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Gains on Commodity Sales a Real Loser of a Tax

By Richard W. Rahn

THE IRS FORCES TAXPAYERS TO SHELL OUT FOR IMAGINARY GAINS ON COMMODITY SALES

Would you be in favor of a tax that loses money for the government, and penalizes entrepreneurship, job creation and economic growth? Only muddy-brained or mean-spirited people would favor such a tax — yet many such people are found in the Internal Revenue Service and Congress. The tax that I am referring to is the capital gains tax, and even more specifically, the capital gains tax as it is applied to the sale of commodities.

A capital gains tax liability occurs when you sell an asset for more than you paid for it. The asset could be stocks, bonds, real estate, art or gold and other commodities. There are many problems with the capital gains tax, and one of them is that it taxes inflation (which is a change in the price level caused by government monetary authorities) rather than income. Assume that in 1989 you bought a small Florida orange grove for $120,000, and this year you sold it for $180,000 (after maintaining it and replacing old or damaged trees). The IRS would say you have a $60,000 capital gain, and demand that you pay tax on it. The price level has doubled since 1989, so now you would need $240,000 to have the same purchasing power as $120,000 had in 1989. In real inflation-adjusted dollars, you suffered a $60,000 loss, not a gain — but many folks at the IRS, having little in the way of an ethical compass, will insist on taxing you on the imaginary gain — which is really a loss. (Note: There is no law requiring the IRS to tax imaginary capital gains; it was an administrative decision.)

It gets worse. Most commodities decline in real price over time, as the technology for producing them improves. The real price (inflation-adjusted) of wheat and corn is roughly one-sixth, and cotton one-tenth, of what it was a hundred years ago. The same is true with most metals, despite endless doomsayers claiming we are going to run out of this or that. The real price of aluminum is roughly one-fifth of what it was a hundred years ago. Even the price of oil has not increased — the current real price is close to what it was in 1920, despite the world having consumed hundreds of billions of barrels of the stuff. In 1920, many thought the world would run out of oil by 1930; instead, oil reserves have been growing much faster than consumption and no one alive today, or even their grandchildren, will see a world without oil at a reasonable price.

Given that the real price of most commodities tends to fall over long periods of time (with many ups and downs), the only way government can obtain tax revenue is by taxing the non-real gain due to inflation and restricting the deductibility of losses (which they do), since there are more real losses than gains. Most commodity prices have fallen, after reaching a cyclical high at the beginning of the Great Recession, which means, even in nominal terms (not-inflation-adjusted), the capital gains tax on commodities is a net revenue loser for the government.

The issue is of renewed importance because of the rise of new, private digital-like monies (e.g., bitcoin). In theory, all of those who use bitcoin and its competitors for purchases of real goods and services have to keep records of their acquisition price for each bitcoin they buy and the dollar equivalent price of each item they purchase with a bitcoin. They then have to calculate their capital gain or loss on each transaction, no matter how small. This task is so complex, costly and time-consuming, and virtually no one is likely to do it. As the use of private digital currencies expands, more and more people will be in violation.

Back in 1981, I wrote an article for The Wall Street Journal arguing that the capital gains tax on commodities trading was destructive, and a long-term money loser. At the time, Congress had established a "Gold Commission" to recommend whether gold ought to have a greater role in the U.S. monetary system because of the double-digit inflation the United States was experiencing at the time. Since 1977, it has been possible to make legally enforceable contracts for payment in gold. A major reason why private gold contracts have not become common is the capital gains tax on such transactions.

The IRS does have many tools that make avoiding the capital gains taxes on physical commodity trades very risky. However, it is very hard — almost impossible — for the IRS to monitor all of the bitcoin transactions because of the use of blockchain and other largely anonymous systems. The smart people are in the private sector — not at the IRS — developing alternatives to government monopoly money.

The solution is obvious — stop losing tax revenue, squashing economic growth and liberty, by trying to apply the capital gains tax to commodity and foreign currency transactions, including intangible commodities like bitcoin. Many countries do not apply capital gains taxes to commodity transactions, and a number of very economically successful and sensible countries, such as the Netherlands, South Korea, Luxembourg and Switzerland, do not even have a capital gains tax.

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