property had to be adjusted downward for any depreciation or depletion taken on the property by the taxpayer prior to its sale. Id. art. 1561.[21]

These regulatory departures from equating "cost" with original purchase price as the measure of capital gains made sound economic sense and helped harmonize the capital gains tax with other provisions of the Code. Indeed, many of these regulations were congressionally adopted in the IRC as expressly authorized adjustments to basis for assessing gain. The relevant point, however, is that these adjustments to basis were not expressly

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21/ Similarly, the regulations provided that in the case of an exchange of stock for other stock of greater par value, the gain taxed would be either the excess of the fair market value of the new stock over the cost of the old stock or the excess of the par value of the new stock over the par value of the old stock. Furthermore, for purposes of later transactions, the "cost" of the new stock would be considered to be the cost of the old stock "plus the profit taxed on the exchange." Id. art. 1569

authorized by the 1918 Revenue Act. The only relevant measure of basis in that Act was "cost."[22]

The Treasury thus defined the statutory term "cost" as not limited to the original purchase price; other measures of "cost" could be used if justified by sound economic and tax considerations. This was so even if using a measure other than original cost, as with the measurement of basis in property acquired by gift, was not needed to harmonize the capital gain rule with other IRC provisions. This contemporaneous administrative interpretation of the initial IRC provision equating basis with "cost" is convincing evidence that "cost" was not intended by Congress to be a static concept relating only to the original purchase price of property, but rather was understood to authorize administrative adjustments that are consistent with economic reality and tax fairness.

The legislative history of the 1918 Act itself points in different directions and is, in all events, not directly on point. Nowhere in the Committee Reports accompanying the Act did Congress define or explain "basis" or "cost." The legislative history of the 1918 Act nonetheless arguably supports an inference that Congress did not intend to limit "cost" to historical

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22/ The 1918 Act did provide a separate mechanism for the determination of the basis of inventory, but none of the regulations discussed in text were promulgated under this provision.

or original cost. The Revenue Act of 1918 also included an "Excess or War Profits Tax" Title. This tax utilized a concept known as "invested capital" to measure an excess profit. Section 326(a)(3) of the House bill defined "invested capital" to mean "paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during the taxable year, and not including the increase in the value of any asset above the original cost until such increase is actually realized by sale." (Emphasis added). H.R. Rep. No. 12863, 65th Cong., 1st Sess. (1918). The use of the term "original cost" in section 323(a)(3), when juxtaposed with the use of the term "cost" in the basis provision of the same bill, appears to demonstrate a consciously flexible understanding of the term "cost."[23]

Further confusing the situation is a portion of the House debate on what became section 202. One member of the House, Representative Hardy, objected to certain aspects of the basis rules which he felt were inequitable. His main objection to the provision was the fact that it would allow taxation on increases in value that accrued prior to the taxable year in question. In his extended colloquy with other members, Mr. Hardy raised the

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23/ The Senate Bill deleted the clause of section 326(a)(3) underscored above. The Senate Finance Committee considered the clause unnecessary because it considered the remaining definition of invested capital to recognize that only the original cost was to be used in the computation. S. Rep. No. 617, 65th Cong., 1st Sess., at 11 (1918).

possible effects of inflation on capital gains as another problem with the provision, and indicated that he understood the provision to require the subtraction of purchase price from the amount realized on sale of the asset. The debate is worth quoting at length:

> Mr. Hardy: Mr. Chairman, I move to strike out Section 201 [the pre-cursor to § 202], which makes income out of the difference between what a man sells his property for and what it was worth in March 1913, if he bought it before then, or what he paid for it if he bought after that date. I do so because Section 201 is absolutely inequitable . . . . In simple principle and policy, a piece of property bought in 1913, if its exchange value today is to be equal to its exchange value when it was bought, must bring in dollars and cents something like two times what it cost . . . . If you comply with Section 201 you will have to keep a schedule of every sale of personal, real, or mixed property that you make, because your income is by Section 201 declared to be the difference between what you paid and what you sell it for if you bought it since March 1913, or a difference between what it was worth in March 1913, and what you sell it for if you bought it before that, and that takes every sale that a man makes. If complied with, Section 201 will require that every seller of personal or other property should keep a schedule of what he paid for that property if he bought after 1913, or an estimate of what it was worth in 1913 that if he bought it before that . . . . I am appealing to the committee not to adopt the principle of this Section now, because it will cause a stagnation in all trade and there will be infinite difficulty in the enforcement of it . . . .
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> Mr. Garner: This is merely enacting into law the rules and regulations now enforced under the present statute.
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> Mr. Hardy: So far as the present rules and regulations are concerned, they have not cut the figure that this will. You take a man who has done a great deal of trading, who bought his property years ago and now is in the habit of making trades, whether it be in the buying and selling of ships or the buying and selling of land, that man today makes a sale of a tract of land which he bought in 1913 at the prices then prevailing,

> and he sold it today at 100 percent of apparent profit and reinvested the money, he could not obtain any more property now then he could have obtained in 1913 with the money then paid for the same land.
>
> And yet he is taxed under this bill for alleged profits accruing from his sale . . . .
>
> Mr. Garner: If a man bought a piece of land in 1915 for $10,000 and sold it 1918 for $20,000, then I understand the gentlemen to argue that he has made no profit because $20,000 now is not worth as much $10,000, then.
>
> Mr. Hardy: That is one proposition, one ground of my objection to this tax.

This is key

Cong. Rec. 10349-10350 (September 16, 1918). Rep. Hardy later made clear that his real objection to this statute was that it taxed a seller of property for the gain that had accrued throughout the time he held the property instead of just for the gain accruing during the taxable year in question. He thus withdrew his proposed amendment to strike the section entirely, and replaced it with an amendment that would define the basis of the property as the property's fair market value at the beginning of the taxable year in which it was sold. Id. at 10351. The amendment was rejected. Id. at 10357.

This discussion is notable for a number of reasons. It demonstrates that at least certain members of Congress were aware of the effects of inflation on capital gains. It also can be argued to reflect an understanding of Congress that a property's basis referred to the acquisition cost of the property.

This legislative history, however, should not foreclose Treasury's authority to promulgate a different interpretation of the term cost. As an initial matter, the floor statements of opponents of statutory provisions are notoriously weak indications of congressional intent. See generally 2A N. Singer, Sutherland Statutory Construction § 48.13 (5th ed. 1992). Thus, Rep. Hardy's criticisms of what became section 202 do not carry substantial weight in the legislative history analysis. Second, Rep. Hardy's proposals went far beyond merely accounting for inflation in the calculation of capital gains. His initial proposal, to delete entirely the provision taxing gains on sales of property, would have eliminated taxation of all gains, not just those attributable solely to inflation. His second, more limited, proposal was even less suited to deal with the problem of taxing inflationary gains, for it eliminated taxation entirely on all gains, whether inflationary or not, accruing on property before the taxable year of the sale, while it subjected to taxation the entire gain, whether inflationary or not, accruing during the taxable year of the sale. In short, rejection of these proposals can hardly be construed as reflecting a congressional determination that gains attributable solely to inflation should be taxed.

More importantly, rejection of Rep. Hardy's proposals plainly cannot be construed as a congressional determination to deny Treasury any interpretative discretion over the term "cost."

The legislative history of the 1918 Act, including the colloquy on the House floor concerning the issue of taxing inflationary gains, simply did not address the precise question that is relevant here, *i.e.*, the definition of "cost" for all circumstances and the Treasury's authority to interpret that term to comport with economic realities, changing conditions, and/or shifting policy imperatives. While Congress did not *require* Treasury to adjust basis for inflation in taxing capital gains, neither did it deny, either expressly or implicitly, the Treasury discretion to implement the capital gains provisions in a manner that takes account of inflation. Congress did not, for example, statutorily limit the meaning of the term "cost" to original purchase price. Thus, Congress did not foreclose the Treasury's discretion to take account of cost considerations other than original purchase price when warranted by economic reality or tax fairness. And the Treasury did not hesitate to exercise this discretion, as previously discussed, in its 1918 regulations concerning depreciation, basis of gift property, and similar matters. Congress' failure itself to address in the statute cost-related considerations such as depreciation, gifts, and inflation did not foreclose the Treasury's ability to do so.

