Florida Tax Review

Volume 18 Article 1

2023

Toward Income Tax Accounting Consistency: Eliminating Accrual, Depreciation, and the Existing Tax Treatment of Borrowing

Joseph M. Dodge

FLORIDA TAX REVIEW

Volume 18 *2015* *Number 1*

TOWARD INCOME TAX ACCOUNTING CONSISTENCY: ELIMINATING ACCRUAL, DEPRECIATION, AND THE EXISTING TAX TREATMENT OF BORROWING

by

*Joseph M. Dodge**

ABSTRACT

The thesis here is that inconsistent tax accounting rules undermine the individual income tax, and the best available move for improving it—given the unassailability of the realization principle—is to eliminate its accrual (and quasi-accrual) features. Specifically, the agenda is to eliminate tax accrual accounting in the conventional sense, revamp the tax treatment of borrowing to (inter alia) abolish the Crane doctrine, and eliminate depreciation deductions for indivisible productive assets. The end result would be a consistent cash realization system for (at least) individual taxpayers.

The proposals made herein would upset long-standing features of the income tax and therefore are highly controversial. Nevertheless, these features create structural asymmetries that are systematically exploited to the advantage of taxpayers.

TABLE OF CONTENTS

I. INTRODUCTION

The thesis here is that inconsistent tax accounting rules undermine the individual income tax. The best available move for improvement is to eliminate its accrual (and quasi-accrual) features. Specifically, the agenda is to eliminate accrual accounting in the conventional sense,[1] revamp the tax treatment of borrowing to (*inter alia*) abolish the *Crane* doctrine,[2] and

1. Accrual accounting in tax, derived from business accounting, reckons gross income and expense items when the right to receive or obligation to pay cash is fixed, rather than when cash is received or paid.

2. Borrowed money is treated as non-income, but the corollary is that principal repayments are not deductible. The *Crane* doctrine is named after the case of Crane v. Commissioner, 331 U.S. 1 (1947), which stands for the proposition that acquisition debt is immediately included in the income tax cost basis of the acquired asset.

eliminate depreciation deductions for indivisible productive assets.[3] The end result would be a consistent cash realization system for (at least) individual taxpayers.

The proposals made herein would upset long-standing features of the income tax and therefore are highly controversial. Nevertheless, these features create structural asymmetries that are systematically exploited by taxpayers at the expense of the government and economic efficiency.

Part II explains why tax reform should focus on the current realization income tax, rather than ideal systems (such as an accretion income tax or personal consumption tax). Part III considers what "realization" really means in a general sense. Part IV argues that the accrual method should be abolished. Proposals for revamping the tax treatment of borrowing are the subject of Part V. The case for abolishing depreciation is made in Part VI. Part VII considers the feasibility of limiting the proposed changes to the individual income tax, and Part VIII is the conclusion.

II. REASONS TO FOCUS ON THE REALIZATION INCOME TAX

Reform discussions should take place in the context of the existing realization income tax, rather than that of unattainable ideal systems, such as a personal consumption tax or accretion income tax.

A. Income vs. Consumption Tax

This Article is not concerned with whether a personal (i.e., cash-flow) consumption tax[4] is preferable to an income tax in theory or as a matter of economic policy. Rather, this Article stays within the income tax, the principal reason being that the income tax has been the dominant revenue source for the U.S. federal government for over a century. Moreover, it is a universal feature of the tax systems of countries with productive private economies. In contrast, no country has had a universal personal consumption tax. In the two countries that experimented with a personal consumption tax (India and Ceylon, now Sri Lanka), the tax was narrow in scope (being aimed at the upper classes), and

3. Depreciation (and amortization) refers to a series of annual deductions, derived from an asset's cost, over the asset's useful life as prescribed for income tax purposes.

