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# Government as Investor: The Case of Immediate Expensing

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### Government as Investor: The Case of Immediate Expensing

*Rebecca N. Morrow*<sup>1</sup>

#### ABSTRACT

*For more than sixty years, tax scholars have recognized conditions under which the government ceases to be a mere taxing entity—imposing a rate of tax on a business’s profits—and through the operation of tax law becomes more like an investment partner—contributing its fair share of capital to new investments and proportionately sharing in losses as well as gains. These conditions, which are satisfied by immediate expensing policies, are now common.*

*The investment partner analogy has been analyzed from the perspective of a taxpayer who, as a result of partnership-like treatment, enjoys returns on investment that are effectively tax-exempt. However, far less attention has been paid to the government’s perspective. The government—based solely on the operation of tax law—contributes capital to and assumes risks of investments it does not select.*

*This Article argues that when tax policies make the government descriptively less like a taxing entity and more like an investor, it should do what any rational investor is expected to do: identify its attributes as an investor, consider how these attributes affect its investment priorities, and seek ways to align its investments with its priorities. Taking the example of immediate expensing, this Article*

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*identifies several changes that the government might make to tax laws to better align capital investing with its own preferences regarding risk, reward, and timing.*

*After identifying several potential policy changes implied by the government's investment role, this Article considers which changes make sense given the other priorities and roles of the government. In some cases, the government-as-investor perspective offers new justifications for tax policy changes that have long been advocated. In other cases, it suggests changes that should be rejected as inconsistent with the government's competing priorities and roles. And in several cases, it reveals new policy prescriptions that should be adopted because they advance the government's investment priorities, while at the same time advancing traditional tax goals and broader social goals. These changes could reduce distortion, increase revenues, promote economic stability, and even protect involuntary and unsecured creditors.*

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## INTRODUCTION

It is not surprising that scholars of tax and economics have given such long-standing, diverse, and detailed attention to decisions between capitalization<sup>1</sup> and immediate expensing (the immediate deduction of the full cost of a long-term investment in the year it is made). Disagreements between taxpayers seeking to immediately expense their investments and IRS agents seeking to have those investments capitalized and recovered gradually over time are the single most common cause of audits and the single most expensive source of deficiencies for large and mid-sized businesses.<sup>2</sup> At heart, decisions about whether investments should be capitalized and deducted gradually as they lose value over time or whether they should be immediately expensed are decisions about whether our system should aim to tax income or consumption.<sup>3</sup> The argument about whether a

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<sup>1</sup> When an outlay is capitalized, it is not immediately deducted. Instead, the outlay creates “cost basis” in the purchased asset. 26 U.S.C. § 1012(a) (2012). If the asset is depreciable tangible property, this cost basis is recovered gradually over time through § 167 and § 168 “depreciation deduction[s].” *Id.* §§ 167(a), 168(a). If the asset is amortizable intangible property, this cost basis is recovered gradually over time through § 167 and § 197 “amortization deduction[s].” *Id.* §§ 167(a), 197(a). Finally, if the asset is neither depreciable nor amortizable, the cost basis is recovered upon asset disposition. *See id.* § 165(a) (providing that the owner of an asset may take a loss deduction if it is sold for a loss, abandoned, or otherwise disposed of for a loss); *id.* § 1001(a)–(b) (providing that when the owner of an asset sells it, she is not taxed on the full sale proceeds (known as “amount realized”) but only on the gain, which is defined as the excess of sale proceeds over her unrecovered basis in the asset).

<sup>2</sup> U.S. GEN. ACCOUNTING OFFICE, GAO/GGD-95-232, TAX ADMINISTRATION: RECURRING ISSUES IN TAX DISPUTES OVER BUSINESS EXPENSE DEDUCTIONS 2 (1995) (“In the 117 Office of Appeals cases, large corporate taxpayers disagreed with IRS most frequently over the issue of capital expenditures, which accounted for about 42 percent of the issues they contested. It was also the issue with the most dollars at stake in the 117 cases, accounting for \$1.1 billion of the total \$1.9 billion in proposed tax adjustments. In these cases, the corporations argued for immediate deduction of large expenses[,] . . . [while] IRS contended that such expenditures had future benefits and should therefore be treated as capital expenditures, not immediately deductible in the current tax year.”); John W. Lee, *Transaction Costs Relating to Acquisition or Enhancement of Intangible Property: A Populist, Political, but Practical Perspective*, 22 VA. TAX REV. 273, 277 (2002) (footnotes omitted) (“[O]ver the last decade, expensing versus capitalizing of costs with present and future, often intangible benefits became the most significant federal income tax issue in audits of big businesses, which report the bulk of both the corporate sector income and additional tax revenues raised by tax audits and collections. An indicator of this phenomenon was the action of the Internal Revenue Service (Service) in directing team tax auditors of the largest 1500 or so corporations . . . to examine specific expensing/capitalizing issues . . . .”); *id.* at 278 (explaining that “[b]etween 25% and 40% of the audit and litigation resources of the Large and Mid-Size Business unit (LMSB) of the Service” were devoted to expensing versus capitalization issues); Ethan Yale, *When Are Capitalization Exceptions Justified?*, 57 TAX L. REV. 549, 549 (2004) (“[R]ules [that a taxpayer should capitalize an expenditure that produces long-term benefit] are among the most controversial in all of federal income taxation.”); *id.* at 549 n.1 (noting that “approximately 25% of audit resources for large and mid-sized businesses are devoted to capitalization issues”) (citing John E. Hembera, *ABA Tax Section Meeting: Capitalization Issues on Front Burner*, *Olson Says*, Tax Notes Today, Aug. 3, 2001, LEXIS, 2001 TNT 152–7).

<sup>3</sup> *See, e.g.*, Noël B. Cunningham, *The Taxation of Capital Income and the Choice of Tax Base*, 52 TAX L. REV. 17, 20 (1996) (explaining that the difference between a consumption tax and an income tax is that “[u]nder the [consumption tax imposed on] cash flow . . . all capital investment is deducted, or expensed, when made, while under an income tax, capital investment is recovered through depreciation deductions or upon disposition”).

normative income tax (which uses capitalization) is preferable to a normative consumption tax (which uses immediate expensing) has long raged.<sup>4</sup>

Scholars have also considered how decisions between expensing and capitalization should be affected by practical realities, including that the income tax as implemented sacrifices economic ideals in favor of ease of administration. For example, the U.S. federal income tax avoids the difficulty of valuing each asset each year by declining to tax unrealized appreciation<sup>5</sup> and by depreciating assets over estimated recovery periods from simplified schedules rather than their actual economic useful lives.<sup>6</sup> Similarly, it avoids the difficulty of distinguishing between nominal and real economic gains by calculating gains without adjusting for inflation.<sup>7</sup> In each of these ways and more, the income tax as implemented is not a

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<sup>4</sup> See, e.g., William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974) [hereinafter Andrews, *Consumption Tax*] (advocating a consumption tax); William D. Andrews, *Fairness and the Personal Income Tax: A Reply to Professor Warren*, 88 HARV. L. REV. 947, 947 (1975) [hereinafter Andrews, *Reply*] (advocating that a consumption tax is “ideally fairer [than an accretion-type income tax] even if a true accretion-type tax were feasible”); Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax over an Ideal Income Tax*, 58 STAN. L. REV. 1413, 1415–16, 1420–21 (2006) (advocating a consumption tax after addressing three common arguments for an income tax: 1) efficiency—since the comparison between tax bases “depends on empirically unknowable or indeterminate facts,” we should not presume that a consumption tax would be more efficient; 2) redistribution—while a consumption tax fails “to tax returns to savings,” leaving “enormous pools of wealth untaxed” and “creating vast inequalities in our society,” an income tax reaches these pools and better redistributes resources from the wealthy to the poor; and 3) fairness—“an income tax is more effective than a consumption tax” at reaching wealth, which is “thought to bring a host of benefits, such as power, prestige, and security”); Cunningham, *supra* note 3, at 44 (advocating a consumption tax); Barbara H. Fried, *Fairness and the Consumption Tax*, 44 STAN. L. REV. 961, 966 (1992) (finding that fairness supports the income tax’s inclusion of capital income in the tax base); Alan Gunn, *The Case for an Income Tax*, 46 U. CHI. L. REV. 370, 374–78 (1980) (arguing that income best measures a taxpayer’s ability to pay tax); Alvin Warren, *Would a Consumption Tax Be Fairer than an Income Tax?*, 89 YALE L.J. 1081 (1979); Alvin C. Warren, Jr., *How Much Capital Income Taxed Under an Income Tax Is Exempt Under a Cash Flow Tax?*, 52 TAX L. REV. 1 (1996) (advocating a consumption tax); Yale, *supra* note 2, at 550 (arguing that capitalization and economic depreciation are normative or first-best rules for an income tax, meaning that deviations should be rare and narrow).

<sup>5</sup> Andrews, *Consumption Tax*, *supra* note 4, at 1129 (“[W]hile waiting for realization may be convenient in relation to a single investment, the inconsistency between taxing realized gains and cash savings and not taxing unrealized and unrecognized gains, is the generating source of most of the worst complexity, inequity, and distortion in our existing tax.”).

<sup>6</sup> Jeremy I. Bulow & Lawrence H. Summers, *The Taxation of Risky Assets*, 92 J. POL. ECON. 20, 21–24 (1984) (exploring the implications of “tax laws’ use of ex ante depreciation schedules rather than ex post depreciation”).

<sup>7</sup> Andrews, *Consumption Tax*, *supra* note 4, at 1143 (“[Inflation is a fundamental difficulty with a true accretion-type income tax since] [a]n increase in monetary values may not reflect any real accumulation or increase in value if the real value of money is going down. Changes in value that reflect only inflation are important, however, since the holder of property that goes up in money value is better off by that much than another who holds cash balances or fixed principal securities. The proper remedy, under an accretion model, if we wished to exclude inflation, would be a general adjustment that would not only offset any gain due to inflation for taxpayers holding assets that go up in value, but also produce a net loss for holders of fixed money amounts.”).

normative income tax, and scholars have considered how implementation issues should affect the selection of an appropriate tax base.<sup>8</sup>

Finally, scholars have explored in detail how decisions between expensing and capitalization should be informed by predictable taxpayer responses to the imposition of tax.<sup>9</sup> For example, because income taxes typically reduce the returns

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<sup>8</sup> See, e.g., Andrews, *Reply*, *supra* note 4, at 947 (explaining that most of the author's preference for a consumption tax as opposed to an income tax is based on "intractable difficulties in the existing income tax [that] arise from the virtual impossibility of achieving a satisfactory reflection of real accumulation in a practical income tax base . . . difficulties [that] could be readily avoided by pursuing the goal of consumption instead of accretion").

<sup>9</sup> See, e.g., Joseph Bankman & Barbara H. Fried, *Winners and Losers in the Shift to a Consumption Tax*, 86 GEO. L.J. 539, 542 (1998) ("[T]he income tax reduces the standard deviation in possible outcomes on the upside and downside, by shifting a portion of the risk onto the government as an involuntary co-investor. This implies that investors may be able to offset entirely the effects of an income tax on risk by increasing their pre-tax level of risk . . ."); Joseph Bankman & Thomas Griffith, *Is the Debate Between an Income Tax and a Consumption Tax a Debate About Risk? Does It Matter?*, 47 TAX L. REV. 377, 378 (1992) (explaining that even though an income tax appears to tax returns to risk-taking, "under certain assumptions, investors in risky assets are able to offset the effects of government taxation of the risk premium by changing their investment portfolios"); Cunningham, *supra* note 3, at 21 ("[T]he income tax will not reach the premium a sophisticated investor receives for investing in risky investments."); Evsey D. Domar & Richard A. Musgrave, *Proportional Income Taxation and Risk-Taking*, 58 Q.J. ECON. 388, 390 (1944) (explaining that "[i]f [an income tax is imposed and] losses can be offset, and the Treasury assumes part of the risk, as well as of the yield," the taxpayer will "adjust his asset combination so as to increase . . . total risk . . . above the pre-tax level"); David Elkins & Christopher H. Hanna, *Taxation of Supernormal Returns*, 62 TAX LAW. 93, 93 (2008) ("As is generally accepted, under certain assumptions an accrual income tax system taxes the risk-free rate of return on capital but does not tax the risk premium . . ."); Louis Kaplow, *Taxation and Risk Taking: A General Equilibrium Perspective*, 47 NAT'L TAX J. 789, 793 (1994) ("[W]hen portfolio adjustments are made in a corresponding manner, an income tax consists of a wage tax plus a tax on riskless returns . . ."); Jack M. Mintz, *Some Additional Results on Investment, Risk Taking, and Full Loss Offset Corporate Taxation with Interest Deductibility*, 96 Q.J. ECON. 631, 631 (1981) ("[T]he government, through taxation, reduces the variance and leaves unaffected the mean of the returns earned on the risky asset."); Adam H. Rosenzweig, *Imperfect Financial Markets and the Hidden Costs of a Modern Income Tax*, 62 SMU L. REV. 239, 241-42 (2009) ("[U]nder a number of assumptions, relatively simple changes by both taxpayers and the government can result in risky returns . . . avoiding the impact of an income tax altogether."); Daniel N. Shaviro, *Replacing the Income Tax with a Progressive Consumption Tax*, TAX NOTES 91, 102 (Apr. 5, 2004) ("[D]ue to portfolio adjustments, an income tax fails to affect either *ex ante* risk premiums or *ex post* risky outcomes."); J.E. Stiglitz, *The Effects of Income, Wealth, and Capital Gains Taxation on Risk-Taking*, 83 Q.J. ECON. 263 (1969); David A. Weisbach, *The (Non)Taxation of Risk*, 58 TAX L. REV. 1, 2 (2004) (explaining that individuals can and will "eliminate the tax on" returns to risk-bearing by ramping up the risk in their investments to the point that their after-tax returns match their pre-tax preferences). *But see* Bankman & Fried, *supra*, at 543 (footnotes omitted) ("The claim that investors can offset entirely the effects of an income tax on returns to risk relies critically on several assumptions. First, it assumes full loss offsets under the income tax, clearly not the case under existing law. To the extent losses cannot be recognized currently, an income tax will reduce the expected return to risky investments in a form that cannot be offset by portfolio adjustments. Second, it assumes that imposing an income tax will not change the pre-tax price of risky investments. The assumption is not a trivial one, because imposing a tax on risk likely increases the demand for risky assets, which will, *ceteris paribus*, drive down their expected return. Third, it assumes that investors can relatively costlessly increase the riskiness of their portfolio. In many cases, one or more of these assumptions will lack validity. In that event, investors will be unable to offset the effect of an income tax on marginal returns to risk."); John R. Brooks II, *Taxation, Risk, and Portfolio Choice: The Treatment of Returns to Risk Under a Normative Income*

from risk-taking that taxpayers enjoy (since they receive smaller after-tax profits rather than larger before-tax profits from their investments) and correspondingly reduce the losses from risk-taking that taxpayers suffer (since they experience smaller after-deduction losses rather than larger before-deduction losses from their investments), scholars have explored the extent to which taxpayers do what economics predicts they should do.<sup>10</sup> They consider whether taxpayers increase the riskiness of their investments up to the point that their after-tax risks and returns match their preferences without regard to pre-tax investment performance.<sup>11</sup>

Despite long-standing arguments on all sides of this debate,<sup>12</sup> the United States has long maintained a mixed system in which certain long-term investments are capitalized and gradually depreciated while others are immediately expensed.<sup>13</sup> Further, the United States has employed an evolving system, using immediate expensing rules temporarily and flexibly so that the same asset might be eligible for immediate expensing if purchased in certain timeframes and subject to capitalization if purchased in other timeframes.<sup>14</sup> The government has used these flexible rules with the aim of increasing capital investment and stimulating the economy during and following recession.<sup>15</sup>

The mixed and flexible system is interesting because, while we purport to tax income in the United States, when we allow a long-term investment to be immediately expensed, we effectively exempt the income produced by that

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*Tax*, 66 TAX L. REV. 255 (2013) (arguing that a normative income tax discourages risky tax returns to some extent because it makes taxpayers less wealthy, and therefore, less tolerant of risk, which prevents them from ramping up the riskiness of their investments to the extent necessary to avoid incurring tax on risky returns); Martin S. Feldstein, *The Effects of Taxation on Risk Taking*, 77 J. POL. ECON. 755, 755 (1969) (arguing that while “[t]he proposition that a proportional [income] tax with full loss offset increases personal risk taking is now widely accepted by professional economists,” this proposition has “relied on a variety of restrictive and implausible assumptions”); Deborah H. Schenk, *Saving the Income Tax with a Wealth Tax*, 53 TAX L. REV. 423 (2000) (arguing that investor myopia, transaction costs, and other market imperfections prevent taxpayers from ramping up the riskiness of their investments to the extent necessary to avoid tax on risky returns); Theodore S. Sims, *Capital Income, Risky Investments, and Income and Cash Flow Taxation*, 67 TAX L. REV. 3 (2013) (arguing that tax triggers a wealth effect that interferes with portfolio adjustments); Lawrence Zelenak, *The Sometimes-Taxation of the Returns to Risk-Bearing Under a Progressive Income Tax*, 59 SMU L. REV. 879 (2006) (arguing that the progressive rate schedule imposes tax on some risky returns because it causes some losses to be deducted at lower rates than some gains).

<sup>10</sup> See generally Weisbach, *supra* note 9 (examining whether models of taxation and risk in literature are realistic and reflect taxpayer behavior in the real world).

<sup>11</sup> *Id.* at 2.

<sup>12</sup> Bankman & Weisbach, *supra* note 4, at 1414 (characterizing the debate as raging since “at least the time of Hobbes and Mill, without apparent resolution”).

<sup>13</sup> See *infra* notes 98–110 and accompanying text.

<sup>14</sup> See, e.g., *infra* notes 109–114 and accompanying text.

<sup>15</sup> See *infra* note 173.



investment from tax.<sup>16</sup> E. Cary Brown, a Massachusetts Institute of Technology economist, provided the most accessible explanation of this phenomenon, establishing that when the government allows a long-term investment to be immediately expensed, the government effectively becomes a co-investor or a co-owner of the expensed asset.<sup>17</sup> As Brown phrased it, through immediate expensing, the government “would literally be a partner” in the investment.<sup>18</sup> Part I of this Article explains Brown’s perspective in detail. In short, it observes that a taxpayer who immediately expenses an asset receives an extraordinary benefit from the government at the time of investment in the form of tax savings equal to the cost of the investment times the taxpayer’s marginal tax rate. These tax savings mimic a capital contribution. If they are used to fund part of the investment’s purchase price, then the outcome is analogous to the government putting up capital equal to the tax savings and the purchaser putting up the remaining capital. When the government then assumes a proportionate share of losses (by allowing their deduction) and collects a proportionate share of profits from the investment (by taxing them), the imposition of tax is analogous to the government taking a proportionate return on its up-front capital contribution.

Before addressing the co-investor relationship created by tax law’s immediate expensing policies, it seems useful to note that, in the United States, we are probably uncomfortable thinking of the government as an investor.<sup>19</sup> Save a few recent, notable exceptions—including AIG and GM<sup>20</sup>—we believe that the government generally has and should continue to avoid direct investment

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<sup>16</sup> See *id.*; see also E. Cary Brown, *Business-Income Taxation and Investment Incentives*, in INCOME, EMPLOYMENT AND PUBLIC POLICY: ESSAYS IN HONOR OF ALVIN H. HANSEN 300, 309–10 (1948) (discussing “a graft of the Kalecki system of a credit for investment onto the Domar-Musgrave system” to “neutralize the effect of the tax”).

<sup>17</sup> See Brown, *supra* note 16.

<sup>18</sup> *Id.* at 309–10.

<sup>19</sup> See, e.g., Barbara Black, *The U.S. as “Reluctant Shareholder”: Government, Business and the Law*, 5 ENTREPRENEURIAL BUS. L.J. 561, 561–64 (2010) (observing that through the Troubled Asset Relief Program (TARP), the U.S. Government put a “staggering” amount of financial assistance into private businesses and “became a substantial equity holder in five major U.S. companies [AIG, Citigroup, General Motors, Chrysler, and Ally Financial (formerly GMAC)] . . . [without a] rule book for how the government should act as a shareholder”); *id.* at 575–92 (exploring the government’s actions as a shareholder in these firms); *id.* at 564 (“Unlike some other countries, the U.S. government [typically] does not invest surplus funds or engage in entrepreneurial activities for economic gain.”); Benjamin A. Templin, *The Government Shareholder: Regulating Public Ownership of Private Enterprise*, 62 ADMIN. L. REV. 1127, 1184–85 (2010) (noting that when the government assumes a direct ownership interest in a firm, as it did with AIG and GM, liberal market economy proponents worry that the government might be tempted to pursue broader social goals that might make “the firm less competitive”). See generally Benjamin A. Templin, *State Entrepreneurism* (Thomas Jefferson Sch. of Law, Working Paper No. 1428108, 2009), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1428108](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1428108) (follow “Download this Paper” hyperlink) [<https://perma.cc/J9N-ZDLW>], (exploring conflicting philosophies of government and business).

<sup>20</sup> Mike Allen & David Rogers, *Bush Announces \$17.4 Billion Auto Bailout*, POLITICO (Dec. 19, 2008, 8:22 AM), <http://www.politico.com/story/2008/12/bush-announces-174-billion-auto-bailout-016740> [<https://perma.cc/CUF5-BVEG>]; Matthew Karnitschnig et al., *U.S. to Take over AIG in \$85 Billion Bailout; Central Banks Inject Cash As Credit Dries up*, WALL ST. J. (Sept. 16, 2008), <https://www.wsj.com/articles/SB122156561931242905> [<https://perma.cc/3JZB-EV49>].

activities.<sup>21</sup> This Article does not take a position on whether the government should aim to expand or withdraw from its direct investments, or even on whether it should, as an independent goal, aim to expand or withdraw from the more extensive indirect investment activities described in this Article: those arising from the operation of tax law.<sup>22</sup> Its goal is not to justify immediate expensing tax policies.

Rather, it argues that since the government already, by operation of immediate expensing tax policies, acts like an indirect investor in long-standing,<sup>23</sup> extensive, and expanding ways,<sup>24</sup> it should expressly acknowledge and begin to be deliberate about this role. To guide that deliberation, this Article seeks to explore whether the assets that the government co-finances via tax policy are consistent with the assets that the government should invest in, given the government's unique investment characteristics and priorities. To the extent that tax policy causes the government to indirectly invest in assets that are inappropriate given the government's investment characteristics and priorities, or causes the government to fail to invest in more appropriate assets, this Article proposes policy modifications that would cause tax policy to better reflect the government's investment role.

When viewed from the government's perspective, the co-investor analogy suggests several policy prescriptions. Some potential changes (like the possibility of using tax subsidies to privilege the government's preferred businesses<sup>25</sup> or issuing low-interest Treasury securities to finance high-risk investments<sup>26</sup>) should be rejected because they sacrifice other tax policy goals or produce benefits for the government merely by imposing corresponding costs on the public. Others (like denying interest deductions to taxpayers who immediately expense their debt-financed investments) provide new justifications for changes long advocated by tax

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<sup>21</sup> See *supra* note 19.

<sup>22</sup> By using the government-as-investor perspective, this Article considers how the government's investment characteristics and priorities might inform immediate expensing policies. Some proposed changes would expand immediate expensing opportunities, see *infra* Part III.B (suggesting that purchasers should be allowed to partially immediately expense buildings and other real property structures), while other proposed changes would make immediate expensing policies more limited, see *infra* Part III.A.2 (proposing that immediate expensing, which is now permanent, be phased in and out based on changes to Treasury securities rates), or less generous, see *infra* Part III.C (reforming debt finance and securitization rules in ways that would make immediate expensing less appealing to taxpayers).