In sum, the legislative history of the 1918 Act simply does not speak directly and clearly to the "precise question at

issue." Chevron, 476 U.S. at 843 n.9.[24] Since "legislative history which does not demonstrate a clear and certain congressional intent cannot form the basis for enjoining the [agency's] regulations," Rust, 111 S. Ct. at 1770, there seems little doubt that a Treasury Regulation promulgated under the 1918 Act and providing for indexation of capital gains would have been upheld as a reasonable statutory interpretation under the principles of judicial deference announced in Chevron. The question thus becomes whether, subsequent to passage of the 1918 Act, Congress clearly manifested an intent to deprive the agency of its interpretive discretion.

b. The 1921 Act. The Revenue Act of 1921, Pub. L. No. 67-98, 42 Stat. 227 (1921), made no relevant changes in the definitions of basis or cost, and the legislative history did not illuminate the meaning of these terms. This Act is significant, however, because it represents the first Revenue Act in which a

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24/ Furthermore, the statements made during the debate to the effect that this provision merely codified the law as it was applied under the 1913 and 1916 Acts should not be read to imply that these Acts foreclosed a definition of basis that took inflation into account. As discussed, the 1913 and 1916 Acts themselves did not define basis. To the extent that basis was defined in the regulations, the Treasury moved away from a more specific definition of basis that would not allow inflation to be taken into account ("buying price") to a broader definition that arguably could be read to take inflation into account ("cost"). Finally, that Congress might not have felt the need to act affirmatively to counter the effects of inflation does not mean that it did not provide the Treasury with the authority to take such action if it should find it necessary.

preference was given to capital gains income. The final version of the statute taxed capital gains at a preferential rate of 12.5 percent. This preferential rate was applicable only to gains on assets held for more than two years. Revenue Act of 1921, § 206.

The House and Senate Reports justified the newly-enacted preference on two grounds. First was so-called "bunching" -- taxing in the year of the sale all of the gain accrued over the course of time that the asset is held. Under a progressive rate system, this "bunching" could have the effect of placing the taxpayer into a higher bracket than if he had been taxed each year on the gain accruing during that year. Bunching was considered to discourage taxpayers from selling their capital assets, and thus was also tied to the second rationale for the preference -- to encourage the sale of assets. <u>See</u> H. Rep. No. 350 (1921); S. Rep. No. 275 (1921).

These concerns were expressed in both the Senate and the House hearings through the testimony of the same witness -- a lawyer named Frederick R. Kellog. Mr. Kellog criticized the capital gains tax provision on the grounds that it had a "lock-in" effect. The perceived high rate of tax on capital gains "kills transactions which would be made if the taxation were reasonable." <u>Internal Revenue Hearings: Hearings Before Senate Finance Committee</u>, May 9 - May 27, 1921 at 534 (statement of Frederick R. Kellog). <u>See also</u> <u>Hearings Before House Ways and</u>

Means Committee, Internal Revenue Revision, July 26 - July 29, 1921 at 405 (statement of Frederick R. Kellog). Mr. Kellog also referred to another perceived problem with the manner in which the capital gains tax was administered -- the adverse effect of inflation on capital gains.[25/] Thus, a concern with inflation

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25/ In the House hearings, Mr. Kellog described the experience of an acquaintance who was forced to sell his house when he needed to relocate for occupational reasons. Mr. Kellog stated that his friend "then became very keenly alive to the fact that the purchasing power of a dollar had lessened so much that a supposed profit was largely stage money. It did not amount to anything, but the government, nevertheless, under the present law had no alternative but to require him to pay a tax on that amount." House Hearings at 129.

This problem was discussed even more explicitly in the Senate Hearings:

> Senator McCumber: Suppose property was purchased in 1914 and held until 1921 and it has increased in value 100 percent. A dollar has decreased 50 percent. The property has increased mainly because of the inflation and the cheaper dollar rather than from any more income that you could get out of it. Is it not unjust to say that a person, because he sells it for the same number of dollars that he purchases it for in the general market, has got to pay the Government some money?
>
> Mr. Kellog: I think you have touched the most vital point in the whole matter.
>
> Senator McCumber: The fact is, that he has not made a cent if those figures are correct.
>
> Mr. Kellog: I believe that is one of the strongest reasons. I am very sorry that I did not think of it myself. But it is absolutely sound, as it appears to me now."

Senate Hearings at 545.

played a role, albeit minor, in the establishment of the first capital gains tax preference.

c. 1924-1977. During this period, many new revenue measures were enacted, and the tax laws were codified two different times (in 1939 and 1954). But, while the structure of the IRC changed, the essential provisions at issue did not. Basis continued to be defined in terms of "cost," and "cost" was not itself defined.[26/]

The legislative history of some of the provisions enacted during this period provides indirect references to how "cost" was understood. In discussing different aspects of the capital gains provisions, the legislative history often used examples that contemplated the use of historical cost. For example, the House Report on the Revenue Bill of 1932 explained the principles behind provisions relating to the carryover of basis by using examples which equated original cost with basis. H. Rep. No. 708, 72d Cong., 1st Sess. at 18 (1932).[27/] The use of such examples, however, merely reflected the practice of the time, and

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26/ Not until 1957 was "cost" explicitly defined in the Regulations to mean purchase price.

27/ At various points during The Revenue Act of 1932: Hearings Before The House Ways and Means Committee Congressmen or witnesses described capital gains as the difference between the price "paid" for an asset and the price received upon its disposition. See, e.g., Revenue Revision, 1932: Hearings Before the Ways and Means Committee, 72d Cong., 1st Sess. at 47, 325-326 (1932). These discussions did not take place in the context of a discussion of the meaning of cost.

cannot be read as expressing Congress' intent to foreclose a different interpretation of basis. The same is true of scattered references in the reports characterizing basis as the "original capital investment in the property." Id. at 19. None of these isolated references speak to the precise question at issue, i.e., the limits of the meaning of "cost" or the interpretive discretion of the Treasury over a term not defined in the statute.

The one feature of the capital gains provisions that did change during this time was the exact nature of the capital gains preference. From 1924 through 1933, long-term capital gains were taxed at a preferential 12.5% rate. Beginning in 1934, the nature of the preference changed. A portion of capital gain was excluded from income entirely, depending upon the holding period of the asset. See § 117(a), Revenue Act of 1934, Pub. L. No. 73-216, 48 Stat. 680 (1934). While the percentage of gain excludable from income, the number of holding periods used, and the length of the holding periods[28] varied from act to act, capital gains received preferential tax treatment until 1986.

28/ For example, under the 1934 Act, five different holding periods were specified. The longer the holding period, the greater amount of capital gain excluded from taxable income. Thus, the use of the holding period in this and other acts can be seen as a recognition that gains are more adversely affected by inflation for assets held for longer periods. In 1938, the number of exclusion ratios was reduced from five to three. The Revenue Bill of 1942 simplified the distinction between short-term capital gains and long-term capital gains, specifying a six-month holding period. Gains on

Footnote continued on next page.

