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Loose Application of the Depreciation Doctrine
 Deborah Geier
 120 Tax Notes 989 (Sept. 8, 2008)

In their commentary,^{/1/} Messrs. Torosyan and Johnson do note that the IRS has not acquiesced in the Liddle and Simon decisions, which allowed professional musicians to depreciate historically significant antique musical instruments and bows that had an infinite life in the collector market after their playing lives were over. They nevertheless proceeded to encourage taxpayers to expand the application of Liddle and Simon beyond their facts, encouraging depreciation of other antiques and metals whose lives similarly are potentially infinite. This is wrong as a theoretical matter,^{/2/} and I hope that the IRS continues to challenge allowance of such depreciation on the merits.

A loose application of capitalization doctrine that allows current expensing of what should be categorized as nonde-
 ductible capital expenditures, as well as premature deduction of capital expenditures under the depreciation provisions, inadvertently provides consumption tax treatment (rather than income tax treatment) through the back door.^{/3/} Worse than that, because many (if not most) of these assets are debt-financed and take advantage of the income tax treatment of debt (rather than the consumption tax treatment of debt), the investment can result in better than consumption tax treatment -- tax arbitrage (a double tax benefit for the same dollars to the same taxpayer), or even a negative tax rate.^{/4/}

Under an income tax, capital expenditures should not be deducted, depreciation should allow only the final, irretrievable passage-of-time losses that occur as an asset comes ever closer to the end of its useful life (even as transient market forces provide for transient increases in fair market value), returns in excess of tax-free basis recovery should be fully included in the tax base, and business and investment interest should be deductible. Under a cash-flow consumption tax, investment outlays would be fully deductible in the year of the outlay (that is, there would be no distinction between a current "expense" and a "capital expenditure" in income tax jargon), the entire amount realized (with no basis recovery) would be includable in the tax base, and no interest would be deductible.^{/5/} An economically equivalent method (which we can, for convenience, call a wage tax) would prevent deduction of the investment outlay, exclude all returns from the investment, and disallow deduction of interest expense.

Congress knows well how to draft consumption tax provisions (whether of the cash-flow consumption tax or wage tax variety) when it wishes to provide more favorable consumption tax treatment. For example, it allows exclusion of home sale gain, deferred recognition of certain other realized gains (such as like-kind exchanges), exclusion of state and local bond interest, and exclusion of Roth IRA returns after initial nondeduction of the original investment -- wage tax provisions, all. It allows immediate expensing of certain capital expenditures incurred by small businesses under section 179 and immediate deduction (or exclusion) of traditional IRA contributions, coupled with full inclusion of the return on the investment -- cash-flow consumption tax provisions. Interpreters of the statute, whether the IRS or a court, should be wary of extending favorable consumption tax treatment when Congress has not clearly contemplated the more favorable treatment.

This, unfortunately, was done by both the Second and Third circuits in the Simon and Liddle cases. The authority to take a depreciation deduction is found only in section 167, which contains the words "there shall be allowed as a depreciation deduction." Section 168 provides only the manner in which depreciation should be calculated for tangible property that satisfies the requirements for depreciation in section 167(a). Section 167(a) allows depreciation only if (1) the asset is used in business or investment (rather than in personal consumption) and (2) the asset is subject to "wear and tear." The "wear and tear" language was not amended when section 168 was enacted, and that language has always been interpreted (prior to Simon and Liddle) to mean that the asset must be a wasting asset over time. (This has sometimes been captured in the language "ascertainable useful life.") This hoary interpretation makes sense in the context of income tax theory. If an asset does not waste over time, no permanent, irretrievable loss in the one strand of value reflecting the passage of time^{/6/} occurs, and depreciation would allow premature deduction, consistent with a consumption tax rather than an income tax.

The Simon and Liddle courts concluded (remarkably, in my opinion) that the unamended "wear and tear" language in section 167(a) took on a new meaning when a separate statute was enacted (section 168). When you think about it, that is an unusual feat of statutory interpretation marksmanship. There is no reason to think that Congress intended non-wasting assets to be suddenly depreciable under section 167(a) when it enacted section 168. The legislative history (both the Conference Report and the blue book) clearly provided:

Assets used in a trade or business or for the production of income are depreciable if they are subject to wear and tear, decay or decline from natural causes or obsolescence. Assets that do not decline in value on a predictable basis or do not have a determinable useful life, such as land, goodwill, and stock, are not depreciable.^{7/} In enacting section 168, it is clear that Congress intended to make the mechanics of determining the depreciation deduction much easier by allowing deduction over recovery periods that did not necessarily have any real connection to the asset's actual useful life. But there is no reason to believe that Congress, by downplaying the importance of useful life in calculating the rate of depreciation, intended to oust the concept of useful life (that is, the concept of a wasting asset under the "wear and tear" language) from the determination under section 167(a) regarding whether an asset is depreciable at all in the first place.

Yet, the Second and Third circuits dramatically uprooted the section 167(a) "wear and tear" language from its previous conceptual moorings and newly interpreted the unamended words in a literal fashion to mean only that the asset must be subject to physical manifestations of use -- regardless of whether the asset has an infinite life in the collector market. Through this dramatic reinterpretation of this unamended language in section 167, the courts extended what in effect is consumption tax treatment (premature deduction of an investment with a potentially infinite life) without a clear indication from Congress that it intended such treatment. Absent a clear indication from Congress that consumption tax treatment is intended, courts and the administrators of the statute should (in my view) interpret language to be consistent with the default rule that the tax base should be comprised of "income."