4. The tax base of a personal consumption tax is potential consumption (i.e., aggregate cash receipts, including cash borrowings and sales proceeds) less non-consumption expenditures (i.e., aggregate business and investment outlays, principal and interest payments) of an individual for the taxable year.

the experiment was short-lived.[5]

In the United States, the personal consumption tax has had strong advocates in academia, mainly based on the hypothesis that it would increase national investment and savings,[6] but the political window of opportunity for replacing the income tax with the personal consumption tax appears to have passed. Although personal consumption taxes were "on the table" during recent Republican administrations,[7] political support was insufficient to move them through the legislative process. A plausible hypothesis is that constituencies desiring lower taxes on capital might actually prefer the existing mix of personal consumption tax features (e.g., the expensing or accelerated write-off of capital expenditures) and income tax features (e.g., the exclusion of borrowed money and deferral of unrealized gains), which can produce a better result (lower, or negative, taxes) than a consumption tax. This political-behavior hypothesis is hard to prove, except anecdotally,[8] because it is unlikely that politicians and constituent advocates would publicly admit such a reason for maintaining the status quo. Nevertheless, the facts speak for themselves. The second Bush administration did not seriously push for a cash-flow consumption tax,[9] and neither did the comprehensive income tax reform

5. *See* Patrick L. Kelley, *Is an Expenditure Tax Feasible?*, 23 NAT'L TAX J. 237, 248–51 (1970).

6. Business and investment expenditures (including capital expenditures, as well as expenses) would be deductible and, hence, not taxed currently so long as not converted to personal consumption. Under certain assumptions, deduction for business and investment capital expenditures produces the same result as the exclusion of income from investment. *See, e.g.*, JOSEPH M. DODGE, J. CLIFTON FLEMING, JR., & ROBERT J. PERONI, FEDERAL INCOME TAX: DOCTRINE, STRUCTURE, AND POLICY 143–45 (4th ed. 2012).

7. The 1984 Treasury study that preceded the Tax Reform Act of 1986 opted to reform the income tax. The reasons for this choice are detailed in Charles E. McLure, Jr. & George R. Zodrow, *Treasury I and the Tax Reform Act of 1986: The Economics and Politics of Tax Reform*, 1 J. ECON. PERSPECTIVES 37, 40–42 (1987). A modified consumption tax called the "USA Tax" was introduced in Congress in 1995 and later years, but never gained traction. Simplified USA Tax Act of 2003, H.R. 269, 108th Cong. (2003). For earlier attempts, *see* U.S. TREAS. DEPT., BLUEPRINTS FOR BASIC TAX REFORM (1977).

8. A leading President George W. Bush economic advisor, Glenn Hubbard, consistently has advocated such a hybrid tax. *See, e.g.*, http://glennhubbard.net/commentary-and-op-eds/398-a-conservative-growth-agenda-for-the-us-economy (July 17, 2012).

9. Although a modified consumption tax was proposed in THE PRESIDENT'S ADVISORY PANEL ON TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM (2005), http://www.taxpolicycenter.org/taxtopics/upload/tax-panel-2.pdf, it was apparently not advanced to Congress. Since this proposal did not call for the inclusion of

proposal put forth by the Republican Chairman of the House Ways & Means Committee in early 2014.[10]

The other reason to stay within the income tax is that taxing net increases in wealth (whether invested or consumed) is a better "general" tax base for redistribution than a personal consumption tax or, for that matter, an annual wealth tax.[11] Top-down redistribution lies at the heart of academic concern and political conflict. A person opposed to government redistribution as a matter of principle should also favor an income tax, because such a tax, if imposed at a flat rate, leaves income distributions intact. Any other tax base would implicitly produce redistributive effects.

B. Accretion Income vs. Realization Income

A principle issue, within the income tax, is how to account for wealth. One approach is known as an *accretion* income tax, in which all changes in fair market value of business and investment assets during the taxable year are included in, or deducted from, the income tax base,[12] as the case may be. The

---

borrowing, it supports the hypothesis that important constituencies support expensing (consumption-tax) treatment of investments and exclusion (income-tax) treatment of borrowing.

10. On February 26, 2014, the Ways and Means Committee Chairman Dave Camp officially introduced H.R. 1, the Tax Reform Act of 2014. Press Release, Ways and Means Committee, Camp Formally Introduces the Tax Reform Act of 2014 (December 11, 2014), http://waysandmeans.house.gov/camp-formally-introduces-the-tax-reform-act-of-2014//.