Throughout this time, one of the criticisms of the capital gains tax, and one of the rationales for the preference accorded to capital gains, was the effect of inflation on capital gains. For example, the Joint Committee on Internal Revenue Taxation prepared a Supplemental Report on Capital Gains and Losses pursuant to § 1203(b)(6) of the Revenue Act of 1926. This Report recognized that "a large part of our tax on capital gains is derived from the taxation of appreciation in money value as distinct from actual value. In other words, a large tax is derived from these provisions merely because of the reduced purchasing power of the dollar." Supplemental Report at 2. See also The Revenue Bill of 1934, H. Rep. No. 704, 73d Cong., 2d Sess. at 10 (1934) (justifying preferential treatment and adding extra holding periods for capital gains in part because of the "taxes imposed on the mere increase in the monetary value resulting from the depreciation of the dollar instead of on a real increase in value."). This realization was also expressed during hearings over the Revenue Act of 1934.29/

Footnote continued from previous page.

assets held more than six-months were allowed a 50% exclusion from income. In 1969, the effective maximum capital gains rate was increased although it remained below the rates for ordinary income.

29/ During hearings before the Senate Finance Committee, the following colloquy took place between a Senator and a Treasury witness:

Footnote continued on next page.

Thus, it can be argued that one of the reasons that neither the Treasury nor the Congress specifically accounted for inflation in the determination of "cost" is that the adverse effect of inflation was ameliorated by the general capital gains tax preference. This is particularly true since the longer a taxpayer held a capital asset -- and thus the more likely it was that inflation would create an inflated gain from the asset's sale -- the larger the preference. While the preference was at best a blunt tool to counter inflation, it was nonetheless recognized as such a tool. It thus obviated the need and impetus, from 1921 until 1986, to establish a more accurate counter for inflation, such as indexation.

Footnote continued from previous page.

> Senator Reed: . . . Have you taken into account at all the fact that we have changed the value of the currency of America so that there is a nominal profit which is really non-existent? Assuming a man gets back his cost in gold equivalent, there is a nominal profit in so-called dollars, whereas we all know that there is no profit as expressed in gold. There has been no account taken of that?
>
> Dr. Magill: No provision directly directed to that proposition. This provision with respect to capital gains and losses, you will observe, gives some relief with respect to property which is sold at a profit, and conceivably you could regard what is done with respect to capital gains and losses as being a provision to take care of the things you have in mind."

<u>Revenue Act of 1934: Hearings Befor The Senate Finance Committee</u>, 73d Cong., 2d Sess. (1934).

d. 1978 to Present. Over the last 15 years, there has been much legislative action in the area of capital gains. During this time, the capital gains preference was initially expanded and then virtually eliminated. Furthermore, over this period at least six different measures were proposed to provide for indexation of capital gains through an amendment to the IRC. Although indexation legislation has passed at different times in both the House and Senate, none of these measures was enacted.

The Revenue Act of 1978 increased the exclusion for capital gains to 60 percent. One of the reasons given for the increased preference was the desire to "offset the effect of inflation by reducing the amount of gain which is subject to tax." General explanation of the Revenue Act of 1978, Joint Committee on Taxation, March 12, 1979 at 252.

More interesting is the course of Congress' deliberations on indexing capital gains as it considered the Revenue Act of 1978. The House actually passed legislation indexing capital gains. Under the House bill, the adjusted basis of certain capital assets, such as common stock, tangible personal property, and real property, would be indexed to the Consumer Price Index. See Revenue Act of 1978, H. Rep. No. 1445, 95th Cong., 2d Sess. at 125-132 (1978). The Senate bill, however, did not include an indexing provision, and the Senate version was adopted in conference. The Senate Report indicated that the Finance Committee

believed that an increased capital gains deduction would be sufficient to offset the effect of inflation. The Senate Report stated:

> [A]n increased capital gains deduction will tend to offset the affect of inflation by reducing the amount of gain which is subject to tax. Thus, by increasing the deduction, taxable gain should be reconciled more closely with the real, rather than merely inflationary gain. However, since the deduction is constant, unlike the automatic adjustments generally provided for in various indexation proposals, it should not tend to exascerbate inflationary increases."

Revenue Act of 1978, S. Rep. No. 1263, 95th Cong., 2d Sess. at 192 (1978).

One commentator has viewed this passage from the Senate Report as "decisive" evidence of a congressional intent to preclude administrative indexation of capital gains: "Congress has indicated, in authoritative Committee Reports, that special capital gains rates are appropriate because (among other reasons) the law does not permit basis adjustments to reflect inflation." L. Zelenak, "Does Treasury Have Authority To Index Basis For Inflation?," Tax Notes 841, 844 (May 11, 1992) (emphasis added). We believe that this reading overstates the significance of this legislative history. The quoted passage reflects only that the IRC did not require "basis adjustments to reflect inflation" and that the Senate Finance Committee, unlike the House, did not believe that the IRC should have been amended to require such adjustments. Nowhere in the Senate Report, or elsewhere in the legislative history of the 1978 Act, is there any indication that

Congress considered the term "cost" to have a clear and unambiguous meaning or that it intended to preclude the Treasury from exercising any interpretative discretion that it may have possessed over the term. In other words, if there were any "gaps" left by Congress in the statutory meaning of "cost" prior to enactment of the 1978 Act, those gaps were not closed when Congress failed to amend the statute. By failing to fill in itself one of the "gaps" in the meaning of "cost," Congress did not _a fortiori_ forbid the Treasury from doing so, and nothing in the legislative history of the 1978 Act evidences such a congressional intent.

Indeed, the legislative history of the 1978 Act, including the Senate Report quoted above, clearly reflects a congressional recognition of the difference between "real" and "merely inflationary" gains and the desirability of making some effort to reconcile taxable gain with real gain.

In 1982, the Senate approved a capital gains indexation provision. During consideration of the Tax Equity and Fiscal Responsibility Act of 1982, Senator Armstrong proposed an amendment calling for the prospective indexing of the basis of capital assets for capital gains purposes. _See_ 128 Cong. Rec., S8903 (July 22, 1982). The Senate approved the amendment by a vote of 64 to 32, but the provision was dropped in conference.

Which brings us to the Tax Reform Act of 1986 -- by all accounts a watershed measure. While a complete discussion of the fundamental changes wrought by the 1986 Act is beyond the scope of this memorandum, a fairly extensive discussion of the history of the Act is required to examine its provisions on capital gains.

In November 1984, the Treasury Department made a report to the President outlining and discussing tax reform proposals. Tax Reform for Fairness, Simplicity, and Economic Growth, The Treasury Department Report to the President (November 1984) ("Treasury I"). This report recommended the repeal of the capital gains exclusion and its replacement with indexation of capital gains. Id., Vol. 2 at 178-188.[30]

In May 1985, the President submitted his tax proposals to the Congress. The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity (May 1985) ("Treasury II"). These proposal differed significantly from the Treasury I Proposals. With respect to capital gains, the Treasury II Proposals did not recommend the repeal of the capital gains preference. Instead the proposal was to reduce the amount of the preference, but to keep the preference intact. The indexation proposal, however, was virtually eliminated. Treasury II included a proposal

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[30] The Report also proposed the indexation of inventories, interest on indebtedness, and depreciable assets.

that would allow an individual taxpayer to choose, beginning in 1991, either to use the capital gains exclusion preference or to index the basis of capital assets for inflation occurring after January 1, 1991. See Treasury II at 168-69.[31]

In many respects, the Tax Reform Act as passed by Congress and signed into law by President Reagan represented the worst features of both proposals. The 1986 Act enacted the Treasury I proposal to eliminate the capital gains preference, while it also followed Treasury II by refusing to enact a capital gains indexation provision. At bottom, the elimination of the preference without a compensating provision for indexation was justified by Congress by the substantial reductions in tax rates enacted in the 1986 Act. The effective tax rate on capital gains, however, was increased. As stated in the Senate Report, "the Committee believes that as a result of the large reductions in tax rates, it is no longer necessary to provide a lower rate for capital gains." S. Rep. No. 313, 99th Cong., 2d Sess. (1986). See also Joint Committee on Taxation, General Explanation of The Tax Reform Act of 1986 at 178 (same). The Congress also felt that elimination of the capital gains preference would eliminate a range of tax shelters whereby taxpayers sought to convert ordinary income into capital gain. Id.

