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Expensing and the Interest Deduction

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It was heartening to see support among the business community at a recent Washington conference on business taxation for a revenue-neutral repeal of special tax breaks, such as the deduction for U.S. production activities, in exchange for lower corporate marginal tax rates — harkening back to the halcyon days of the Tax Reform Act of 1986.[1] Congress can and should go even further, by returning to the 1986 act's repeal of the special reduced tax rate on capital gains, and should fully integrate the corporate and individual taxes so that income is taxed "once but only once" — as long as the integration method is sufficiently robust to ensure that income does not effectively escape tax entirely — Coupling low effective (as opposed to marginal) corporate tax rates (because of our narrow, loophole-ridden corporate tax base) with a low rate imposed at the individual level not only on stock returns with respect to corporations subject to the separate subchapter C tax but on all capital assets (whatever they are — carried interest, anyone?) is an inefficient and unsatisfying alternative.

But another alternative was also discussed at the Washington conference: broadening the corporate tax base, keeping corporate tax rates the same, but allowing immediate deduction (expensing) of as much as 80 percent of the cost of all new investments.[2] After reading the Treasury report that served as the background for the conference, it was not clear to me whether 80 percent expensing would be limited to subchapter C corporations or whether it would be available to individual sole proprietors and subchapter K entities as well. More important, it also was not clear to me whether the interest deduction would be denied for debt-financed investments to the extent that they were expensed. This is a crucial requirement that must attach to any expensing proposal if we are to avoid providing *better*-than-consumption-tax treatment (tax arbitrage), which is already a problem in the current U.S. hybrid income/consumption tax and would be exacerbated markedly if 80 percent expensing were allowed together with interest deductions on debt-financed investments that were expensed.

Under a pure income tax, borrowed principal is excluded from the tax base. (The receipt is not considered a wealth accession because of the absolute obligation to repay.) Principal repayments are not deductible because they represent no loss in wealth, a prerequisite for a deduction under an income tax. (The cash outlay is offset by a reduction in the taxpayer's liabilities, leaving net worth unchanged.) But business or investment interest payments are deducted, as those outlays represent a current wealth reduction. The purchase of a wasting business or investment asset with a useful life extending substantially beyond the end of the year is a nondeductible capital expenditure, because the outlay merely changes the form of the taxpayer's wealth (from cash to an asset in kind) without reducing wealth on purchase. But a pure income tax also provides for depreciation deductions over the life of the wasting asset as it is used up in producing income, called economic depreciation, because economic depreciation represents an irretrievable wealth reduction arising solely because of the passage of time. While the depreciation schedule applicable to an asset under current law may be too fast or too slow when compared with economic depreciation, the tax code pretty much gets it right overall. As the 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 a pure 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 pure cash-flow consumption tax (or a cash-flow business tax imposed on corporations), borrowed principal would be fully included in the tax

[1] Heidi Glenn, "Business Leaders Would Give Up Tax Breaks for Lower Rates," *Tax Notes*, July 30, 2007, p. 324, *Doc 2007-17544*, *2007 TNT 145-3*.

[2] *See id.* at 325.

[3] Treasury Department, "Business Taxation and Competitiveness," [hereinafter Treasury report], *reprinted in Tax Notes*, July 30, 2007, p. 399, at 412, n.24 (2007).

base, both principal and interest payments would be deducted, and 100 percent of the cost of new investments 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 but also deny deductions for 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.