<sup>23</sup> Since at least the 1958 passage of 26 U.S.C. § 179, the United States has had a tax system in which certain long-term assets are immediately expensed at certain times, and this Article considers how the government's investment characteristics and priorities might inform decisions about immediate expensing. See *infra* Part III.

<sup>24</sup> See *infra* Part I.D.

<sup>25</sup> See, e.g., Paul Chesser, *Government Shouldn't Pick Winners and Losers*, AM. SPECTATOR (May. 24, 2011, 7:52 PM), <http://spectator.org/blog/26160/government-shouldnt-pick-winners-and-losers> [<https://perma.cc/6RLY-P47B>].

<sup>26</sup> See *infra* note 136.

scholars.<sup>27</sup> Still others (like tagging immediate expensing policies expressly to the government's borrowing rates and encouraging investments that compensate for difficult-to-diversify risk) should be adopted because they advance the government's investment priorities while also advancing traditional tax goals and broader social goals.<sup>28</sup> Finally, one important policy modification implied by the government-as-investor perspective could help achieve a goal long pursued by bankruptcy and secured transactions scholars. If the government more explicitly recognized and more aggressively asserted its co-investor role, it ought to prevent taxpayers from encumbering with a security interest the full value of property they elect to immediately expense.<sup>29</sup> In turn, this would better protect the interests of tort claimants, employees with claims for unpaid wages, environmental claimants, and other involuntary and unsecured creditors.<sup>30</sup>

Part I explains how the government comes to act as an investor in the acquisition of property by sharing in gains, sharing in losses, and contributing to the capital necessary to acquire property and shows how this investor role has become more common as immediate expensing and accelerated depreciation policies have expanded.<sup>31</sup> If the current proposals to expand immediate expensing by the Trump Administration, the House, or the Senate are adopted, this role will only further expand.<sup>32</sup> Importantly, the government becomes a co-investor in particular assets purchased by a taxpayer but the government does not become a co-investor in the taxpayer's overall business enterprise. Part II identifies unique characteristics that the government has as an investor, including cheap access to capital (especially during and after recession), deep diversification, and a

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<sup>27</sup> See *infra* Section III.C.1.

<sup>28</sup> See *infra* Sections III.A.2, III.B.

<sup>29</sup> See *infra* Part III.C.2.

<sup>30</sup> See *infra* Part III.C.2.

<sup>31</sup> Some readers may believe that the government should not be in the business of investing. This Article does not take a position on whether it should or should not. Rather, after noting that tax policy—in long-standing, increasing, and well-recognized ways—already causes the government to participate in many taxpayer investments by providing tax breaks that mimic capital contributions equal to the taxpayer's marginal rate, by proportionately suffering losses, and by proportionately sharing in gains, it suggests that the government should consider the implications of this investment-like role. At a minimum, the government should avoid being a thoughtless investor that ignores its investment priorities. Other readers may take exception to the analogy that tax law has long made between the government and an investor. But, it is worth noting that the biggest difference between a typical economic investor and the government is that a typical economic investor has more choice as to what investments to buy and sell, when, and for what price. That difference seems only to increase the appropriateness of the government paying attention to its investment preferences while bearing in mind its other responsibilities and commitments.

<sup>32</sup> UNIFIED FRAMEWORK FOR FIXING TAX OUR BROKEN TAX CODE 7 (Sept. 27, 2017), <https://www.treasury.gov/press-center/press-releases/Documents/Tax-Framework.pdf> [<https://perma.cc/KPJ3-3987>] (proposing that policies allowing businesses to immediately expense depreciable assets should be extended “for at least five years”); A BETTER WAY: OUR VISION FOR A CONFIDENT AMERICA 25–26 (June 24, 2016), <https://www.speaker.gov/sites/speaker.house.gov/files/documents/ABetter-Booklet.pdf> [<https://perma.cc/K8DF-4ZE9>] (proposing that businesses should be allowed to “fully and immediately” write off the cost of tangible and intangible assets, but not land).

compromised ability to advance its investment priorities through sales of its property interests or investor protections.

After observing that, whether it intended to or not, the government took advantage of its unique investment characteristics and advanced its own investment priorities by making immediate expensing more widely available and more generous during and following recent recessions,<sup>33</sup> Part III suggests various ways that the government might modify existing law to better align tax policy with its investment priorities. These modifications include: automatically adjusting immediate expensing policies based on Treasury securities rates such that they would cause the government to pay for a larger share of its investments when it can borrow cheaply and a smaller share when it cannot; expanding immediate expensing to certain real property and other investments that likely compensate private investors for difficult-to-diversify risk and would therefore overcompensate the government; and reforming debt-finance rules on immediately expensed property to stop the exploitative use of government investments by the private owners of property.<sup>34</sup>

The Article concludes by noting that these self-interested changes would not necessarily undermine—and in many cases, could meaningfully advance—traditional tax values and social policy values. They could reduce distortion, increase revenues, promote economic stability, and even protect involuntary and unsecured creditors.

## I. THE GOVERNMENT’S ROLE AS AN INVESTOR

Scholars have long recognized that when the government imposes an income tax, it acts, to varying degrees, as an investor in the projects it taxes.<sup>35</sup>

### A. *Sharing Profits*

Simply by receiving a share (equal to the tax rate) of the profits generated by a project, the government enjoys one of the key features of partnership.<sup>36</sup> The importance of profit-sharing is recognized by the Uniform Partnership Act, which

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<sup>33</sup> Significant evidence indicates that the government intended immediate expensing and accelerated depreciation policies to promote general economic stimulus by increasing the positive net present value of capital investments. *See infra* note 173. However, data is mixed on whether these policies achieved this intent. *See* Rebecca N. Morrow, *Accelerating Depreciation in Recession*, 19 FLA. TAX REV. 465, 488–90 (2016) (reviewing the mixed economic impacts of accelerated depreciation).

<sup>34</sup> *See infra* Part III.

<sup>35</sup> *See, e.g., supra* note 9.

<sup>36</sup> *See, e.g.,* Domar & Musgrave, *supra* note 9, at 389 (“By imposing an income tax on the investor, the Treasury appoints itself as his partner, who will always share in his gains, but whose share in his losses will depend on the investor’s ability to [deduct losses and to] offset losses against other income.”).

provides that an entity<sup>37</sup> that “receives a share of the profits of a business is presumed to be a partner in the business, unless the profits were received in payment[s,] [including payments for a debt, services, or rent].”<sup>38</sup> The presumption that profit-sharers are partners applies even when the profit-sharers did not intend to form a partnership.<sup>39</sup>

When the tax system makes the government a mere profit-sharer by taxing profits but not allowing the deduction of losses, it reduces the taxpayer’s after-tax returns—diverting a share of these returns to be paid instead to the government—without reducing the amount of risk that the taxpayer assumes by investing.<sup>40</sup> Accordingly, the tax system makes investing—and in particular higher-risk/higher-return investing—less profitable, decreases taxpayers’ incentives to take risk, and encourages taxpayers to reduce the amount that they invest.<sup>41</sup> An income tax system without full deduction of losses denies taxpayers a share of the returns that would otherwise compensate them for bearing risk.<sup>42</sup>

### B. Sharing Losses

A system that aims to tax *net* income, including the United States income tax system, does not simply make the government a profit-sharer in the income

<sup>37</sup> Although the Uniform Partnership Act uses the word “person” when establishing the presumption that a “person who receives a share of the profits of a business is presumed to be a partner,” it defines “person” to include entities and even governments. UNIF. P’SHIP ACT § 102(14) (NAT’L CONFERENCE OF COMM’RS ON UNIF. STATE LAWS 2013); *id.* § 202(c)(3) (“‘Person’ means an individual, . . . government or governmental subdivision, agency, or instrumentality, or any other legal or commercial entity.”).

<sup>38</sup> *Id.* § 202(c)(3) (“A person who receives a share of the profits of a business is presumed to be a partner in the business, unless the profits were received in payment: (A) of a debt . . . ; (B) for services . . . ; (C) of rent; (D) of an annuity or other retirement or health benefit . . . ; (E) of interest or other charge on a loan . . . ; or (F) for the sale of the goodwill of a business or other property . . . .”); *see also id.* § 202(a) (“[T]he association of two or more persons to carry on as co-owners a business for profit forms a partnership, whether or not the persons intend to form a partnership.”). While the UPA does not define “co-owners” or “co-ownership” in the § 102 definition section, the presumption that a profit-sharer is a partner seems to imply that even if loss-sharing is a common feature of partnership, it is not an essential feature of partnership. *See id.* § 102; *id.* § 202(c).

<sup>39</sup> *Id.* § 202(a) (stating that, except for associations formed under non-partnership statutes, “the association of two or more persons to carry on as co-owners a business for profit forms a partnership, whether or not the persons intend to form a partnership”).

<sup>40</sup> *See* Domar & Musgrave, *supra* note 9, at 403 (“By imposing a tax without loss offset, the Treasury shares in the investor’s gains, while leaving his losses unchanged.”).

<sup>41</sup> *Id.* at 405–06 (“[T]ax will reduce the compensation per unit of risk. . . . [and] [t]he investor will therefore tend to take less risk.”); *id.* at 408 (“If the tax is very heavy, the investor may prefer to hold . . . assets in cash.”); *see also id.* at 408–09 (“Prior to imposition of a tax, the investor is indifferent between a more risky investment, bearing, say, ten per cent, and a less risky investment, bearing, say, three per cent, the difference of seven per cent being just sufficient to compensate the investor for the additional risk of the second investment. If now a 50 per cent tax is imposed and both yields are cut by one-half . . . , the difference is reduced to 3.5 per cent, which is not sufficient to compensate for the difference in risk. Hence the conclusion that the investor will take the less risky investment.”).

<sup>42</sup> *Id.* at 405–09.

produced by investments. Instead, it allows taxpayers to deduct investment losses, which makes the government a loss-sharer in critically important ways. This feature of the income tax system was beautifully explained and explored in Evsey D. Domar and Richard A. Musgrave's seminal 1944 article, *Proportional Income Taxation and Risk-Taking*.<sup>43</sup> Domar and Musgrave observed that when a tax system allows a taxpayer to fully deduct losses as against income, the taxpayer and the government effectively share losses in the same proportion as they share investment profits.<sup>44</sup> In a world of full loss deductibility,<sup>45</sup> the income tax causes the government to enjoy a share of profits equal to the tax rate and to suffer a share of losses equal to that same tax rate.<sup>46</sup> This is because the taxpayer's deduction for losses suffered will reduce her tax liability by the amount of loss times the tax rate.<sup>47</sup> As Domar and Musgrave explain, "[F]ull loss [deductibility] means that whenever the investor suffers a loss, the Treasury reimburses him for a fraction of the loss equal to the tax rate. The Treasury thus becomes a partner who shares equally in both losses and gains."<sup>48</sup> While full loss offsets are necessary to make the government a full economic partner, the lack of full loss offsets likely has less impact in the context of immediate expensing because, through immediate expensing, the government has already fully shared in the large, up-front risk that the price for a capital investment will prove to have been too high.<sup>49</sup> Additionally, some immediately expensed property is not affected by capital loss limitations since it is depreciable trade or business property addressed by 26 U.S.C. § 1231, which

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<sup>43</sup> See generally *id.* (examining the Treasury's potential for profit- and loss-sharing upon imposing income taxes on investors).

<sup>44</sup> See *id.* at 409.

<sup>45</sup> Full loss deductibility means that losses are fully deductible in the year incurred and at the same rate as income earned in that year is taxed. Many provisions—including net operating loss limitations and capital loss limitations—as well as the progressive rate schedule itself and the taxpayer's need to have sufficient income to enjoy loss deductions, limit full loss deductibility. See, e.g., 26 U.S.C. § 172 (Supp. III 2012) (limiting net operating losses); *id.* at § 469 (limiting passive activity losses); *id.* at § 1211 (2012) (limiting capital losses); Leandra Lederman, *The Entrepreneurship Effect: An Accidental Externality in the Federal Income Tax*, 65 OHIO ST. L.J. 1401, 1409–35 (2004) (explaining restrictions on the full deductibility of investment expenses and losses).

<sup>46</sup> Domar & Musgrave, *supra* note 9, at 409; see also Zelenak, *supra* note 9, at 880–84 (explaining that the graduated progressive rate schedule itself limits full loss offsets “when it results in the potential gain from a risky investment being taxed at a higher marginal rate than the rate against which potential losses from the investment would be deducted”).

<sup>47</sup> Domar & Musgrave, *supra* note 9, at 409; see also Michael Livingston, *Risky Business: Economics, Culture and the Taxation of High-Risk Activities*, 48 TAX L. REV. 163, 188 (1993) (“The most important of these [loss limitations] is that losses generally are not refundable; that is, losses that exceed income for the taxable year are not refunded to the taxpayer, but are lost for tax purposes unless a carryover provision applies.”).

<sup>48</sup> Domar & Musgrave, *supra* note 9, at 409.

<sup>49</sup> See Brown, *supra* note 16, at 313 (explaining that while full loss offsets are necessary to eliminate any impact of tax, “[o]ne-year depreciation and a reasonably long carry-forward of losses would probably come very close”).

allows losses to be taken as ordinary losses that are fully deductible as against ordinary income, even as gains receive preferential capital gains treatment.<sup>50</sup> Scholars have described the government's proportionate sharing of gains and losses as a form of partnership in the underlying investment.<sup>51</sup>

In contrast to a mere profit-sharing system, a tax system that makes the government a full loss-sharer as well as a full profit-sharer does not decrease taxpayers' incentive to take risk.<sup>52</sup> As long as a taxpayer can fully deduct losses at his tax rate, the taxpayer does not suffer the full economic loss.<sup>53</sup> Rather, the taxpayer's net loss is the total loss minus the amount of taxes he saves by deducting the loss against other income, or total loss  $\times$  (1 - tax rate), while the government bears total loss  $\times$  (tax rate).<sup>54</sup> This loss sharing is just the flip side of the taxpayer not enjoying the full economic gain from an investment and instead enjoying total gain  $\times$  (1 - tax rate) while the government enjoys total gain  $\times$  (tax rate).<sup>55</sup> Since an income tax system with full loss deductibility causes the government to share equally in losses and gains, it does not decrease incentives to take risk.<sup>56</sup>

While an income tax system with full loss offsets reduces the taxpayer's after-tax returns from an investment, it correspondingly reduces the after-tax risk level of that investment.<sup>57</sup> In other words, "The yield *and* the risk of the investment have been reduced by the rate of the tax, so that the return per unit

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<sup>50</sup> See 26 U.S.C. § 1231 (Supp. III 2012).

<sup>51</sup> See, e.g., Zelenak, *supra* note 9, at 883-84 (footnote omitted) ("When the income tax [with full loss offsets] is introduced, it reduces the taxpayer's expected return per dollar invested in the risky asset, but it correspondingly reduces the risk per dollar invested (because of the cushioning effect of full loss offsets). When the taxpayer increases [the amount of] his investment in the risky asset by a factor of  $1/(1 - t)$ , he reproduces the level of risk he was willing to accept in the no tax world, and he also reproduces the expected return to risk-bearing he enjoyed in the no-tax world. To put the point another way, a 20% tax makes the government a 20% partner in the risky investment (with respect to both gains and losses), and the taxpayer can return to his preferred tradeoff between risk and reward by increasing the partnership's investment in the risky asset so that his share of the partnership's investment equals the amount he would have invested in the risky asset in the no-tax world."). Although increasing the amount of investment by a factor of  $1/(1 - t)$ , where  $t$  is the tax rate, comes close to returning a taxpayer to a no-tax world, it is not exact. *Id.* at 883. For example, this adjustment assumes that the taxpayer has access to the capital necessary to increase the amount of his investment, which he may not. *See id.* at 883-84. Even if he does increase the amount of his investment, the payment of tax decreases the taxpayer's wealth and therefore likely decreases his risk tolerance. *Id.* Finally, even if a taxpayer can afford to increase the amount of his investment, he will incur a tax on the "riskless rate of return" on a larger investment. *See id.* at 883-84 (explaining that after a taxpayer increases the amount of investment to replicate pre-tax preferences for risk and reward, the result is the imposition of an income tax only on the "riskless rate of return on the entire portfolio"); see also Brooks, *supra* note 9, at 256-57 (explaining that the no-tax world cannot be replicated since tax necessarily reduces a taxpayer's wealth and a reduction in wealth is associated with a reduction in risk tolerance).

<sup>52</sup> Domar & Musgrave, *supra* note 9, at 390. This is the theoretical conclusion. For some of its limitations, see *supra* note 51.

<sup>53</sup> See Cunningham, *supra* note 3, at 31.

<sup>54</sup> *See id.*

<sup>55</sup> *See id.*

<sup>56</sup> This is the theoretical conclusion. For some of its limitations, see *supra* note 51-52.

<sup>57</sup> See Domar & Musgrave, *supra* note 9, at 389.

of risk-taking remains unchanged.<sup>58</sup> If a taxpayer wishes to replicate his pre-tax risk and return preferences in an after-tax world,<sup>59</sup> he can do so by increasing the amount he invests<sup>60</sup> or by retaining his level of investment, but shifting more of it to investments that have higher pre-tax risks and returns,<sup>61</sup> such that *his share* of the risks and returns after tax reflects his preferences.<sup>62</sup>

Although an income tax system with full loss offsets puts the government in more of a partner-like role with the taxpayer than one without full loss offsets, this partnership analogy might still be more theoretically useful than practically observable.<sup>63</sup> Imagine a prospective partner determining that he would like to participate in an investment, demanding a share of the investment's returns from the existing partners and claiming that it would be fair for him to receive this share of returns simply because he would also agree to proportionately share in any

<sup>58</sup> *Id.*

<sup>59</sup> The pre-tax world is not perfectly replicated since the taxpayer must pay tax on the risk-free component of the return even if she makes adjustments to her investment portfolio to appropriately ramp up pre-tax risk (such that after sharing that risk with the government, she achieves her risk preferences in the after-tax world). *See, e.g.,* Weisbach, *supra* note 9, at 2 (explaining that after portfolio adjustments, “[a]ll that is left of capital income to be taxed is the risk-free or pure time value return”).

<sup>60</sup> *See, e.g., id.* at 8–12 (showing that because an income tax with full loss offsets not only reduces the positive expected return on an investment by the tax rate, but also decreases the risk of the investment proportionately, allowing the taxpayer to increase the size of the investment (by  $1/(1 - t)$ ) and be “in exactly the same position as without tax”).

<sup>61</sup> Weisbach, *supra* note 9, at 16 n.23 (“[I]f derivative markets in the risk in question exist, the individual need not borrow and buy an investment. Instead, he can eliminate the tax on risk merely by increasing his bet through a derivative.”); Zelenak, *supra* note 9, at 882–84 (showing that the taxpayer need not necessarily fund the increase in his risky investments by savings; instead, he could fund this increase by diverting from safe investments growing at the riskless rate of return and providing a mathematical example of such a diversion).

<sup>62</sup> For a numeric example, *see* Zelenak, *supra* note 9, at 884 (explaining that by diverting amounts from safe to risky investments, a taxpayer “reproduces the expected return to risk-bearing he enjoyed in the no-tax world. . . [and] can return to his preferred tradeoff between risk and reward by increasing the partnership’s investment in the risky asset so that his share of the partnership’s investment equals the amount he would have invested in the risky asset in the no-tax world”).

<sup>63</sup> This analogy is deeply useful, informing many tax law debates, and even leading to a very well-respected conclusion that the robust debate about whether to prefer an income tax or a consumption tax might not be about what base is subject to tax, but about how that same tax base should be reached from an administrative perspective. *See, e.g.,* Andrews, *Consumption Tax*, *supra* note 4, at 1120 (“The difference between an accretion-type and a consumption-type personal income tax involves only accumulation, and it is in an important sense only a difference of timing.”); Michael J. Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. L. REV. 1575, 1598 (1979) (footnote omitted) (“[T]he widely expressed notion [is] that the difference between an income tax and an expenditure tax is solely a matter of timing.”); Weisbach, *supra* note 9, at 2–3 (footnote omitted) (“[A] Haig-Simons [income] tax is basically the same as a consumption tax (which imposes a zero rate of return on capital), and the debate between the two tax bases is not particularly meaningful. The decision [between income tax and consumption tax] might best be made on administrative grounds rather than on deep philosophical arguments about the proper distribution of the tax burden.”).



losses. That prospective partner might accurately point out that his willingness to share in both risk and reward means that the existing partners could restore their pre-existing economic position simply by putting more capital into the investment. Yet, it would be difficult, or even impossible, to find existing partners willing to sign on to such an expanded partnership. As newly-minted partners in law firms,<sup>64</sup> accounting firms,<sup>65</sup> architecture firms,<sup>66</sup> dental practices,<sup>67</sup> and medical practices<sup>68</sup> (and their newly-depleted bank accounts) know well,<sup>69</sup> becoming a partner is not simply a matter of agreeing to share losses as well as gains proportionately. Importantly, it is also a matter of “buying in” with a capital contribution.<sup>70</sup>

The “buy in” necessary to acquire a co-ownership interest is not simply a matter of common practice; it is a matter of real economic importance.<sup>71</sup> For example, real-world economic partnerships might observe that the contribution of additional capital can restore pre-existing partners to their pre-existing levels of risk and reward in existing investments, but they do not put the additional capital

<sup>64</sup> Anonymous Partner, *Buying In: A Partner's Perspective*, ABOVE THE LAW (June 12, 2012, 10:07 AM), <http://abovethelaw.com/2012/06/buying-in-a-partners-perspective/?rf=1> [<https://perma.cc/9HBC-EXXL>].

<sup>65</sup> Cheryl Meyer, *What to Know Before You Become Partner*, AICPA, <http://www.aicpa.org/interestareas/youngcpanetwork/resources/career/pages/cpa-firm-partner-what-to-know.aspx> [<https://perma.cc/6ETW-EF9J>] (last visited Oct. 26, 2017).

<sup>66</sup> See PETER PIVEN & BRADFORD PERKINS, ARCHITECT'S ESSENTIALS OF STARTING A DESIGN FIRM 2–3, 76–79 (2003) (discussing formation of a design firm and initial capital needs required for a successful business enterprise).

<sup>67</sup> See John K. McGill & Blake Hassan, *Key Issues to a Successful Practice Buy-In*, DENTAL ECON., Feb. 2011, at 104, 104 <http://www.dentaleconomics.com/articles/print/volume-101/issue-2/finances/key-issues-to-a-successful-practice-buy-in.html> (URL would not allow Perma link).

<sup>68</sup> Joanne Tetrault, *The Partnership Track*, PHYSICIANS PRAC. (July 15, 2002), <http://www.physicianspractice.com/articles/partnership-track> (follow “PDF” icon) [<https://perma.cc/M7AB-87KJ>].

<sup>69</sup> New partners may finance their capital contributions with loans from third-party lenders or loans from the partnership itself, but debt-financing a capital contribution does not change the fact that a capital contribution must be made. See, e.g., Nicholas Gaffney, *Financial Considerations for New Law Firm Partners*, A.B.A. L. PRAC. TODAY (Dec. 12, 2014), <http://www.lawpracticetoday.org/article/financial-considerations-new-law-firm-partners> [<https://perma.cc/ZW4H-QJL7>] (explaining that many law “firms have banking relationships that can be used to facilitate financing” for a new partner’s “required capital contributions”); Thomas L. Snyder, *Strategies for Partnership Buy-In*, DENTIST'S NETWORK (The Dentist's Network, La Jolla, Cal.), Aug. 14, 2007, <http://www.thedentistsnetwork.net/newsletters/print/snyder/printSnyder26.html> [<https://perma.cc/5J7Y-3AKH>] (explaining that new partners in dental practice may finance their required buy-ins with bank loans or partnership loans in which the “Senior Partners . . . function as a bank, charging an interest rate and receiving principal and interest payments”).