11. Redistribution is currently a hot topic on account of increasing (and extreme) disparities of wealth. *See, e.g.*, THOMAS PIKETTY, CAPITAL IN THE TWENTY-FIRST CENTURY (Arthur Gold Hammer trans., 2014); Emmanuel Saez & Gabriel Zucman**,** *Wealth Inequality in the United States since 1913: Evidence from Capitalized Income Tax Data* (Nat'l Bureau of Econ. Research, Working Paper No. 20625, 2014), http://www.nber.org/papers/w20625. Contrary to Piketty, an annual wealth tax is not the most desirable tax approach to correcting wealth disparities (which derive from income and inheritance disparities) for several reasons. One is that it would require periodic valuations, with high costs of administration, attendant inaccuracies, potential for abuse of government discretion, leakage through ownership of tangible personal property, and budgetary volatility. Second, to avoid encroachment on capital, the tax rate would need to be less than a conservative rate of return, emasculating its redistributive potential. Third, a federal wealth tax is unconstitutional in the United States, unless it is apportioned among the states according to population, a requirement that is geographically counter-redistributive. A robust wealth transfer tax, along with a progressive income tax, avoids all of these problems except (to some extent) the valuation problem.

12. This Article does not discuss the issue of how consumption with respect to consumer assets should be accounted for, except to state that my view of the matter

opposite approach to one of annual valuations—and the one continuously followed by the U.S. income tax—is to reckon income, gain, loss, and deduction items only as they are *realized*, generally meaning the receipt of cash, the payment of cash, or the sale or other disposition of property.

Contemporary advocates of an accretion income tax claim Henry Simons as their Moses, on the basis of the statement in Simons's major work on taxation that income is "the algebraic sum of (1) the market value of rights exercised in [personal] consumption and (2) the change in the value of the store of property rights between the beginning and the end of the period in question."[13] Simons's only stated justification for the annual-valuation approach is the notion that, ideally, all data for computation of a year's income should exist in the year itself. Simons admitted that his definition is preliminary and theoretical, and one that has to be pragmatically tested. Ultimately, Simons accepted the realization principle,[14] as did Simons's chief acolyte, Stanley Surrey.[15] In short, citing Simons as an advocate of the accretion tax is to take a quote out of context.

Turning to the merits of the accretion concept, it is claimed to be the embodiment of economic efficiency.[16] A major complaint is that the realization principle favors investments in appreciating assets relative to those that generate current income, like interest. But is deferred realization systematically advantageous to taxpayers? It is true, of course, that the deferral

---

is that consumption outlays (whether expenses or capital expenditures) are nondeductible items that are simply ignored in constituting the tax base.

13. HENRY C. SIMONS, PERSONAL INCOME TAXATION 50 (5th ed. 1965) [hereinafter SIMONS, PERS. INCOME TAX'N].

14. *See id.* at 100 (referring to realization principle as "practical expedient"), 162 (stating that realization is "not only indispensable to a feasible income-tax system but relatively unobjectionable in principle . . . ."), 168–69 (stating that deferral of realization of gains is relatively harmless, and that realization avoids extreme fluctuations of income), 207 ("[o]utright abandonment of the realization criterion would be utter folly").

15. *See* STANLEY S. SURREY, PATHWAYS TO TAX REFORM 16–18 (1973) [hereinafter SURREY, PATHWAYS].

16. This phenomenon, which gained traction in the 1960s and 1970s under the banner of "the comprehensive tax base," is noted in Nancy C. Staudt, *The Political Economy of Taxation: A Critical Review of a Classic*, 30 LAW & SOC'Y REV. 651, 652 (1996). Favoring the accretion income tax in the name of economic efficiency are Calvin H. Johnson, *Soft Money Investing Under the Income Tax*, 1989 U. ILL. L. REV. 1019 (1989) [hereinafter Johnson, *Soft Money Investing*] (explaining that investments should always be after-tax, a condition that requires accretion taxation); David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111 (1986) (proposing a comprehensive accretion tax); Reed Shuldiner, *A General Approach to the Taxation of Financial Instruments*, 71 TEX. L. REV. 243 (1992) (suggesting that income tax should be moved towards accretion income tax).

of a *fixed dollar* amount of income is beneficial in the sense that the present value of the future tax (assumed to be at the current tax rate) is less than what the current tax would be. However, unrealized gain is not a liquidated amount, but is an amount that can grow or shrink as the years go by. In fact, if the "deferred income" grows at the same rate as the discount rate, the present value of the future tax is not reduced by reason of deferral.[17] The real culprit here is not realization but lower capital gains rates[18] and complete avoidance of tax on unrealized gain by the step-up-to-value-at-death basis rule of section 1014.[19]

A slightly different argument is that the deferral attendant upon the realization principle creates a lock-in effect for appreciating assets, because a taxpayer will end up worse off by selling and reinvesting relative to holding, *ceteris paribus*.[20] The lock-in effect supposedly inhibits the flow of capital to its highest and best use. Again, capital gains rates and especially section 1014 are major factors in encouraging the holding of appreciating assets. An accretion tax, on the other hand, is neutral between selling and holding.