Mistakes like this are exacerbated when the investment being treated favorably under consumption tax principles is debt-financed, and the income tax treatment of debt is respected. The mixing of consumption tax treatment of an investment (either premature deduction of a capital expenditure or exclusion of an investment return) with the income tax treatment of debt (deduction of the interest) can result in better than consumption tax treatment. Under either a pure income tax or a pure consumption tax, the same dollars should not provide a double tax benefit to the same taxpayer -- tax arbitrage that reduces the effective tax rate or even garners a negative tax rate for the taxpayer. This precept is implemented in different ways under a consumption tax and income tax, but both share this fundamental precept.

The mixing of the income tax treatment of debt with consumption tax provisions embedded in the Internal Revenue Code (providing double tax benefits to the same taxpayer for the same dollars) is a real problem. Congress attempts to prevent this tax arbitrage in the most obvious cases in which it can apply. For example, if debt is used to purchase tax-exempt section 103 bonds, the interest is not deductible, thanks to section 265(a)(2) (though this provision is notoriously difficult to enforce). A more subtle example is section 163(d)(4)(B)(iii). The reduced rate for net capital gain approaches consumption taxation. Under the wage tax version of consumption taxation, the return would be fully excludable. Net capital gain is not fully excludable but is subject to a reduced tax rate. Taxpayers cannot both deduct investment interest fully (against ordinary income) and have their net capital gain taxed at lower rates.

At other times, however, Congress is either not aware of or chooses to allow tax arbitrage in the form of allowing full interest deductibility on debt used to finance an investment being treated under consumption tax norms. For example, a taxpayer using borrowed money to buy an investment that is expensed under section 179 is effectively engaging in allowable tax arbitrage (exclusion of the loan proceeds, immediate deduction of the investment purchased with those loan proceeds, and deduction of the interest on that debt). If both the investment and the debt were treated under consumption tax norms, the investment would still be immediately deductible, but the interest would not be deductible.^{8/} We have to assume, however, that Congress intended this tax arbitrage to be permissible, because it specifically enacted section 179 to allow consumption tax treatment and, at the same time, did not limit the deductibility of the interest on debt used to purchase those expensed assets. If section 179 is explained as a tax expenditure rather than a normative provision, however, this extremely favorable treatment might make sense.

While depreciation under an income tax is a normative provision (one that seeks to measure "income" properly), the artificially reduced recovery periods in section 168 were clearly intended to be tax expenditures in the form of a subsidy to business to invest in such assets. In that sense, sections 167 and 168 contain both normative and tax expenditure elements. It is not at all clear, however, that Congress intended not only to allow artificially reduced recovery periods that do not match actual useful life but also to change the fundamental nature of which assets are depreciable in the first place. Indeed, the above-quoted language from the legislative history implies just the opposite.

Only a court interpretation of the unamended "wear and tear" language has changed its meaning from assets that waste over time (that is, that have an ascertainable useful life) -- an interpretation that makes sense in the context of income tax theory -- to assets that show some signs of physical use, whether or not the asset wastes over time or has an infinite life in another market. The fact that the asset may become unusable in one market does not mean that it should be depreciable if it has an infinite life in another market. Land, for example, can become unusable for, say, farming over some predictable period of time. Nevertheless, land is clearly not depreciable (even to the Liddle and Simon courts), because it can be used for another purpose in another market.

In sum, Liddle and Simon were wrongly decided. They should not be extended even further.

Best wishes,

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Sept. 3, 2008

FOOTNOTES /1/ Andy A. Torosyan and Joseph M. Johnson, "Rethinking Depreciation of Antiques and Metals," Tax Notes, Sept. 1, 2008, p. 853, Doc 2008-18061, 2008 TNT 171-25.

/2/ See Joseph M. Dodge and Geier, "Simon Says: A Liddle Night Music With Those Depreciation Deductions, Please," Tax Notes, Oct. 30, 1995, p. 617, 95 TNT 213-39.

/3/ See generally Deborah A. Geier, "The Myth of the Matching Principle as a Tax Value," 15 Am. J. Tax Pol'y 17 (1998).

/4/ See Joseph M. Dodge, J. Clifton Fleming, Jr., and Deborah A. Geier, Federal Income Tax: Doctrine, Structure & Policy 67-85 (3d. ed. 2004).

/5/ Under a pure version of the cash-flow consumption tax, the receipt of borrowed principal would be fully included in the year of receipt, and the repayment of principal as well as interest would be fully deductible. The same economic result could be obtained, however, if principal receipt and repayment were ignored but interest were not deducted.

/6/ Assets are properly depreciable if they are wasting assets even if they are temporarily increasing in fair market value. Several factors affect fair market value, only one of which is a permanent loss in value as a wasting asset comes ever closer to the end of its life. Other (transient) factors that affect fair market value can temporarily overcome the fact that the asset is one year closer to the end of its life, but this does not mean that a permanent, irretrievable (that is, realized) loss has not occurred. See generally Dodge, Fleming, and Geier, *supra* note 4, at 679-705.

/7/ Economic Recovery Tax Act, Conference Report, at 206: Blue Book at 41 (emphasis added).

/8/ Stated another way, the loan proceeds would be immediately includable, and both principal and interest payments would be deductible. If the receipt and repayment of principal is ignored, however, the interest must be nondeductible under a consumption tax. See *supra* note 5.