<sup>70</sup> See *supra* notes 66–69 and accompanying text. The professional service partnership examples were selected because they are accessible. However, non-professional service partnerships also require capital contributions. Indeed, the requirement of buying in by professional service partnerships may make the point even stronger since the capital contribution is required even after the newly-minted partner has been deemed to have already contributed to the partnership’s profitability through partnership-worthy work as an associate.

<sup>71</sup> See, e.g., Cunningham, *supra* note 3, at 36–39 (showing that even if a taxpayer can increase her investment by borrowing, taxpayers borrow at different interest rates and “[a]s a general proposition, the wealthier an investor, the better her credit rating and the lower her borrowing rate”); *id.* (explaining that by triggering a need to borrow in order to make tax-minimizing portfolio adjustments and to pay for that borrowing with interest rates that generally favor wealthy investors, the income tax has effects that are “regressive with respect to wealth”).

contribution requirement on the pre-existing partners.<sup>72</sup> Rather, the new partner must supply the necessary additional capital.<sup>73</sup> Accordingly, the new partner bears any costs needed to raise the capital and assumes a proportionate share of the front-end risk that investments might be imprudent. For example, one risk of a capital investment is that it might produce net negative revenue (for instance, the investment is in a machine that produces less revenue than its cost of fuel); however, a potentially far greater risk of a capital investment is that while it produces net positive revenue, this revenue falls short of the expectations used to determine the asset's price. As a result, the investment will be a loss, not because of annual losses (shared by all those who bear annual risk), but because it was purchased at a price that proved to be too high (a loss shared only by those partners who contributed capital on the front-end for their proportionate shares of the purchase price).<sup>74</sup>

Taking this analogy to the world of tax, the government does not accurately mimic a full and fair investment partner by proportionately sharing ongoing risks and returns, while assuming that the taxpayer will be the source of any new capital needed to restore his pre-existing economic position. This might be consistent with the behavior of a taxing entity, but it is not consistent with the behavior of a true economic partner. Rather, the government acts more like a true investment partner when it supplies any new capital needed to restore the taxpayer to his pre-existing economic position, which, in this case, is equivalent to a tax-free position.

### C. *Sharing Capital Contributions*

The idea that the government might itself supply the new capital needed to make it more like a true investment partner, and to restore a taxpayer to a tax-free position is neither hypothetical nor far-fetched.<sup>75</sup> Indeed, the government often co-finances investments, and its role as a co-financer has recently grown.<sup>76</sup>

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<sup>72</sup> See, e.g., *id.*

<sup>73</sup> See, e.g., *id.*

<sup>74</sup> Because total depreciation deductions over the useful life of an asset equal the purchase price of the asset, gradual depreciation causes the government to incur the risk that the asset was purchased for too high a price and that depreciation deductions will be too large given the smaller income produced by the asset. For a discussion on depreciation policy, see, for example, Henry J. Lischer, Jr., *Depreciation Policy: Whither Thou Goest*, 32 SW. L.J. 545 (1978). However, this risk is far larger in the case of immediate expensing and accelerated depreciation since these policies cause the government to pay its full share of the purchase price in the year of acquisition. See *id.* at 553, 588–89.

<sup>75</sup> The Domar & Musgrave result follows from the government proportionately sharing gains and losses. See Domar & Musgrave, *supra* note 9, at 389–91. Since this reduces the risk of an investment commensurate with tax's reduction of the returns to that investment, a taxpayer can nearly replicate a no-tax world by increasing the amount of the investment to restore pre-tax preference for higher risk and higher reward. *Id.* The E. Cary Brown partnership goes one step further in that the government proportionately shares gains (through tax), losses (through full loss offsets), and the capital contribution

Looking at traditional investment partners first, the proportionate sharing of capital contributions to fund investments is common. When one partner contributes \$20,000 to fund 20% of the purchase price for a \$100,000 asset, we expect that he will properly collect 20% of the profits produced by that asset and suffer 20% of any losses. In so doing, the 20% partner is not “taxing” the investment; he is simply taking a return on the investment consistent with his share of ownership in the partnership.

As E. Cary Brown established, when the government allows immediate expensing (also known as fully accelerated depreciation) of capital investments, it acts just like the 20% partner described above.<sup>77</sup> Immediate expensing allows a taxpayer to deduct the full cost of a capital asset in the year it is purchased, resulting in a tax savings equal to the full cost of the capital asset times the taxpayer’s marginal rate.<sup>78</sup> By providing these tax savings, the government effectively cuts the taxpayer a check for the amount of tax savings, which can be used toward the purchase of the capital asset.<sup>79</sup> Other than a very short<sup>80</sup> lapse of time between when a taxpayer purchases a capital asset and when he receives the tax savings, the government is like a partner that contributes a percent (equal to the taxpayer’s marginal tax rate) of capital (in the form of tax savings) to fund partnership investments.<sup>81</sup> It then collects that same percentage of profits and

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(through immediate expensing). Brown, *supra* note 16, at 309–10. As a result, the taxpayer need not raise additional capital or reduce his wealth in order to increase the amount of the investment and return to pre-tax preferences. *Id.* at 310. Rather, he can simply use the tax savings from immediate expensing to fund the additional amount of investment. *See id.* As a result, he does not pay a tax on the risk-free rate of return of the full portfolio—only the share that the government did not effectively purchase via immediate expensing.

<sup>76</sup> *See, e.g.*, Brown, *supra* note 16, at 300–02, 309–10, 314–16.

<sup>77</sup> *See id.* at 309–10.

<sup>78</sup> *Id.* at 309.

<sup>79</sup> *See, e.g.*, U.S. DEPT OF THE TREASURY, THE CASE FOR TEMPORARY 100 PERCENT EXPENSING: ENCOURAGING BUSINESS TO EXPAND NOW BY LOWERING THE COST OF INVESTMENT 7–8 (2010) (“Allowing 100 percent bonus depreciation is economically equivalent to full expensing of depreciable asset purchases, because it allows a complete write-off of the cost of eligible property in the year in which the property is placed in service. Expensing a capital expenditure means the government effectively finances a portion of the investment’s cost (in the form of a reduction in current taxes). . . . [This means that] there is no tax imposed on the income representing the taxpayer’s investment “share” of the return from a marginal investment that a business is otherwise indifferent about making (unless tax rates change over time). Thus, for non-corporate businesses (which incur only a single level of tax), the expected income from an on-the-margin expensed investment in depreciable property is taxed at an effective rate of zero, and the minimum pre-tax rate of return required from such an investment is equal to the after-tax rate of return demanded by the firm to induce it to invest in tangible property. In other words, with full expensing, there is no additional tax burden imposed on a firm’s marginal investment activity in qualified assets.”); *see also* Brown, *supra* note 16, at 310.

<sup>80</sup> For quarterly taxpayers, the time lapse between an outlay and the receipt of tax savings from its deduction might only be a matter of months; for annual taxpayers, the lapse might range from a matter of months to slightly more than a year. *See, e.g.*, IRS, IRS PUBLICATION NO. 505: TAX WITHHOLDING AND ESTIMATED TAX (2017), <https://www.irs.gov/publications/p505> [<https://perma.cc/85RD-WJ9N>].

<sup>81</sup> *See* Brown, *supra* note 16, at 309–10.

likewise suffers that same percentage of losses produced by the investment.<sup>82</sup> The government is not taxing its co-owner on the co-owner's share of returns; rather, it is simply collecting its own share of returns based on its own share of ownership in the asset.<sup>83</sup> Accordingly, any profit-sharing payments to the government over the life of the asset are not in the nature of tax; they are in the nature of proportionate returns on the government's investment.

Since the government is taking a share of profits and losses commensurate with its share of the total capital outlay, the taxpayer is restored to a tax-free position without having to increase either the amount he invests or the risk level of his investments. As E. Cary Brown concluded, by allowing a full deduction in the year a taxpayer purchases an asset, the Treasury effectively enters into an economic partnership with the taxpayer in which each party effectively contributes a share of the purchase price of an asset, and each collects its proportionate share of the income from the asset.<sup>84</sup> Because the taxpayer is restored to a tax-free position, under the assumptions specified,<sup>85</sup> an immediate deduction for a capital investment

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<sup>82</sup> See *id.* The following is an example of the model: Assume for purposes of this example that a taxpayer is subject to a tax rate of 20%, that taxes are due immediately (ignoring withholding and estimated tax payments), and that the taxpayer is making a \$100,000 capital investment with a 10% pre-tax annual rate of return. The model is illustrated by comparing the effect of exempting the returns on the capital investment from tax (Scenario 1) to the effect of immediately deducting the full cost of the capital investment (Scenario 2). In Scenario 1, the taxpayer makes a \$100,000 capital investment and does not receive any deduction for it. Each year, the capital investment produces \$10,000 profits (based on the 10% pre-tax annual rate of return). Those \$10,000 profits are exempt from tax, meaning that the after-tax rate of return is the same as the pre-tax annual rate of return of 10%. In Scenario 2, the taxpayer makes a \$100,000 capital investment and deducts the outlay in full (resulting in a \$20,000 tax benefit from the immediate deduction). The taxpayer has made a net outlay of \$80,000. Each year, the capital investment produces a \$10,000 profit (based on the 10% pre-tax annual rate of return). That annual profit of \$10,000 is subject to a 20% tax rate, meaning that the government receives \$2,000 in tax each year and the taxpayer retains \$8,000 in after-tax profits each year. This continues as long as the capital investment continues producing income at the 10% pre-tax annual rate of return. The taxpayer's annual after-tax return is \$8,000. Although technically the capital investment was \$100,000, so it initially appears that the after-tax rate of return is 8%, the economic realities do not match this initial appearance. The economic reality is not that the taxpayer outlaid the full \$100,000 to purchase the asset; the economic reality is that the taxpayer made a net outlay of \$80,000 and used \$20,000 tax savings to fund the purchase price. Thereafter, the taxpayer received annual after-tax returns of \$8,000 on a net outlay of \$80,000. In Scenario 2, just as in Scenario 1, the taxpayer's after-tax rate of return is 10% annually whether this outcome is accomplished by exempting the returns on the capital investment from tax or whether it is accomplished by the economically-equivalent approach of allowing an immediate deduction for the entire amount of the capital investment in the year of purchase.

<sup>83</sup> See *id.* at 310.

<sup>84</sup> *Id.*

<sup>85</sup> *Id.* at 302–03, 303 n.4 (listing the assumptions at work when an entrepreneur/taxpayer is certain of the net receipts an asset will produce to include: 1) that an entrepreneur invests whenever “the investment yield equals or exceeds the rate of interest” that “he must pay on funds made available to him for the investment”; 2) that tax policy allows full loss offsets, meaning that “each dollar of additional income will be taxed at the given rate; each dollar of additional expense will be reimbursed [through full deductibility] at the same rate. . . . whether or not past, present, or future taxable income is earned”; 3) that “[i]nterest and dividend payments are not deductible[,] . . . [meaning that, contrary to current tax

is the mathematical equivalent of exempting from tax the annual returns on that investment.<sup>86</sup> Scholars have called this equivalence the “yield-exemption phenomenon.”<sup>87</sup>

While the impact of this partnership has been analyzed from the perspective of a taxpayer who now enjoys returns on investment that are effectively exempt from

rules,] the interest costs of the entrepreneur are not partially reimbursed by the Government through reduction in taxable income”; and 4) that interest rates available to entrepreneurs are not affected by tax).

<sup>86</sup> See Cunningham, *supra* note 3, at 25 (summarizing the assumptions simply by saying that “[a]t a constant rate of tax and allowing for full loss offsets, expensing the cost of a capital asset is the equivalent of exempting the yield from that asset”). While investments often have uncertain future returns, the proportionate sharing of this uncertainty between the taxpayer/entrepreneur and the government is consistent with the partnership analogy. See *id.* (explaining that uncertainty regarding returns does not undermine the government as investor analogy, except that the government is an investor that the taxpayer may not choose to exclude).

The total exemption view is premised on the fact that under a cash flow tax, the government is a partner in all ventures—those that are lucrative as well as those that are not. It cannot be excluded. Therefore, the government invests in whatever an investor chooses, and in all cases, the investor's yield on her net investment is tax-free. The tax savings view, on the other hand, does not accept the government's participation as a matter of right and is designed to highlight one particular situation: where an investor faces an attractive, but limited, investment opportunity. As is the case with all other investments, the government cannot be excluded from participating in this investment. To the extent that its participation prevents the investor from investing as much in this particular venture as she would like, the tax savings view would hold that her return from this attractive investment is exempt from the cash flow tax only to the extent that the investor is able to reinvest her tax savings.

*Id.* at 27. But see Graetz, *supra* note 63, at 1600 (noting that the “[i]mmediate-[d]eduction/[y]ield- [e]xemption [e]quivalence . . . reflects an ex ante approach to tax parity” in which predicted rates of return prove to be exactly and constantly accurate). If predicted rates of return, including the 10% pre-tax annual rate of return used in the example in footnote 82, prove inaccurate, the parity is lost. See *supra* note 82. A taxpayer who, in fact, experienced lower-than-projected returns would have been better off immediately deducting the full cost of the outlay and paying tax on its low yields while a taxpayer who, in fact, experienced higher-than-projected returns would have been better off not deducting the full cost of the outlay and avoiding tax on its high yields. As Professor Graetz explains, “Under the Yield-Exemption option, ‘lucky investors might become very rich and owe no additional [expenditure] tax liability on future consumption of their wealth [and] unlucky investors will have prepaid a tax on expected returns and will then obtain no deduction for the losses they incur.” Graetz, *supra* note 63, at 1600. While the “[i]mmediate-[d]eduction/[y]ield-[e]xemption [e]quivalence” typically takes an ex ante view, that equivalence holds ex post only “under a restrictive set of conditions . . . which are typically assumed (although often not explicitly) in the economic and legal literature.” *Id.* at 1601. These conditions are that:

- (1) Tax rates are not progressive; moreover, they do not change over time.
- (2) Taxpayers have no accumulated wealth when the system is first introduced.
- (3) The system is closed; either the taxpayer exhausts his wealth by death, the system classifies all remaining capital balances (all bequests) as being consumption in the taxpayer's final return, or an identical tax is subsequently imposed on bequests in some other manner.
- (4) There exists a perfect capital market with no uncertainty; all taxpayers can borrow and lend unlimited amounts at a risk-free interest rate.
- (5) All income can be classified as one of two types: wage income or income to capital accumulated during and after the initial period.

*Id.* at 1602.

<sup>87</sup> E.g., Deborah A. Geier, *The Myth of the Matching Principle as a Tax Value*, 15 AM. J. TAX POLY 17, 26 (1998) (describing this equivalence as the “yield-exemption phenomenon”); see Christopher H. Hanna, *The Magic in the Tax Legislative Process*, 59 SMU L. REV. 649, 681 n.174 (2006) (“Dr. Brown has been credited with developing the theorem that immediately deducting the cost of an asset is equivalent to excluding the return of the asset from tax.”).

tax,<sup>88</sup> less attention has been paid to the impact of this partnership on the government.<sup>89</sup> As a result of this partnership, the government has—based solely on the operation of tax law—contributed capital to, and assumed ongoing risks of, an investment it did not select. Indeed, because the taxpayer selected the investment, it seems rational to assume that the investment will reflect the investment priorities of the taxpayer, not those of the government.

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<sup>88</sup> See, e.g., Brown, *supra* note 16, at 310 (“From the point of view of the entrepreneur such a tax [allowing full loss offsets and immediate expensing] would imply a substitution of Government funds for private funds in proportion to the tax, with a corresponding shift in interest payments from private lenders to the Government in the form of taxes.”); Christopher H. Hanna, *Demystifying Tax Deferral*, 52 SMU L. REV. 383, 384–86 (1999) (establishing that taxpayers benefit from the yield-exemption in many different situations, not just immediate expensing). Professor Hanna identifies four additional situations: 1) the deferral of tax on gain from installment sales, *id.* at 392; 2) the deferral of tax on prepaid income, *id.* at 399; 3) the deferral of tax on retirement plans, *see id.* at 406–08; and 4) the deferral of tax on unrealized appreciation, *id.* at 412. The yield-exemption phenomenon has been observed in other contexts, including retirement, where scholars have observed that Traditional IRAs (which allow a full deduction when funded but result in taxable income upon withdrawals) and Roth IRAs (which do not allow a deduction when funded but result in exempt income upon withdrawals) are equivalent provided the owner’s marginal rate at deposit equals her marginal rate upon withdrawals. See, e.g., Daniel I. Halperin & Alvin C. Warren, Jr., *Understanding Income Tax Deferral*, 67 TAX L. REV. 317, 325 (2014) (“[T]raditional and Roth IRAs produce equivalent results if tax rates do not change. Traditional IRAs and qualified pension plans are versions of expensing, while the Roth IRA is a straightforward example of tax exemption.”); Gregg D. Polsky & Brant J. Hellwig, *Taxing Structured Settlements*, 51 B.C. L. REV. 39, 39, 41 (2010) (exploring the exemption of the “investment yield imbedded within the structured settlement”).

<sup>89</sup> But see Cunningham, *supra* note 3, at 25 (“It is worthwhile to look at the government’s role in this investment. The government is in a very real way a co-investor . . . , if you will, a 40% limited partner. All gains and losses would be shared 60–40 by the investor and the government. The only difference between the government’s role and that of a limited partner is that the government has no say in either making the investment or terminating it. These matters are totally within *T*’s [taxpayer’s] control. By virtue of *T*’s initial deduction, the government could be viewed as investing \$400 to acquire a 40% interest in the [immediately expensed asset]. Each year, *T*’s tax payments of \$40 to the government would be exactly equal to the amount that *T* would have paid a 40% limited partner. Similarly, if and when *T* sold the [asset], *T* would owe taxes of 40% of the proceeds, which could be viewed as a return of the government’s initial investment, or if the [asset] becomes worthless, *T* and the government lose their respective investments. This analogy holds no matter how speculative the investment and no matter what the nature of the investment.”); Weisbach, *supra* note 9, at 11 (describing how the income tax causes the government to share in risk/return “bets” selected by taxpayers, exploring the possibility that the government might adjust its portfolio to hedge those bets or retain its portfolio if it “like[s] its chances” on those bets, and concluding that “[t]he income tax becomes in this case just a complicated, indirect, and very expensive way for the government to take market positions”).

*D. Investor Role Has Dramatically Expanded*

The government's role in the partnership that results when it shares profits, losses, and capital contributions for investments deserves more attention,<sup>90</sup> especially because expanded immediate expensing and accelerated depreciation policies have made these partnerships far more common.<sup>91</sup>

Historically, while the government shared in the profits,<sup>92</sup> operating expenses,<sup>93</sup> and losses associated with capital investments,<sup>94</sup> it did not share in the initial capital contributions used to finance capital investments. Instead of allowing the purchasing taxpayer to deduct the full cost of a capital investment in the year the investment was made, which would have provided up-front tax savings to co-finance the investment, tax law required the purchasing taxpayer to deduct the cost of a capital investment gradually over a series of years.<sup>95</sup> Initially, gradual depreciation deductions were taken over the period of time that the capital investment was expected to produce profit (its economic useful life), such that the cost to acquire the asset would be fully recovered as the asset's useful life ended.<sup>96</sup> While the government finally shared in the cost to acquire an asset by the time that asset was fully worn out and worthless, the burden to finance the investment at the time of purchase was borne by the taxpayer alone.<sup>97</sup> Gradual depreciation created, and is still creating, partial partnerships between the government and purchasers of gradually depreciated assets, like buildings.

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<sup>90</sup> *E.g.*, Hanna, *supra* note 88, at 384–85 (explaining that while scholars have explored E. Cary Brown's conclusion that "immediately deducting the cost of an asset is equivalent to excluding from gross income the future annual return of the asset. . . . the focus and confusion has always been on the concept of excluding the future annual return (or future investment income) of the asset from gross income [, while the economic partnership that takes place between the government and the taxpayer] has been almost completely ignored in the tax literature").

<sup>91</sup> See Bruce Bartlett, *Depreciation's Place in Tax Policy*, N.Y. TIMES: ECONOMIX (Sept. 10, 2013, 12:01 AM), <https://economix.blogs.nytimes.com/2013/09/10/depreciations-place-in-tax-policy/> [<https://perma.cc/XP24-XBSK>] (discussing the growth in the use of depreciation policies); see also *supra* notes 23–24 and accompanying text.

<sup>92</sup> See 26 U.S.C. § 61(a)(2) (2012) (stating that "income derived from business" operations is gross income subject to tax).

<sup>93</sup> See *id.* § 162(a) (allowing a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business," which allows deductions for the cost of operating capital investments, including fuel and labor).

<sup>94</sup> See Brown, *supra* note 16, at 301.

<sup>95</sup> See, e.g., *Simon v. Comm'r*, 68 F.3d 41, 44 (2d Cir. 1995); see also Lischer, *supra* note 74, at 550.

<sup>96</sup> *Simon*, 68 F.3d at 44 ("In its traditional incarnation, therefore, the pace of depreciation deductions was determined by the period of time that the asset would produce income in the taxpayer's business [also known as the asset's economic useful life].").

<sup>97</sup> See Brown, *supra* note 16, at 301 (noting that because gradual depreciation causes deductions that are "spread over the economic life of an asset, the tax will adversely affect investment incentives," even if the government allows full loss offsets).

However, the government departed from gradual depreciation for many eligible assets, like machinery and equipment.<sup>98</sup> In its most significant departure, the government replaced gradual depreciation with full immediate expensing under § 179.<sup>99</sup> Initially aimed to simplify tax accounting for small businesses by allowing them to immediately expense investments<sup>100</sup> up to a \$2,000 per year cap,<sup>101</sup> § 179 has been expanded to allow much larger businesses to immediately expense much larger portions of much larger investments.<sup>102</sup> In response to recent recessions and sluggish recoveries, § 179's immediate expensing cap was raised to \$100,000 in 2003, to \$125,000 in 2007, to \$250,000 in 2008, and finally to \$500,000 in 2010.<sup>103</sup> While lawmakers initially hoped that the expansion of immediate expensing would encourage increased capital investing and stimulate the economy following recession, on December 18, 2015, they embraced its use in non-recession economies by making § 179 immediate expensing permanent.<sup>104</sup> As a result, taxpayers could immediately expense up to \$500,000 of eligible investment in

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<sup>98</sup> Section 179 defines “section 179 property” as “tangible property” (or certain computer software) that is depreciable, was “acquired by purchase for use in the active conduct of a trade or business,” and is either personal property or other “section 1245 property.” 26 U.S.C. § 179(d)(1) (2012 & Supp. III 2012). Section 1245 property includes personal property and a few limited types of real property (including real property amortized under special elections, including pollution control facilities, qualified refinery property, and certain energy efficient buildings). *Id.* § 1245(a)(3); *see also* GARY GUENTHER, CONG. RESEARCH SERV., RL31852, THE SECTION 179 AND BONUS DEPRECIATION EXPENSING ALLOWANCES: CURRENT LAW AND ISSUES FOR THE 114TH CONGRESS 2 (2015) (“With a few minor exceptions, this property consists of machinery and equipment used in manufacturing, mining, transportation, communications, the generation and transmission of electricity, gas and water distribution, and sewage disposal. Most buildings and their structural components . . . do not qualify for the allowance.”).

<sup>99</sup> *Compare* 26 U.S.C. § 179(b)(1) (Supp. III 2012), *with id.* § 179(b)(1) (Supp. IV 2006), *id.* § 179(b)(1) (Supp. I 2006), *id.* § 179(b)(1) (Supp. III 2000), *and id.* § 168(a) (2012). *See generally* GUENTHER, *supra* note 98 (discussing the evolution of § 179 allowances).

<sup>100</sup> To immediately expense an investment is to deduct the full cost of an investment in the year the investment is made.

