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## IRS: Heads I Win, Tails You Lose

By Richard W. Rahn

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### *Paying for inflation rubs more salt in capital-gains wounds*

Do you know who is perpetuating the biggest tax scam ever and who the victims are? It is an organization that claims to be a "service" to the people but whose actual behavior can be summed up in its unwritten motto, "Might means right." As tax day approaches, millions of Americans are finding they are victims of this scam. It is called the capital gains tax, and it is run by the Internal Revenue "Service."

Capital gains come from sales of stocks and bonds, businesses, real estate, art objects and anything else of value. The IRS capital-gains tax scam consists of two parts. First, it does not just tax real gains, but also imaginary gains resulting solely from government-caused inflation. The second part of the scam involves severely restricting the deductibility of net losses.

Most investors in the stock market or in real estate suffered major losses during the past year and are hurting. Taxpayers are allowed to deduct their losses from their gains but are restricted in deducting their net losses against ordinary income to just \$3,000 per year. Yet the government taxes people on 100 percent of their gains.

If you complain about the obvious unfairness and injustice of such a rule, the IRS will tell you that you can carry over your losses to future years, again subject to the \$3,000-per-year limitation. However, by not allowing taxpayers to take their full losses, the IRS in effect forces them to overreport their income in the year of the loss and then pay a tax on this imaginary income.

If you suffered a \$30,000 loss this past year, it will take you 10 years to recoup your total loss (assuming there is no inflation - ha, ha) or if you suffered a \$300,000 loss, you will need 100 years to recoup your loss.

As far as the IRS and Congress are concerned, the fact that you are unlikely to live another 100 years is your problem, not theirs - you lose, they win.

Economists and non-economists alike understand that price rises caused solely by inflation are not income - because there has been no increase in purchasing power from the inflation gain. The U.S. Constitution - i.e., the 16th Amendment - only gives Congress the power to "lay and collect taxes on incomes." Many legal scholars think taxing the portion of a capital gain caused by inflation is unconstitutional because it is not income. It is truly Orwellian to claim that an inflation-induced change in the price level is "income." (I will leave it up to the reader's imagination to picture which member of Congress would play which animal in "Animal Farm.")

Apologists for the present capital gains tax, including many members of Congress, claim that because some, but not all, capital gains are taxed at a lower rate (which the president wants to increase) that part of the unfairness is offset. However, the effective rate (inflation-adjusted) is almost always much higher than the statutory rate, and the Tax Foundation found that at times the effective rate has been as high as 300 percent.

Many studies, by both private and government researchers, have shown that often most of the tax is paid merely on inflationary gains, not real gains. The apologists also ignore the fact that most capital gains are taxed multiple times. For instance, investors in corporate stock pay a tax on their investment funds when they earn the money; then the corporation pays federal, state and local taxes before investors are taxed once again on the same stream of earnings. This multiple taxation of capital results in lower productivity and job growth.

Finally, the apologists claim the tax is paid only by the rich, which is another whopper. Anyone with a farm, small business or corporate stock - which includes most Americans - almost always pays capital gains taxes at some point. A person who has spent 30 years building a small business and sells it for \$300,000 in order to retire is considered "rich" that year by the political left and the IRS.

The IRS also charges capital gains taxes on the trading of commodities, such as metals, agricultural products, etc. Commodities trading is a zero-sum game because price decreases are as likely as price increases. (In fact, over the long run, the prices of most commodities fall in real - inflation-adjusted - terms because of productivity gains.) As a result, the only way the IRS can get tax revenue from commodity trades over the long run is by taxing the inflation component and limiting loss deductions - which are both fundamentally dishonest and unjust ways to tax. In addition, the tax on commodity trading is extremely costly to administer and prevents taxpayers from protecting themselves against the government-induced inflation.

Congress could easily stop the scam by permitting an inflation adjustment to the basis for a capital gain and allowing a full write-off of losses in the year in which they occur. Now is an ideal time to make these changes, given that capital-gains tax receipts will be very low because of the drop in the stock and real estate markets. If imaginary income were properly removed, these receipts would be close to zero.

As Bernard Madoff found out, it is a crime to tell people they have imaginary income, yet the folks at the IRS tell millions of taxpayers each year that they also have imaginary income - and worse yet, force them to pay tax on this nonexistent income. Why is Madoff in jail but the folks at the IRS and Congress who devised a similar scam still running free?

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