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TAX AMORTIZATION IS THE KEY TO THE STABLE DOOR

RICHARD B. STEPHENS

Federal monetary needs are great and will continue so for many years to come. Even if current defense expenditures can be safely scaled down and many other budgetary items slashed or eliminated, debt servicing and reduction loom as strong secondary reasons for severe revenue measures. Some dangers lurk in present very high tax rates[1] — and perhaps they will be reduced; but in and of itself the annual exaction of enormous sums of money from our populace is not a major cause for alarm. The important thing is, first, that federal expenditures be made with wisdom and efficiency and for essential governmental purposes and, second, that taxing policies be geared to expenditures and existing obligations and be designed and administered in a manner calculated to impose the least possible burdens and restrictions on our economy.

This article does not deal with federal expenditures; it assumes large fiscal requirements and is directed, instead, to one important aspect of federal income taxation. Large revenue collections are not necessarily inconsistent with a strong economy. And yet some measures, designed to accomplish short-range revenue increases, do constitute a serious threat to business. The federal income tax has been such a successful device for raising funds[2] that the long-range consequences of some of its features have been largely ignored. In part this is traceable to the complexity of the tax laws themselves and to the difficulty of analyzing the economic effect of specific taxing measures.[3] But if tax policies are permitted to destroy business the Gov-

[1]The present maximum individual combined normal and surtax rate of 92% approaches the point of confiscation.

[2]"In the fiscal year 1951, individual and corporation income taxes together accounted for more than 75 percent of the collections of the Federal Government (other than social insurance payments) . . . ." *Constitutional Limitation on Federal Income, Estate and Gift Tax Rates,* JOINT COMM. PRINT, 82nd Cong., 2d Sess. (Feb. 22, 1952).

[3]Some serious efforts are being made to overcome this problem; see, *e.g.,* KIMMEL, TAXES AND ECONOMIC INCENTIVES (1950); TAX INSTITUTE, ECONOMIC EFFECTS OF SECTION 102 (1951); and the six volumes of a series of books on *Effects of Taxation,* published since 1949 by the Harvard Business School under a grant from the Merrill Foundation for Advancement of Financial Knowledge.

ernment will eventually have nothing left on which to levy; and, even before that happens, we will have ceased to exist as a strong nation. This article deals with one tax provision that threatens to contribute to that result without any corresponding or offsetting fiscal necessity.

The problem discussed here is the proper tax treatment of capital expenditures. The question is how such expenditures should be taken into account for federal income tax purposes. The objective is to suggest a treatment of such expenditures that imposes minimum burdens and restrictions on business while at the same time affording ample protection to tax revenue.

Present Tax Treatment of Capital Expenditures

Some types of capital expenditures are given special treatment under the tax laws. For example, money spent to acquire mining properties gives rise to a depletion deduction,[4] and the deduction is not always limited to the amount expended but may be based on discovery value,[5] or in some instances may be based on a percentage of the profits[6] from operating the mine, without any limitations as to cost or value. Some other mining expenditures of a capital nature are treated specially as expenses deductible from gross income.[7] Sums spent for intangible properties, such as a patent, may generally be deducted over the life of the property.[8] This article, however, is directed to the tax treatment of expenditures for tangible assets normally used in the conduct of a trade or business.

1. Normal Depreciation

Business property, other than land, declines in value and ultimately becomes worthless because of wear and tear or obsolescence. The diminution in value of such property has always been regarded as a cost of doing business. The determination of profits was important for many purposes before the enactment of the modern in-

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[4]INT. REV. CODE §23 (m).

[5]INT. REV. CODE §114 (b) (2).

[6]INT. REV. CODE §114 (b) (4).

[7]INT. REV. CODE §23 (cc); see 1 REP. PRESIDENT'S MATERIALS POLICY COMM'N 35 (1952).

[8]U.S. Treas. Reg. 111, §29.23 (l)-3 (1949).

come tax in 1913. In deciding a public utility rate-making case in 1908, the United States Supreme Court said:[9]

> "Before coming to the question of profit at all the company is entitled to earn a sufficient sum annually to provide not only for current repairs but for making good the depreciation and replacing the parts of the property when they come to the end of their life."

This early concept of the relationship between capital expenditures and profits[10] has from the outset been accepted in the federal income tax laws.[11] Not long ago, in a tax case, Mr. Justice Jackson expressed the proposition simply: ". . . as a layman might put it, the machine in its lifetime must pay for itself before it can be said to pay anything to its owner."[12]

The present Internal Revenue Code provision permitting a depreciation deduction is Section 23 (l), which authorizes as an offset against gross income "a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) of property" either used in the trade or business or held for the production of income. The comments in this article are directed largely to the first of the two classes, that is, business property, excluding property held only for investment.