<sup>101</sup> Technical Amendments Act of 1958, Pub. L. No. 85–866, § 204(a), 72 Stat. 1606, 1679 (providing immediate expensing up to a \$2,000 cap); *see* GUENTHER, *supra* note 98, at 5 (arguing that the initial purpose of immediate expensing was to simplify tax record-keeping for small businesses).

<sup>102</sup> *Compare* 26 U.S.C. § 179(b)(2) (Supp. III 2012) (establishing \$2,000,000 as the reduction in limitation cap), *with id.* § 179(b)(2) (Supp. IV 2006) (establishing \$800,000 as the reduction in limitation cap for years “after 2007 and before 2010,” \$2,000,000 for years 2010 and 2011, and \$200,000 for years after 2011), *id.* § 179(b)(2) (Supp. I 2006) (establishing \$200,000 as the reduction in limitation cap for years 2006 and earlier and \$500,000 as the reduction in limitation cap for “years beginning after 2006 and before 2011”), *id.* § 179(b)(2) (Supp. III 2000) (establishing \$200,000 as the reduction in limitation cap for years 2002 and earlier and \$400,000 as the reduction in limitation cap for “years beginning after 2002 and before 2006”); *id.* § 179 (2007), *and id.* § 179 (2003).

<sup>103</sup> *See* GUENTHER, *supra* note 98, at 3 tbl.1 (providing § 179 data for 1987–2015).

<sup>104</sup> Consolidated Appropriations Act of 2016, Pub. L. No. 114–113, § 124(a)(1), 129 Stat. 2242, 3053 (2015).



2016,<sup>105</sup> provided their total eligible investment for the year did not exceed \$2,010,000.<sup>106</sup> For tax years 2017 and beyond, these permanent benefits will be further adjusted for inflation.<sup>107</sup> Thus, whenever inflation is positive, these benefits will automatically increase.

Since § 179 authorizes a taxpayer to currently deduct the entire cost of an asset worth \$500,000 or less in the year of its purchase,<sup>108</sup> § 179 makes the government a full investment partner in immediately expensed assets. In addition to taxing the profits and allowing the deduction of any ongoing losses produced by the asset, the government supplies capital in the year the asset is purchased equal to the purchase price times the taxpayer's marginal rate.<sup>109</sup> This provision of capital means that the government is effectively co-financing the investment.

While immediate expensing is the clearest example of the government becoming a full investment partner by supplying its proportionate share of capital for a growing number of investments, it is not the only example. As lawmakers expanded § 179 immediate expensing, they also enacted and expanded § 168(k) bonus depreciation and applied it to a similar class of eligible investments, meaning that § 168(k) bonus depreciation can be taken in addition to § 179 immediate expensing.<sup>110</sup> Bonus depreciation allows a large percent of an asset's purchase price to be deducted in the year of purchase.<sup>111</sup> When the bonus depreciation percent is 100%, as it was at the end of 2010 and for 2011,<sup>112</sup> bonus depreciation makes the government a full investment partner in the same way that immediate expensing does. But, over the years bonus depreciation rates have been set at different levels, including 30% at the end of 2002 and the beginning of 2003,<sup>113</sup> and at 50% from

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<sup>105</sup> Protecting Americans from Tax Hikes Act of 2015, § 124(a), (f) (establishing \$500,000 cap for 2015, but providing that it should be adjusted for inflation); Rev. Proc. 2016-14, 2016-9 I.R.B. 365, § 3.03 (establishing that the cap remains \$500,000 for 2016 due to low inflation).

<sup>106</sup> 26 U.S.C. § 179(b)(2) (Supp. III 2012) (establishing that the immediate expensing cap "shall be reduced . . . by the amount by which the cost of section 179 property placed in service during such taxable year exceeds [an un-inflation-adjusted threshold of] \$2,000,000"); Rev. Proc. 2016-14, 2016-9 I.R.B. 365, § 3.03 (establishing that inflation adjusting makes the 2016 threshold \$2,010,000). If the taxpayer's total eligible investment exceeds \$2,010,000, that excess causes a dollar-for-dollar reduction in the \$500,000 immediate expensing cap. *Id.* For example, a taxpayer with total eligible investment of \$2,310,000 may immediately expense \$200,000 (reflecting the full \$500,000 cap minus the \$300,000 excess over the \$2,010,000 phase out amount).

<sup>107</sup> 26 U.S.C. § 179(b)(6).

<sup>108</sup> *Id.* § 179(b)(1).

<sup>109</sup> See Brown, *supra* note 16, at 309–10.

<sup>110</sup> GUNTHER, *supra* note 98, at 3 (noting that most assets that are eligible for immediate expensing under § 179 are also eligible for bonus depreciation under § 168(k)). Of course, the total depreciation deduction may not exceed 100% of the cost of the asset, even if multiple provisions are used. *Id.*

<sup>111</sup> See, e.g., *id.* at 1, 3–4.

<sup>112</sup> Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 401, 124 Stat. 3296, 3304–06 (authorizing 100% bonus depreciation for the end of 2010 and for the entirety of 2011).

<sup>113</sup> Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, § 101, 116 Stat. 21, 22–25 (authorizing 30% bonus depreciation for the end of 2001 and before 2004).

late 2003 until the end of 2005, 2008 until the beginning of 2010, and from 2012 to the present.<sup>114</sup>

Allowing a taxpayer to deduct half of the cost of a long-term asset in the year of purchase is a significant step towards making the government a co-financing investment partner, especially when the purchasing taxpayer can also immediately expense part of the purchase price. For example, a taxpayer purchasing a \$1,000,000 asset that is eligible for immediate expensing and bonus depreciation can deduct \$800,000 in the year of acquisition, making the government a proportionate co-financer of 80% of the investment and a delayed co-financer of the remaining 20%.<sup>115</sup> Although this falls short of a true partnership in which the government supplies its proportionate share of the purchase price entirely in the year of acquisition, it is substantially similar. The accelerated depreciation caused by §168(k) bonus depreciation and the standard depreciation regime of §168(a) cause the full cost of a capital asset to be recovered far before the end of the asset's useful life and trigger large deductions in the year of acquisition.<sup>116</sup> E. Cary Brown

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<sup>114</sup> Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108–27, § 201, 117 Stat. 752, 756–57 (authorizing 50% bonus depreciation from the May 2003 until the end of 2005); Economic Stimulus Act of 2008, Pub. L. No. 110–185, § 103(a)–(b), 122 Stat. 613, 618 (authorizing 50% bonus depreciation from 2008 until the beginning of 2010); American Taxpayer Relief Act of 2012, Pub. L. No. 112–240, § 331(a), 126 Stat. 2313, 2335 (2013) (extending 50% bonus depreciation beyond 2012); Tax Increase Prevention Act of 2014, H.R. 5771, 113th Cong. § 125(a)(2014) (extending bonus depreciation from 2014 to 2016); Consolidated Appropriations Act of 2016, Pub. L. No. 114–113, § 143(a), 129 Stat. 2242, 3056 (2015) (extending bonus depreciation from 2015 to 2017); *id.* § 143(b), 129 Stat. at 3057–65 (providing a phase down of the bonus depreciation percentage starting in 2018). Under current law, taxpayers may bonus depreciate 50% of the adjusted bases of eligible assets.

26 U.S.C. § 168(k)(1)(A) (2012). Beginning in 2018, the 50% bonus depreciation percentage is set to phase down such that it will be 40% for 2018, *id.* § 168(k)(6)(A) (Supp. III 2012), and for 2019, it will be 30%, *id.* § 168(k)(6)(B). However, bonus depreciation has frequently been extended and made more generous. Accordingly, these lower 2018 and 2019 amounts may be increased.

<sup>115</sup> This example assumes that an asset was purchased in 2016 (which makes for round numbers), has a five-year recovery period, is subject to the double declining balance method of depreciation, and is subject to the half-year convention. This \$800,000 first-year deduction reflects \$500,000 of immediate expensing, *id.* § 179(b)(1) (Supp. III 2012), plus \$250,000 of bonus depreciation, *id.* § 168(k) (2012 & Supp. III 2012) (reflecting 50% of the remaining \$500,000 adjusted basis), plus \$50,000 of regular depreciation, *id.* § 168(a) (2012) (reflecting 20% of the \$250,000 basis remaining after immediate expensing and bonus depreciation).

<sup>116</sup> Section 168(a) (2012) accelerates tax depreciation relative to economic depreciation through several techniques, including by allowing the depreciation of assets that retain or grow in value, *see* *Simon v. Comm'r*, 68 F.3d 41, 43–46 (2d Cir. 1995), by allowing depreciation over a recovery period that is typically far shorter than an asset's actual economic useful life, *see* 26 U.S.C. § 168(e) (2012 & Supp. III 2012) (converting asset class lives to shorter recovery periods), by treating the salvage value of all assets as zero, *id.* § 168(b)(4) (2012), and by frequently using the double-declining-balance method of depreciation to frontload deductions, *see id.* § 168(b)(1) (making the double-declining-balance method the default method of tax depreciation).

recognized that depreciation that is substantially similar to immediate expensing can trigger similar partnership effects.<sup>117</sup>

## II. THE GOVERNMENT'S CHARACTERISTICS AS AN INVESTOR

The government is uniquely situated as an investor. Among all investors, it has the lowest cost of capital.<sup>118</sup> While most others often find it particularly difficult and costly to raise capital during and following recession, the government's cost of capital usually drops during and following recession.<sup>119</sup> Among all investors, it is also uniquely well diversified.<sup>120</sup> While others seek diversification by purchasing a variety of the investments that are available to them, the government is naturally diversified because, through the operation of tax law, it shares in streams of income from labor compensation, streams of profits from asset appreciation, shares of privately-held investments, and interests in publically-traded investments.<sup>121</sup> Finally, among all investors, it is uniquely compromised in its ability to pursue its investment priorities.<sup>122</sup> While others can purchase investments that are aligned with their investment priorities, sell these investments when they become misaligned, and even appeal to investor protection laws, the government is an involuntary investor<sup>123</sup> and is not covered by investor protection laws.<sup>124</sup> Each of

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<sup>117</sup> Brown, *supra* note 16, at 301 (acknowledging that while full immediate expensing is necessary to make the government a full investment partner and neutralize the adverse effect of tax, “[d]epreciation of assets over a short period, say, three to five years, would come reasonably close to neutralizing the adverse effect of the tax”). Interestingly, taxpayers seem to far prefer increased depreciation deductions in the year of acquisition over shortened recovery periods. See, e.g., Eric Zwick & James Mahon, *Do Financial Frictions Amplify Fiscal Policy? Evidence from Business Investment Stimulus 5* (Nov. 25, 2013) (working paper), <https://www.irs.gov/pub/irs-soi/businessinveststimmahonzwick.pdf> [<https://perma.cc/R2KX-C75C>] (finding that “firms *only* respond to investment incentives when the [bonus depreciation] policy immediately generates cash flows.”). Thus, from a taxpayer’s perspective, the government might be a more complete investment partner by allowing a larger percentage of cost to be deducted in the year of acquisition rather than deduction ratably over a short, three-to-five-year recovery period.

<sup>118</sup> See *infra* note 136 and accompanying text.

<sup>119</sup> See *infra* notes 137–140 and accompanying text.

<sup>120</sup> See, e.g., Jeffrey R. Brown, *Introduction: What Role Should the Government Play in Insuring Private Market Risks?*, in *PUBLIC INSURANCE AND PRIVATE MARKETS* 1, 10 (Jeffrey R. Brown ed., 2010) (noting “that the government has the unique ability to diversify risk across generations through fiscal policy”). But see Shu-Yi Oei, *Taxing Bankrupts*, 55 B.C. L. Rev. 375, 421 (2014) (“[S]imply saying that the government [with its ability to raise revenue through borrowing or through spending cuts and/or tax increases on future generations] has superior powers of diversification does not say very much about whether the methods of diversification employed are desirable.”). See *infra* Part II.B., for an in-depth explanation of the government’s diversification.

<sup>121</sup> See, e.g., Cunningham, *supra* note 3, at 29 (observing that “the government is a partner in all [capital] investments and cannot be excluded”).

<sup>122</sup> See *infra* Part II.C.

<sup>123</sup> The government is an involuntary investor in the sense that, through immediate expensing and accelerated depreciation policies, it takes an indirect investment role without making particularized buy and sell decisions. But, it decides which categories of investments are eligible for immediate expensing and accelerated depreciation treatment and can change its indirect investments by changing these categories.

<sup>124</sup> See *infra* note 158 and accompanying text.

these characteristics informs consideration of the government's investment preferences.

### A. *Low Cost of Capital, Especially Following Recession*

When federal taxes<sup>125</sup> are insufficient to cover the federal government's expenses, the Department of Treasury borrows money by issuing Treasury bills and other securities.<sup>126</sup> Private parties and foreign governments buy a Treasury security,<sup>127</sup> providing the federal government with immediate use of the security's purchase price. Typically, while the Treasury security is outstanding, the government must pay interest to the holder at a rate that was fixed at the time the security was issued.<sup>128</sup> When the security matures, the government must repay the

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<sup>125</sup> Federal income taxes, payroll taxes, and corporate taxes are the largest sources of federal tax revenue. See *SOI Tax Stats – Gross Collections by Type of Tax – IRS Data Book Table 6*, INTERNAL REVENUE SERV., <https://www.irs.gov/uac/soi-tax-stats-gross-collections-by-type-of-tax-irs-data-book-table-6> [<https://perma.cc/DFW7-AGVF>] (last updated Feb. 14, 2017) (showing that most Internal Revenue collections are from business income taxes, individual income taxes, and employment taxes). In addition, the federal government imposes a variety of excise taxes and transfer taxes. See *id.* (showing that estate taxes, gift taxes, and excise taxes make up a minority of Internal Revenue collections).

<sup>126</sup> Treasury securities include: Treasury bills (“with maturities ranging from a few days to 52 weeks”), Treasury notes (“with maturities of 2, 3, 5, 7, and 10 years and pay interest every six months”), Treasury bonds (which “pay interest every six months and mature in 30 years”), Treasury Inflation-Protected Securities (which “pay interest every six months and are issued with maturities of 5, 10, and 30 years” but “whose principal is adjusted by changes in the Consumer Price Index”), Floating Rate Notes (“issued for a term of 2 years and pay interest quarterly” but whose “interest payments . . . rise and fall based on discount rates for 13-week Treasury bills), and savings bonds (whose “[i]nterest accrues over the life of the bond and is paid upon redemption”). *Treasury Securities & Programs*, TREASURYDIRECT, <http://treasurydirect.gov/indiv/products/products.htm> [<https://perma.cc/2QMJ-P3T6>] (last updated July 27, 2017) (for information on all products except savings bonds); see also *Comparison of TIPS and Series I Savings Bonds*, TREASURYDIRECT, [http://treasurydirect.gov/indiv/products/prod\\_tipsvsibonds.htm](http://treasurydirect.gov/indiv/products/prod_tipsvsibonds.htm) [<https://perma.cc/UYP5-BYS2>] (last updated Oct. 11, 2012) (for information on savings bonds).

<sup>127</sup> About thirty percent of federal debt is “intragovernmental holdings” borrowed from other federal accounts, including the Social Security trust fund, while about seventy percent is borrowed from private parties and foreign governments. See *Debt Position and Activity Report: Total Public Debt Outstanding as of December 31, 2015*, TREASURYDIRECT, [https://treasurydirect.gov/govt/reports/pd/pd\\_debtposacrpt\\_1215.pdf](https://treasurydirect.gov/govt/reports/pd/pd_debtposacrpt_1215.pdf) [<https://perma.cc/SQS7-DK48>] (last updated Nov. 3, 2016); *Who Does the U.S. Government Owe Money to?*, NAT'L PRIORITIES PROJECT, [https://media.nationalpriorities.org/uploads/debt\\_owners\\_pie\\_chart\\_dec\\_2014\\_6.11.2015.png](https://media.nationalpriorities.org/uploads/debt_owners_pie_chart_dec_2014_6.11.2015.png) [<https://perma.cc/5D86-LL3R>] (last visited Sept. 17, 2017) (showing via graph that as of December 2014, the U.S. government owed about 28% of its debt to “[f]ederal [a]ccounts,” about 15% to “[d]omestic [p]rivate [i]nvestors,” and about 34% to “[i]nternational [i]nvestors”).

<sup>128</sup> Exceptions are Treasury Inflation-Protected Securities (TIPS) since the interest rates and principal repayment amounts are not fixed but adjusted to account for inflation, Floating Rate Notes (FRNs) since interest rates are adjusted based on discount rates for 13-week Treasury bills, and certain savings bonds. See *TIPS in Depth*, TREASURYDIRECT, [https://treasurydirect.gov/indiv/research/indepth/tips/res\\_tips.htm](https://treasurydirect.gov/indiv/research/indepth/tips/res_tips.htm) [<https://perma.cc/4SE8-682A>] (last updated Jan. 21, 2014); *Treasury Securities & Programs*, *supra* note 126 (discussing logistics of FRNs); *I Savings Bonds*, TREASURYDIRECT,

full face value.<sup>129</sup> Accordingly, if the government needs to finance an investment and cannot do so through current tax or other revenue sources, it finances the investment by issuing Treasury securities.<sup>130</sup> This means that the government's cost to raise capital is the interest it must pay to Treasury security holders, which, depending on the duration of the loan, is known as the Treasury bill rate, Treasury note rate, or Treasury bond rate.<sup>131</sup>

Treasury security rates are far lower than the rates of interest that firms must pay to their bondholders because the holders of Treasury securities alone need not fear that the borrower will be unable to make required payments.<sup>132</sup> The U.S. government cannot involuntarily default on its debts.<sup>133</sup> Since investors can be highly certain that the government will not default, they are exposed to little risk when they lend money to the government.<sup>134</sup> In fact, the Treasury security rate is popularly known as the risk-free rate, as it is free from the risk of borrower default.<sup>135</sup>

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[https://treasurydirect.gov/indiv/research/indepth/ibonds/res\\_ibonds.htm](https://treasurydirect.gov/indiv/research/indepth/ibonds/res_ibonds.htm) [<https://perma.cc/V9FT-Y5G9>] (last updated Sept. 17, 2015).

<sup>129</sup> *I Savings Bonds*, *supra* note 128; *TIPS in Depth*, *supra* note 128.

<sup>130</sup> *See I Savings Bonds*, *supra* note 128; *TIPS in Depth*, *supra* note 128; *Treasury Securities & Programs*, *supra* note 126.

<sup>131</sup> *See generally infra* Part II.C.

<sup>132</sup> *See* Neil H. Buchanan, *Is It Sometimes Good to Run Budget Deficits? If So, Should We Admit It (Out Loud)?*, 26 VA. TAX R. 325, 334 (2006) (footnotes omitted) (quoting Alan S. Blinder, *Is the National Debt Really – I Mean, Really – A Burden?*, in DEBT AND THE TWIN DEFICITS DEBATE 209, 218 (James M. Rock ed., 1991)) (“Because [U.S.] deficits are financed by issuing debt that is denominated in dollars, ‘we can always print as many dollars as we need.’ While this may be ‘wise or foolish,’ any ‘fear of default is simply a red herring in the U.S. case.’”). Thus, while there may be extremely compelling reasons not to print more money, chiefly fears of dangerous inflation, the ability to print money means that the U.S. government cannot involuntarily default on its debts. *See id.* This is in contrast to Greece, where significant government debt was owed in euros, the supply of which is controlled by European Central Bank rather than any member country of the Eurozone. *See About, EUR. CENT. BANK*, <https://www.ecb.europa.eu/ecb/html/index.en.html> [<https://perma.cc/GKT2-74ZU>] (last visited Oct. 28, 2017).

<sup>133</sup> *See* Buchanan, *supra* note 132, at 334.

<sup>134</sup> *See* U.S. CONST. amend. XIV, § 4 (“The validity of the public debt of the United States, authorized by law, including debts incurred for payment of pensions and bounties for services in suppressing insurrection or rebellion, shall not be questioned.”).

<sup>135</sup> *See, e.g.*, ANDREW B. ABEL, BEN S. BERNANKE & DEAN CROUSHORE, *MACROECONOMICS* 115 (7th ed. 2011) (observing that U.S. federal “debt is believed to be free from default risk”); STEPHEN A. ROSS, RANDOLPH W. WESTERFIELD & JEFFREY JAFFE, *CORPORATE FINANCE* 404 (10th ed. 2013) (“No U.S. Treasury instrument has ever defaulted and, at least at the present time, no instrument is considered to be in the slightest danger of future default. For this reason, [the interest rates on] Treasury instruments are generally considered to be risk-free [rates].”). Most Treasury securities are exposed to the risk that inflation might make the future interest and maturity date payments they guarantee less valuable in terms of buying power. Thus, most would be known as nominal risk-free rates. *See, e.g.*, Aswath Damodaran, *What Is the Riskfree Rate? A Search for the Basic Building Block* 12–13 (Dec. 18, 2008) (unpublished manuscript), <https://ssrn.com/abstract=1317436> [<https://perma.cc/3AHP-VGS5>] (follow “Download this Paper” hyperlink) (“[T]he risk free rate used to come up with expected returns should be measured consistently with the cash flows are measured. Thus, if cash flows are estimated in nominal US dollar terms, the risk free rate will be the US Treasury bond rate”). A real risk-free rate might be found by looking at Treasury securities that solve for the risk of inflation, Treasury Inflation-Protected Securities. *Id.* at 14–15 (“An inflation-indexed treasury

Because Treasury securities are free from the risk of borrower default and are exposed only to the risk that inflation might make future fixed payments less valuable in terms of their buying power, Treasury securities rates are low across all economies<sup>136</sup> and often forced to historic lows during and following recessions.<sup>137</sup> This decline is due to a number of forces, including decreased concern among investors about the risk of inflation, increased concern among investors about the risk that other investments will post losses and other borrowers will default, and a desire to retreat from the market during periods of high volatility.<sup>138</sup> This decline was observed following the two most recent recessions when Treasury securities rates dropped to historic lows and even approached zero.<sup>139</sup> As a result, the government’s cost of capital following the two most recent recessions was nearly negligible.<sup>140</sup>

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security (TIPs) does not offer a guaranteed nominal return to buyers, but instead provides a guaranteed real return. . . . [as a result, now we can] use the inflation-indexed treasury rate as a real riskfree rate in the United States.”)

<sup>136</sup> See, e.g., ROSS ET AL., *supra* note 135, at 317–18 (estimating that the historic average nominal risk-free rate is 3.6% and explaining that investments other than those in Treasury securities must pay an additional risk premium).

<sup>137</sup> See, e.g., ABEL ET AL., *supra* note 135, at 298 (observing that Treasury securities rates are “procyclical and lag[ging],” making them low during and following recession); *id.* at 115 (explaining that “Treasury bills, notes, and bonds of various maturities” had rates that “decreased between July 2008 and July 2009”); HOWARD J. SHERMAN, *THE BUSINESS CYCLE: GROWTH AND CRISIS UNDER CAPITALISM* 287 (1991) (noting that interest rates tend to be unusually low during and following recession); Jean-Pierre Danthine, Vice Chairman of the Governing Bd. of the Swiss Nat’l Bank, Speech at the Swisscanto Market Outlook 2014: Causes and Consequences of Low Interest Rates (Nov. 14, 2013) (citing “low or negative output growth[,] . . . pessimism about future prospects[,] . . . .” “heightened uncertainty in global financial markets,” and increased “demand for safe assets like government bonds” as causes of low Treasury securities rates during and following recession).

<sup>138</sup> See, e.g., ROSS ET AL., *supra* note 135, at 317–18.

<sup>139</sup> See ABEL ET AL., *supra* note 135, at 114–15; Danthine, *supra* note 137.