It is hard to gauge the extent to which deferred realization impedes the desirable flow of capital, because most of the literature focuses on the issue of whether a further reduction in capital gains rates will increase realizations and

---

17. For example, suppose X invests $100, the growth rate (for any asset) is 4 percent per annum, and the tax rate is 30 percent. After 12 months, X has unrealized gain of $4, the tax on which would be $1.2 if the gain were realized. After year 2, the total gain is $8.16, which is realized. Of the total gain, $0.16 is appreciation "on" the year 1 appreciation. The tax on the $4.16 of 24-month appreciation is $1.248, the present-value of which (as of the 12 months date) is $1.2x. A related argument, that unrealized appreciation is "reinvested income" that obtains favorable consumption tax treatment, is circular because it simply assumes that unrealized appreciation is the same as realized-and-reinvested income. However, no reason exists to sell and reinvest in the same (asset apart from tax).

18. SIMONS, PERS. INCOME TAX'N, *supra* note 13, at 150–53 (opposing special rates for net capital gains).

19. Academic commentators are universally opposed to § 1014. *See* SIMONS, PERS. INCOME TAX'N, *supra* note 13, at 162–67; Joseph M. Dodge, *A Deemed-Realization Approach Is Superior to Carryover Basis (and Avoids Most of the Problems of the Estate and Gift Tax)*, 54 TAX L. REV. 421, 434 n. 57 (2001) (citing unanimity of prior academic commentators).

20. For example, suppose Y invests $100, the growth rate (for any asset) is 4 percent per annum, and the tax rate is 30 percent. After 12 months, Y realizes gain of $4 and pays a tax of $1.2. Suppose the remaining $102.8 is reinvested, and the gain for the next 12 months is $4.112 ($106.912 – $102.8), yielding a tax of $1.2336, leaving Y with $105.678. If the year 1 gain is not realized, the asset grows to $108.16, yielding a gain (after 24 months) of $8.16x, subject to tax of $2.448, leaving Y with $105.712.

possibly revenue,[21] issues that do not concern us here. It would seem that facilitation of internal changes in securities portfolios would have little effect on the underlying economy, or vice versa.[22] As far as venture capital is concerned, the realization principle would have no effect on the realization of losses. In any event, it is logical to suppose that accretion taxation of (marketable) securities would operate to reduce total investment, at least in that sector. In sum, the broader economic effects of the choice between an accretion and realization income tax are hard to pin down.

An economic argument in favor of realization is that an annual tax on unrealized appreciation could distort economic activity by requiring a sale or borrowing. This rationale is fairly weak in the case of a person with a publicly-traded investment portfolio, but it should not be dismissed out of hand in the case of illiquid assets like pension accounts, unimproved land, closely-held business interests, unproven mineral interests and intellectual property, and collectibles.[23] A pure accretion income tax would discourage investment in illiquid assets, but accretion taxation for *only* liquid assets would have just the opposite effect, aside from posing line-drawing issues and incentivizing the apparent or real destruction of wealth.[24]

Although the realization principle might cause some economic distortions, any tax principle (including the accretion ideal) having to do with

---

21. *See, e.g.*, Leonard E. Burman & William C. Randolph, *Measuring Permanent Responses to Capital-Gains Tax Changes in Panel Data*, 84 *AM. ECON. REV.* 794 (1994); Wayne R. Landsman & Douglas A. Shackelford, *The Lock-In Effect of Capital Gains Taxes: Evidence from the RJR Nabisco Leveraged Buyout*, 48 NAT'L TAX J. 245 (1995).