The basic features of the depreciation deduction stand out more clearly in a provision in the regulations which reads, in part, as follows:[13]

> "The proper allowance for . . . depreciation is that amount which should be set aside for the *taxable year* in accordance with a reasonably consistent plan (not necessarily at a uniform rate), whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the *useful life* of the depreciable property, equal the cost or other basis of the property . . . ."

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[9]Knoxville v. Knoxville Water Co., 212 U.S. 1, 13 (1908).

[10]Judicial vacillation as regards depreciation in rate-making is reviewed by Dean in *Provision for Capital Exhaustion under Changing Price Levels*, 65 HARV. L. REV. 1339, 1349 (1952).

[11]See 4 MERTENS, LAW OF FEDERAL INCOME TAXATION §23.01 (1942).

[12]Detroit Edison Co. v. Commissioner, 319 U.S. 98, 101 (1943).

[13]U.S. Treas. Reg. 111, §29.23 (l)-1 (1949). Italics supplied.

Two features are important. First of all the depreciation deduction is sought to be fitted into the statutory policy of determining a net income for established, twelve-month accounting periods; thus the depreciation deduction for each "taxable year" must be determined. Second, adoption of an annual accounting period for tax purposes has induced the "useful life" approach to a determination of the amount of the deduction.

Annual Accounting. The calendar-year taxpayer, accustomed or resigned to his March bout with Form 1040, probably seldom stops to consider whether his federal income tax might be made payable on something other than a twelve-month basis. No general change in such tax accounting is suggested here, but it should be recognized that no natural or fundamental law requires the annual filing of tax returns. Annual tax accounting may have its roots deep in antiquity, in the annual harvest. Probably its more modern origin is: (1) the common business practice of yearly viewing the results of operations for such purposes as making comparisons with business successes or failures over similar periods of time and determining whether there are net earnings that may properly be distributed to owners, and (2) administrative convenience and the fiscal need for a steady and predictable flow of revenue. Business practice probably dictated the twelve-month basis as an answer to the administrative and fiscal requirements, although other periods might have met such requirements as well or better.

There are numerous limited departures from the basic concept of an annual net income. Some of them are considered subsequently in connection with the proposal that the tax treatment of capital expenditures be made the subject of another such departure.

Useful Life. If the sole objective is the determination of a net annual income, it is logical to spread deductions for capital expenditures over the period during which the property acquired will be useful in the business. That is, it is logical to treat such expenditures as business costs chargeable ratably to income for the years during which the property will be used. An uncritical adherence to the annual concept of income taxation has yielded this result for federal tax purposes. Therefore, as the regulations provide,[14] the taxpayer has been required to write off capital expenditures in annual amounts

[14]*Ibid.*

generally representative of the extent to which the property has decreased in value during the year as a result either of deterioration or approaching obsolescence.

The simplest and probably therefore most common method of determining depreciation for tax purposes is the straight-line method. Under this method, and disregarding salvage value, if the taxpayer acquires a machine that has a useful life of twenty years and pays $20,000 for it, he deducts $1000 (1-20th of the cost) each year for twenty years. The depreciation deduction with respect to the machine ends, of course, when the aggregate of the deductions equals the cost or other basis. Other methods of depreciation, which have gained at least the qualified approval of the Commissioner, are the unit of work method, the job basis method, the declining balance method, and the retirement method.[15] They too spread the deduction over the supposed useful life of the property, but not necessarily at a constant sum per year as is the case under the straight-line method.

Admittedly, as suggested previously in this article, the useful-life approach to the depreciation problem, if ideally administered, is consistent with the effort to determine an annual net income. If the cost of a machine were taken into account only when it was disposed of, supposed income for the years in which the machine was used would have been determined without regard to the cost of producing the income. On the other hand, if the entire cost were written off in the year of acquisition, the income for that year would have been subjected to a charge in part properly attributable to subsequent periods in which the machine was used; thus an unrealistically low income would be shown for the first year and an unrealistically high income would be shown for later years. The question still to be considered, however, is whether for tax purposes it is essential or desirable to adhere in this connection to the annual net income concept, which is itself artificial.

2. Defects in Present Depreciation Policies

The present federal income tax treatment of expenditures for property used in a trade or business has been the subject of a double error. There is a substantive error in Code Section 23 (l) which permits a deduction with respect to such expenditures only ratably over the anticipated life of the property. There is an administrative error

[15]These are discussed in 4 MERTENS, *op. cit. supra* note 11, §§23-31 *et seq.*

in the Treasury Department's current niggardly and unrealistic implementation of the statutory policy. These combined errors have had serious adverse effects on our economy in the past and, unless corrected, constitute serious threats for the future.