<sup>140</sup> See, e.g., ABEL ET AL., *supra* note 135, at 315; *Historical Data for 5-Year Treasury Constant Maturity Rate*, FIN. FORECAST CTR., <http://www.forecasts.org/data/data/GS5.htm> [<https://perma.cc/Z9QM-NYTR>] (last visited Oct. 28, 2017).

### B. Diversified

The government is uniquely well diversified, even when compared to large institutional investors.<sup>141</sup> Institutional investors might own a diverse portfolio of publically-traded investments. However, through the imposition of tax, the government obtains a share of returns on that same portfolio, plus a share of income and profit streams from assets that frequently cause under-diversification for private investors—income streams, like labor compensation, and profit streams from assets, like owner-occupied real property, property used in business operations, and privately-held investments.<sup>142</sup>

In contrast to private investors, including large institutional investors, the government is highly diversified.<sup>143</sup> Private investors generally enjoy their own individual labor incomes and perhaps a share of the incomes of their family and/or household members, own a limited set of assets fully and directly, perhaps own a non-diverse set of investments in partnerships or other non-publically traded

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<sup>141</sup> See, e.g., Albert J. Boro, Jr., *Banking Disclosure Regimes for Regulating Speculative Behavior*, 74 CALIF. L. REV. 431, 453 (1986) (“Given its capacity for deficit spending, the depth of its resources, and the ability to diversify risk nationwide, the federal government is the logical insurer of [bank] deposits or guarantor of nonfederal insurers.”); Brown, *supra* note 120, at 10 (noting “that the government has the unique ability to diversify risk across generations through fiscal policy”); Frances R. Hill, *Toward a Theory of Bankruptcy Tax: A Statutory Coordination Approach*, 50 TAX LAW. 103, 148–50 (1996) (noting the “[Internal Revenue] Service’s ability to absorb and spread costs”); David Kamin, *Risky Returns: Accounting for Risk in the Federal Budget*, 88 IND. L.J. 723, 732 & n. 28 (2013) (emphasis added) (“To the extent that the risk taken on by the federal government is undiversifiable—and does not average out across the portfolio of the federal government or the American people—then it creates uncertainty as to how much resources people will have at their disposal as a result of either government spending or taxation. . . . [But,] to the extent the government takes on *diversifiable* risk, that risk should, essentially, be eliminated as the federal government spreads it across the population as a whole—and there should not be a cost associated with it to taxpayers or program beneficiaries.”); William T. Plumb, Jr., *Federal Liens and Priorities—Agenda for the Next Decade*, 77 YALE L.J. 228, 244 (1967) (“The [g]overnment . . . is in a better position to self-insure its risks than are private parties, for some of whom the failure of even a single major debtor may be ruinous.”); Christopher Serkin, *Big Differences for Small Governments: Local Governments and the Takings Clause*, 81 N.Y.U. L. REV. 1624, 1668 (2006) (“It is as if governments diversify their exposure to risk through the sheer number of their constituents. The greater the number of taxpayers, the smaller the

per-taxpayer stake in any government action.”); Michael Simkovic, *Risk-Based Student Loans*, 70 WASH. & LEE L. REV. 527, 601 (2013) (“A subsidy is most likely to be welfare-enhancing when individual students are risk-averse—for example, because they cannot easily diversify their investment in human capital—and the government is risk neutral because it is more diversified. The government should ideally view itself not as a mere lender, but rather as a diversified investor in the global competitiveness of the United States labor force.”); Rocío Albert López-Ibor & Joaquín Artés-Caselles, *Bankruptcy Proceedings and Government: Should Bankruptcy Law Grant Privileges to the Treasury?* 15 (German Working Papers in Law & Econ., Paper No. 9, 2003) [<https://perma.cc/F7B9-B5CA>].

<sup>142</sup> Compare *infra* note 213 (providing examples of under-diversification in housing), note 214 (providing examples of under-diversification in labor and benefits like stock options), and note 215 (providing examples of under-diversification in business real property), with 26 U.S.C. § 61(a) (2012) (providing that gross income subject to tax includes income from labor, pass through businesses, rents, dividends, and gains).

<sup>143</sup> See Brown, *supra* note 120, at 10; Plumb, *supra* note 141, at 244. See generally *supra* note 141.

companies, and often own a larger set of publically-traded investments. In contrast, the government is entitled to a share of a far broader and more diverse set of income streams.

Under existing tax policy, the government currently owns a share in the overwhelming majority of the United States labor force.<sup>144</sup> It collects this share through payroll taxes (collected even for low-income earners who do not pay a federal income tax),<sup>145</sup> as well as federal income taxes.<sup>146</sup> Given the federal income tax's progressive rate schedule, as one person's labor earnings grow, so too does the government's share of those labor earnings, and this growth is automatic.<sup>147</sup> Further, the government currently owns a share in the overwhelming majority of the profits produced by closely-held entities—entities whose profits cannot be enjoyed by most private and even institutional investors.<sup>148</sup> While these entities generally are not subject to tax at the entity level, their profits are subject to the federal income tax at the owner level.<sup>149</sup> Similarly, the government currently owns a

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<sup>144</sup> See, e.g., Brad Plumer, *Who Doesn't Pay Taxes*, in *Eight Charts*, WASH. POST (Sept. 18, 2012), [https://www.washingtonpost.com/news/wonk/wp/2012/09/18/who-doesnt-pay-taxes-in-charts/?utm\\_term=.1053aa6780d6](https://www.washingtonpost.com/news/wonk/wp/2012/09/18/who-doesnt-pay-taxes-in-charts/?utm_term=.1053aa6780d6) [<https://perma.cc/K2NV-STWN>] (responding to then presidential candidate Mitt Romney's famous comment that forty-seven percent of Americans pay no federal income tax by showing that while true (in 2011, 53.6% paid and 46.4% did not pay federal income tax), the percentage of nonpayers that year was "abnormally high" given the recession and slow recovery ("it's usually only about 40 percent of U.S. households that aren't paying [federal] income taxes"), and most households that do not pay federal income tax do pay payroll taxes ("60 percent of those who don't pay [federal] income tax are still working and paying taxes for Social Security and Medicare")); *id.* ("Another 22 percent of non-payers are retirees."); *id.* ("Only about 7.9 percent of households are not paying any federal taxes at all. That's usually because they're either unemployed or on disability or students or are very poor.").

<sup>145</sup> See 26 U.S.C. §§ 3101–3128 (2012 & Supp. III 2012).

<sup>146</sup> *Id.* §§ 1–1564; see *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 429–30 (1955) (citations omitted) (first quoting *Helvering v. Clifford*, 309 U.S. 331, 334 (1940); then quoting *Helvering v. Midland Mut. Life Ins. Co.*, 300 U.S. 216, 223 (1937); then quoting *Douglas v. Willcuts*, 296 U.S. 1, 9 (1935); and then quoting *Irwin v. Gavit*, 268 U.S. 161, 166 (1925) (finding the Congress adopted a broad definition of income in order to exert "the full measure of its taxing power' . . . And the Court has given a liberal construction to this broad phraseology in recognition of the intention of Congress to tax all gains except those specifically exempted").

<sup>147</sup> See 26 U.S.C. § 1 (2012) (imposing taxes according to a progressive rate schedule). In contrast, private investors must actively rebalance their portfolios to maintain diversification in response to differences in how investments perform. See, e.g., Laurent E. Calvet, John Y. Campbell & Paolo Sodini, *Fight or Flight? Portfolio Rebalancing by Individual Investors*, 124 Q.J. ECON. 301, 302–04 (2009) (noting that "[i]f the aggregate value of risky securities falls, the average share of risky assets in household portfolios must necessarily fall as well" and exploring the extent to which individual households rebalance their portfolios to restore diversification). In a sense, the graduated rate schedule might mimic the needed portfolio adjustments automatically for the government by automatically increasing its share as one taxpayer's wages, property gains, share of pass-through profits, or other income increases and automatically reducing the government's share in the reverse scenario.

<sup>148</sup> See, e.g., § 701 (imposing an owner level tax on partnership profits); *id.* § 1366 (imposing an owner level tax on S-Corporation profits).

<sup>149</sup> See *supra* note 148.



share in the overwhelming majority of assets held by individuals—assets whose growth cannot be shared by most private investors.<sup>150</sup> For example, when an individual sells an asset for a gain, that gain will be enjoyed by the individual seller and the government, but it is not reached by other investors in the market. Finally, like other investors, the government has access to the full spectrum of publically-traded investments.<sup>151</sup> In contrast to those other investors, however, the government is an “involuntary” investor, so while institutional investors and private investors might be dissuaded from being fully diversified because of transaction costs, bias, or limited access to the capital that private investors typically need in order to acquire ownership interests in investments, the government cannot be so dissuaded and will hold ownership interests in investments without an affirmative investment decision.<sup>152</sup> Indeed, the federal government even takes a share of gratuitous life transfers and death transfers for the wealthiest individuals.<sup>153</sup>

In addition to current sources of diversification, the government uniquely enjoys the ability to diversify risk across generations. Even if a private investor engages in active use of insurance markets in an effort to diversify its risk, insurance “[m]arkets must be incomplete, because a person cannot engage in risk-sharing trades with those who are not yet born. The risks associated with holding capital assets, for instance, can be shared with others alive at the same time, but they cannot be shared with future generations.”<sup>154</sup> In contrast, the government can diversify risk over generations by incurring greater deficits in depressions and recessions and paying off those deficits with surpluses collected during periods of sustained economic growth.<sup>155</sup>

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<sup>150</sup> See, e.g., § 1001(a) (defining gain as “amount realized” minus “adjusted basis”); *id.* § 1001(c) (providing that realized gains must be “recognized”).

<sup>151</sup> See, e.g., *id.* § 11 (imposing a tax at the entity level on corporate profits); *id.* § 301(c)(1) (imposing a tax at the shareholder level when corporate earnings and profits are distributed to shareholders as dividends). Notably, the average effective corporate tax rate is very low, indicating that the government may not be getting its “rightful” share of corporate income. To the extent that the low average effective corporate tax rate is evidence of evasion, such evasion interferes with the government’s diversification. See OFFICE OF TAX ANALYSIS, U.S. DEP’T OF THE TREASURY, AVERAGE EFFECTIVE FEDERAL CORPORATE TAX RATES 1 (2016), <https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/Average-Effective-Tax-Rates-2016.pdf> [<https://perma.cc/AGL8-4ETR>] (“[T]ax planning, noncompliance, and costly enforcement [are partly attributable for the fact that,] . . . [b]ased on data from federal corporate income tax returns for 2007 through 2011 . . . the U.S. ATR [average effective ‘actual’ federal corporate tax rate] on income earned by profitable corporations with over \$10 million in assets was 22 percent (when averaged over all firms in all years), well below the top statutory rate of 35 percent.”).

<sup>152</sup> See *supra* note 151.

<sup>153</sup> See 26 U.S.C. § 2001(a) (imposing an estate tax); *id.* § 2501(a)(1) (imposing a gift tax); *id.* § 2601 (imposing a generation-skipping transfer tax on transfers to grandchildren and other members of distant future generations).

<sup>154</sup> Kamin, *supra* note 141, at 756 (citing Laurence Ball & N. Gregory Mankiw, *Intergenerational Risk Sharing in the Spirit of Arrow, Debreu, and Rawls, with Applications to Social Security Design*, 115 J. POL. ECON. 523, 524 (2007)).

<sup>155</sup> *Id.*

The government is uniquely well diversified<sup>156</sup> because currently, by operation of existing tax law, it owns a share of many income streams and profit streams that even the largest institutional investors cannot hope to access, much less automatically share in.<sup>157</sup>

### C. Cannot Pursue Investment Priorities through Sales or Investor Protections

The government's uniqueness is not limited to advantages like its cheap access to capital and extraordinary diversification. The government also has unique disadvantages in that it cannot pursue its investment priorities through purchases or

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<sup>156</sup> In addition to being uniquely highly diversified in its investments, the government is unique in its ability to engage in deficit spending, to respond to cost increases or tax collection deficits in one generation through spending cuts or tax increases in later generations, and the government is privileged in its ability to collect the returns it is owed. Each of these factors adds to the government's ability to bear risk more easily and cheaply than private actors in the market. See, e.g., *id.* (“[T]here is good reason to believe that the federal government may be able to bear risk more efficiently than the private markets by completing insurance markets that the private sector cannot. Perhaps most importantly, the federal government may be able to diversify risk across generations—completing an insurance market that would exist if generations could actually strike deals with one another.”). Scholars have noted, however, that “[s]imply saying that the government [with its ability to raise revenue through borrowing or through spending cuts and/or tax increases on future generations] has superior powers of diversification does not say very much about whether the methods of diversification employed are desirable.” Oei, *supra* note 120, at 421. For an excellent discussion on when deficit spending is desirable, see Buchanan, *supra* note 132.

<sup>157</sup> A thoughtful and comprehensive article, *Taxing Bankrupts*, challenges the prevailing notion expressed by scholars who believe that tax debts should not receive priority in bankruptcy cases because the government can easily diversify against the risk that a tax debt will be discharged. See generally Oei, *supra* note 120. The article argues that: “the government is constrained in its ability to diversify against such risk via both substantive tax policy [changes aimed at increasing diversification might come at the expense of efficiency, equitability, administerability; might be politically unfeasible; or might unfairly shift tax burdens from noncompliant and predominantly middle-class bankruptcy claimants to compliant taxpayers including working-class payers of the automatically collected and paid over Federal Payroll Tax] and changes in tax administration.” *Id.* at 375.

While this author agrees with many of the thoughtful insights in this important piece, at least in the context of the government's investment characteristics and priorities, the appropriate focus for this Article is less on the government's “ability to diversify” and more on the government's existing level of diversification. Currently, and through the operation of existing federal tax law, the government shares in the wages of the U.S. labor forces (through payroll taxes on many lower-earners and both payroll taxes and federal income taxes on middle- and higher-earners); the appreciation experienced on assets whether they are held by individuals, closely-held entities, or publically-traded entities; the operating profits of privately-traded entities; and the operating profits of publically-traded entities. No other investor has access to many of these income streams, much less current ownership interests in them.

In contrast to a dispute in the bankruptcy priority literature about whether the government can take new, affirmative steps (like raising tax rates) to protect itself against the risk of debtor discharge of tax debts through bankruptcy, this Article focuses on the government's currently unique and high level of diversification resulting not from new action but simply by the operation of existing tax law.

sales of investments.<sup>158</sup> While this observation may be obvious, its implications are worth exploring.

Economists Franco Modigliani and Merton Miller famously created a model to determine when firms should undertake investments with risky returns.<sup>159</sup> They noted that while the question might initially appear to depend on the unique characteristics and investment priorities of the firm's existing shareholders, in fact, the question is abstract from these considerations.<sup>160</sup> Modigliani and Miller proposed an "approach, based on market value maximization," that asks nothing about the investment priorities of existing shareholders and instead asks only, "Will the project, as financed, raise the market value of the firm's shares? If so, it is worth undertaking; if not, its return is less than the marginal cost of capital to the firm [and it is not worth undertaking]."<sup>161</sup> The approach is "entirely independent of the tastes of the [firm's] current owners" because "[i]f any current stockholder disagrees with management and the market over the valuation of the project, he is free to sell out and reinvest elsewhere, but will still benefit from the capital appreciation resulting from management's decision."<sup>162</sup> Even if a shareholder's investment priorities are inconsistent with a firm's investment decision, that shareholder's interests are protected as long as the investment's expected returns exceed the cost of capital that the firm must pay to finance the investment.<sup>163</sup> This is because the excess of expected returns over the cost of capital increases the market value of the firm as well as the price of its shares.<sup>164</sup> A nominally dissatisfied shareholder will, in fact, happily sell out for a profit and reinvest in a manner that better reflects his investment priorities.<sup>165</sup>

Although a private investor can "sell out and reinvest elsewhere,"<sup>166</sup> the government cannot—despite the fact that it may act as an investor in a firm's projects by sharing returns, sharing risk, and co-financing projects. Nor does it have

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<sup>158</sup> See Cunningham, *supra* note 3, at 25 ("The only difference between the government's role and that of a limited partner is that the government has no say in either making the investment or terminating it. These matters are totally within T's [taxpayer's] control."). Nor does the taxpayer have the ability to exclude the government from an investment opportunity. *Id.* at 27 ("[T]he government is a partner in all ventures . . . [i]t cannot be excluded. . . . [This means that] where an investor faces an attractive, but limited, investment opportunity[,] . . . the government cannot be excluded from participating in this investment[,] . . . [which potentially] prevents the investor from investing as much in this particular venture as she would like . . .").

<sup>159</sup> See generally Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporate Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958).

<sup>160</sup> *Id.* at 264 ("[T]he utility approach has serious drawbacks for normative as well as analytical purposes. How, for example, is management to ascertain the risk preferences of its stockholders and to compromise among their tastes? And how can the economist build a meaningful investment function in the face of the fact that any given investment opportunity might or might not be worth exploiting depending on precisely who happen to be the owners of the firm at the moment?").

<sup>161</sup> *Id.*

<sup>162</sup> *Id.*

<sup>163</sup> See *id.*

<sup>164</sup> *Id.*

<sup>165</sup> *Id.*

<sup>166</sup> *Id.*

a private investor's ability to choose in the first instance whether, when, and at what price to acquire investments. Rather, because a firm's decision to invest in a capital asset of the firm's choosing triggers the immediate expensing that makes the government a co-investor in that same asset, the firm has the privileged position to impose its investment priorities even at the expense of the government's investment priorities. The government is unique in that its dissatisfaction with an investment decision cannot be cured through a sale.

Because the government cannot choose whether, when, how long, and at what price to be engaged in investment activities, it is uniquely hindered in its ability to align its investments with its investment priorities. Further, the government's investment priorities are not incorporated into market prices because it cannot buy investments from prospective sellers who value them less or sell investments to prospective buyers who value them more.

Similarly, the government cannot use most standard legal protections available for investors.<sup>167</sup> Private investors may sue their investment partners for breach of fiduciary duty while the government is owed no fiduciary duty.<sup>168</sup> As a result, the government's investment partners can, consistent with the law, engage in planning

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<sup>167</sup> For example, investors may protect against managerial abuses by bringing derivative suits if they are stockholders, while the government may not bring derivative suits even if tax policy makes it descriptively like a stockholder. See, e.g., *Schoon v. Smith*, 953 A.2d 196, 201 (Del. 2008) (footnotes omitted) (“To prevent ‘a failure of justice,’ courts of equity granted equitable standing to stockholders to sue on behalf of the corporation ‘for managerial abuse in economic units which by their nature deprived some participants of an effective voice in their administration.’”); *Cantor v. Sachs*, 162 A. 73, 76 (Del. Ch. 1932) (“[S]tockholders have a right in equity to compel the assertion of the corporation’s rights to redress.”). At least historically, stockholder derivative suits were viewed as powerful tools to combat managerial abuses. See, e.g., Daniel J. Dykstra, *The Revival of the Derivative Suit*, 116 U. PA. L. REV. 74, 75 (1967) (arguing that stockholder derivative suits “have flourished because they serve a basic and increasing need in the contemporary economy”); *id.* at 81 (footnote omitted) (quoting *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541, 548 (1949)) (“Though it is an awkward, costly, and intricate mechanism, it continues to be ‘the chief regulator of corporate management.’”). More recently, the efficiency and necessity of shareholder derivative suits is subject to serious debate. See, e.g., Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 134 (2004) (footnote omitted) (describing shareholder derivative or securities fraud claims as “the most frequently maligned legal check on managerial misconduct within corporations”); E. Norman Veasey & Michael P. Dooley, *The Role of Corporate Litigation in the Twenty-First Century*, 25 DEL. J. CORP. L. 131, 143 (2000) (footnote omitted) (explaining that the corporate governance system “envisions the shareholder suit as a true exception to a system that is otherwise built on self-governance [that] should be regarded as a remedy of last resort only when the mechanisms of self-governance, that is board fidelity and the informed exercise of the shareholders franchise, has broken down”).

<sup>168</sup> See, e.g., *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934) (Hand, J.) (first citing *United States v. Isham*, 84 U.S. 496, 506 (1873); and then citing *Bullen v. Wisconsin*, 240 U.S. 625, 630 (1916)) (“Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes.”).

to shift profits to themselves and away from the government. For example, they can choose to sell investment assets in years when these sales would minimize their tax burdens (otherwise known as the government's share of gains). While the government can challenge a taxpayer for violating tax law, it cannot challenge a taxpayer for prioritizing the taxpayer's investment interests over the government's own interests. The requirements of tax law are unaffected by the government's role as an investor. Tax planning that is legal when the government solely shares in the profits of an investment is also legal when the government proportionately shares in capital contributions and losses as well as profits. Similarly, even when the government has proportionately shared capital contributions, losses, and profits, it has no voting rights and no rights to representation.

Since the government cannot pursue its investment priorities through choice over its investments or through use of legal protections applicable to other investors, it relies on third-party decision makers to advance its interests.<sup>169</sup> In order to advance its interests, the government must consider how its investment interests align with or diverge from those of relevant decision makers. If a decision maker is less diverse or less able to raise capital, the government cannot solve that divergence by selling the investment.<sup>170</sup> Rather, few methods exist for the government to advance its own investment priorities.<sup>171</sup> One possible method is to change tax policy to advance them.

### III. TAX POLICY CHANGES THAT COULD ADVANCE THE GOVERNMENT'S INVESTMENT PRIORITIES

The lawmakers who enacted and expanded immediate expensing and accelerated depreciation policies did not set out to advance the government's investment priorities. Indeed, the legislative history does not indicate that the government's investment characteristics or priorities were even discussed.<sup>172</sup> Rather,

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<sup>169</sup> See Cunningham, *supra* note 3, at 27 (noting that with regard to its tax policies, the "government is a partner in all ventures" and "[t]herefore, the government invests in whatever an investor chooses"). Therefore, the government does not affirmatively and individually select what investment opportunities it pursues, and must instead rely on its co-partners.

<sup>170</sup> See Cunningham, *supra* note 3, at 25 (noting that a "difference between the government's role and that of a limited partner is that the government has no say in either making the investment or terminating it"); see also *supra* note 86 and accompanying text.

<sup>171</sup> See *supra* note 167 and accompanying text. Changing tax policy is not the only method by which the government might seek to advance its own investment priorities. The government might use persuasion, appeals to civic duty, and direct spending policies. Indeed, the corporate social responsibility literature extensively discusses how corporations might be made to advance broader social goals. See, e.g., Reuven S. Avi-Yonah, *Corporate Taxation and Corporate Social Responsibility*, 11 N.Y.U. J.L. & BUS. 1, 3 (2014) (arguing that corporate social responsibility might be used to counter corporate inversions and other aggressive tax planning and arguing the "only solution is to change the *attitude* of major U.S. multinationals back to where . . . a tax director of a major U.S. multinational would typically reject aggressive tax-motivated transactions as inconsistent with [corporate social responsibility]").