31/ Treasury II included some other limited indexation proposals, including a proposal to index inventories under the FIFO Method of Inventory Accounting.

In one sense, the elimination of the capital gains preference represented nothing more than part of a trade off for the substantial reductions in ordinary tax rates. Congress brought a superficial similarity of treatment to the taxation of ordinary income and capital gains income by the elimination of the preference.[32] The similarity is superficial because of the fundamental difference between capital gains and most ordinary income. Ordinary income in the form of wages, salaries, etc. is generally earned during the taxable year. Thus, it is not affected by inflation from previous years. Capital gains, on the other hand, may be adversely affected by inflation for the entire holding period of the asset, which could be many years. Thus,

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32/ In one sense it is technically inaccurate to say that by eliminating the partial exclusion of capital gains from taxable income, the Congress intended to treat ordinary income and capital gains income exactly the same. While the effect of the elimination of the exclusion was to tax capital gains income at the same rate as ordinary income, with a maximum rate of 28%, the Tax Reform Act of 1986 did not collapse the tax rates into one rate. Instead, the Act provided a cap of 28% for capital gains rates. For the time being this meant that the two types of income were taxed at the same rate. But the presence of the cap was protection against later attempts to increase ordinary income tax rates. This is exactly what happened in 1990 with the Omnibus Budget Reconciliation Act. That Act increased ordinary income tax rates for both individuals and corporations slightly, but because of the cap on capital gains, capital gains remain taxable at 28%. Thus, capital gains do currently enjoy a slight preference.

capital gains are inherently more susceptible to the adverse effects of inflation.[33/]

While concern about inflation did not play nearly as great a role in 1986 as it did in Congress' consideration of the 1978 Act, inflation and indexing were discussed at various points during the consideration of the 1986 Act. As discussed previously (*supra* at 57-58), both Treasury I and Treasury II included indexing proposals. The subject of indexation also was raised at congressional hearings on the Tax Reform Act. *See*, *e.g.*, *Tax Reform Act of 1986, Part IV (Deficit Reduction and Capital Formation): Hearings Before The Senate Finance Committee*, at 61 (February 5 and 6, 1986).[34/]

Indexation again became a topic of congressional consideration in 1988. This time the subject of indexation was not raised in the context of consideration of a tax bill, but rather in the consideration of the Senate Budget Resolution. Senator Armstrong, who had introduced the indexation amendment that

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33/ This point was recognized in the Senate debate on the Act. Senator Gordon discussed the merits of indexation on the floor of the Senate, and noted that the tax bill effectively taxed capital gains more than it taxed ordinary income, because long-term capital gains include inflationary "gain" that ordinary income does not. 132 Cong. Rec. S7663-64 (1986).

34/ While the House debated and rejected a Republican alternative proposal that included a provision for limited indexing of capital gains, the House debate did not address this feature of the Republican alternative.

passed the Senate in 1982, offered an amendment to the Budget Resolution which would have reduced the revenue base and certain funding levels. This measure was proposed in order to allow, under the terms of Congress' Budget Agreement with President Reagan, proposal of an amendment to the IRC that would provide for the indexing of capital gains. This amendment was opposed in debate by several Senators for various reasons.[35/] The Senate tabled the Armstrong amendment by a vote of 66 to 29.

During consideration of the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239 (1989), the House again passed a provision indexing capital gains. Under the House bill, certain assets (including corporate stock, tangible capital assets and property used in a trade or business) acquired after December 31, 1991, were subject to an indexation scheme tied to the Consumer Price Index for purposes of determining gain (but not loss). See

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35/ Senator Bradley indicated that the indexation of capital assets was a logical concept, but that he believed that capital gains should not be indexed alone. Rather, in order to be completely fair and to have a completely neutral system, he suggested that depreciation and interest payments also would need to be indexed. Senator Bradley also opposed the spending reductions suggested by Senator Armstrong. 134 Cong. Rec. S3954 (1988). Senator Bentsen opposed the amendment although he characterized himself as a "strong supporter of a low capital gains rate". Id. at S3955. He did not think that the Budget Resolution was the proper place to consider revisions to the tax code. He also was concerned with the potential for instability in the tax code, expressing the opinion that it was too soon after the 1986 Act to be tinkering with the IRC. Id. Senator Packwood opposed the amendment on similar grounds, as did Senator DeConcini and Senator Chiles.

H.R. Rep. 247, 101st. Cong., 1st Sess. 1476-77 (1989). The Senate bill did not include an indexing provision, and the House indexing provision was dropped in conference. H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. 664 (1989).

The most recent congressional consideration of indexing proposals occurred in the current session. The House passed tax legislation that provided for the prospective indexation of capital assets. The Senate version provided for a capital gain exclusion preference. The Conference version of the bill as approved by the House and the Senate contained a modified version of the Senate's progressive exclusion. The act imposed a capital gain marginal tax rate of 0, 14, 21 or 28 percent, depending on the individual's taxable income. See generally Tax Fairness and Economic Growth Act of 1992, Conference Report, H. Rep. No. 461, 102d Cong., 2d Sess. at 356-364 (1992). President Bush vetoed this bill.

* * *

We have discussed the legislative history of the capital gains provisions in the IRC at great length. This discussion has been complicated at times because the legislative history is itself complicated. At the risk of over-simplification, the following can be gleaned from the legislative history: Since 1918, Congress has defined basis as "cost"; nowhere in the legislative history of the IRC's capital gains provisions has Congress

"directly addressed the precise question" either of the meaning of the term "cost" or of the Treasury's interpretive discretion over that term; the Treasury early on took a flexible interpretive approach to "basis" and "cost" and provided for the regulatory adjustment of these items in ways not explicitly sanctioned in the corresponding provisions of the revenue acts; at various times during the legislative evolution of the IRC isolated congressional discussions of the capital gains provisions evidence a general assumption that the capital gains computation entails the subtraction of original cost from the amount realized on the sale or disposition of an asset; from early on, and with greater force in recent years, Congress has recognized the adverse impact of inflation on capital gains; for most of the history of the IRC -- more than 60 years -- Congress has attempted to ameliorate in part this effect through the provision of a general capital gains tax preference and an additional preference for long-term holders of assets; Congress has recently failed on several occasions to enact provisions for the indexation of capital gains, although both the House and the Senate have individually passed such measures.

Some of these points can be argued to support a construction of the IRC forbidding an administratively mandated capital gains indexing system. We address the most forceful of these arguments below (<u>infra</u> at 75-87). We believe, however, that none of these arguments is convincing. Congress simply has not spoken clearly

and directly to the "precise issue" involved in making such a determination. In neither the language nor the legislative history of the IRC has Congress definitively and explicitly defined the term "cost" or otherwise evidenced an intent to limit its meaning to original purchase price. Nor does the legislative history contain persuasive evidence that Congress intended to deny the Treasury any interpretive discretion to take account of economic considerations other than original purchase price in calculating "cost" for purposes of determining capital gains. To the contrary, the legislative and regulatory history of the IRC's capital gains provisions affirmatively demonstrates that the Treasury has exercised, without objection from the Congress, regulatory discretion in applying the concept of cost. The regulations promulgated by the Treasury -- especially under the Revenue Act of 1918, the statute which first codified the "cost" definition of basis -- demonstrate that the Treasury did not view itself as confined to a definition of cost that was limited to original or historical cost if use of such a basis would not truly and accurately measure the income of the taxpayer.