Administration. Disregard, for the moment, the substantive error in the annual accounting, useful-life approach to the tax treatment of capital expenditures. This statutory policy, wrong though it may be, has not always been badly administered. For the first twenty years of the modern income tax the depreciation provision was liberally construed. Although the regulations were at times self-contradictory,[16] the businessman's determination of a proper allowance for depreciation was in fact accepted "unless shown by clear and convincing evidence to be unreasonable."[17] It is very important to understand, at this point and in connection with proposals subsequently made in this article, that over a period of time a liberal depreciation policy has no direct adverse effect on the revenue. Indirect effects, favorable to the revenue, are discussed later; but the point to be emphasized is that the depreciation deduction with respect to a piece of property is limited to its cost (or other tax basis), and the aggregate of such deductions cannot exceed such cost.[18] Therefore, if property is written off taxwise in a short period, the effect is to increase net income in subsequent years, because, if the depreciation deduction has been exhausted, it cannot be used to offset the income later earned.[19]

Nevertheless, strictly as a matter of fiscal expediency,[20] in 1934

[16]Early regulations purported to place the burden of proving reasonableness of the deduction on the taxpayer but provided at the same time for acceptance of his determination in most instances; see, *e.g.*, U.S. Treas. Reg. 77, Art. 205.

[17]See note 16 *supra*.

[18]There have been some suggestions that original cost is not a proper basis for tax depreciation. For example, in the light of increased replacement costs it may be appropriate "to reconsider the validity of using past recorded original cost figures as the basis for current provision for capital exhaustion." Dean, *supra* note 10, at 1346. See also McMullen, *Depreciation and High Costs: The Emerging Pattern*, 88 J. ACCOUNTANCY 302 (1949). These proposals certainly have merit for many corporate accounting purposes. They are not, however, subscribed to here as appropriate in the case of tax depreciation, and of course they do not reflect current tax practice.

[19]See *Revenue Revision, 1947-48*, H.R. DOC. No. 523, 80th Cong., 2d Sess. 26 (1948).

[20]See *Factors Affecting Volume and Stability of Private Investment*, JOINT COMM. PRINT, 81st Cong., 1st Sess. 164 (1949).

the Treasury abandoned its long-standing and proper interpretation of the depreciation provision.[21] The action was not unlike the Biblical sale of a birthright for a mess of pottage. In the depths of the depression, in order to achieve a temporary revenue increase, the Treasury shifted the burden of proof in depreciation matters to the taxpayer.[22] The shift was highly significant in the light of the Treasury's Bulletin F,[23] which purports to be a guide to Treasury policy as regards the useful life of most items of depreciable property and which fixes the useful life at a period generally longer than that recognized in the business world. Despite the fact that most businessmen seem to disagree with the Treasury's Bulletin F statement of useful lives,[24] there is little they can do about it. The administrative policy change in 1934, which placed a heavy evidentiary burden on the taxpayer, has made Bulletin F largely determinative of tax depreciation rates.

One clear-cut and unfortunate consequence of the 1934 shift in the administration of the depreciation provisions has been the promotion of bitter and extensive controversy between the Government and the taxpayer.[25] Few would disagree with Lewis Kimmel's statement that "Since 1934 depreciation has been one of the most controversial aspects of federal income tax administration."[26] The cost and commotion engendered by such controversies must be viewed with the fact in mind that an increase in depreciation rates does not have an adverse long-range effect upon the revenue.

Another serious aspect of the current tax depreciation policies is that if business is right and the Government wrong about normal useful lives the unwarranted limitation of the deduction results in an overstatement of annual net income. That is, within the annual accounting concept, too little is being charged against current income for wear and tear on business assets. This difficulty has been aggra-

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[21]See T.D. 4422, XIII-1 CUM. BULL. 58 (1934).

[22]T.D. 4422, *supra* note 21, among other things, deleted from U.S. Treas. Reg. 77, Art. 205, the provision that "such deductions will not be disallowed unless shown by clear and convincing evidence to be unreasonable."

[23]See 2 P-H 1952 FED. TAX SERV. ¶14,160 (1952).

[24]See *Volume and Stability of Private Investment,* SEN. Doc. No. 149, 81st Cong., 2d Sess. 19 (1950), reporting that large and small companies recommended to a subcommittee of the Joint Committee on the Economic Report a liberalization of depreciation policies.

[25]See 2 P-H 1952 FED. TAX SERV. ¶14,159 (1952), listing hundreds of tax cases in which the rate of depreciation has been litigated.

[26]KIMMEL, *op. cit. supra* note 3, at 47.

vated by the recent tremendous advance in replacement costs. For business purposes some companies have attempted to meet the problem by establishing replacement reserves based on increased costs,[27] but these are not recognized as deductions for tax purposes. Current unprecedented high income tax rates make the overstatement of net income for tax purposes a serious matter. And there are the attending problems of labor's demands for higher wages and shareholders' demands for larger distributions in the light of artificial reported net incomes,[28] although at least one writer has pointed out that a dividend distribution based on income as reported for federal income tax purposes might, in effect, constitute an impairment of capital.[29]

Statutory Defects. These difficulties, chargeable largely to administration, call for careful consideration, but they pale into insignificance in the light of one other problem attributable in part to administration but in part also to the statute itself. The machine tool industry has recently presented to Congress a persuasive case for the proposition that current tax depreciation policies have been a substantial contributing factor to the lag in plant modernization in the United States.[30] The basic facts are clear. At the beginning of World War II "existing machine tool facilities . . . were utterly inadequate even to make a start upon full war production."[31] Again in 1949, shortly before Korea, according to a trade journal 49% of the machine tools in use were ten or more years old "and at least 95% were more than ten years old in design."[32] Treasury Decision 4422,[33] announcing the 1934 Treasury shift, and Bulletin F are considered major causes of these conditions. The argument is two-fold.