22. *Compare* Morgan Housel, *Growing Economy Doesn't Guarantee Stock Gains; Most Economic Indicators Have Little Value in Predicting the Market's Future Course*, WALL ST. J., Nov. 7, 2014, http://www.wsj.com/articles/a-growing-economy-doesnt-guarantee-stocks-will-rise-1415372093 (finding that, over time, increases in GDP bear little correlation to rises in the stock market), *with* Ross Levine & Sara Zervos, *Stock Markets, Banks, and Economic Growth*, 88 AM. ECON. REV. 537 (1998) (finding, from cross-country studies, that liquid stock markets facilitate riskier investments and productivity growth).

23. Second-best accretion techniques, such as the imputation of economic returns and retroactive taxation with interest, would be complex, barely comprehensible, and a political hard sell. In addition, the imputed-return approach is no different than a property tax, which would raise constitutional issues.

24. The gift/estate tax operates to encourage self-imposed illiquidity and other value-reducing actions in order to obtain valuation discounts.

timing will create economic distortions, and it is not clear that one set of timing rules is more harmful than another.[25]

In any event, even assuming that an ideal accretion tax is less distortive than a realization income tax, the economic-efficiency payoff can be obtained only if the accretion concept is universally applied to all income and deduction items.[26] Otherwise, distortions will occur as taxpayers seek tax arbitrage opportunities. Adoption of a pure and universal accretion income tax is practically and politically impossible. Obtaining annual valuations with any semblance of accuracy would be very costly, and perhaps intrusive. Finally, the economic-efficiency claims of accretion income tax advocates must deal with widespread assertions that other ideal taxes, namely, personal consumption taxes, wage taxes, and lump-sum capital taxes, are more efficient than an accretion income tax.[27] If these claims are credible, then economic efficiency would not appear to be the true prime directive for accretion tax devotees. Simons favored a realization income tax because of its (social-justice) redistributive potential, notwithstanding its modest efficiency deficiencies.[28]

To state the matter more abstractly, economic efficiency is a norm for achieving a particular goal, namely, the maximization of wealth. Opinions obviously differ as to whether this is the primary goal that should be pursued by government in general or taxation in particular. Simons did not think it was. In addition to social (external-to-tax) norms, the internal-to-tax (i.e., institutional) norms of allocative fairness and administrative efficiency also impose constraints on tax system design.

Allocative fairness, another concern of Simons, refers to the justness of the allocation of the burden of taxes among the population with reference to the function of taxes to raise revenue for the government.[29] Since taxes are payable only in cash, it is appropriate that the tax base be similarly constituted

---

25. For example, the tendency of the realization principle to reduce or postpone sales avoids pointless transaction costs, and it is unclear that a churning strategy gives better investment results than a buy-and-hold strategy.

26. *See* Jeff Strnad, *Periodicity and Accretion Taxation: Norms and Implementation*, 99 YALE L.J. 1817 (1990) [hereinafter Strnad, *Periodicity and Accretion Tax'n*].

27. The principal contention is that a cash-flow consumption tax is neutral between savings relative to current consumption. *See, e.g.*, Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax over an Ideal Income Tax,* 58 STAN. L. REV. 1413 (2006); David F. Bradford, *The Case for a Personal Consumption Tax*, *in* WHAT SHOULD BE TAXED: INCOME OR CONSUMPTION? (Joseph A. Pechman ed.) 75–113 (1980).

28. *See* SIMONS, PERS. INCOME TAX'N, *supra* note 13, at 19–25.

29. *See id*. at 3.

as far as timing rules are concerned.[30] Realization focuses on final economic (transactional) outcomes of individuals, as opposed to tentative or interim outcomes.[31]

Realization (deferred reckoning of income and deductions until sale or disposition) is often spoken of condescendingly as a "mere" concession to administrative efficiency, mainly because by obviating any need for annual valuations it saves costs and effort, and avoids guesses and estimates. Another practical issue with accretion income taxation (even if limited to highly-liquid assets) is that it would be a volatile revenue generator, weakening the connection between taxing and spending in annual budget cycles. Pragmatic considerations such as these should not be relegated to the bottom of the normative hierarchy. A theory of an ideal tax base that cannot be put into practice with across-the-board consistency is a poor theory.