Because the Treasury's 1918 regulations implementing the concept of "cost" were promulgated contemporaneously with the Congress' initial enactment of that term, they are especially illuminating indications of both Congress' and the Treasury's intent concerning the flexibility of the term -- far more illuminating than arguably inconsistent references in the legislative

deliberations of later Congresses. Indeed, the Supreme Court has recognized the unreliability, if not irrelevance of, statements in the legislative history of later statutes purporting to interpret the intent of Congress in enacting an earlier statute.[36/]

In short, we believe that nothing in the legislative history forecloses a reinterpretation by the Treasury of "cost" that would better comport with economic reality and the principles underlying the taxation of income, especially in light of the

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36/ In Pierce v. Underwood, 487 U.S. 552, 566-67 (1988), the Supreme Court stated that such legislative history is not to be given effect. The question in Pierce was whether a committee report setting forth a very definite view of the 1980 statute at the time the statute was reenacted in 1985 without change to its language could influence the reading of the statutory language. The Court stated:

> If this [committee report] language is to be controlling upon us, it must be either (1) an authoritative interpretation of what the 1980 statute meant, or (2) an authoritative expression of what the 1985 Congress intended. It cannot, of course, be the former, since it is the function of the courts and not the Legislature, much less a Committee of one House of the Legislature, to say what an enacted statute means. Nor can it reasonably be thought to be the latter -- because it is not an explanation of any language that the 1985 Committee drafted, because on its face it accepts the 1980 meaning of the terms as subsisting, and because there is no indication whatever in the text or even the legislative history of the 1985 reenactment that Congress thought it was doing anything insofar as the present issue is concerned except reenacting and making permanent the 1980 legislation.

Pierce, 487 U.S. at 566-67.

Supreme Court's recent pronouncements requiring very clear indications of a contrary congressional intent before it will invalidate an agency interpretation of a statute. See Rust, 111 S. Ct. at 1770 ("It is well established that legislative history which does not demonstrate a clear and certain congressional intent cannot form the basis for enjoining the regulations."). As the Court of Appeals for the District of Columbia Circuit put it in an analogous context: "By leaving the operative statutory terms undefined and delegating broad rulemaking authority to the [Treasury], . . . Congress has left a gap in the regulatory regime for the agency to fill." Drummond Coal Co. v. Hodel, 796 F.2d at 507.

3. Case Law Under the IRC Supports the Treasury's Discretion to Interpret "Cost" to Account for Inflation

Nothing in the case law interpreting the capital gains provisions of the IRC contradicts our conclusion concerning the Treasury's interpretive discretion. To the contrary, an early Supreme Court decision, United States v. Ludey, 274 U.S. 295 (1927), upheld the Treasury's discretion to fill in gaps left by Congress in the IRC's capital gains provisions, specifically in the concept of "cost." The issue in Ludey concerned the tax owing on the sale of oil mining property and equipment that had been owned and operated by the taxpayer for several years. Because the taxpayer sold the properties for less than he had

paid for them, he contended that he had suffered a loss on the sale and thus owed no taxes. The Treasury, however, deducted from the taxpayer's purchase price certain amounts for depletion and depreciation "[f]or the purpose of determining the cost of the properties sold." Id. at 297. After thus reducing the taxpayer's basis in the property, the IRS calculated that the taxpayer actually had a taxable gain on the sale.

The Court, in an opinion by Justice Brandeis, upheld the Treasury's authority to require the deductions despite the fact that at the time of the sale "none of the Revenue Acts provided in terms that, in computing the gain from a sale of any property, a deduction shall be made from the original cost on account of depreciation and depletion during the period of operation." Id. The Ludey Court agreed with the Treasury's view that the real "cost" of the taxpayer's asset for purposes of determining gain or loss on its sale was less than its "original cost" by an amount equal to the sum of the annual deductions from taxable income permitted for depreciation (and depletion). As the Court explained:

> The theory underlying this allowance for depreciation is that by using up the [asset] a gradual sale is made of it. The depreciation charged is the measure of the cost of the part which has been sold. When the plant is disposed of after years of use, the thing then sold is not the whole thing originally acquired. The amount of the depreciation must be deducted from the original cost of the whole in order to determine the cost of that disposed of in the final sale of properties.

Id. at 301 (emphasis added). Thus, the Supreme Court agreed with the Treasury that Congress had not intended to blind the agency to economic reality by confining its calculation of capital gains to items of cost expressly stated in the IRC.[37/]

But the Court has made equally clear that the Treasury's discretion to "fill in the gaps" in the capital gains provisions is limited by economic reality as well.[38/] At issue in Koshland v. Helvering, 298 U.S. 441 (1936), was a sale of preferred stock on which dividends had been paid in the form of common stock rather than cash. In calculating the taxpayer's gain, the Treasury allocated to the common stock a proportionate amount of the

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37/ See also Even Realty Co., 1 BTA 355-358 (1925) (Under revenue act, basis was merely "the starting point or primary figure in computation of gain or loss," and Congress "expected a computation to include all adjustments necessary to a logical ascertainment of gain or loss.").

38/ Indeed, in Goodrich v. Edwards, 255 U.S. 527 (1921), the Court ignored plain statutory language that could not be harmonized with economic reality. The taxpayer had purchased corporate stock in 1912 for $291,600 and had sold it at a loss four years later for $269,000. The relevant capital gains provisions of the IRC at the time of the sale, however, provided that the basis of property acquired before March 1, 1913 "shall be" the fair market value of the property as of that date. Id. at 535. As of March 1, 1913, the taxpayer's stock had a fair market value of $149,000, and he was accordingly taxed the difference between that amount and the amount realized from the sale. Notwithstanding the specificity of the applicable statutory language, the Court concluded that Congress intended to tax the sale of property "to the extent only that gains are derived therefrom." Id. Since the taxpayer had realized no real "gain" from the sale of the stock, no tax could be assessed against him. The Court's approach to basis for assets acquired prior to March 1, 1913, was codified in section 202(a) of the IRC of 1921.

preferred stock's cost, thus decreasing the basis of the preferred stock and increasing the gain on its sale. The Court rejected the Treasury's analysis.

The Court reasoned that the common stock dividend was in reality taxable income to the taxpayer: "[W]here a stock dividend gives the stockholder an interest different from that which his former stock holdings represented he receives income." Id. at 446. In contrast, a stock dividend does not constitute income if it "work[s] no change in the corporate entity, the same interest in the same corporation being represented after the distribution by more shares of precisely the same character . . . ." Id. at 445. Because in Koshland the stock dividends constituted taxable income to the taxpayer, rather than simply an increase in the number of preferred shares representing the taxpayer's unchanged proportionate interest in the corporation, allocating a portion of the preferred stock's basis to the common stock dividends would "in effect . . . convert[] an income tax into a capital levy" on the preferred stock. Id. at 445. Accordingly, notwithstanding the "great weight" given to the agency's long-standing administrative construction, "the Treasury is without power by regulatory amendment to add a provision that income derived from the capital asset shall be used to reduce [its] cost." Id. at 447.

The Koshland Court thus refused to allow the determination of capital gain to be influenced by a concept unrelated to cost. As we have previously discussed, however, inflation is clearly and directly related to the cost of a capital asset. Indeed, taxing gains attributable solely to inflation, like the regulatory policy invalidated in Koshland, "in effect . . . converts an income tax into a capital levy." While we do not believe that Koshland requires the Treasury to bring its regulatory interpretation of "cost" into harmony with the economic realities of inflation, it surely supports the Treasury's regulatory discretion to do so.[39/]

Additional support for the Treasury's interpretive discretion concerning the concept of cost in the IRC's capital gains provisions is provided by cases recognizing similar discretion with respect to terms in other provisions of the IRC that are no more ambiguous. For example, in Helvering v. Reynolds, 313 U.S.

39/ In a number of Tax Court cases, a taxpayer argued that the IRC requires the Treasury to account for the effects of inflation. See, e.g., Gajewski v. Commissioner, 67 T.C. 181 (1976), aff'd, 578 F.2d 1383 (8th Cir. 1978); Silba v. Commissioner, 68 T.C. 422 (1977), aff'd, 611 F.2d 1260 (9th Cir. 1980); Crossland v. Commissioner, 35 T.C.M. (CCH) 262 (1976); Ruben v. Commissioner, 53 T.C.M. (CCH) 992 (1987). These courts refused, in the absence of clear statutory provisions to the contrary, to accept the taxpayer's construction of the IRC over the Treasury's contrary construction. None of these cases, however, addressed the issue of whether the Treasury could itself interpret the IRC to allow for the consideration of inflation. This distinction is dispositive, in light of the Chevron doctrine.