First of all, a businessman has a natural disinclination toward taking action based on a prediction of business activities extending fifteen

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[27]Despite some early reluctance on the part of the Securities and Exchange Commission and the accounting profession, these practices seem to be gaining acceptance for nontax purposes; see McMullen, *supra* note 18.

[28]See *Factors Affecting Volume and Stability of Private Investment, supra* note 20, at 165.

[29]KIMMEL, *op. cit. supra* note 3, at 49.

[30]Statement by L. D. McDonald, of Warner & Swazey Co., in *Hearings before Subcommittee on Mobilization and Procurement of Senate Small Business Committee,* 82d Cong., 2d Sess. (April 2, 1952).

[31]*Ibid.*

[32]*Ibid.*

[33]XIII-1 CUM. BULL. 58 (1934).

or twenty or more years into the future.[34] That is, when he contemplates expenditures for new equipment he likes to be able to foresee reasonably immediate business against which he can write off the cost. In this light, Bulletin F fosters "creeping obsolescence" by placing an obstacle in the way of such expenditures and thus impeding proper modernization efforts. Closely related is the problem of financing new acquisitions of facilities. Mr. L. D. McDonald gave the Subcommittee on Mobilization and Procurement, Senate Small Business Committee, this example of this aspect of the problem:[35]

> "A company has, let us say, a certain tool for which it paid, ten years ago, $1,000. On Bulletin 'F,' this machine has a twenty year life. The company has, therefore, recovered $500 of the capital which it originally invested in the machine. It wants to replace the machine because it has had heavy duty, it has started to wear out, and, furthermore, it is obsolete . . . a new and better model is available. The new model costs $2,000.
>
> "The company must, therefore, earn at normal and surtax rates of 52% $3,125 to provide the additional $1,500 with which to buy the new machine, and under the overall 70% limitation rate would have to earn $5,000.
>
> "And how fast can it recover the $2,000 of capital invested in the new machine? Under Bulletin 'F' it may recover this at the rate of *$100 a year.* To the small company without access to capital markets replacement is practically impossible in this situation."

As a minimum, this statement represents one businessman's reaction to the problem of plant modernization in the light of present tax depreciation policies. There is good reason to believe his is not a unique reaction.[36] But, as subsequently explained, it is doubtful if a modification of Bulletin F is an answer to the problem.

The second reason why current policies may seriously deter plant modernization is less logical but no less persuasive. As in the previous example, low depreciation rates may leave an asset on the

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[34]Under Bulletin F the supposed useful life of many types of productive equipment is 20 or 25 years.

[35]McDonald, in *Hearings, supra* note 30.

[36]See, *e.g.*, POLICY DECLARATIONS OF THE CHAMBER OF COMMERCE OF THE UNITED STATES 83 (1951).

books at about one half its cost at the time it should be replaced. George Terborgh sees at least an adverse psychological effect in this:[37]

> "Not infrequently there is a marked unwillingness to take a loss on the disposal of assets with substantial remaining book value, and their replacement is handicapped accordingly.
>
> "Right or wrong, rational or irrational, this prejudice exists in many places and must be reckoned with. It means that a depreciation policy which yields a retarded write-off of capital assets is conducive to tardy replacement."

These comments may involve assumptions about which reasonable men can differ. Be that as it may, Congress in one instance and the Treasury in another have both recognized the validity of two basic propositions. Current depreciation policies (1) artificially deter plant modernization and (2) result in an overstatement of business profits. In World War II and in the present emergency period, Congress has undertaken by statute to remove the tax obstacle to industrial modernization and expansion by permitting tax amortization, at accelerated rates, in lieu of normal depreciation.[38] The device is effective, and its nature is discussed in more detail subsequently in this article. But, for the moment, it should be observed that it smacks too much of locking the stable door after the horse has escaped. These amortization provisions reflect frenzied emergency action, which should have been taken in an orderly way before the emergency arose.

The Treasury seems, in a situation only indirectly related to the question of the depreciation deduction, to give limited recognition to the proposition that normal depreciation as presently allowed does not conform to current financial needs for replacement of facilities, whether Bulletin F is sound or not. For the purpose of determining whether a corporation has accumulated surplus beyond the reasonable needs of the business so as to be subject to the penalty surtax under Code Section 102, but not for the purpose of determining the amount of the tax if the section is applicable,[39] the Treasury may take into account additions to replacement reserves unrelated to original cost.[40]

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[37]TERBORGH, DYNAMIC EQUIPMENT POLICY 4 (1949).