The mixing of income tax and consumption tax rules in the current Internal Revenue 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. Congress explicitly denies this tax arbitrage in some circumstances but not in others. For example, E. Cary Brown showed many years ago that an economically equivalent way to reach the same result as 100 percent expensing is to deny expensing but to exempt the return on the investment from tax. Thus, any provision in the IRC that exempts investment return is a cash-flow consumption tax provision (in disguise). The most obvious of these is the section 103 exclusion for interest earned on state and local bonds. To prevent tax arbitrage, however, Congress enacted section 265(a)(2), which denies the usual income tax treatment of debt (the interest deduction) for debt used to purchase or carry section 103 bonds. Rather, the cash-flow consumption tax treatment of debt (interest deduction denial) is required for this investment because the investment itself is treated under cash-flow consumption tax norms. Congress would also have to deny an interest deduction if the interest return on state and local bonds were included in the tax base (contrary to current law) but the cost of the bond itself were allowed to be 100 percent expensed in the year of purchase.

In short, the one clearly incorrect outcome for Sally's debt-financed purchase of her widget-making machine would be to provide her cash-flow consumption tax treatment for the purchase outlay (100 percent current expensing in the year of purchase instead of economic depreciation deductions over time) coupled with income tax treatment for the debt (deduction of her interest expense). If she is allowed to expense her debt-financed investment, her interest deductions must be denied.

Currently, taxpayers who can take advantage of expensing under section 179[4] yet also take full advantage of the interest deduction for their debt-financed, expensed investment 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 economic policy grounds, the argument that the treatment violates tax norms is a red herring.[5] Rather, the nontax

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[4]In general, section 179 allows taxpayers who place into service no more than $500,000 of equipment to expense the first $125,000 and depreciate the rest. The $125,000 deduction is reduced, dollar for dollar, by the amount by which the total amount of equipment placed into service exceeds $500,000, which means that the expensing amount is reduced to zero for taxpayers who place at least $625,000 of equipment into service for the year. The expensing amount was $25,000 and the phaseout threshold was $200,000 as recently as 2002. Before the recent enactment of the Small Business and Work Opportunity Act of 2007, the expensing amount was $100,000 and the phaseout threshold was $400,000. The repeated expansion of section 179 in recent years is one example of the encroaching presence of consumption tax provisions in the tax system, increasing tax arbitrage opportunities when combined with the income tax treatment of debt.

[5]For example, it's a red herring to argue that the home mortgage interest deduction is indefensible *simply* because the imputed income from owner-occupied residences is not included. That "tax norm" argument would be persuasive only if the reason for providing the home mortgage interest deduction was to more accurately measure the taxpayer's income. But the home mortgage interest deduction is a tax expenditure, or a provision that exists for nontax reasons. In evaluating whether a tax expenditure is wise, you must identify the nontax reason for its existence and then evaluate whether the tax provision is the best means to deliver that nontax goal. I believe that the home mortgage deduction fails woefully under any such analysis and should be reformed. *See* Deborah A. Geier, 25 *ABA Section of Taxation Newsletter* (Point/Counterpoint column) (Winter 2006). But my reasoning has nothing to do with the fact that we don't tax the related imputed income.

Similarly, Congress apparently allows arbitrage with the use of borrowed money to purchase a traditional (deductible) IRA. Under a pure income tax, the taxpayer would exclude the borrowed principal, not deduct the investment, include the return on the investment, and deduct the interest. Under a pure cash-flow consumption tax, she would include the borrowed principal, deduct 100 percent of the cost of the investment, and deduct principal and interest payments. Alternatively, she would be allowed to exclude the principal, deduct 100 percent of the cost of the investment, and *not* deduct principal and interest payments. Under none of these scenarios would the taxpayer be permitted to exclude the borrowed principal, deduct 100 percent of the investment, and deduct the interest as well. Under current law, however, that's just what the taxpayer is able to do, although the interest deduction is denied under section 163(d) until investment income (even if unrelated) is included. In short, the taxpayer is able to exclude *and* deduct the same dollars — a double tax benefit for the same dollars. Perhaps Congress believes that it should provide *better*-than-consumption-tax treatment to encourage greater retirement savings. Or perhaps Congress has not fully realized that it is providing *better*-than-consumption-tax treatment when debt is

(Footnote continued on next page.)

