Thirty Percent Of Zero - Part II

As if it is not bad enough that Obama would like to double the capital gains tax from 15 to 30 percent, the impact of the hidden tax of inflation should be considered by anyone trying to evaluate the full unfairness of his proposal. One enormous problem with the capital gains tax is that it is not indexed for inflation. The result is that investors pay tax *on what is actually not a gain at all.*

Consider the following example:

You buy $10,000 worth of stock in a company and hold onto that stock for 10 years. You then sell it for $18,000, realizing a gross profit of $8,000. You pay a 15 percent capital gains tax on the $8,000 gain, or profit. Your tax is $1,200.

$18,000 minus $10,000 equals $8,000; $8,000 times 15 percent equals $1,200.
Your net profit from the stock sale is $6,800 ($8,000 minus the $1,200 tax).

But don't forget that during the 10 years you held your stock, inflation has reduced the purchasing power of the dollar. Although the *price* of the stock has increased from $10,000 to $18,000, the *value* of the stock has gone up by $8,000 *minus* the inflation factor. A loaf of bread that used to cost $1.00 and now costs $2.00 is still nothing more than a loaf of bread. It may now *cost* $2.00, but that price increase may be a result of inflation—the government expanding the money supply—rather than an improvement in the product itself. Or, to look at inflation in another way, think of money as milk and the Federal Reserve as the dairy farmer. If he adds 10 gallons of water to 100 gallons of milk and sells you 110 gallons of milk, *would you feel cheated?*

As the Federal Reserve expands the money supply, year after year after year, the value of your money is "watered down." Assume that over 10 years inflation alone has increased the price of the stock by $6,000, and that only $2,000 of the stock increase is the result of increased value from the company's improved operating efficiencies, etc. That is, your $10,000 stock is now priced at $18,000, but $6,000 of the $8,000 gain or profit is merely the result of inflation. Or, to state it another way, the $18,000 you get from the stock sale has the purchasing power of only $12,000 because of 10 years of inflation. (Your money has been watered down.) You technically made a "real" profit of only $2,000—but you will have to pay the 15 percent capital gains tax on the full $8,000. Your final profit is therefore *not* $6,800; your profit is only $800:

$18,000 sale price minus the $10,000 purchase price gives you $8,000 gross profit
$8,000 minus $6,000 lost to inflation leaves you with a $2,000 "real" profit
$8,000 times 15 percent is your $1,200 capital gains tax
$2,000 "real" profit minus $1,200 capital gains tax leaves you with an $800 net/actual profit

You invested $10,000 over 10 years and have a mere $800 profit to show for your investment.

But Obama wants to *double* the capital gains tax to 30 percent. Under that scenario, you *lose money* on your 10-year investment:

$18,000 sale price minus the $10,000 purchase price gives you $8,000 gross profit
$8,000 minus $6,000 lost to inflation leaves you with a $2,000 "real" profit
$8,000 times 30 percent is your $2,400 capital gains tax
$2,000 "real" profit minus $2,400 capital gains tax leaves you with a $600 *net loss*

The IRS, Obama, and most members of Congress *do not care* that your profit has been eaten away by inflation. If they did, the capital gains tax would be adjusted for inflation. You must pay the tax on the difference between the sale price and the purchase price. In the above example, you must pay tax on the $8,000 profit *regardless of how much inflation has reduced the value of that $8,000.*

That, folks, is one reason why politicians *love* the hidden tax of inflation. Via the Federal Reserve, Ben Bernanke inflates the money supply. As a result, products and services *cost* more—but they are not necessarily *worth* more. Yet you are forced to pay taxes on the rising *price*, not the more slowly-rising *value*.

Congressman A: "Hey, I've got an idea! Let's tax *imaginary profits*!"
Congressman B: "That would never work. No one is dumb enough to fall for that."
Congressman A: "Well, let's just try it and see…"

Now you know why the capital gains tax is not indexed for inflation…

Don Fredrick
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Note: The ideal capital gains tax would, of course, be no capital gains tax at all. Instead, a flat tax of between 10–15 percent should apply to all income, regardless of source, with a standard deduction for every family member. By taxing all income equally, individuals would act in their own rational self interest—rather than acting to get around IRS regulations. (If the tax on rational activity is higher than the tax on irrational activity, individuals are encouraged by the law to act irrationally. It should *not* be the business of government to steer people one way or the other. Individuals should make employment and investment decisions based on what is reasonable, logical, and productive—*not* to avoid a tax.)

A flat tax—or a national sales tax *in place of* all taxes on income, capital gains, and dividends—has several advantages. First, it treats everyone equally. Second, it eliminates the ability of politicians to engage in class warfare. (If *everyone* pays the same tax rate, then *everyone* has an interest in keeping that rate low and in preventing wasteful government spending.) Third, it simplifies the tax code dramatically. (Add up your sources of income, subtract the standard deductions, and pay a flat 10–15 percent.) That

would free up the millions of man-hours and billions of dollars currently wasted on tax preparation. Fourth, it helps reduce tax-avoidance—especially with a national sales tax. (For example, the person who currently "works for cash under the table" to avoid paying income taxes would not be able to escape a national sales tax.)

Additional note: Some readers have claimed that the examples above are incorrect because inflation would not consume $6,000 of an $8,000 stock increase over 10 years. First, of course, the example is just that—an example. Second, inflation varies from year to year. Using the government's "official" inflation rate, $10,000 invested in 1970 would be equivalent to $21,260 in 1980! Between 1980 and 1990, inflation was less, and $10,000 would be "worth" $15,856. By 2010, $10,000 invested in 2000 would be the equivalent of $12,533—because, according to the government, inflation has been "tamed." These, those calculations (using http://www.westegg.com/inflation/) are based on what the government *says* the inflation rate has been. In actuality, inflation is much higher than the government pretends—as anyone who buys groceries and gasoline knows. In any event, the rate of inflation is irrelevant to the argument that the capital gains tax is not indexed to inflation. The taxpayer is therefore being forced to pay a tax on an imaginary gain—the higher the rate of inflation, the more the taxpayer is being cheated.