[38]INT. REV. CODE §§124, 124A.

[39]In its present form INT. REV. CODE §102 leaves no room for such discretion in computing the tax once the section has been found applicable.

[40]Professor Hall so states in *The Taxation of Corporate Surplus Accumulations,*

In partial summary, the conclusions to be reached here are that current depreciation policies (a) engender needless controversy and litigation, (b) distort annual net income while seeming to aid in its determination, and, most important, (c) deter plant modernization. A few words should now be said about the substitute to which Congress has belatedly, but with great good luck, resorted in two periods of national crisis.

3. Emergency Tax Amortization

In World War II and in the present emergency Congress has allowed a deduction akin to but in lieu of normal depreciation[41] as an inducement to industrial expansion needed in the interests of national defense. The current provision[42] permits the tax amortization of emergency facilities over a sixty-month period instead of over a period determined with regard to the useful life of the property.

The basic concept of current tax amortization under Internal Revenue Code Section 124A can best be understood by reference to an example previously used in this article[43] in explaining straight-line depreciation. Under normal depreciation the acquisition of a machine with a useful life of twenty years for a cost of $20,000 would give rise to a deduction of $1000 each year for twenty years, but under the present amortization provision the annual deduction would be $4000 (12/60ths of the cost) for five years.[44] In each case, of course, deductions end when aggregate deductions taken equal cost.

JOINT COMM. PRINT, 82d Cong., 2d Sess. 23 (May 2, 1952), but it is not clear how far this policy extends. See TAX INSTITUTE, ECONOMIC EFFECTS OF SECTION 102, p. 47 (1951).

[41]See 1 MONTGOMERY, FEDERAL TAXES: CORPORATIONS AND PARTNERSHIPS 933 (1950). The comparable World War I provisions, Revenue Act of 1918, §§214 (a) (9), 234 (a) (8), 40 STAT. 1067, 1078, and Revenue Act of 1921, §§214 (a) (9), 234 (a)(8), 42 STAT. 240, 255, did not establish a fiscal amortization period but allowed amortization in lieu of depreciation, to be followed later by a recomputation of the tax at the instance of either the taxpayer or the Commissioner. For a critical consideration of the World War I provisions see TERBORGH, AMORTIZATION OF DEFENSE FACILITIES 20 (1952).

[42]INT. REV. CODE §124A.

[43]*Supra* p. 265.

[44]The deduction is to be taken over a 60-month period, but the taxpayer may elect to begin the period with the beginning of the taxable year following the year in which the depreciable asset was acquired, INT. REV. CODE §124A (a).

Administration. This article is not intended to include a full analysis of the current emergency amortization program. Nevertheless, it is desirable to include some brief comments on its administration and later to consider in more detail some substantive attacks on the merits of the program.

In the first place, the deduction under Section 124A is allowed only with respect to an "emergency facility," which subsections (d) and (e) define, in general, as any land, buildings, equipment, and so forth, the acquisition of which was completed after December 31, 1949, and which is certified "as necessary in the interest of national defense during the emergency period." As this statement suggests, the deduction is not automatically available; a prerequisite is a necessity certificate issued by the Defense Production Administration.[45]

DPA, which has primary responsibility, aided by so-called delegate agencies that make recommendations on which DPA acts, has had a difficult job in attempting to determine what new facilities are needed in the national emergency and what percentages of such facilities can be so treated. The statute authorizes percentage certification.[46] Apart from arguments going to the merits of particular decisions, the administration of the program has not been smooth. Particularly in the winter of 1950-1951, the problem of developing a proper organization for handling certification caused great delay and confusion.[47] Administratively, the program has now pretty well run its course.[48]

Incentive Purpose. Recognition of the incentive nature of the emergency amortization program is essential to an understanding of the proposals that follow in this article. The clear objective in each recent Congressional resort to tax amortization was to remove tax obstructions to plant expansion and improvement and so to encourage the construction and acquisition of needed facilities.

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[45]INT. REV. CODE §124A (d); Exec. Order No. 10,200, 16 FED. REG. 61 (1951), making DPA the certifying authority.

[46]INT. REV. CODE §124A (d).

[47]See Defense Production Act, SEN. REP. No. 1107, 82d Cong., 2d Sess. 45 (1952).

[48]In the spring of 1952 DPA announced that beginning March 1, 1952, expansion programs begun without prior certification would be denied accelerated amortization, 5 CCH 1952 FED. TAX REP. ¶8693 (1952). DPA Release No. 385, July 10, 1952, reports the issuance of 11,869 necessity certificates approving accelerated amortization amounting to $20,575,228,606.