428 (1941), the Supreme Court rejected the taxpayer's contention that the term "acquisition," as it related to property received by bequest, is unambiguous, noting that its meaning could not be resolved "by reference to explicit statements of Congressional purpose." Id. at 432. Because the meaning of "acquisition," "[h]owever unambiguous that word might be as respects other transactions," was unclear in the context of bequests, the Treasury had regulatory discretion to define the term so long as its interpretation was "not a strained or artificial one." Id. at 433.

Similarly, in Bob Jones University, the Supreme Court upheld the Treasury's construction of the term "charitable" in section 501(c)(3) of the IRC, which exempts from taxation organizations operated for "religious, charitable . . . or educational purposes." The Treasury regulation at issue there interpreted "charitable" to include a requirement that the exempt organization operate in a manner consistent with federal "public policy," specifically the policy against racial discrimination. The Treasury applied this requirement not only to "charitable" organizations, but also to organizations qualifying as "religious" and "educational" under section 501(c)(3). Thus, the Treasury's interpretation of the provision read the disjunctive "or" to mean the conjunctive "and." The Supreme Court nonetheless upheld the Treasury's interpretive regulation, noting that "ever since the inception of the Tax Code, Congress has seen fit to vest in those

administering the tax laws very broad authority to interpret those laws." Id. at 596.

Notably, both of these cases, particularly Bob Jones University, strongly support the Treasury's discretion to change a long-standing statutory interpretation. in Bob Jones University, the Treasury, prior to 1970, had consistently interpreted section 501(c)(3) and its predecessors to allow bona fide educational institutions to qualify for tax exempt status without regard to whether they conformed in all respects to federal "public policy." The Treasury "abruptly" changed course in 1970 and read a public policy requirement into its construction of the IRC provision. 461 U.S. at 619 (Rehnquist, J., dissenting). In upholding Treasury's reinterpretation, the Supreme Court noted: "In an area as complex as the tax system, the agency Congress vests with administrative responsiblity must be able to exercise its authority to meet changing conditions and new problems." Id. at 596. The Court recognized that "the need for continuing interpretation of [the IRC] is unavoidable." Id. at 597.

Similarly, Reynolds upheld the Treasury's revised view of the statutory term "acquisiton" even though that view reversed prior administrative interpretation. See 313 U.S. at 430-31.

In Dickman v. Commissioner, 465 U.S. 330 (1984), the Supreme Court upheld an agency construction of the IRC which changed the

agency's interpretation of the gift tax "transfer" provisions. The Court noted:

> [I]t is well established that the Commissioner may change an earlier interpretation of the law, even if such a change is made retroactive in effect . . . . This rule applies even though a taxpayer may have relied to his detriment upon the Commissioner's prior position . . . . The Commissioner is under no duty to assert a particular position as soon as the statute authorizes such an interpretation.

Id. at 344 (citations omitted). See also Davis v. United States, 110 S. Ct. 2014, 2022 (1990) (noting in dicta that the IRS "may retain some flexibility to adopt other interpretations [of a statutory term] in the future"); Morrissey v. Commissioner, 296 U.S. 344, 354-55 (1935) (Treasury rulemaking authority is not "so restricted that the regulations, once issued, cannot later be clarified or enlarged so as to meet administrative exigencies or conform to judicial decision."); Cohen v. Commissioner, 910 F.2d 422, 427 (7th Cir. 1990) (upholding Treasury interpretation changing construction of gift tax measurement law); Yarbro v. Commissioner, 737 F.2d 479, 483 (5th Cir. 1984) (relying on Dickman to uphold interpretation of IRC provision regarding sales or exchanges of capital asset "by abandonment"). Thus, there is ample precedent both for Treasury's discretion to change its

interpretation of the IRC and for the judicial validation, under principles of deference, of such changes.40/

In sum, the case law relating to the Treasury's interpretive discretion in the capital gains and analogous contexts supports the conclusions that the concept of "cost" is ambiguous and that the Treasury has regulatory discretion to define and apply it in a manner that accords with economic reality and the principles underlying the taxation of income. Indeed, the cases, particularly Ludey, tend to confirm our view (supra at 47) that if the Treasury had initially defined the term "cost" in the IRC of 1918 to account for inflation, the agency's statutory construction would have received substantial deference and would have been upheld.

The agency did not, however, initially define "cost" to account for inflation, and a decision to do so now would

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40/ This support is not undercut by cases according judicial deference to Treasury regulations that represent a "contemporaneous" construction of the IRC provision at issue. See, e.g., National Muffler Dealers, 440 U.S. at 477; Bingler, 394 U.S. at 749; Fulman v. United States, 434 U.S. 528, 533 (1978); Fawcus Mach. Co. v. United States, 282 U.S. 375, 378 (1931). While some courts have suggested that Treasury interpretations that are not "contemporaneous" are entitled to less deference than contemporaneous interpretations, see, e.g., City of Tucson, 820 F.2d at 1287 n.26, the Supreme Court noted in National Muffler Dealers, 440 U.S. at 485: "Contemporaneity . . . is only one of many considerations that counsel courts to defer to the administrative interpretation of a statute. It need not control here . . . . We would be reluctant to adopt the rigid view that an agency may not alter its interpretation in light of administrative experience."

constitute a clear change in its long-standing practice. The inquiry into the validity of such a change must therefore address whether Congress has in some way adopted the Treasury's construction of "cost" and has thus precluded any regulatory change. In the absence of congressional action amending the IRC to incorporate expressly the Treasury's definition of "cost," the question becomes whether Congress has effectively adopted the Treasury's definition through inaction, either by reenacting the IRC without specifically changing the Treasury's definition of the term or by failing to enact legislative proposals designed to change the agency's definition and thus "acquiescing" in it. For the reasons discussed below, we do not believe that either argument based on congressional inaction is likely to be sustained in this case.

D. Adoption by Treasury of Capital Gains Indexing Is Not Foreclosed by Congress' Prior Reenactments of the IRC or by Its Failure To Enact Its own Indexing Measure

Prior to the enactment of the 1939 Code, Congress generally enacted entirely new revenue acts every two years or so. During this time, a doctrine developed giving Treasury regulations substantially more force if Congress had reenacted the revenue laws while the regulations were in effect without changing the provisions interpreted by the regulations.

The classic statement of the reenactment doctrine can be found in Helvering v. Winmill, 305 U.S. 79, 83 (1938): "Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law." The doctrine has even earlier antecedents, however. See, e.g., Morrissey, 296 U.S. at 355; Brewster, 280 U.S. at 337.

Although revenue acts are no longer generally reenacted every two years, the reenactment doctrine retains some vitality today. In the Cottage Savings case, announced only a year ago, the Supreme Court upheld the Treasury interpretation at issue, relying in part on the fact that the agency's interpretation had remained consistent since 1934. 111 S. Ct. at 1508. Quoting Winmill, the Court noted that such a long-standing administrative interpretation, applying to a substantially reenacted statute, was "deemed to have received congressional approval and have the effect of law." Id.[41/]

41/ See also Davis, 110 S. Ct. at 2021 ("Congress' reenactment of the statute in 1954, using the same language, indicates its apparent satisfaction with the prevailing interpretation of the statute."); Bob Jones University, 461 U.S. at 599 ("Congress' awareness of the [IRS interpretation at issue] when enacting other and related legislation make out an unusually strong case of legislative acquiescence in and ratification by implication of the 1970 and 1971 rulings.").

With respect to indexing capital gains, it could be argued under the reenactment doctrine that a new Treasury interpretation of "cost" has been congressionally precluded. In light of the Treasury's consistent and long-standing interpretation of cost to mean original cost, the reenactment of the IRC arguably gives the agency's interpretation the force of law. We believe, however, that the reenactment doctrine is not designed and cannot be utilized to support such an argument.

