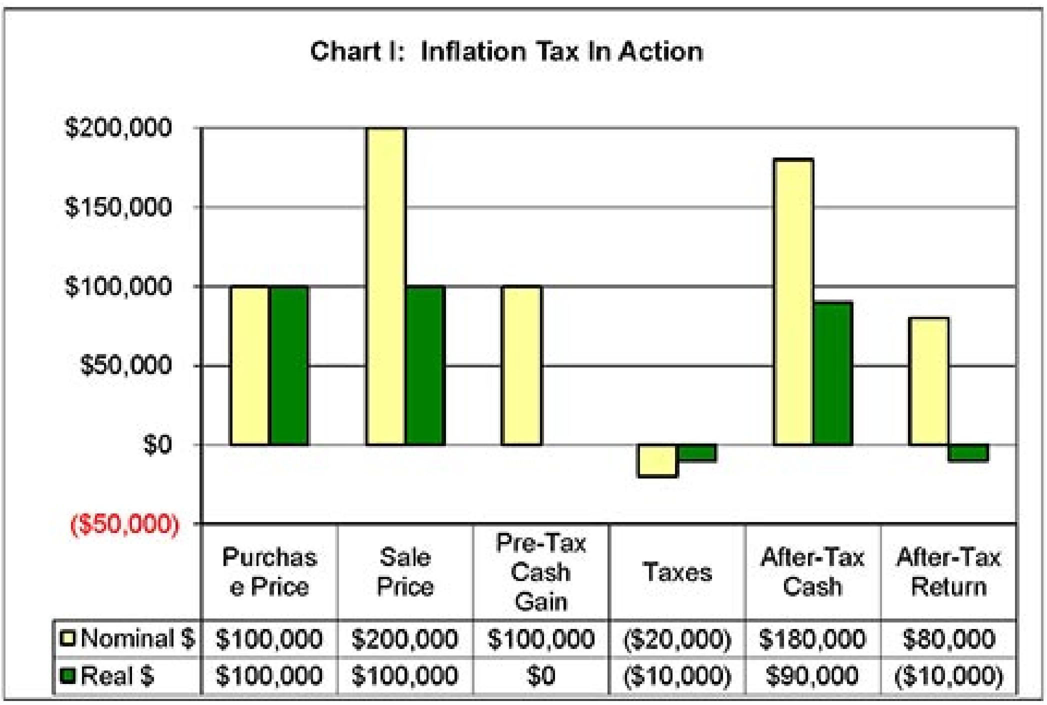
Chart I: The Inflation Tax In Action

Inflation: 100%
Tax Rate: 20%

	Nominal Dollars	Real Dollars (Inflation-Adjusted)
Purchase Price	**$100,000**	**$100,000**
Sale Price	**$200,000**	**$100,000**
Pre-Tax Cash Gain	$100,000	$0
Taxes	($20,000)	($10,000)
After-Tax Cash	$180,000	$90,000
After-Tax Return	$80,000	($10,000)
After-Tax Return (Percent)	80.0%	-10.0%

Ending Value Of The Asset:

What The Government Sees:	**$200,000**
The Economic Reality:	**$100,000**



The left column represents nominal dollars. You buy almost any kind of asset for $100,000, and hold it long enough and in most cases you will be eligible for long-term capital gains tax treatment. During that time, inflation destroys half the value of the dollar, meaning it now takes $2 to buy what $1 used to. (NOTE:7% inflation will halve the value of the dollar in 10 years. 3.5% halves it in 20 years.)

Our key assumption is that your asset exactly keeps up with the surge of inflation – meaning it likely did better than most investments. So you get $200,000 when you sell it – even though in purchasing power or real dollar terms, the asset is unchanged in value (the right column, and the dark green blocks and bars are real dollars).

The government does not recognize inflation in its tax policy, but rather sees only nominal dollars (the pale yellow bars and boxes). In other words, what the government sees is that you just made $100,000, and it wants its share in the form of $20,000 in capital gains taxes. Now as long as we ignore inflation, that's not so bad. We still have $80,000 in "profits". Indeed, that 80% after-tax return on investment may look pretty sweet.

The problem is when we adjust our 80% after-tax return for the technicality of a dollar only buying what fifty cents used to. That is, when we look at our real wealth in terms of the goods and services we can buy with the proceeds of selling our asset. When we go down the Real Dollars column and look with our dark green economic "eyes", we see that we bought the asset for $100,000, and sold it for $100,000; therefore in terms of real wealth – our pre-tax gain is zero. But, we still have to pay taxes. When we discount those future taxes to bring them back to current dollars, at least it drops the real cost in half, down to $10,000. So once we pay those taxes – in purchasing power terms we have $90,000 left.

Meaning that instead of making an $80,000 profit, as it appeared when looking at our tax return – we in fact lost $10,000 out of our $100,000 investment in real terms. We see that when we adjust for inflation and look at what a dollar will buy – our sweet 80% return vanishes, and what we are left with is a 10% loss on our investment.

We just met the "Inflation Tax". And it ran over us.