In Progress Report No. 13 under the Defense Production Act, the incentive effect of Code Section 124A is explained as follows:[49]

> "Accelerated amortization operates to encourage expansion by permitting concentration of depreciation allowances in the first few years after construction or acquisition of the facility. It is designed also to help the taxpayer finance expansion by telescoping much of the process of capital adjustment into the years immediately ahead when the chances for high income and full use of the new facilities seem good."

A prompt return to tax amortization in 1950,[50] after full experience with the device during World War II, is perhaps the best indication of Congressional recognition that it affords a substantial inducement to industrial activity.

Tax Amortization Is Sound. There has been a great deal of criticism of emergency tax amortization, going both to the administration of the program and to the objectives of the statute itself. The objection most frequently raised is that it affords excessive benefits to the taxpayers affected. But tax amortization does not involve any subsidy or grant to business. Although some suggestions that it does may be made in entire good faith, this is not the nature of the beast.

It is true, of course, that one who takes advantage of the amortization provision and writes off the cost of a facility for income tax purposes over a five-year period may pay less tax during those five years than he would pay if he were held to the normal depreciation deduction. But two things must be borne in mind. First of all, the amortization deduction raises the question only of how business costs admittedly incurred by the taxpayer should be charged against his income. It is the taxpayer's dollars that are at risk and that must be recovered, if at all, by way of profitable business. As subsequently explained, temporary forbearance of tax exactions, when the condition is greater taxes later, cannot properly be regarded as a grant of federal funds.

Second, the amortization deduction involves only the postponement of tax, not exemption from tax.[51] A taxpayer is permitted to

[49]*Defense Production Act,* SEN. REP. No. 1107, 82d Cong., 2d Sess. 45 (1952).

[50]Sec. 124A was added to the Code by Sec. 216 (a) of the Revenue Act of 1950 shortly after the outbreak of hostilities in Korea.

[51]In this respect tax amortization is similar to the provisions in §112 post-

write off by way of amortization or depreciation, or in part by way of each, only his cost of the facility in question. As previously suggested, when the cost is written off the deduction ends.[52] A taxpayer who writes off his assets under the amortization provisions will have more net taxable income after the amortization period than he would have had if he had adhered to normal depreciation, because he will no longer be entitled to deduct any part of the cost of such amortized facilities.

The suggestion is sometimes made that the amortization provision will result in serious revenue losses to the Federal Government. Even if this were so there might be good reasons to support tax amortization. But the truth of the matter is that it is at most uncertain[53] whether there will be any revenue loss, and in the long run there may be a very substantial gain attributable to amortization.

No one can know what the future holds, but, as previously suggested, it seems reasonably safe to rephrase the old adage to refer to death and *high* taxes. Despite the short-lived flurry of tax reduction after World War II, the current national debt and the demands of national defense, to mention only two relatively uncontroversial factors, suggest that federal income tax rates may continue high for many years to come.[54] Furthermore, the probable inflationary effect of large defense and related spending makes it seem equally likely that the national income in terms of dollars will continue at a high level. These factors argue against the likelihood of revenue loss resulting from current emergency tax amortization. Income in later

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poning recognition of gain in the case of certain transactions or provisions in §22 (b) (9) permitting elective postponement of the tax recognition of gains arising out of the discharge of corporate indebtedness for less than its face amount.

[52]Thus tax amortization bears no resemblance to "discovery value" or "percentage" depletion under §§23 (m) and 114. These provisions do involve direct benefits but perhaps desirable ones.

[53]"Uncertain," said the Staff of the Joint Committee on Internal Revenue Taxation on the question of probable revenue loss through amortization. See the Staff's *Summary of H.R. 8920, the Revenue Act of 1950,* p. 19.

[54]H.J. Res. 323, 82d Cong., 2d Sess. (1952), proposing a constitutional amendment which with some exceptions would limit federal income tax rates to 25%, may cast some doubt on this. Likewise the excess profits tax is not yet, at least, a permanent part of our taxing system and may be eliminated. Either of these eventualities could, in part, convert temporary tax postponements to permanent tax savings.

years which would be offset in part by the normal depreciation deduction will be taxed without any such reduction if the facilities involved have been written off under the amortization provisions.

It should be noted that amortization may work to increase the tax base. To the extent that amortization stimulates business and increases the real national income, it will result in a revenue gain; and this seems more likely than that there will be a revenue loss chargeable to the amortization deduction. It is this incentive feature of the amortization treatment of capital expenditures which suggests its possible utility in more nearly normal times.

But there is one aspect of tax amortization that does not sit well with some persons in and out of government who would prefer to see this country moving down the road to socialism. All may agree on the need for the industrial expansion that has taken place during the past two years in the interest of national defense. There are different ways, however, of achieving such expansion. One way is by freeing private industry from unnecessary obstructions. That is consistent with our form of government and our heritage, and it is the course we have followed. Tax amortization is a form of assurance[55] to the efficient businessman against loss through a possible wasting of capital invested in the present defense effort. But if his amortized facilities continue to be used after the emergency period, or indeed after a five-year period even though the emergency continues, and if his business continues to be profitable, he will pay for such present assurance in the form of higher taxes later.