<sup>172</sup> This conclusion is based on a review of the legislative history from the passage and every subsequent extension or expansion of 26 U.S.C. § 168(k) (bonus depreciation) and 26 U.S.C. § 179 (immediate expensing).

lawmakers set out to encourage capital investing, stimulate the economy, and facilitate recovery following recession.<sup>173</sup> Scholars have debated the effectiveness of immediate expensing and accelerated depreciation policies in advancing these goals and have empirically tested whether these policies seem to have succeeded or failed as tools of general economic stimulus.<sup>174</sup> While critically important and useful, these tests are difficult to construct and have resulted in ambiguous findings.<sup>175</sup> This Article considers whether these policies might have been used unintentionally in the past and whether they might be used more strategically in the future to pursue a goal other than general economic stimulus. Maybe they are not solely about general economic stimulus. Maybe important features of immediate expensing and accelerated depreciation policies are and can even more effectively be about encouraging firms to use the government's investment dollars in ways that are particularly profitable for the government, nudging firms somewhat toward the government's investment priorities.<sup>176</sup>

When the government is viewed as an investor pursuing its own priorities in the market, immediate expensing and accelerated depreciation policies make more sense. These policies encouraged increased investing during and following the two most recent recessions when Treasury securities rates were at historic lows.<sup>177</sup> As a

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<sup>173</sup> See, e.g., JANE G. GRAVELLE, DONALD J. MARPLES & MOLLY F. SHERLOCK, CONG. RESEARCH SERV., R43510, SELECTED RECENTLY EXPIRED BUSINESS TAX PROVISIONS (“TAX EXTENDERS”) 12 (2015) (“Bonus depreciation was intended for a specific, short-term purpose: to provide an economic stimulus during a recession.”); S. REP. NO. 97–144, at 47 (1981) (expressing hope that “the more rapid acceleration of cost recovery deductions” would be “an effective way of stimulating capital formation, increasing productivity[,] and improving the nation’s competitiveness in international trade”); MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION: A LAW STUDENT’S GUIDE TO THE LEADING CASES AND CONCEPTS 162 (9th ed. 2002) (“Congress’ stated aim [in allowing immediate expensing and accelerating depreciation] was to stimulate investment . . . and with this overriding goal in view it simply discarded accuracy of measurement as an objective for the tax law to pursue.”); Michael J. Graetz & Alvin C. Warren, Jr., *Income Tax Discrimination and the Political and Economic Integration of Europe*, 115 YALE L.J. 1186, 1225 (2006) (describing immediate expensing and accelerated depreciation as our government’s “standard method for combating recessions”); Darrel Cohen & Jason Cummins, *A Retrospective Evaluation of the Effects of Temporary Partial Expensing 2* (Fed. Reserve Bd., Fin. & Econ. Discussion Series, Paper No. 19, 2006), <https://federalreserve.gov/pubs/feds/2006/200619/200619pap.pdf> [<https://perma.cc/R4MH-R4A2>] (“To help stimulate short-run economic activity, a tax bill was enacted in March 2002 and subsequently expanded in May 2003 that included a temporarily enhanced incentive to invest in business equipment and software. This incentive, a form of accelerated depreciation . . . is commonly referred to as temporary partial expensing or bonus depreciation.”).

<sup>174</sup> See Morrow, *supra* note 33, at 488–90 (summarizing recent empirical tests).

<sup>175</sup> *Id.*

<sup>176</sup> Of course, firms remain free to pursue their own investment priorities alone. Nonetheless, should they wish to do so while also wishing to return to a pre-tax position on risk and reward, the government might properly leave the burden on them to supply the additional needed capital. See Zelenak, *supra* note 9, at 883–84 (describing how a firm can return to a pre-tax position on risk and reward by putting additional capital into an investment).

<sup>177</sup> See ABEL ET AL., *supra* note 135, at 115; Danthine, *supra* note 137; see also *supra* Part II.A.

result, the government was able to purchase its share of depreciable assets when its low cost of capital made these purchases especially affordable.<sup>178</sup> Further, these policies encouraged increased risk-taking<sup>179</sup> when the appetite for risk was atypically low,<sup>180</sup> which likely benefited investors generally and well-diversified investors especially.<sup>181</sup> By encouraging increased investing in higher-risk investments during and following recession, existing immediate expensing and accelerated depreciation policies seemed to nudge capital investing somewhat towards the investment priorities of the government. Still, more could be done to align capital investing with the government's investment preferences. And when these changes would also advance traditional tax goals and broader social goals, more should be done.

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<sup>178</sup> See ABEL ET AL., *supra* note 135, at 315; *Historical Data for 5-Year Treasury Constant Maturity Rate*, *supra* note 140; *see also supra* Part II.A.

<sup>179</sup> For the portion of an investment that a firm must fund using external capital, the firm must expect to include a risk premium in the rate of return commensurate with the riskiness of the investment. *See* Morrow, *supra* note 33, at 472. But, for the portion of an investment that a firm can fund using the tax savings from immediate expensing, no risk premium must be paid. Since immediate expensing and accelerated depreciation policies allow the firm to pay a risk premium on only part of the purchase price of an asset, the firm will take on more risk than it would have if it had to pay the risk premium on the entire purchase price. *See supra* Part I.B.

<sup>180</sup> *See, e.g.*, George M. Constantinides, Understanding the Equity Risk Premium Puzzle 34 (Mar. 6, 2006) (unpublished manuscript), <http://faculty.chicagobooth.edu/george.constantinides/documents/Premium%20Essay%202006.pdf> [<http://perma.cc/8VDD-UQCF>] (“[T]he risk premium is highest in a recession because the stock is a poor hedge against the uninsurable income shocks, such as job loss, that are more likely to arrive during a recession.”); *id.* at 29 (“In economic recessions, investors are exposed to the double hazard of stock market losses and job loss. Investment in equities not only fails to hedge the risk of job loss but accentuates its implications. Investors require a hefty equity premium in order to be induced to hold equities.”); *id.* at 37 (“[C]onsumers face uninsurable and idiosyncratic income shocks, for example, the loss of employment. The prospect of such events is higher in economic downturns and this observation takes us a long way toward understanding both the unconditional moments of asset returns and their variation along the business cycle.”).

<sup>181</sup> *See* Sanjai Bhagat, Brian Bolton & Roberta Romano, *Getting Incentives Right: Is Deferred Bank Executive Compensation Sufficient?*, 31 YALE J. REG. 523, 536–37 (2014) (footnotes omitted) (explaining the Restricted Equity proposal and how restricted long-term stock options assist in solving the incentive for executives to focus too often on short-term effects); *see also* Lucian A. Bebchuk & Jesse M. Fried, *Paying for Long-Term Performance*, 158 U. PA. L. REV. 1915, 1922 (2010) (“Equity compensation arrangements should . . . provide ex-executives with incentives to maximize long-term value, not the short-term stock price.”); Patrick Bolton, José Scheinkman & Wei Xiong, *Executive Compensation and Short-Termist Behaviour in Speculative Markets*, 73 REV. ECON. STUD. 577, 580 (2006) (“[I]f the goal is to ensure the maximization of long-run fundamental value, then one may want to not only strengthen corporate governance but also lengthen stock-option vesting periods, lengthen director terms, insulate the board of directors more from market swings, and more generally take steps ensuring that controlling shareholders (or the board of directors) have a longer-term outlook.”); Alex Edmans et al., *Dynamic CEO Compensation*, 67 J. FIN. 1603, 1605–06 (2012) (suggesting that incentives with gradual, long-term vesting prevent short-term thinking and incentivize long-term effort).

*A. How the Government Might Exploit its Low Cost of Capital*

i. The Government Should Not Seek to Profit by Using its Low-Cost Capital to Finance High Risk/High Reward Investments

Although this Article argues that the government should pursue profits based on its unique investment characteristics, it should not pursue profits based solely on its low cost of capital relative to private investors. It might initially be tempting to suggest that since the government has access to a uniquely low cost of capital,<sup>182</sup> it can use cheap debt to finance investments and keep a greater share of investment returns as profits. Further, since private investors must pay higher costs of capital when they finance riskier investments, while the government alone can assure its lenders that its increased investment risk will not increase the risk of it defaulting on its obligations,<sup>183</sup> the profit spread that the government enjoys between its low cost of capital and its investment returns should only grow as the risk/return level of its investing increases.<sup>184</sup> Thus, the government might seek to profit by using tax policy to encourage higher-risk/higher-reward investing.

While the observation that the government can uniquely profit from higher risk/higher reward investing because it alone can issue Treasury securities to finance higher risk/higher reward investments is true in a simple sense, it also misses an important part of the picture. As economists warn, this “should not be presented as a free lunch.”<sup>185</sup> The government can assume investment risk without compensating its lenders because the government’s investment risk is not transferred to its lenders.<sup>186</sup> Other investors shift investment risk to lenders when they default on loan obligations.<sup>187</sup> In contrast, the government alone retains full

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<sup>182</sup> See Morrow, *supra* note 33, at 500, 511; see also *supra* note 132, 136 and accompanying text (detailing that the government’s cost of capital is uniquely low because the government alone can guarantee repayment—even if by printing additional currency to meet its repayment obligations—so it need only compensate lenders for the risk-free rate to borrow money, which is historically about 3.6%).

<sup>183</sup> See, e.g., Damodaran, *supra* note 135, at 6 (“[Securities issued by] even the largest and safest firms have some measure of default risk. The only securities that have a chance of being risk free are government securities, not because governments are better run than corporations, but because they control the printing of currency. At least in nominal terms, they should be able to fulfill their promises [to pay back their own currency].”).

<sup>184</sup> Finally, since costs of capital must be paid for the duration of the investment, the government’s low cost of capital should make longer-term investments more profitable for the government than for other investors.

<sup>185</sup> PETER A. DIAMOND & PETER R. ORSZAG, *SAVING SOCIAL SECURITY: A BALANCED APPROACH* 42 (2004).

<sup>186</sup> See, e.g., Deborah Lucas & Marvin Phaup, *The Cost of Risk to the Government and Its Implications for Federal Budgeting*, in *MEASURING AND MANAGING FEDERAL FINANCIAL RISK* 29, 34 (Deborah Lucas ed., 2010).

<sup>187</sup> *Id.*



investment risk, effectively causing current and future taxpayers to bear it without compensation.<sup>188</sup>

Economists Deborah Lucas and Marvin Phaup provide a helpful example:

[A]ssume that the government borrows \$100 to buy \$100 in stock and will liquidate the entire position in one year. The Treasury securities promise 5 percent risk free, whereas the stock will return -2 percent in a recession and 20 percent in a boom. Assuming an equal probability of a boom or a bust, the expected return on the stock is 9 percent, a 4 percent premium over the Treasury rate. At the end of the year, taxpayers are liable for repayment of the Treasury debt, regardless of whether the stock gains or loses value. In a recession, the government will be short \$7—money that must be obtained from the public through expenditure cuts, higher taxes, or increased debt liabilities. In a boom, it will be ahead by \$15, which again will be passed through to the public through changes in expenditures, taxes, or government debt. This shows that the stock is not really entirely financed by the Treasury debt. The public serves as the residual claimant of the return on the stock minus the Treasury rate; it is as if the public is a highly leveraged equity holder in the stock investment. A taxpayer accepting the same risk in a private financial transaction would expect compensation equal to the levered market risk premium to participate.<sup>189</sup>

Instead of producing a risk premium without its associated risk,<sup>190</sup> the government's use of Treasury securities to finance high risk/high reward investments would simply decouple the risk premium (to be retained by the government) from its associated risk (to be borne by the public). This Article recommends that the government exploit its unique investment opportunities only to the extent that doing so benefits the public,<sup>191</sup> not to the extent that doing so shifts benefits from the public to the government.

#### ii. The Government Should Phase In and Phase Out Immediate Expensing Automatically Based on Changes in its Cost of Capital

Although attempting to profit based on the government's low cost of capital relative to that of private investors is generally ill-advised, the government is like other investors in that it can profit by making purchases when its cost of capital is atypically low.<sup>192</sup> Accordingly, the government should modify immediate expensing and accelerated depreciation policies so that they automatically encourage increased

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<sup>188</sup> *Id.*

<sup>189</sup> *Id.*

<sup>190</sup> *See id.* (citation omitted) (“The argument that the government cannot create value by exchanging safe for risky claims is an application to public finance of the well-known Modigliani-Miller theorem. They show that in the absence of market imperfections, the cost of risk associated with an asset depends only on its own characteristics, not on the combination of financial securities used to finance it.”).

<sup>191</sup> To a much more limited extent, encouraging investing in certain higher risk, higher reward investments—investments that compensate for difficult-to-diversify risk—can create (rather than simply shift) value by taking advantage of the government's uniquely deep diversification. *See, e.g., infra* Part III.B.

<sup>192</sup> *See supra* Part II.A.

investing when the government can cheaply finance its share and withdraw incentives when the government can less cheaply finance its share.<sup>193</sup> This modification could be implemented by making the generosity of immediate expensing and accelerated depreciation expressly and automatically dependent on changes in relevant Treasury security rates.<sup>194</sup> When Treasury securities rates decrease, these incentives should automatically become more generous. When rates increase, the incentives should automatically become less generous. And in cases where other concerns—including concerns about recession or inflation—compel competing changes to immediate expensing policies, these default adjustments based on Treasury securities rates can be superseded.

Why would the government want to expand immediate expensing when Treasury securities rates are low? It has the same motive as a prospective homebuyer hoping to take advantage of low mortgage rates. When a large purchase can be financed with debt at a low interest rate, the purchaser will pay far less interest over the life of the loan, making the purchase far more affordable. If the government has the option to finance its share of capital investments when Treasury securities rates are either low or high, it should prefer to do so when rates are low.

The government's potential benefit from financing its share of capital investments with low Treasury securities rates likely exceeds the potential benefit to a prospective homebuyer financing a home purchase with low interest rates. Unlike a prospective homebuyer, the government does not face as much risk that low interest rates will be capitalized into higher prices. In the case of a prospective homebuyer, when mortgage rates drop, these reduced rates are available to all qualified prospective homebuyers.<sup>195</sup> Since low rates make homes more affordable to all qualified prospective homebuyers, the demand for homes increases, causing either an expansion of supply or, to the extent that the housing supply is

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<sup>193</sup> Recall that, currently, immediate expensing under § 179 is permanent at a \$500,000 cap that is adjusted on the basis of inflation. 26 U.S.C. § 179 (2012 & Supp. III 2012); *see also supra* notes 105–106 and accompanying text.

<sup>194</sup> The relevant Treasury security rate will depend on the economic useful life of the asset since immediate expensing and accelerated depreciation policies provide government benefits immediately upon purchase of an asset rather than spread out over the duration of that asset's economic useful life. Thus, for example, assets with five-year economic useful lives should be assessed based on the rate of return on five-year Treasury notes. *See, e.g.,* Damodaran, *supra* note 135, at 9 (explaining that the riskfree rate used to assess a cash flow should match the duration of the cash flow).

<sup>195</sup> *See, e.g.,* Kevin Mercadante, *How Low Mortgage Rates Can Be Bad for Homebuyers*, MONEY UNDER 30 (Oct. 29, 2015), <http://www.moneyunder30.com/low-mortgage-rates-can-be-bad-for-homebuyers> [<https://perma.cc/6C6S-7LF2>] (“Generally speaking, when mortgage rates are low, home selling is brisk. Property values are often rising, sometimes at speculative levels. But rising rates have the opposite effect. Every time rates move up a notch, a whole bunch of borrowers are eliminated from the pool of potential homeowners. As the number of borrowers/buyers shrinks, the market cools. Sellers begin competing with one another for the shrinking buyer pool by offering discounts and incentives. You may actually find house prices are lower in a higher rate environment.”).

constrained, an increase in prices.<sup>196</sup> Thus, for prospective homebuyers, low interest rates can be capitalized into higher prices.<sup>197</sup> In the government's case, this risk is not equally present. Through immediate expensing, the government makes an investment in a capital asset. If the government uses debt to finance this investment, the investment becomes more affordable when the government's interest rate, namely the applicable Treasury securities rate, is low. Other purchasers of capital assets cannot borrow at the Treasury security rate, and the borrowing rates that are available to those other purchasers are not necessarily correlated with the government's rate, especially following recession.<sup>198</sup> Further, since the government does not directly decide what capital assets to purchase and at what price,<sup>199</sup> the prices of capital assets will reflect the borrowing rates of direct purchasers rather than those of the government.<sup>200</sup> While the benefit of the tax subsidy that direct purchasers receive due to immediate expensing<sup>201</sup> might partially be capitalized into higher prices for capital assets, the benefit of the government's low Treasury security rate will not be capitalized into these prices.

While motivated by the government's rational self interest in encouraging firms to make capital investments at times when the government can most affordably fund its share of those investments, modifying immediate expensing and accelerated depreciation policies so that they automatically adjust based on Treasury securities rates also advances traditional tax policy goals and broader social goals. These suggested modifications avoid some of the rent-seeking and retroactive windfalls that plagued prior extensions of immediate expensing and accelerated depreciation policies<sup>202</sup> and offer the predictability sought by taxpayers.<sup>203</sup>

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<sup>196</sup> *Id.*

<sup>197</sup> *See id.*

<sup>198</sup> *See* Morrow, *supra* note 33, at 510–11 (explaining, for example, that during and following recession, risk-free rates at which the government borrows money tend to plummet, while the average-risk rates at which businesses borrow money stay high because investors flee to safe investments and demand higher premiums for bearing risk).

<sup>199</sup> *See supra* Part II.C.

<sup>200</sup> *See supra* Part II.C.

<sup>201</sup> Many capital asset purchasers are likely to be in a position to take advantage of immediate expensing. However, some may be impeded from taking advantage of immediate expensing because they have already reached caps on the benefits, *see* 26 U.S.C. § 179(b)(1) (Supp. III 2012), or are in a loss position, meaning that they do not have trade or business income to offset with immediate expensing deductions. *See id.* § 179(b)(3)(A)–(B) (2012).

<sup>202</sup> *See, e.g.,* David A. Super, Opinion, *A Costly and Outrageous Tax Break*, N.Y. TIMES (Dec. 2, 2014), <https://www.nytimes.com/2014/12/03/opinion/a-costly-and-outrageous-tax-break.html> [<https://perma.cc/J4GL-KFN2>] (expressing concern that accelerated depreciation policies have been expanded retroactively, which is unfortunate since “retroactive tax cuts provide no incentive at all”); Megan R. Wilson, *Industries Unite in Defense of Tax Break*, HILL (Mar. 19, 2015, 4:34 PM), <http://thehill.com/policy/finance/236342-industries-unite-in-defense-of-tax-break> [<https://perma.cc/2SCH-2RJV>] (“Lobbying heavyweights such as Comcast and The American Petroleum Institute have already signed up with the Cost Recovery Advances the Nation’s Economy coalition (CRANE), which will press lawmakers to keep accelerated depreciation in the tax code.”).

<sup>203</sup> There may be instances when, for good reason, the government does not wish to decrease immediate expensing and accelerated depreciation benefits despite its high cost of borrowing, or when it

*B. The Government Should Exploit its Diversification by Encouraging  
Investments that Compensate for Difficult-to-Diversify Risk*

In an efficient market, investors are compensated for assuming the systematic risk inherent in their investments.<sup>204</sup> Systematic risk is the uncertainty that permeates the market as a whole.<sup>205</sup> When the market drops, most investments are expected to drop with it, but to different extents depending on whether the investment is subject to only systematic risks rather than subject to both systematic *and* unsystematic risks.<sup>206</sup> For example, stocks (whose returns depend on the profitability of firms) are expected to drop more than bonds (whose returns are “guaranteed” even if the firm is not profitable, provided that the firm remains solvent). This is another way of saying that stocks are more exposed to systematic risk than are bonds and must compensate investors for that comparatively high systemic risk exposure.<sup>207</sup>

In an efficient market, however, investors are not compensated for taking on unsystematic risk in their investments.<sup>208</sup> Unsystematic risk is the risk that a particular company or a particular industry might suffer independently of the market as a whole.<sup>209</sup> For example, poor management might cause one company to

does not wish to increase these benefits despite its low cost of borrowing. Thus, while changes to the government’s cost of borrowing should automatically trigger changes to immediate expensing and accelerated depreciation policies, these changes should be subject to modification or override.

<sup>204</sup> Kamin, *supra* note 141, at 730 (footnote omitted) (“Those who bear undiversifiable risk generally demand compensation, referred to as a ‘risk premium,’ for doing so, reflecting the cost of risk.”).

<sup>205</sup> ROSS ET AL., *supra* note 135, at 354 (“Uncertainty about general economic conditions, such as GNP, interest rates, or inflation, is an example of systematic risk.”); *id.* (“Sometimes systematic risk is referred to as *market risk*. This emphasizes the fact that [it] influences all assets in the market to some extent.”); Kamin, *supra* note 141, at 730 (footnotes omitted) (“[U]ndiversifiable risk would remain, even if markets were efficient [and investors were diversified, because] . . . uncertain outcomes are either correlated with one another, or the variance of one outcome is too large relative to the others; as a result, combining the outcomes cannot eliminate risk. Economic downturns and booms are often cited examples. In these cases, returns across investments will fall and rise together, and combining them does not eliminate uncertainty (this is why undiversifiable risk is frequently referred to as ‘market [or systemic] risk’).”).

<sup>206</sup> ROSS ET AL., *supra* note 135, at 355–56 (“While essentially all securities have some systematic risk, certain securities have more of this risk than others. The amount of systematic risk is measured by . . . *beta* . . .”).

<sup>207</sup> Kamin, *supra* note 141, at 730–31 (“[S]tocks tend to pay higher rates of return than relatively risk-free government securities because stocks are subject to undiversifiable risk for which investors demand compensation . . .”).

<sup>208</sup> See ROSS ET AL., *supra* note 135, at 354–64 (explaining how direct investors measure unsystematic risks and use diversification in their portfolios to reduce unsystematic risks).

<sup>209</sup> *Id.* at 354 (emphasizing that unsystematic risk “affects only some specific companies,” which is why “we sometimes call it an *idiosyncratic risk*”).

fail even as its direct competitors thrive by gobbling up the failing company's prior market share. Unsystematic risk is often called diversifiable risk because the market puts the onus on investors to compile portfolios of sufficiently numerous and varied investments to avoid it.<sup>210</sup> When investors diversify their investments, they are protected from the negative performance of one company or even one industry by sharing in the successes of competitors.<sup>211</sup> As a result, an efficient market only compensates investors for assuming systematic risk, not diversifiable risk.<sup>212</sup>

While the principle that only systematic risk should be compensated in an efficient market is settled, it is also settled that the United States economy is not a fully efficient market.<sup>213</sup> For example, contrary to an efficient market's condition that transaction costs should not interfere with the sale of an asset valued more by a potential buyer and less by its owner, high transaction costs do interfere with such a sale.<sup>214</sup> In markets dominated by high transaction costs, we should expect market

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<sup>210</sup> Moshe Ben-Horim & Haim Levy, *Total Risk, Diversifiable Risk and Non-Diversifiable Risk: A Pedagogic Note*, 15 J. FIN. & QUANTITATIVE ANALYSIS 289, 289 (1980) (“[D]iversifiable risk is the risk that can be ‘washed out’ by diversification.”); *Systematic and Unsystematic Risk*, INST. OF BUS. & FIN. (Jan. 29, 2016), <http://icfs.com/financial-knowledge-center/systematic-and-unsystmatic-risk> [<https://perma.cc/8HWG-X9FF>] (explaining that diversifiable risk “can be eliminated by diversification”).

<sup>211</sup> See, e.g., ROSS ET AL., *supra* note 135, at 355 (explaining that “only unsystematic risk” can be “diversified away”); *id.* (stating that systematic risk does not “decrease through diversification”); *id.* at 360 (“Unsystematic risk can be diversified away in a large portfolio but systematic risk cannot. Thus, a diversified investor must worry about the systematic risk, but not the unsystematic risk, of every security in a portfolio.”).

<sup>212</sup> *Id.* at 365 (explaining that the “capital asset pricing model . . . implies that the expected return on a security is linearly related to its beta [the measurement of its systematic risk]”); *id.* at 378 (explaining that since unsystematic risk can be eliminated through diversification while systematic risk cannot, systematic risk alone is measured by beta, and beta establishes the expected return on a security through its linear relationship).