The reenactment doctrine has generally been invoked as a shield to taxpayer challenges to long-standing agency interpretations. The doctrine is not properly available to a taxpayer as a sword with which to invalidate a new interpretation promulgated by the Treasury. Were it otherwise, the doctrine would eviscerate the agency's well-recognized authority, discussed above, to revise its interpretations in light of experience, shifting policy imperatives, and/or changed circumstances.

This point was made clear in Helvering v. Wilshire Oil Co., 308 U.S. 90 (1939). The taxpayer in that case argued that Congress' reenactment of the revenue laws after the Treasury had interpreted a certain IRC provision prevented the Treasury from later changing its interpretation of the provision. Noting that "[t]ax statutes and tax regulations never have been static," id. at 97, the Court rejected the taxpayer's argument. The Court's discussion is worth quoting at length:

The oft-repeated statement that administrative construction receives legislative approval by reenactment of a statutory provision, without material change . . . covers the situation where the validity of administrative action standing by itself may be dubious or where ambiguities in a statute or rules are resolved by reference to administrative practice prior to reenactment of a statute; and where it does not appear that the rule or practice has been changed by the administrative agency through exercise of its continuing rulemaking power. <u>It does not mean that a regulation interpreting a provision of one act becomes frozen into another act merely by reenactment of that provision, so that administrative interpretation cannot be changed prospectively through exercise of appropriate rulemaking powers</u> . . . . The contrary conclusion would not only drastically curtail the scope and materially impair the flexibility of administrative action; it would produce a most awkward situation. Outstanding regulations which would have survived one Act could be changed only after a pre-view by the Congress. In preparation for a new revenue Act the Commissioner would have to prepare in advance new regulations covering old provisions. Their effectiveness would have to await Congressional approval of the new Act. The effect of such procedures, so far as time is concerned, would be precisely the same as if these new regulations were submitted to the Congress for approval. Such dilution of administrative powers would deprive the administrative process of some of its valuable qualities -- ease of adjustment to change, flexibility in light of experience, swiftness in meeting new or emergency situations. It would make the administrative process under these circumstances cumbersome and slow. Known inequities in existing regulations would have to await the advent of a new revenue act. Paralysis in effort to keep abreast of changes in business practices and new conditions would redound at times to the detriment of the revenue; at times to the disadvantage of the taxpayer. Likewise, the result would be to read into the grant of express administrative powers an implied condition that they were not to be exercised unless, in effect, the Congress had consented. We do not believe that such impairment of the administrative process is consistent

> with the statutory scheme which the Congress had designed.

Id. at 100-101 (emphasis added).[42/]

Two years later, in Helvering v. Reynolds, 313 U.S. at 432, the Court again made clear that the reenactment doctrine

> is no more than an aid in statutory construction. While it is useful at times in resolving statutory ambiguities, it does not mean that the prior construction has become so embedded in the law that only Congress can effect a change . . . . It gives way before changes in the prior rule or practice through exercise by the administrative agency of its continuing rulemaking power.

This understanding of the reenactment doctrine has been recognized in many cases since Wilshire and Reynolds. See, e.g., American Chicle Co. v. United States, 316 U.S. 450, 454-55 (1942); Campbell v. Brown, 245 F.2d 662 (5th Cir. 1957); Phillips Petroleum Co. v. Jones, 176 F.2d 737, 739 (10th Cir. 1949), cert. denied, 339 U.S. 904 (1950). See also Schuster v. Commissioner, 800 F.2d 672, 676 (7th Cir. 1986) (upholding change in Treasury construction of IRC provision despite argument that prior construction had been adopted by Congress through reenactment of the IRC).

42/ Thus, the Court's analysis in Wilshire rejected, although it did not explicitly overrule, the Supreme Court's earlier dicta in the case of Helvering v. R.J. Reynolds Tobacco Co., 306 U.S. 110 (1939). See Bittker ¶ 110.4.3

Indeed, the Wilshire-Reynolds discussion of the reenactment doctrine can be seen as a precursor to the vision of modern administrative law and the role of agencies recognized in cases like Chevron and Rust. These cases recognize that in order for an agency to fulfill its statutory mandate, it must have the flexibility to vary, within reasonable limits, its interpretations of governing statutes in accordance with experience and changes in policy perspectives and circumstances. A contrary rule, allowing an agency only one shot at interpreting a statutory provision, would drain all meaning from statutory delegations of interpretive discretion and would eliminate the very flexibility that is often the raison d'etre for the administrative scheme.[43/]

Thus, the Treasury would have, in our view, a very strong argument against the application of the reenactment doctrine to "carve in stone" its current interpretation of "cost." Rather, we believe that the doctrine would be seen merely as a rule of construction designed to assist a reviewing court in determining

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43/ Moreover, to give controlling effect to an administrative interpretation of the statute once that statute has been reenacted is effectively to transform an executive agency into a legislature. A prior administrative construction of the statute cannot permanently modify the meaning of the underlying legislation because an administrative construction does not meet the requirements in Article I for the passage of binding legislation. See INS v. Chadha, 462 U.S. 919 (1983). See also State Farm, 467 U.S. at 45 (Congress' "ratification of an agency construction for failure to change the underlying statute does not incorporate agency construction into statute.").

whether a new administrative interpretation of "cost" is reasonable, under the general standards of deference applied to agency interpretations of their governing statutes.[44/]

A similar issue is raised by Congress' failure to enact capital gains indexation legislation, which has been proposed at least five times over the last fifteen years. This question implicates the doctrine of "legislative acquiescence." The theory underlying the doctrine is that Congress' failure to enact a proposed amendment to an existing statute signifies a congressional determination that the law cannot be interpreted in accordance with the proposed amendment. See L. Tribe, Toward A Syntax of the Unsaid: Construing the Sounds of Congressional and Constitutional Silence, 57 Ind. L.J. 515 (1982).

As a theory of statutory construction, the legislative acquiescence doctrine suffers from most of the same flaws discussed above with respect to the reenactment doctrine. Most importantly, the doctrine is virtually blind to the simple truth that legislative proposals are rejected for an infinite variety of reasons, many having nothing to do with Congress' views concerning their merits. Allowing Congress' failure to enact a

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44/ See Fribourg Nav. Co. v. Commissioner, 383 U.S. 272, 283-86 (1966); United States v. Leslie Salt Co., 350 U.S. 383, 396-97 (1956). Each of these cases, which rejected a Treasury interpretation of the IRC, can be read as applying the reenactment doctrine merely as a rule of construction, rather than as automatically invalidating a later administrative interpretation.

measure to have controlling interpretive significance over the enactments of a previous Congress not only ignores the realities of the legislative process, but comes perilously close to transferring Congress' exclusive constitutional lawmaking power to executive agencies. As Professor Tribe has noted, "justifying an interpretation of a prior enactment by pointing to what a subsequent Congress did not enact seems incompatible with our constitutional structure." Tribe, 57 Ind. L.J. at 530 (emphasis in original); see note 43, supra; Puerto Rico Department of Consumer Affairs v. Isla Petroleum Corp., 485 U.S. 495, 501 (1988) ("[u]nenacted approvals, beliefs, and desires are not laws").