If private business would not have undertaken the necessary industrial expansion — and much recent expansion might not have been warranted from the standpoint of sound business judgment absent the amortization provision — the alternative might have been for government to step in to do the job. This, of course, is what the socialist would like. It might come about by more extensive and more liberalized government lending — a slow way to government ownership and additional control of business — or by direct and immediate entrance of government into all manner of business enterprises. In a measure, and by a kind of proper bargained-for assurance to industry, tax amortization has helped to avoid these alternatives in the present emergency.

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[55]It is only some assurance, not a guarantee, because profitable business, not tax deductions, is what returns capital to the investor.

NONEMERGENCY TAX AMORTIZATION

No one can say for certain whether at least in normal times lower tax rates might stimulate business so that the resultant increase in the tax base would produce greater revenue despite the lower rates. Dean Griswold of the Harvard Law School has appropriately raised the question:[56]

> "How far are men of means faced with such a tax on their gains induced to say 'To hell with it,' put their money into tax exempt securities and loll on the sand in Florida – instead of risking their means on productive enterprise?"

In this light it seems eminently sensible to consider ways of adjusting the tax laws so as to encourage private business initiative, at least to the fullest extent that such adjustments can be made without being likely to result in ultimate revenue losses. The incentive effect of the current emergency amortization program seems clear. Although there are, of course, many other factors that have contributed to recent industrial expansion, amortization has played a large part. Without it many businessmen would have regarded their recent expansion programs as involving too serious business risks, and many others would have been denied private loans needed for the expansion.

The question is whether it would be desirable to provide for all industry, both now and after the emergency, tax treatment of capital expenditures somewhat similar to the treatment now afforded emergency facilities under the amortization provisions. This is not an entirely new thought.

After World War II the Special Tax Study Committee of the House Ways and Means Committee headed by Roswell Magill considered, among many other problems of revenue revision, the question of the depreciation deduction. In its report the Committee said:[57]

> "We . . . recommend that, for taxable years commencing on or after January 1, 1948, in the cases of assets with a life of more than 5 years, a deduction shall be allowed for the depreciation claimed by the taxpayer on his return, in accordance with the method of computing depreciation and the rate used in

[56]GRISWOLD, CASES AND MATERIALS ON FEDERAL TAXATION 116 (3d ed. 1950).
[57]*Revenue Revision 1947-48*, H.R. Doc. No. 523, 80th Cong., 2d Sess. 27 (1948).

> his books of account. The taxpayer, once having determined a rate and method of depreciation for an asset, will be required to continue its use, unless permission to change is granted by the Commissioner."

The Committee recognized that initially taxpayers might seek to take what would be regarded under the present provisions as excessive depreciation deductions but concluded: "In the end . . . they cannot gain, for they cannot deduct altogether more than the cost of the asset."[58]

It will be observed that the Committee's recommendation may fall short of proposing an amortization deduction, because limitations would probably arise out of accounting theory. In practice, however, the Committee's suggestion would probably get pretty far away from the current income tax concept of depreciation which has grown up over the past forty years.[59] Whether it would hasten a substantial change in the accounting concept of depreciation is more conjectural. Certainly accountants would be under greater pressure to recognize as proper more of the reasons advanced by businessmen for a rapid write-off of capital expenditures.

As the preceding comments in this article indicate, tax depreciation involves a periodic recognition of a lessening in the value of assets and the treatment of the annual drop in value as a deductible cost of doing business. Tax amortization, on the other hand, is not tied so closely to diminution of value as a basis for determining the annual deduction but instead involves the tax write-off of the cost of an asset over a more arbitrarily determined period.

If the ultimate objective of the tax laws is to come as close as possible to a true net income for each twelve-month period, probably the depreciation deduction affords the better means for treating capital expenditures. Amortization, to the extent that it departs from normal useful life as the basis for writing off capital expenditures, probably distorts the net income for a particular taxable year. Costs attributable in part to future income are charged against income of an earlier year more than in instances in which the normal depreciation deduction is taken. But is that bad? Is there anything

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[58]*Id.* at 26.

[59]The reference here is, of course, to the normal useful life concept, which has stood since 1913, subject only to administrative changes previously discussed in this article.

sacrosanct about allowing tax deductions for capital expenditures on the basis of normal useful life? The answer seems to be that the method of allowing the tax write-off of capital expenditures which affords the least hindrance to business and at the same time protects the federal fisc is the best method and the one that should be adopted.[60]

Apart from the current tax amortization provisions, examples of departures from the strict twelve-month determination of net income are not lacking. In some instances individuals are permitted, in effect, to spread bunched income over several taxable years;[61] taxpayers are permitted to carry forward and back net operating losses[62] and to carry over to later years losses arising from the sale or exchange of capital assets.[63] It will be argued immediately that these illustrative provisions are supported by the common objective of removing hardships which otherwise would attend the imposition of the income tax on a twelve-month basis and that no such obvious hardship attends the usual requirement that capital expenditures be written off over the normal useful life of the asset acquired. While that may be true, the examples nevertheless show departures from the twelve-month basis for income taxation, and the question remains whether there are sound economic and fiscal reasons in support of another departure by way of amortization rather than depreciation treatment of capital expenditures.