<sup>213</sup> See, e.g., Bulow & Summers, *supra* note 6, at 22 & n.1 (summarizing the “perfect markets assumptions” of the capital asset pricing model (CAPM) as including “the absence of transaction costs, limitations on short selling, homogeneous expectations, the existence of a safe asset, and competitive behavior”); *id.* at n.2 (“If these [perfect markets] assumptions are not satisfied, the government can increase welfare by serving as a financial intermediary. However, if there are economic reasons for the nonexistence of [perfect] markets, such as moral hazard problems, there is no presumption that tax policy can increase welfare.”); Robert A. Jarrow & Martin Larsson, *The Meaning of Market Efficiency*, 22 MATHEMATICAL FIN. 1, 11–16 (2012) (describing what is necessary for there to be a fully efficient market); *Efficiency and Beyond*, ECONOMIST (July 16, 2009), <http://www.economist.com/node/14030296> [<https://perma.cc/W3WA-JLW5>] (discussing the various holes that scholars have picked over the years in the “efficient-markets hypothesis”).

<sup>214</sup> See, e.g., Yoram Barzel, *Transaction Costs: Are They Just Costs?*, 141 J. INSTITUTIONAL & THEORETICAL ECON. 4, 4 (1985) (“[W]hen transaction costs are positive, people are able to gain at each other’s expense. In order to minimize the associated loss, people will agree to restrain themselves in various ways, and will erect social institutions to impose and enforce the restraints. Such institutions have no significant function when transacting is costless.”); R. H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 387, 390–91 (1937) (footnote omitted) (“[I]n economic theory we find that the allocation of factors of production between different uses is determined by the price mechanism. The price of factor *A* becomes higher in *X* than in *Y*. As a result, *A* moves from *Y* to *X* until the difference between the prices in *X* and *Y* . . . disappears. Yet in the real world, we find that there are many areas where this does not apply [, including because] . . . [t]he costs of negotiating and concluding a separate contract for each exchange transaction which takes place on a market must also be taken into account.”). See generally OLIVER E. WILLIAMSON,

prices to less efficiently reflect value.<sup>215</sup> Further, in markets where ownership units are large and expensive, we should expect investors to be less able to afford diverse investments.<sup>216</sup> Markets dominated by under-diversified investors present opportunities for the government to receive compensation for difficult-to-diversify risk that the direct owner bears but the government, as a partial and indirect owner, does not.

For example, some sectors of the real estate market<sup>217</sup> have high transaction costs and large, expensive ownership units.<sup>218</sup> As a result, these sectors are dominated by under-diversified investors.<sup>219</sup> Just as “[m]any individuals bear significant nonsystematic risk by holding much of their wealth in the form of owner-occupied housing,”<sup>220</sup> many business owners bear significant nonsystematic risk by holding much of their wealth in the assets of one business,<sup>221</sup> including

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MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS 1–40 (1975) (defining and explaining how transaction costs interfere with efficient market exchanges).

<sup>215</sup> David A. Lesmond, Joseph P. Ogden & Charles A. Trzcinka, *A New Estimate of Transaction Costs*, 12 REV. FIN. STUD. 1113, 1115 (1999) (“[T]he marginal (informed) investor will trade on new (or accumulated) information not reflected in the price of a security only if the trade yields a profit net of transaction costs. The cost of transacting constitutes a *threshold* that must be exceeded before a security’s return will reflect new information. A security with high transaction costs will have less frequent price movements . . . than a security with low transaction costs.”).

<sup>216</sup> *See id.*

<sup>217</sup> Although this Article uses the term real property, it might more accurately use the term “non-Class A real property.” *See generally* Tanya D. Marsh, *Too Big to Fail vs. Too Small to Notice: Addressing the Commercial Real Estate Debt*, 63 ALA. L. REV. 321, 350 (2012) (“Class A assets are generally large, newer, and built of high quality materials with a high level of finish. . . . located at the most convenient locations in the most desirable markets.”). Class A real properties are likely excluded from this analysis because they are predominantly owned by real estate investment trusts (REITs), pension funds, equity funds, rental companies, and investment companies, *id.* at 351, that are likely to be well diversified.

<sup>218</sup> Michael J. Sullivan, Steven M. Cassidy & Charles M. Ermer, *A Note on the Effect of Transaction Costs on Real Estate Investment Returns*, 6 J. REAL EST. RES. 113, 113 (1991) (“[T]ransaction costs are relatively higher for real estate than exchanged-traded securities, . . . rang[ing] from 6% to 10% of a property’s sale price.”); *see* Richard B. Gold, *Why the Efficient Frontier for Real Estate Is “Fuzzy”*, 1 J. REAL EST. PORTFOLIO MGMT. 59, 61 (1995) (“[E]quity real estate transactions are not typically available for ownership units smaller than a single building or parcel of land.”).

<sup>219</sup> *See generally* Robert J. Shiller & Allan N. Weiss, *Home Equity Insurance*, 19 J. REAL EST. FIN. & ECON. 21, 21–47 (1999) (explaining that many households become undiversified and highly leveraged as a result of purchasing a home).

<sup>220</sup> Louis Kaplow, *Taxation and Risk Taking: A General Equilibrium Perspective* 21 n.32 (Nat’l Bureau of Econ. Research, Working Paper No. 3709, 1991), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1663534](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663534) [<https://perma.cc/BAF9-EP6C>] (follow “Download this Paper” hyperlink).

<sup>221</sup> Ronald C. Anderson & David M. Reeb, *Founding-Family Ownership, Corporate Diversification, and Firm Leverage*, 46 J.L. & ECON. 653, 654 n.6 (2003) (estimating that families listed in “*Forbes’s* 400 Wealthiest Americans” and controlling shareholders in S&P 500 firms have about 70% of their wealth invested in family-owned company stock); Elisabeth Mueller, *Underdiversification in Private Companies—Required Returns and Incentive Effects* (Ctr. for European Econ. Research, Working Discussion Paper No. 04–29,

buildings owned and used for business operations.<sup>222</sup> Since high transaction costs and large ownership shares interfere with the ability of most investors to diversify, it is likely that these markets have been forced to accede to the demands of investors by compensating them for risk that, while theoretically diversifiable, is not practically diversifiable.<sup>223</sup> Diverse investors in such markets are positioned to receive compensation for risk they do not bear.<sup>224</sup>

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2004), <https://www.econstor.eu/bitstream/10419/24054/1/dp0429.pdf> [https://perma.cc/LJ9C-FYZ8] (“Owners of private companies are typically highly underdiversified. In the USA, they have on average 30% of their net worth invested in one company. This concentrated investment exposes them to company-specific risk.”); see Frank Kerins, Janet Kiholm Smith & Richard Smith, *Opportunity Cost of Capital for Venture Capital Investors and Entrepreneurs*, 39 J. FIN. & QUANTITATIVE ANALYSIS 385, 387 (2004) (footnote omitted) (“Because an entrepreneur must commit a significant fraction of financial and human capital to a single venture, the entrepreneur’s cost of capital is affected by total risk, correlation with risk of the entrepreneur’s other investment opportunities, and achievable diversification.”); see also *id.* at n.5 (citation omitted) (“The entrepreneur’s underdiversification is similar to that of a public corporation executive whose compensation includes illiquid stock options or an employee whose pension assets include illiquid firm equity.”).

<sup>222</sup> See, e.g., Jeffrey D. Fisher, *New Strategies for Commercial Real Estate Investment and Risk Management*, 31 J. PORTFOLIO MGMT. 154 (2005) (explaining the risk associated with commercial real estate and how it can be managed using investment strategies employed for other asset classes); Michael J. Seiler, James R. Webb & F.C. Neil Myer, *Diversification Issues in Real Estate Investment*, 7 J. REAL EST. LITERATURE 163 (1999) (discussing real estate diversification issues in relation to disagreement about the optimal percentage of real estate investment in a mixed-asset portfolio); Sullivan et al., *supra* note 218 (demonstrating that the higher returns in real estate when compared to similarly risky investments in corporate or government securities can be partially explained by accounting for the high transaction costs associated with real estate); Masaaki Otaka & Yuichiro Kawaguchi, *Hedging and Pricing of Real Estate Securities Under Market Incompleteness* (Jan. 2002) (unpublished manuscript), [https://www.researchgate.net/profile/Yuichiro\\_Kawaguchi/publication/246363284\\_Hedging\\_and\\_Pricing\\_of\\_Real\\_Estate\\_Securities\\_under\\_Market\\_Incompleteness/links/56d05d4008ae85c823485cd3/Hedging-and-Pricing-of-Real-Estate-Securities-under-Market-Incompleteness.pdf](https://www.researchgate.net/profile/Yuichiro_Kawaguchi/publication/246363284_Hedging_and_Pricing_of_Real_Estate_Securities_under_Market_Incompleteness/links/56d05d4008ae85c823485cd3/Hedging-and-Pricing-of-Real-Estate-Securities-under-Market-Incompleteness.pdf) [https://perma.cc/U3ER-T2K2].

<sup>223</sup> See, e.g., ROSS ET AL., *supra* note 135, at 353–68 (suggesting that the market compensates for diversifiable risk in markets in which risk is not efficiently diversified); Dennis R. Capozza & Gregory M. Schwann, *The Value of Risk in Real Estate Markets*, 3 J. REAL EST. FIN. & ECON. 117 (1990) (suggesting that investors demanding prices for real estate indicates they are being compensated for theoretically diversifiable risk); Hui Chen, Jianjun Miao & Neng Wang, *Entrepreneurial Finance and Nondiversifiable Risk*, 23 REV. FIN. STUD. 4348, 4351 (2010) (“[D]ue to market incompleteness, the entrepreneur will demand an idiosyncratic [diversifiable] risk premium when valuing the firm.”); Rebecca S. Rudnick, *Enforcing the Fundamental Premises of Partnership Taxation*, 22 HOFSTRA L. REV. 229, 270 n.184 (1993) (citation omitted) (“Evidence suggests that the market compensates for unsystemic risk in areas in which risk is not efficiently diversified. For example, a particular venture in real estate may have a high degree of unsystematic risk associated with it, and thus the argument that the venture could be fully diversified, creating a perfectly balanced portfolio, is inadequate.”); Mueller, *supra* note 221 (“Underdiversified owners should only be willing to invest, if the expected returns are high enough to provide a compensation for their exposure to company-specific risk. . . . [E]mpirical results show a positive, significant relationship between underdiversification and the profitability of companies. . . . [This is likely due to] two possible mechanisms: first, owners can select the projects in which they invest such that the expected returns are sufficient to cover the cost of underdiversification and, second, if owners are at the same time managers, they can work harder to ensure the success of the company.”).

<sup>224</sup> Kerins et al., *supra* note 221, at 403–04 (explaining how value may be created by shifting nonmarket risk to a well-diversified outside investor without affecting the investor’s opportunity cost because the investor’s market risk has not changed).

In addition to taking advantage of the government's uniquely deep diversification, allowing immediate expensing of a portion of<sup>225</sup> business real property (which for purposes of this proposal is real property owned and used for business reasons excluding land)<sup>226</sup> in markets that compensate for difficult-to-diversify risk would advance traditional tax values and broader social values. First, it would reduce the current distortion in favor of assets that receive extremely generous depreciation treatment (like equipment and machinery) and against assets that receive far less generous depreciation treatment (like business real property).<sup>227</sup> Tax scholars have long worried that this distortion is excessive and interferes with otherwise efficient investing.<sup>228</sup>

Second, by reducing this distortion, tax rules might better protect the labor market. Tax scholars have likewise been concerned that the distortion in favor of equipment and machinery is problematic not just because it interferes with efficient investing, but because the investing that it most generously subsidizes threatens labor markets.<sup>229</sup> Equipment and machines replace workers to a far greater extent than business real property.<sup>230</sup> Thus, a modification of tax law to allow businesses that purchase real property for use in their business operations to immediately

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<sup>225</sup> Buildings and other real property tend to have far longer economic useful lives than equipment and machinery. Compare 26 U.S.C. § 168(c) (2012) (providing a 27.5 year recovery period for “residential rental property” and a 39 year recovery period for “nonresidential rental property”), with Jane G. Gravelle, *Reducing Depreciation Allowances to Finance a Lower Corporate Tax Rate*, 64 NAT'L TAX J. 1039, 1045 (2011) (noting that most equipment has a five or seven year recovery period). Since allowing immediate expensing of buildings and other real property replaces a lengthy recovery period with an immediate deduction, while allowing immediate expensing of equipment and machinery replaces a far shorter recovery period with an immediate deduction, full immediate expensing of buildings and other real property would provide an excessively large benefit—a benefit that threatens to distort investment excessively in favor of buildings and real property. See Gravelle, *supra* at 1047–48 (explaining that the ratio of revenue gain due to accelerated depreciation is “larger the longer lived the asset”). Thus, the immediate expensing rules should aim to allow a portion of a real property investment to be immediately expensed with the size of that portion aiming to achieve tax neutrality with machine and equipment investments.

<sup>226</sup> Allowing full immediate expensing of real property would be excessive and a better solution would be to allow immediate expensing of part of the cost of real property and then to modify the rest of the recovery period. The reason that full immediate expensing would be excessive for real property is that real property tends to have very long economic useful lives, meaning that replacing a long recovery period with immediate expensing provides an especially large benefit to real property when compared to replacing a shorter recovery period (for most equipment) with immediate expensing. To achieve neutrality in tax treatment of various assets, partial immediate expensing of real property should be authorized.

<sup>227</sup> See, e.g., Jane G. Gravelle, *Whither Tax Depreciation?*, 54 NAT'L TAX J. 513, 525 (2001) (“[T]he largest existing distortion in the tax system is the extremely long lives and slow methods of depreciation for buildings, particularly non-residential buildings.”).

<sup>228</sup> *Id.* (encouraging “greater efforts to achieve correct depreciation for long lived assets”).

<sup>229</sup> See generally Gravelle, *supra* note 227 (evaluating the effects of current depreciation practices).

<sup>230</sup> See Theodore P. Seto, *The Problem with Bonus Depreciation*, 126 TAX NOTES 782, 782–83 (2010).



expense a portion of that business real property might reduce worker displacement and increase employment.

Finally, by providing capital to help finance investments in markets that compensate for difficult-to-diversify risk, the immediate expensing of business real property could help reduce existing inefficiencies in the business real property market<sup>231</sup> and create value on an aggregate basis. As has been explored in the context of risk-shifting contracts between under-diversified entrepreneurs and well-diversified venture capital investors, when diversifiable risk is shifted from an under-diversified party to a well-diversified one, value is created and markets can become more efficient.<sup>232</sup> For one thing, under-diversified actors will predictably decline to pursue otherwise efficient investment opportunities if expected investment returns fall short of compensating for the diversifiable risk these actors hold, even if expected investment returns more than compensate for systemic risk.<sup>233</sup> However, if diversifiable risk can be shifted to the diversified actor, more efficient investments will be undertaken.<sup>234</sup> In the context of business real property, an under-diversified taxpayer may decline to purchase real property even if that purchase would otherwise be efficient if the expected returns on the business real property fall short of compensating the taxpayer for the diversifiable risk it will hold. Immediate expensing, by which the government effectively co-finances investments, could encourage more efficient investing in and pricing of business real property.<sup>235</sup>

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<sup>231</sup> See *supra* note 222 and accompanying text.

<sup>232</sup> See, e.g., Kerins et al., *supra* note 221, at 404 (“The difference in cost of capital between underdiversified and well-diversified investors is an important departure from the Law of One Price. Because the entrepreneur’s cost of capital depends on total risk [, diversifiable and systemic], opportunities exist for designing value-maximizing strategies for undertaking new ventures.”).

<sup>233</sup> Kerins et al., *supra* note 221, at 404 (“Holding total investment constant, contracts between entrepreneurs and investors can enhance value and can turn unacceptable ventures into attractive ones. In particular, contracts that shift risk to investors can reduce the venture’s weighted average cost of capital.”); Chen et al., *supra* note 223, at 4349 (“[N]ondiversifiable business risk generates quantitatively significant effects on dynamic capital budgeting, financing, business exits, and valuation of entrepreneurial firms.”).

<sup>234</sup> See Ben-Horim & Levy, *supra* note 210, at 289. If “diversifiable risk is the risk that can be ‘washed out’ by diversification,” thus leading to efficiency, then an actor (i.e., the government) who is diversified will better increase efficiency, because the risk of diversification is made moot by that actor’s own diversification. *Id.*; see also *supra* Part II.B.

<sup>235</sup> Of course, as is noted in the entrepreneur-venture capital investor context, it is not always preferable to shift risk from an under-diversified investor to a well-diversified investor. See, e.g., *supra* note 221. And checks and balances must be in place to ensure that the under-diversified investor relieved of risk through risk-shifting does not engage in adverse selection or morally hazardous behavior. See, e.g., Kerins et al., *supra* note 221, at 404 (“Of course, differences in perception between the entrepreneur and the investor about the likelihood of success, as well as adverse selection and moral hazard, all may favor contract provisions that shift risk to [or maintain risk to] the entrepreneur.”). Empirical studies could help determine when immediate expensing of business-use real property ceased to reduce market imperfections (the overpricing of property necessary to compensate for difficult-to-diversify risk) and began contributing to market imperfections (the underpricing of property given that a portion of the purchase price is provided by the government without the government being compensated for the risk-level of the investments). Even in the absence of empirical studies, checks and balances on moral hazard could be implemented, including the reforms suggested in paragraphs C.1 and C.2 below

*C. How the Government Should Mitigate its Inability to Pursue Investment  
Priorities through Sales or Investor Protections*

When tax policies make the government descriptively less like a taxing entity and more like a full investment partner, and when that investor role is acknowledged, then the current tax rules regarding debt-financing of immediately expensed property are exposed as nonsense.

i. The Government Should Refuse to Share in Debt-Financing Charges on  
Expensed Property

In the standard world of economic partnerships, when one partner contributes cash for her share of an investment while the other partner debt-finances his share, the debt-financer must pay all charges associated with the debt. Returning to the example from Part I.C., when one partner contributes \$20,000 cash to fund 20% of the purchase price for a \$100,000 asset while the other partner debt-finances his \$80,000 contribution, the 80% partner is responsible for 100% of the interest. The 80% partner could have avoided paying interest by contributing cash instead of taking out an \$80,000 loan. But with the decision to debt-finance comes the obligation to pay all associated interest. If the 80% partner demanded that the 20% partner pay 20% of the interest, the 20% partner would properly refuse.

Recall from Part I.C., however, that when the government allows an investment to be immediately expensed, it is like a 20%<sup>236</sup> partner who contributes cash (in the form of tax savings provided in the year of purchase) for its 20% share of the investment. Unfortunately, the government's neglect to see itself as a 20% investment partner means that instead of requiring the debt-financing partner to pay 100% of the interest, the government effectively pays 20%.

Under current tax law, when a firm pays interest on a debt incurred to purchase a capital asset, it can deduct that interest regardless of whether the government already effectively purchased its share of the asset through immediate expensing.<sup>237</sup> The deduction of interest causes the government to pay the amount of interest times the firm's marginal tax rate (here 20%) while causing the firm to pay only the amount of interest times  $(1 - \text{the firm's marginal tax rate})$  (here 80%).<sup>238</sup> If the government wished to change this anomaly and act like a typical investment

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(limiting the interest on debt-financed property that is eligible for deduction and prohibiting purchasers of immediately expensed property from using the portion of that property effectively purchased by the government as collateral for a loan).

<sup>236</sup> In this section, it is assumed that the taxpayer's marginal rate is 20%. If the taxpayer's marginal rate is 35%, then the government will be like a 35% partner in that it will contribute 35% of capital and share 35% in losses and profits.

<sup>237</sup> See Brown, *supra* note 16, at 309–10.

<sup>238</sup> See, e.g., *id.*

partner would, it should allow the deduction of interest only to the extent that it is attributable to the *unrecovered* cost of the asset.<sup>239</sup> If an asset has been immediately expensed, meaning that the government has purchased its full share, the unrecovered cost is zero and no interest should be deductible. If an asset is still being depreciated, meaning that the government is still purchasing its share, then only the portion on which the government is still paying its share should trigger interest deductions.

This change, while motivated by the government's desire not to be exploited as an investment partner, also advances traditional tax policy goals. A major goal of tax policy is to prevent tax arbitrage, the creation of profits for a taxpayer not based on the pre-tax economic profitability of a transaction, but based purely on the transaction's tax benefits.<sup>240</sup> Scholars have long lamented that a taxpayer's ability to borrow in order to finance the acquisition of a tax-preferred asset and then to deduct the interest on that borrowing is a troubling and common source of tax arbitrage.<sup>241</sup> In turn, this tax arbitrage opportunity undermines economic stability by encouraging purchasers to borrow heavily and repay slowly.<sup>242</sup>

Another major goal of tax policy is to advance horizontal equity by treating similarly situated taxpayers similarly.<sup>243</sup> Current rules allowing the deduction of interest paid on debt-financed, immediately expensed property undermine this goal.<sup>244</sup> According to current law, § 265 prevents taxpayers from deducting costs (including interest and other debt-financing costs) of earning income when the income earned is formally exempt from tax.<sup>245</sup> Thus, if a taxpayer debt-finances the purchase of an exempt municipal bond, § 265 prevents that taxpayer from deducting any interest.<sup>246</sup> However, while the income produced by

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<sup>239</sup> The unrecovered cost of an asset is the initial cost of the asset less any depreciation deductions that have already been taken.

<sup>240</sup> See, e.g., Geier, *supra* note 87, at 25 ("The anti-tax-arbitrage value discourages the creation of profit from the Treasury itself . . ."); *id.* at 26 ("The income-tax value stands for the proposition that consumption-tax treatment should not be allowed absent a clear indication by Congress that such treatment was intended or unless the income-tax value is outweighed by values of administrative convenience if the distortion is minimal.").

<sup>241</sup> See, e.g., Joseph E. Stiglitz, *The General Theory of Tax Avoidance*, 38 NAT'L TAX J. 325 (1985); Alvin C. Warren, Jr., *Accelerated Capital Recovery, Debt, and Tax Arbitrage*, 38 TAX LAW. 549 (1985); Alan J. Auerbach & Kevin Hassett, *Recent U.S. Investment Behavior and the Tax Reform Act of 1986: A Disaggregate View* (Nat'l Bureau of Econ. Research, Working Paper No. 3626, 1991).

<sup>242</sup> See, e.g., Dimitri B. Papadimitriou & L. Randall Wray, *Minsky's Stabilizing an Unstable Economy: Two Decades Later, Introduction to HYMAN P. MINSKY, STABILIZING AN UNSTABLE ECONOMY*, at xi, xxiv (McGraw-Hill 2008) (1986) (attributing the recent crisis in "the U.S. financial sector" in part to policies that "expanded the availability of credit . . . [and] fueled a debt frenzy and [encouraged] greater leveraging"); *infra* note 257.

<sup>243</sup> James Repetti & Diane Ring, *Horizontal Equity Revisited*, 13 FLA. TAX REV. 135, 135–36 (2012) (footnote omitted) ("Horizontal equity (HE) is defined to mean that equals should be treated alike."). *But see generally* Repetti & Ring *supra* (identifying difficulties with the process of determining which taxpayers should be deemed similarly situated and critiquing the concept of horizontal equity in light of that difficulty).

<sup>244</sup> See, e.g., 26 U.S.C. § 265 (2012); Brown, *supra* note 16 (analyzing the impact of "full loss offsets" and "one-year depreciation," including the substantial costs this system imposes).

<sup>245</sup> 26 U.S.C. § 265(a)(2).

<sup>246</sup> *Id.*

immediately expensed property is functionally exempt from tax under the E. Cary Brown theorem, it is formally subject to tax.<sup>247</sup> For example, if a taxpayer's marginal rate is 20%, then the imposition of tax means that the government collects 20% of the profits from a taxpayer's capital asset. While the 20% of profits is formally a tax, when viewed in connection with the government's earlier contribution of 20% of the capital used to acquire the asset, a contribution which was provided through the immediate expensing deduction, it is more properly regarded as a fair return on the government's investment. The profits from immediately expensed property are formally taxed but functionally tax-exempt.<sup>248</sup> Thus, § 265 does not prevent the deduction of interest on debt-financed, immediately expensed property.<sup>249</sup> Accordingly, when a taxpayer debt-finances the purchase of property that he then immediately expenses, he is treated dissimilarly to a similarly situated taxpayer who debt-finances the purchase of a formally tax-exempt investment.<sup>250</sup>

Even if the government's investment self-interest is the impetus to solve the problematic treatment of debt-financed, immediately expensed property, broader tax policy, and economic interests are also advanced.

ii. The Government Should Refuse to Allow Full Use of Expensed Property as Collateral for Debt.