The Supreme Court has recognized these problems and has thus generally eschewed reliance on legislative acquiescence principles in this context. See, e.g., Aaron v. SEC, 446 U.S. 680, 694 n.11 (1980). The Court has repeatedly warned that "'the views of a subsequent Congress form a hazardous basis for inferring the intent of an earlier one.'" Consumer Product Safety Comm'n v. GTE Sylvania, Inc., 447 U.S. 102, 118 (1980) (quoting United States v. Price, 361 U.S. 304, 313 (1960)); see note 36, supra.[45]

45/ See also Girouard v. United States, 328 U.S. 61, 69 (1946) ("It is at best treacherous to find in Congressional silence alone the adoption of a controlling rule of law."); Cleveland v. United States, 329 U.S. 14, 22 n.4 (Rutledge, J., concurring) ("[I]n view of the specific . . . constitutional procedures required for the enactment of legislation," an

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In rare cases, however, the Court has found interpretive significance in congressional inaction. See, e.g., Pacific Gas and Elec. Co. v. State Energy Resources Conservation and Dev. Comm'n, 461 U.S. 190, 220 (1983) ("While we are correctly reluctant to draw inferences from the failure of Congress to act, it would, in this case, appear improper for us to give a reading to the Act that Congress considered and rejected."). In fact, the Court in Bob Jones University relied on such a legislative acquiescence theory in upholding a controversial 1970 Treasury Regulation requiring that tax exempt organizations conform to federal "public policy."

The Bob Jones University Court recognized that "[o]rdinarily, and quite appropriately, courts are slow to attribute significance to the failure of Congress to act on particular legislation." Bob Jones University, 461 U.S. at 600. Still, the Court found the particular circumstances surrounding Congress' nonaction in that case to have interpretive significance:

> Nonaction by Congress is not often a useful guide, but the nonaction here is significant. During the past 12 years their have been no fewer than 13 bills introduced to overturn the IRS interpretation of § 501(c)(3). Not one of these bills has emerged from any committee,

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"action or nonaction not taken in accordance with the prescribed procedures" should be given no "legislative effect.") (emphasis added); Texas Rural Legal Aid, 940 F.2d at 695; Tribe, 57 Ind. L.J. at 516-519.

> although Congress has enacted numerous other amendments to § 501 during this same period, including an amendment to § 501(c)(3) itself . . . . In view of its prolonged and acute awareness of so important an issue, Congress' failure to act on the bills proposed on this subject provides added support for concluding that Congress acquiesced in the IRS rulings of 1970 and 1971.

Id. at 600-601.

In contrast to the circumstances presented in Bob Jones University, however, we believe that Congress' failure to enact capital gains indexation legislation presents a very weak claim of legislative acquiescence. First, while Congress has not actually enacted a capital gains indexing proposal, the legislative history of Congress' consideration of such proposals reveals, if anything, that Congress favors the concept of indexing capital gains. Indeed, as previously discussed (supra at 54-62), indexation measures have passed in recent sessions of both the Senate and the House.

These facts obviously contrast starkly with the history of Congress' consideration of proposals to overturn the Treasury's "public policy" interpretation of section 501(c)(3), where none of the proposals, as the Bob Jones University Court emphasized, even got out of committee. Far from indicating its acquiscence in the existing administrative interpretation of "cost," Congress' deliberations on the issue to date suggest that a majority of both Houses would welcome a Treasury reinterpretation of "cost" to take account of inflation.

More important, however, than these stark factual distinctions between Bob Jones University and this case is the equally stark distinction in the postures in which the claims of legislative acquiescence arise. The Supreme Court in Bob Jones University invoked legislative acquiescence to uphold the Treasury's 1970 change in its prior long-standing interpretation of the IRC, as against a claim by taxpayers that the agency's reinterpretation was not authorized under the statute. Thus, the doctrine of legislative acquiescence buttressed and reinforced the principle of judicial deference to the administrative agency's construction of its statute. Here, in contrast, legislative acquiescence would be invoked as a sword to invalidate the Treasury's reinterpretation of "cost" to account for inflation.

We are aware of no Supreme Court case that has applied the doctrine of legislative acquiescence to void an otherwise valid administrative regulation construing the agency's own statute.[46]

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[46] The Supreme Court has invoked legislative acquiescence principles against the government in the context of de novo judicial review of the statutory issue in dispute. In these cases, however, the Court rejected the government's litigating position rather than a regulation presenting a formal agency construction of statutory language that the agency was charged with administering. See, e.g., Pacific Gas and Elec., 461 U.S. at 220; Federal Trade Comm'n v. Ruberoid Co., 343 U.S. 470, 478-79 (1952). Thus, the Court in these cases was not confronted with an agency psoition entitled to Chevron-type judicial deference. The distinction between the standards of judicial review applicable in these contexts is discussed in the text at 12-16, supra.

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Nor is it difficult to understand why the doctrine has not been applied by the Court as a sword, for invalidating an agency's statutory interpretation on the strength of a claim of legislative acquiescence would raise all the problems recognized, in the passage from Helvering v. Wilshire Oil Co. quoted earlier (supra at 77-79), with respect to the reenactment doctrine. Moreover, such a theory of legislative acquiescence logically could make the validity of agency changes in regulatory policy turn on the timing of judicial review of the agency's action. For example, if a Treasury reinterpretation of "cost" to account for inflation was challenged after a failed congressional attempt to overturn it, the doctrine of legislative acquiescence could be asserted in support of the agency's reinterpretation rather than in opposition to it. Finally, application of the doctrine as a sword against regulatory changes would be inconsistent with the

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In Andrews v. Shell Oil Co., 446 U.S. 657 (1980), the Supreme Court relied in part on legislative acquiescence principles in rejecting the Department of the Interior's changed interpretation of a statutory term. The agency did not argue, however, that its new interpretation was a permissible change in interpretation entitled to deference. Instead, the agency argued that its prior interpretation was "plainly erroneous" and that its new interpretation was required to correct the error. Id. at 662. The Court examined the legislative history of the original statute and concluded that the agency's prior interpretation was the correct one. Id. at 663-66. This conclusion was "confirmed" by the Court's review of later congressional action. Id. at 666.

principles of judicial deference enunciated in Chevron and analogous cases.

We thus do not believe that a Treasury Regulation indexing capital gains for inflation would be vulnerable to challenges based upon the reenactment doctrine or the doctrine of legislative acquiescence. This brings us finally to the question whether such a Treasury Regulation would be supported by a "reasoned analysis."

E. A Treasury Regulation Indexing Capital Gains Would Be Supported by a "Reasoned Analysis"

The Treasury, in our view, would clearly have reasoned support for reinterpreting the term "cost" to permit the indexing of capital gains. As discussed at length earlier in this memorandum, the indexation of capital gains not only furthers the purposes underlying the IRC, it better accords with economic reality than does the Treasury's current approach. The theory of taxation of incomes is to tax a person on an increase in his wealth -- on "a gain, a profit, something of exchangeable value . . . received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal." Eisner v. Macomber, 252 U.S. at 207. To the extent that a tax is imposed on a gain attributable to inflation, it is a tax on an illusory "gain" that may in fact be a loss in the taxpayer's purchasing power, his true wealth. Moreover, taxation of capital gains on an unindexed

basis disadvantages those taxpayers who have made long term investments in capital assets. The indexation of capital gains would, by more accurately assessing real income -- that is, the true increase in a person's wealth or purchasing power -- eliminate these effects and run truer to the principles underlying federal income taxation.

These same considerations support administrative indexation even though it represents a change from the Treasury's current and long-standing practice. In 1986 Congress virtually eliminated the preferential tax treatment historically accorded to capital gains. As previously discussed, this preferential treatment was expressly justified in part by the adverse effect of inflation on capital gains. The preferential tax treatment historically accorded to capital gains renders the Treasury's pre-1986 inaction on the subject of capital gains indexation unremarkable, and the virtual elimination of the preference by Congress supports current administrative action with respect to the issue.[47/] In short, the capital gains taxation regime has

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47/ Many economists support the policy, reflected in the 1986 Act, of eliminating any kind of preferential tax treatment for capital gains, which they see as producing undesirable economic distortions. As Richard and Peggy Musgrave have noted: "With regard to realized gains, most students of taxation hold that there is no good justification on equity grounds for preferential treatment . . . . There seems little doubt, on equity grounds, that realized capital gains should be treated as ordinary income." Musgrave and

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