The report of the Magill Committee, previously referred to,[64] recognizes the inadequacy of the current depreciation provisions and the futility of the controversies engendered by the present administration of those provisions. Although the Committee's recommendations go only to a liberalization of the depreciation provisions, the same arguments which support those recommendations suggest a careful consideration of the permanent adoption of an amortization treatment of capital expenditures.

In discussing possible revenue losses attributable to amortization in the earlier paragraphs of this article, one argument on that point

[60]Depreciation provisions in the tax laws of some foreign countries that have taken this view are discussed by Manning in *Depreciation in the Tax Laws and Practice of the United States, Australia, Canada, Great Britain, New Zealand, and South Africa,* 1 NAT. TAX J. 154 (1948).

[61]INT. REV. CODE §107.

[62]INT. REV. CODE §§23 (s), 122.

[63]INT. REV. CODE §§23 (e), (f), 117 (e).

[64]See note 57 *supra.*

has been reserved for discussion here. It can be demonstrated that use of the amortization deduction, although likely to result in the see-saw of low taxes now for high taxes later, may in an individual case give the taxpayer the benefit of earnings on money retained for a period which would have been immediately payable as tax but for the amortization deduction.[65] A corresponding revenue loss, in the individual case but not necessarily over-all, can likewise be shown;[66] in other words, the Government is denied the use of the money for the period during which the amortization deduction enables the taxpayer to retain it. This and some other tax advantages incident to amortization are sometimes referred to opprobriously as "excessive benefits."[67] But the disdain with which such so-called benefits are viewed by some seems to stem from the fact that tax amortization is something different from tax depreciation rather than from any inherent evil in amortization itself.

In many instances Congress refrains from exacting the pound of flesh. More revenue would be collected if no charitable deductions were allowed, but down the years Congress has seen advantages in encouraging charitable contributions by allowing such deductions.[68] There is no constitutional or other reason why gain from many of the exchanges covered by Code Section 112(b) could not be taxed, but Congress has relieved such exchanges from immediate taxation so as to remove obstacles from important business transactions. Relief from immediate tax in the case of gain arising out of an involuntary conversion is another example of Congressional forebearance.[69] If there are sound economic reasons why tax amortization should replace tax depreciation, the short-range effect on the revenue is only one other factor to be weighed in the balance.

This can properly be said of emergency tax amortization:[70]

> "One of the strongest instruments Congress has provided to encourage the expansion of our industrial capacity, is the accelerated tax amortization authority in section 124-A [*sic*] of the Internal Revenue Code."

[65]See Schlaifer, Butters, and Hunt, *Accelerated Amortization*, 29 HARV. BUS. REV. 113 (1951).

[66]*Ibid.*

[67]*Id.* at 117.

[68]INT. REV. CODE §§23(o), (q).

[69]INT. REV. CODE §112(f); and there are many others.

[70]*Defense Production Act*, SEN. REP. No. 1107, 82d Cong., 2d Sess. 45 (1952).

The statement elicits the question: Why, at any time, should business suffer the artificial restrictive effects of a nonrevenue-producing tax depreciation policy?

Some temporary difficulties may attend the adoption of normal tax amortization. It is not the purpose here to set out in detail how the transition should be accomplished. It may be remarked, however, that problems of short-term revenue reduction are not insurmountable. Among other possibilities, the immediate impact on the revenue might be softened: (a) by the device used in present Section 124A of requiring deductions to be spread over several years, although substantially less than the useful life of the asset; (b) by limiting the deduction taken in any one year to a stated percentage of cost, or (c) by applying the new amortization provisions initially only to productive equipment, on the theory that its modernization and maintenance are most essential to a strong economy.[71]

As regards productive equipment used in business, this is the time at which a shift to normal tax amortization can best be made. A large portion of such property is already covered by necessity certificates and is being written off for tax purposes under the emergency amortization provisions. Thus a change to normal amortization of this property now would have less of an adverse short-range effect on the revenue than would normally be the case.

A more enlightened tax treatment of capital expenditures must be adopted in order to assure a strong economy and to afford long-range protection of the revenue. Eventually, it would seem sound from both a fiscal and economic point of view to permit complete discretion in the tax write-off of capital expenditures in business. Immediate revenue needs require that the change be gradual, but tax amortization points the way. Successive extensions of the concept may eventually bring about the proper result.

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[71]And see H.R. 8561, 82d Cong., 2d Sess. (July 5, 1952), which would amend the Code to allow the expensing of capital expenditures up to $50,000 or 50% of net income.