In the standard world of economic partnerships, when one partner (like the 20% partner above) contributes cash for his share of a capital acquisition, and the other partner (like the 80% partner above) debt-finances his share, the debt-financer is not allowed to use the entire property as collateral for a loan; rather, he is only allowed to use the portion of the property he owns (80% in the example above). This treatment should inform the government/taxpayer partnerships created by immediate expensing rules. After a taxpayer has purchased and immediately expensed a capital asset, the taxpayer is the titleholder for the entire property. But, the government is the beneficial owner of a

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<sup>247</sup> Hanna, *supra* note 87, at 685 (alteration in original) (footnotes omitted) (quoting E. Cary Brown, *Business-Income Taxation and Investment Incentives*, in *INCOME, EMPLOYMENT AND PUBLIC POLICY: ESSAYS IN HONOR OF ALVIN H. HANSEN* 300, 314 (1948), *reprinted in* *AMERICAN ECON. ASS'N, READINGS IN THE ECONOMICS OF TAXATION* 525, 536 (Richard A. Musgrave & Carl S. Shoup eds., 1959)) ("Dr. Cary Brown wrote that '[i]f [expensing of investments is] applied to debt-financed assets [along with deduction of interest payments], it would raise investment incentives above their pretax level.' In other words, expensing coupled with an interest deduction on debt-financed investments yields an effective tax rate of less than zero. If the tax system were to permit full expensing of investments, it appears that the issue of debt-financed investments will need to be addressed. . . . As a result, it would probably be unwise to retain a full interest deduction and also allow expensing of investments.").

<sup>248</sup> See Brown, *supra* note 16, at 309.

<sup>249</sup> See 26 U.S.C. § 265.

<sup>250</sup> Since the formal tax exemption of investments (including in retirement accounts and municipal bonds) is meant to convey the most favorable treatment, this is a problematic outcome.

portion equal to the taxpayer's marginal rate (say 20%) in the sense that the government contributed 20% of the capital for the purchase, shares 20% in losses, and is entitled to 20% of profits.

The government's beneficial ownership share in an immediately expensed asset arises because the government provides capital in the form of tax savings equal to the cost of the asset multiplied by the taxpayer's marginal rate. Thus, for assets purchased and immediately expensed by sole proprietorships, the government's beneficial ownership share is the sole proprietor's marginal tax rate. For corporations, it is the entity's marginal rate. For partnerships and other pass-through entities, it is the weighted average marginal tax rate that the owners pay on partnership income.<sup>251</sup> Regardless, the government's beneficial ownership interest should not be disregarded, and the debt-financer's ownership should not be treated as complete for purposes of collateralizing the debt-financer's loan.<sup>252</sup>

One might initially assume that it makes little difference to the government whether the debt-financer uses his 80% share in the property or the entire property as collateral for a loan. Indeed, use of the entire property might decrease the interest rate that the debt-financer is required to pay, which might increase the

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<sup>251</sup> For partnerships with a small number of identifiable owners, the weighted average marginal tax rate on those owners' partnership income would be the most accurate estimate of the government's beneficial ownership interest in an immediately expensed asset. However, for many partnerships with broad or "opaque" ownership (including circularly owned partnerships), this weighted average may be too difficult to determine at the time the asset is purchased, immediately expensed, and made subject to a security interest. See Michael Cooper et al., *Business in the United States: Who Owns It and How Much Tax Do They Pay?* 3 (Office of Tax Analysis, Working Paper No. 104, Oct. 2015), <https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/WP-104.pdf> [<https://perma.cc/WF69-EN8Y>]. Accordingly, a best guess figure of 15% should be used, meaning that partnerships should only be allowed to subject up to 85% of immediately expensed assets to a security interest. Cf. *id.* at 4 (estimating average partnership income tax at 15.9%). This best guess figure is based on the Office of Tax Analysis's most recent estimate of "the average income tax rate on income earned in the partnership sector" of 15.9%. *Id.* Readers may be surprised that this average rate is so low, and it is for several reasons.

First, capital gains and dividend income, which are taxed at preferred rates, amount to 45% of partnership income. . . . Second, tax exempt and foreign entities earn roughly fifteen percent of partnership income and pay tax rates below 5%. Third, unidentifiable entities and circular partnerships pay an estimated tax rate (10.6%) that is one-third lower than the average tax rate on partnership income overall. The relative flexibility in the allocation of income and deductions among partners can also combine to make the average tax burden on partnerships relatively low.

*Id.* The use of a best guess estimate for partnerships is appropriate since determining the weighted average marginal tax rate of a particular partnership's owners would be difficult, especially at the time an asset is purchased and immediately expensed. See *id.* at 3. However, this best guess estimate should be updated as more recent data on partnership tax rates becomes available and should be used as a presumption that is rebuttable with proof that a particular partnership is associated with a lower average, because, for example, most of its owners are tax exempt entities.

<sup>252</sup> Because immediate expensing is elective, see *infra* note 278, tax law should be modified to make a consequence of this election that the taxpayer cannot subject to a security interest the government's beneficial share of the asset. For example, the immediate expensing provision should define eligible asset to exclude assets that are subject to security interests over the government's beneficial share whether defined by the entity's marginal tax rate (for corporations), the owner's marginal tax rate (for sole proprietorships) or the best guess presumed figure of 15% (for partnerships and other pass through entities). See *supra* note 251 (explaining these rates).

capital investing that immediate expensing aims to stimulate.<sup>253</sup> However, this misses an important point about how the government is situated as an investor. Unlike other investors, the government does not make affirmative decisions about what assets to buy and at what price.<sup>254</sup> If a taxpayer makes a capital investment and immediately expenses it, then the government automatically becomes a partner in that investment, proportionately sharing in whatever price the taxpayer agrees to pay.<sup>255</sup>

Since the government does not participate in decisions about what assets to purchase and at what price, it has a particularly compelling interest to avoid investments in overpriced assets. As to asset purchases that are debt-financed, the government can assert this interest by taking advantage of the potential check on purchase decisions by prospective lenders. If prospective lenders deem the debt-financed portion of the property (above 80%) to be insufficient to secure the debt (above \$80,000), then they can decline to lend and potentially prevent the purchase of an overpriced property. In contrast, if the entire \$100,000 value can be used to secure a debt of \$80,000, this potential check is forfeited. The government should modify immediate expensing policies so that these policies allow taxpayers to use only their portions of expensed property as collateral for their loans.<sup>256</sup>

While motivated by the government's investment considerations and desire to use third-party valuation experts (prospective lenders) to mitigate the risk of automatically becoming a part-owner in imprudent investments, this policy would have the benefit of discouraging risky borrowing, which threatens the stability of the economy as a whole.<sup>257</sup>

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<sup>253</sup> *But see* Elizabeth Warren, Memorandum to the Council of the American Law Inst. (Apr. 25, 1996), in LYNN M. LOPUCKI & ELIZABETH WARREN, SECURED CREDIT: A SYSTEMS APPROACH 805, 807 (2d ed. 1998) (questioning whether prohibiting a portion of a debtor's assets from being secured would necessarily "constrict commercial lending" since "much commercial lending is not based on the liquidation value of the assets, but is based instead on the ability to tie the debtor up and fence it off from other competing lenders").

<sup>254</sup> *See supra* note 158 and accompanying text; *see also supra* notes 86, 168.

<sup>255</sup> *See Brown, supra* note 16, at 309–10; *see also supra* note 158. The same might be said of other minority partners, but unlike other minority partners who can express their disagreement with a firm's investment decisions by selling their ownership interests, the government has no exit opportunity. *See Cunningham, supra* note 3, at 27 (noting the government "cannot be excluded").

<sup>256</sup> The taxpayer's portion of an immediately expensed asset is the percentage of the asset equal to 100% minus the taxpayer's marginal rate. *See Brown, supra* note 16.

<sup>257</sup> *See, e.g.,* Andrew Velarde, *Hearing Weighs Distortion Elimination, Capital Expenditures*, 151 TAX NOTES 1157, May 30, 2016, LEXIS, 2016 TNT 101–1 (noting that "increased reliance on debt [makes firms more susceptible to "the risk of financial distress"] and makes the broader economy more susceptible to severe downturns").

Further, because this policy would discourage<sup>258</sup> a portion of business assets from being secured, it would better protect the interests of tort claimants, wage claimants, environmental claimants, trade claimants, and other involuntary and unsecured creditors in the event that a business becomes distressed.<sup>259</sup> Many bankruptcy scholars lament that these “various rivals of secured creditors”<sup>260</sup> are insufficiently protected in the existing regime, which gives full priority to secured creditors.<sup>261</sup>

In 1996, prominent scholars in bankruptcy and secured transactions law agreed that the rivals of secured creditors needed and deserved more protection, especially given that their interests were nonconsensually subordinated (subordinated by agreements between debtors and prospective secured creditors without their involvement or consent).<sup>262</sup> Scholars proposed that certain debtor property should be “carved out” of the full priority regime so that it would be available to unsecured creditors.<sup>263</sup> Then-Professor and Vice President of the American Law Institute,

<sup>258</sup> I use the term discourage rather than a term like prevent because immediate expensing only occurs at the taxpayer’s election. See *infra* note 278 (providing statutory bases for elections in and out of accelerated depreciation).

<sup>259</sup> See, e.g., Warren, *supra* note 253, at 806 (“When the secured creditors encumber everything a debtor owns, the debtor’s other creditors—particularly the trade creditors, the tort victims, employees, and the environmental claimants—are unable to reach the debtor’s assets even when they can win a judgment against a debtor.”).

<sup>260</sup> This phrase is borrowed from Former Director of the American Law Institute, Geoffrey Hazard, who, in a foreword to a 1996 discussion draft of Article 9, wrote that “the proper legal regime through which to protect various rivals of secured creditors” was not in Article 9 but “in the law of bankruptcy.” UNIF. COMMERCIAL CODE REVISED ART. 9, foreword at xv (AM. LAW INST., Discussion Draft 1996).

<sup>261</sup> See, e.g., Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 YALE L.J. 862 (2014); Kenneth N. Klee, *Barbarians at the Trough: Riposte in Defense of the Warren Carve-Out Proposal*, 82 CORNELL L. REV. 1466 (1997); *id.* at 1468 (footnotes omitted) (applauding then-Professor Elizabeth Warren’s proposal to the American Law Institute’s Drafting Committee that “Article 9 be amended to dedicate a portion of the secured party’s collateral to repayment of judicial lien creditors” since the proposal would counter a flaw of full priority to secured creditors that it “captures values that belong to involuntary and less sophisticated creditors”); Lynn M. LoPucki, *The Unsecured Creditor’s Bargain*, 80 VA. L. REV. 1887, 1891 (1994) (“Security tends to misallocate resources by imposing on unsecured creditors a bargain to which many, if not most, of them have given no meaningful consent. It is an institution in need of basic reform.”); Elizabeth Warren, *Making Policy with Imperfect Information: The Article 9 Full Priority Debates*, 82 CORNELL L. REV. 1373, 1376 (1997) (“The justification for contractual priority [by which a prospective lender and a prospective debtor agree by contract that the lender will have a security interest in the debtor’s property, giving the prospective lender rights that take priority over third parties not present for the negotiation] remains, at best disputed, and at worst, thoroughly debunked.”); *id.* at 1384 (footnote omitted) (advocating a system in which “neither wage claimants nor tort claimants wait behind secured lenders to recover for their injuries”); *id.* at 1389 (critiquing the system of full priority for secured creditors because it “directs resources away from creditors who are involuntary, underrepresented, and least able to spread their losses . . . [and directs those resources] toward lenders who are entirely voluntary, best able to protect their rights, and best able to spread their risks among numerous projects”).

<sup>262</sup> UNIF. COMMERCIAL CODE REVISED ART. 9, foreword (AM. LAW INST., Discussion Draft 1996); Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 870 (1996); Warren, *supra* note 261, at 1374.

<sup>263</sup> See Warren, *supra* note 261; see also Klee, *supra* note 261.

Elizabeth Warren proposed to the ALI Drafting Committee that “Article 9 [of the Uniform Commercial Code] be amended to dedicate a portion [20%] of the secured party’s collateral to repayment of judicial lien creditors.”<sup>264</sup> Professors Lucian Arye Bebchuk and Jesse M. Fried similarly argued that some portion of a secured party’s collateral should be carved out—and treated as though it was unsecured—so that it could be made available to unsecured and involuntary creditors.<sup>265</sup> However, they proposed that the carve out should apply only in bankruptcy and should thus be enacted as a modification to bankruptcy law rather than Article 9.<sup>266</sup> These proposals earned significant support.<sup>267</sup>

Despite significant support for carve-out proposals, “[s]ecured creditors, their attorneys, and their sympathizers in academia . . . responded with predictable outrage.”<sup>268</sup> Among their objections were four contentions that are helpfully answered if the desired protection for unsecured creditors is provided not through an amendment to bankruptcy law or to Article 9 of the Uniform Commercial Code, but through an amendment to tax law.<sup>269</sup> Tax law could provide that in order to be eligible for immediate expensing, an asset may be used as collateral for a loan only to the extent of its value times  $(1 - \text{the taxpayer's marginal rate})$ .<sup>270</sup>

Before this potential tax solution is explored, recall that through immediate expensing the government provides capital towards an investment equal to the cost

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<sup>264</sup> Klee, *supra* note 261, at 1468 (footnote omitted); *see also* LOPUCKI & WARREN, *supra* note 253, at 805–08.

<sup>265</sup> Bebchuk & Fried, *supra* note 262, at 866 (“[W]e believe that full priority is unlikely to be the most efficient rule for allocating value between secured and unsecured creditors. We therefore will consider as alternatives to the rule of full priority . . . bankruptcy priority rules that would reduce or eliminate the inefficiencies we identify by according only partial priority to secured claims. . . . [One rule is a] partial-priority rule [called the ‘fixed-fraction priority rule’ that] would treat a fixed fraction of every secured claim as an unsecured claim, rendering all secured creditors at least partially unsecured.”); *id.* at 909 (“Under this rule, a fixed fraction of a secured creditor’s secured claim would continue to be treated as a secured claim, and the remainder would be treated as an unsecured claim. Thus, under a 75% fixed-fraction rule, 75% of a secured claim would be given full priority over unsecured claims, and the remaining 25% would become an unsecured claim.”); *id.* at 910–11 (stating that “a fixed-fraction priority rule would certainly be preferable to the currently prevailing *de facto* rule of partial priority” because it would at least partially mitigate the unfairness and inefficiency created by the nonconsensual subordination of involuntary and unsecured creditors).

<sup>266</sup> *See* Bebchuk & Fried, *supra* note 262 (analyzing alternatives to the rule of full priority in bankruptcy).

<sup>267</sup> *See supra* note 261 (describing some of the scholarly support for carve-out provisions).

<sup>268</sup> Klee, *supra* note 261, at 1469.

<sup>269</sup> *Id.* at 1476–79.

<sup>270</sup> Again, the implementation of this policy would be more complicated for partnerships and other pass-through entities since they do not receive tax savings based on a single, entity-level marginal tax rate. However, it could be implemented using the weighted average marginal tax rate of the entity’s owners or, if that was too difficult, a best-guess estimated rate. *See supra* note 251 and accompanying text, for further discussion.



of the investment times the taxpayer's marginal rate.<sup>271</sup> The government effectively purchases a percentage of the asset equal to the taxpayer's marginal rate.<sup>272</sup> After putting that tax savings towards the purchase, the taxpayer must still finance the cost of the asset times  $(1 - \text{the taxpayer's marginal rate})$ , and thereafter effectively owns a percent of the asset equal to  $(1 - \text{the taxpayer's marginal rate})$ .<sup>273</sup> When the government's up-front investment is acknowledged, it paves the way to tax-based protections for unsecured creditors that respond to critiques levied when similar protections were sought through changes to bankruptcy law and Article 9.

First, "[c]ritics attack[ed] the [prior Article 9 carve-out] Proposal as an unwarranted regulation of the free market, alienability of property, and freedom of contract. Some even suggest[ed] that the Proposal raise[d] Fifth Amendment takings issues."<sup>274</sup> While these attacks were thoughtfully countered at the time,<sup>275</sup> they are undermined further still if the carve-outs protecting unsecured and involuntary creditors do not apply automatically to some portion of a debtor's entire estate, but apply only to property that the debtor previously elected to immediately expense—in other words, property that the debtor did not effectively purchase and does not effectively own. When the government is acknowledged as an investor in immediately-expensed assets to the extent of the taxpayer's marginal tax rate, the idea that the taxpayer could use the government's share as collateral or that a prospective lender could take a security interest in that share without the involvement or consent of the government takes on the flavor of conversion. That the government's property might later be distributed to the taxpayer's creditors is surprising enough, let alone that it might be distributed to those creditors that the government is least interested in protecting.

Second, critics argued that "the debtor should be able to determine without governmental restraint whether to incur credit."<sup>276</sup> Again, at the time, advocates of carve-outs thoughtfully responded that this freedom of contract argument ignored that contracts between debtors and secured creditors are atypical in that they allow debtors and secured creditors to subvert the interests of non-contracting parties.<sup>277</sup> Still, this argument is even more successfully countered when the government-as-investor perspective is brought to bear. What authority can a taxpayer claim to have to encumber the government's property? Indeed, the government does not just have the right to restrain uses of its property for collateral; it should have full control over any decisions about how the purchase of its property should be financed. If the taxpayer, who makes the decision to purchase an asset, prefers to avoid this involvement by the government, it may elect not to immediately expense property

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<sup>271</sup> See Brown, *supra* note 16, at 309–10.

<sup>272</sup> *Id.*

<sup>273</sup> See, e.g., U.S. DEP'T OF THE TREASURY, *supra* note 79; see also Brown, *supra* note 16, at 309–10.

<sup>274</sup> Klee, *supra* note 261, at 1476 (footnotes omitted).

<sup>275</sup> *Id.* at 1476–77.

<sup>276</sup> *Id.* at 1476.

<sup>277</sup> *Id.*

and instead capitalize and gradually depreciate it.<sup>278</sup> However, once the taxpayer elects to immediately expense an investment, it accedes to government involvement in that investment.

Third, critics contended that prior carve-out proposals, including the Elizabeth Warren proposal to treat 20% of property as though it was unsecured, were arbitrary.<sup>279</sup> At least one proponent admitted, “[o]f course, the Proposal’s selection of 20% is arbitrary,” but defended it on the grounds that it was “[i]n no way . . . unreasonable or unprecedented.”<sup>280</sup> Again, the claim of arbitrariness might always have been flimsy. But, since prior carve-out proposals were not enacted, it is helpful that the government-as-investor perspective answers this critique, too. Policymakers hoping to better protect unsecured and involuntary creditors need not choose between the 20% proposed by Elizabeth Warren or the 25% discussed by Lucian Arye Bebchuk and Jesse M. Fried.<sup>281</sup> To the contrary, when a taxpayer elects to immediately expense a long-term asset, the government invests in that asset to the extent of the taxpayer’s marginal tax rate.<sup>282</sup> Accordingly, the taxpayer’s marginal tax rate at the time the asset is purchased establishes what the government owns and therefore what the taxpayer ought to be prevented from collateralizing.

Finally, critics argued that prior carve-out proposals, including the Warren proposal, “will not be adopted as a uniform state law. Therefore, secured creditors will force debtors to reincorporate in states that refuse to adopt the Proposal. This will create a race to the bottom and discourage legislatures from adopting the Proposal.”<sup>283</sup> Even proponents of the prior carve-out proposal acknowledged that “[t]he uniformity concern is an important issue under existing law” since adoption of the UCC varies between states, meaning that “current commercial law is nonuniform.”<sup>284</sup> They suggested that “[t]o the extent commercial law is nonuniform, perhaps it should be federalized. That way, Congress could use the Commerce Clause to enact uniform commercial laws that balance commercial law and bankruptcy law issues.”<sup>285</sup> For those policymakers who prefer to maintain the current scope of state authority over commercial and bankruptcy law, the government-as-investor perspective might again be helpful. The federal government need not impose a uniform law of secured transactions or a uniform

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<sup>278</sup> Immediate expensing and bonus depreciation are elective provisions. See 26 U.S.C. § 179(a) (2012) (providing an election in to immediate expensing treatment); *id.* § 168(l)(3)(D) (providing an election out of bonus depreciation treatment).

<sup>279</sup> Klee, *supra* note 261, at 1477.

<sup>280</sup> *Id.*

<sup>281</sup> See *supra* notes 264–265 (discussing the Warren and Bebchuk and Fried proposals).

<sup>282</sup> See Brown, *supra* note 16, at 309–10.

<sup>283</sup> Klee, *supra* note 261, at 1478 (footnote omitted).

<sup>284</sup> *Id.* at 1478–79.

<sup>285</sup> *Id.* at 1478 (footnotes omitted).

law of bankruptcy. To the contrary, it can offer a federal tax incentive, such as immediate expensing, that individual taxpayers may elect or decline with the condition that a taxpayer cannot both take the government's capital contribution towards the purchase of a share of an asset and execute a security interest to a third-party lender over that same share. Expanding protections for unsecured and involuntary creditors through federal tax law maintains state authority over commercial and bankruptcy law and maintains taxpayer authority over their own purchases. Taxpayers are not forced—rather, they are economically incentivized—to hold a share of assets that would be available for unsecured and involuntary creditors.

Automatically through operation of tax law, the government effectively purchases a share of an immediately expensed asset. This perspective offers a principled reason to prevent another party (the taxpayer) from placing a security interest on that share. Tax policy could be modified to prevent a taxpayer who immediately expenses an asset from encumbering the share effectively owned by the government. And such a modification to tax law would better protect currently under-protected unsecured creditors, while avoiding many of the critiques leveled against prior efforts to protect them through modifications to secured transactions or bankruptcy law.

#### CONCLUSION

Through the operation of tax law, the government contributes capital to and assumes ongoing risks of investments it does not select. This investment-like role makes relevant the government's unique investment characteristics and priorities. If the government wished to use the government-as-investor perspective to identify its investment priorities and then advance those priorities through modifications to tax law, several modifications are implied. Some of these modifications should be rejected as inconsistent with the government's other priorities and obligations. However, the value of the government-as-investor perspective is established by its suggestion of several modifications that are consistent with and can meaningfully advance traditional tax goals and broader social goals.

This Article has identified several instances when, in pursuing its own investment interests, the government could promote broader societal interests. First, by phasing in and out immediate expensing policies automatically based on changes to relevant Treasury securities rates, the government could pay more of its share of investments up-front when up-front payment is most affordable while also targeting the stimulus provided by immediate expensing policies to times of recession and recovery. Second, by encouraging investments in buildings and other real property structures, the government could collect compensation for difficult-to-diversify risk that it does not bear while also reducing current distortions that cause underinvestment in these structures. Third, by refusing to allow interest deductions on immediately expensed property, the government could stop paying a share of debt expenses for debt it did not incur while also narrowing a problematic tax arbitrage opportunity. Finally, by establishing that only a portion of an immediately expensed asset may be subject to a security

interest, the government could mitigate its risk of investing in an overpriced asset while also establishing a partial unsecured interest to be available to various currently under-protected claimants, including former employees with unpaid wage claims, victims of wrongdoing with tort claims, and other involuntary and unsecured creditors.

