4-24-2009

Op Ed: Throwing Cold Water on Expensing of Assets

Deborah A. Geier
Cleveland State University, d.geier@csuohio.edu

Original Citation
Deborah A. Geier, Op Ed: Throwing Cold Water on Expensing of Assets, 123 Tax Notes 499 (2009)

Throwing Cold Water on Expensing of Assets

To the Editor:

With respect to the viewpoint submitted by William M. VanDenburgh, Philip J. Harmelink, and Nancy B. Nichols,[1] I do not wish to throw cold water on tax simplification efforts. Indeed, I served as an academic adviser to the Joint Committee on Taxation with respect to its 2001 simplification report because I strongly believe in simplification efforts. If the political will is there (the real problem), there are myriad ways in which Congress could dramatically simplify the law without reducing progressivity or revenue.

Nevertheless, I am compelled to respond to their call to allow immediate expensing of all assets except buildings (which would be depreciated over 10 years), with no mention of repealing the interest deduction. If expensing is allowed, it is absolutely essential that the interest deduction also be denied. I do not necessarily oppose expensing — even for buildings — though I would absolutely oppose it if the interest deduction continues to be allowed as well.

Though I prefer income taxation, a defensible case can be made for the tax base to be comprised of consumption, instead. Allowing both immediate expensing and an interest deduction, however, allows better-than-consumption-tax treatment, which is not defensible.[2] The authors appear to trivialize what is at stake by saying that "IRS resources could be better directed to pursuing other areas of noncompliance instead of what are essentially time value of money issues." The difference between an income tax and a consumption tax can be described, in one way, as a decision regarding whether we wish to tax the time value of money. But their proposal goes much further than simply not taxing the time value of money. In effect, they want not only to let the time value of money go untaxed but also, on top of that, to send a government check funded by taxpayer dollars collected from wage earners to anyone who buys business property.

Under an income tax, borrowed principal is excluded from the tax base, principal repayments are not deductible, business and investment expenses (including interest) are immediately deductible, and long-lived assets are depreciated over their lives. While the depreciation schedule applicable to any particular asset under current law may be too fast or too slow when compared to economic depreciation, we pretty much get it right overall. As a 2007 Treasury report notes:

> True economic depreciation is very difficult to measure. Nonetheless, at current inflation rates and when averaged across all investments, existing tax depreciation allowances appear to be fairly close to those implied by (existing estimates of) economic depreciation.[3]

Thus, if Sally purchases a widget-making machine for $100,000 using borrowed money, under an income tax she would (1) exclude the $100,000 borrowed principal, (2) not deduct the $100,000 outlay entirely in the year of purchase, (3) deduct the portion of the $100,000 purchase price in each year (including the purchase year) that corresponds to economic depreciation, (4) not deduct principal repayments, and (5) deduct interest payments.

In contrast, under a cash-flow consumption tax, borrowed principal would be fully included in the tax base, both principal and interest payments would be deducted, and 100 percent of the cost of new investments (even buildings) would be deducted in the year of purchase (expensed). An economically equivalent, but simpler, way to treat debt under a cash-flow consumption tax would be to exclude the principal (as under an income tax) but also deny deductions for both principal *and interest* payments. Under this simpler alternative, Sally's debt-financed purchase of a $100,000 widget-making machine would result in (1) exclusion of the $100,000 borrowed principal, (2) deduction of the entire $100,000 purchase outlay in the year of purchase, and (3) no principal *or interest* deductions.

Tax arbitrage — the mixing of income tax and consumption tax rules in our current tax code — can provide *better*-than-consumption-tax treatment (essentially, a double tax benefit for the same dollars to the same taxpayer) for some investments, and this usually occurs in the context of debt. What typically occurs is that the income tax treatment of debt is applied to an investment that is otherwise treated under consumption tax norms, such as allowing an interest expense deduction for a debt-financed investment that is immediately expensed.

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[1] "A Pragmatic, Incremental Approach to Tax Simplification," *Tax Notes*, Apr. 20, 2009, p. 342, *Doc 2009-5741, 2009 TNT 74-7.*

[2] For both good and bad reasons, Congress allows better-than-consumption tax treatment on social policy grounds when it allows deduction or credit of consumption outlays, such as for certain higher education costs, home mortgage interest, and charitable contributions, to name just a few. But the depreciation and business interest deductions are not of this ilk. They are part of the normative structure that attempts to properly measure the tax base.

[3] Treasury Department, "Business Taxation and Competitiveness," *reprinted in Tax Notes*, July 30, 2007, p. 399, at 412, n.24 (2007). For the report, see *Doc 2007-17146* or *2007 TNT 142-14.*

Currently, taxpayers who can take advantage of expensing under section 179 and yet also take full advantage of the interest deduction for their debt-financed, expensed investments are provided *better*-than-consumption-tax treatment for the portion of their investment that is expensed. But this is thought to be defensible only because section 179 is not based on internal-to-tax norms (providing a more accurate measurement of "income" under an income tax or "consumption" under a cash-flow consumption tax) but on the nontax policy decision (whether or not wise or defensible) to provide either an incentive for the small business person to invest in equipment or a simple subsidy for small business delivered through the tax system, unconnected to any incentive effect. If a rule providing special treatment is based not on tax norms (whether income tax norms or consumption tax norms) but rather on other social or nontax economic policy grounds, it's a red herring to argue that the treatment violates "tax" norms. Rather, the nontax goal that is sought to be accomplished should be identified and the merits of the provision then evaluated by considering whether it is tailored well to achieve those goals as efficiently and fairly as possible without undue windfall benefits, etc. Whether section 179 is the best, most efficient means to deliver the intended incentive or subsidy effect for small business is beyond this letter. The point is that section 179 expensing is not premised on tax norms, per se. Therefore, the fact that section 179 expensing coupled with a full interest deduction provides small business with better-than-consumption-tax treatment is not necessarily a persuasive criticism of the rule if Congress intends just such a special incentive or subsidy for small business and believes that section 179 is the best way to deliver it.

The proposal here, however, is not cut from the same cloth as section 179. The authors argue for full expensing (except for 10-year depreciation of buildings) for all assets and all taxpayers in order to accomplish simplification. If simplification is the goal, then the interest deduction must also be denied. Because tracing is too difficult (and notoriously ineffective), we should not disallow only interest deductions that can be traced to debt-financed investments that have been expensed. The same simplification value that causes them to argue for full expensing (rather than simplified depreciation schedules) likewise supports full repeal of the interest deduction, period.

Best wishes,

Deborah A. Geier
Cleveland-Marshall
College of Law
Cleveland State University
Apr. 21, 2009