goal that is sought to be accomplished should be identified and the merits of the provision then evaluated by considering whether it is tailored to achieve those goals as efficiently and fairly as possible without undue windfall benefits and so on. Whether section 179 is the best, most efficient means to deliver the intended incentive or subsidy effect for small business is beyond this article. 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 Treasury report states explicitly that the proposal grows from the desire to move away from taxing income and toward taxing consumption. The report states:

> Full expensing of investment is a key component of moving from income taxation to cash-flow taxation at the business level. It is also central to the taxation of investment under several approaches to consumption taxation, such as a subtraction-method value added tax and an X-tax [a consumption tax proposal championed by the late economist David Bradford], both of which impose a cash-flow tax at the business level. . . . Partial expensing can be thought of as a two-tiered tax with full expensing on a portion of the investment and income taxation (i.e., economic depreciation) on the remainder.[6]

Because this proposal is based on consumption tax norms, any such proposal must be accompanied by a companion provision to deny the interest deduction on debt-financed investments to the extent that the investment is expensed. This requirement would be difficult to implement, however, because the Treasury report notes that old investments would (as a political matter) likely be extended grandfathered treatment for continued economic depreciation. Because debt dollars are highly fungible (and tracing is notoriously difficult), it would be relatively easy to mortgage old property or borrow to finance current operating expenses while using cash to purchase new investments. The difficulty in enforcing section 265(a)(2) itself is a testament to this fact.

However the problem must be dealt with if this proposal is to go forward. The worst of all possible outcomes would be to allow up to 80 percent expensing (largely cash-flow consumption tax treatment) coupled with full deductibility of all interest (income tax treatment). This combination would allow just what section 265(a)(2) disallows. Section 265(a)(2) would not, of course, apply because consumption tax treatment is not obtained under the new proposal by denying expensing but allowing exemption of the return (as under section 103) but rather by allowing expensing of the investment and inclusion of the return. But, as illustrated above, these are economically equivalent means of achieving the same consumption tax result. For the same reason that section 265(a)(2) denies interest deductions for debt incurred to purchase or carry bonds whose return is free of tax, interest deductions must be denied for a debt-financed investment whose return is included but which was expensed on purchase. The Treasury report is silent on this matter.

That brings me — finally! — to the main point of this article. The difficulty of envisioning an *effective* provision that would deny interest deductions in this context may be reason enough to advocate for the alternative proposal described at the beginning of this viewpoint. The mixing of consumption tax provisions with the income tax treatment of debt in the U.S. tax system already provides too many opportunities for tax arbitrage. The expensing proposal would exacerbate these problems. The alternative proposal of broadening the base and lowering the rates (especially if coupled with eliminating the capital gains preference and integrating the corporate and individual taxes) would go far toward *reducing* the unfortunate mixing of consumption and income tax provisions in a single tax system that already provides too many tax arbitrage opportunities.[7]

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used to take advantage of what would otherwise be considered pure consumption tax treatment for retirement savings.

[6]Treasury report, *supra* note 3, at notes 26 and 27.

[7]The reduced rate on capital gains can be viewed, at the individual level, as a subtle, partial consumption tax provision embedded in our hybrid tax. As illustrated with the section 103 example, one means of employing consumption tax values would be to exempt capital returns entirely but deny all economic depreciation and interest deductions. Just as the Treasury report recognizes that allowing 80 percent expensing effectively exposes an asset to bifurcated income/consumption tax treatment (with 80 percent subject to consumption tax norms and 20 percent subject to income tax norms), an asset producing low-taxed capital gain can be thought of as a bifurcated asset, part of which is subject to full tax at ordinary rates and part of which produces an exempt return. Indeed, the denial of the investment interest deduction pertaining to assets producing low-taxed capital gain in section 163(d)(4)(B) is premised on the same notion that supports section 265(a)(2). Eliminating the reduced rate on capital gain would alleviate another point of tension in our hybrid income/consumption tax.