Next, consider the basis of realization in human psychology. It is reasonable and commonplace for a person to view unrealized gains (even in the case of liquid investments) to be insufficiently "real" or "final" to justify a current tax thereon payable in cash. Prior to realization, nothing has been appropriated for the taxpayer's personal use (even if such use is only to switch to another investment), and no cash has been obtained to share with the government (which only accepts cash). The appreciation is, as far as the taxpayer is concerned, "out there." For example, stock appreciation is reflective of an underlying entity's wealth, which cannot be obtained by the stockholder. Alternatively, the appreciation might have been caused by changes in discount rates, general economic conditions, or other phenomena beyond the investor's control, and which confer no present economic benefit on the investor. In the case of tangibles, the use of the property may well be unchanged. Any "paper" gain represented by unrealized appreciation may disappear by the time the value of the property is converted to beneficial enjoyment. For a person who bought property for $50,000, followed by an increase in value to $1 million, and then followed by a decrease in value to, say, $100,000 (at which point the property is sold), the huge appreciation

30. This Article is about timing rules, not what counts as gross income or what should be deductible. Accordingly, the issue of realization does not deal with whether the receipt of non-cash items is income in the first place. Nevertheless, if one receives a right or claim to services, the item must be included in income, if at all, when received, because it will never be converted to cash. The same analysis applies to receipts of property that will be used up in consumption. Thus, a realization income tax will treat the receipt of non-cash items (such as employee fringe benefits) as gross income where appropriate.

31. A fuller version of the allocative-fairness (and other normative) arguments for a realization income tax based on market transactions is found in Joseph M. Dodge, Allocative Fairness and the Income Tax (Feb. 1, 2015) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2565766.

bubble above the $100,000 sales price was unreal, except as a "might have been."

Realization also has roots in American-style liberal theory and practice.[32] The point about "forced sales" can be re-stated as a problem of government intrusion into private-decision-making, rendered especially acute in the case of assets that are closely linked to livelihood and lifestyle (e.g., closely-held business interests, family farms, collectibles, homes, and interests in trusts).[33] In contrast, the realization principle is both voluntary and "public," because virtually all realization events involve at least one other party, and the other party (or a third party) can assist in IRS enforcement.

In legal academic circles, the realization principle appears to be gaining respectability, or at least acceptance.[34] Acceptance (even if grudging) is a child of necessity, because, given that an accretion income tax has never been adopted in any country, realization must have deep roots indeed. Since an accretion income tax is a pipe-dream, any serious tax reform proposals should begin with a realization income tax as the baseline.

III. REFINING REALIZATION

A. What Is Realization?

Realization refers to a method of avoiding annual valuations of assets and claims while achieving a single final and correct measure of inclusion in, and deduction from, the tax base.

---

32. Many argue that the income tax must accommodate political values. *See, e.g.*, JOSEPH T. SNEED, THE CONFIGURATIONS OF GROSS INCOME 5 (1967); SURREY, PATHWAYS, *supra* note 15; Alice G. Abreu & Richard K. Greenstein, *Defining Income*, 11 FLA. TAX REV. 295 (2011).

33. Such resistance is manifested under the current income tax by the fact that the gain (and use value) of personal residences largely avoids tax, *see* I.R.C. § 121, and state property taxes often cap values at the purchase price (or purchase price plus an interest-type adjustment).

34. *See* Marjorie E. Kornhauser, *The Story of* Macomber*: The Continuing Legacy of Realization*, *in* TAX STORIES 93 (Paul L. Caron ed., 2d ed. 2009); Deborah H. Schenk, *A Positive Account of the Realization Rule*, 57 TAX L. REV. 355 (2004); Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 TAX L. REV. 1 (1992); Edward A. Zelinsky, *For Realization: Income Taxation, Sectoral Accretionism, and the Virtue of Attainable Virtues*, 19 CARDOZO L. REV. 861 (1998).

1. Current Law

The ordinary meaning of realization depends on whether the subject is (a) ordinary gross income and expense items or (b) gains and losses from dealings in property. Inventory gains and losses fall into category (a).[35]

a. Gross Income and Expense Items; Inventories

In the case of gross income and expense items, one set of realization rules is referred to as the cash (receipts and disbursements) method of tax accounting.[36] Here, realization occurs upon the receipt of cash as opposed to rights to cash and, on the expense deduction side, the payment of cash rather than the fixing of the obligation to pay cash. Certain in-kind items are *deemed* to be cash—principal examples being checks, certain notes, and employee fringe benefits—but this line-drawing issue is not of concern here. Individual taxpayers are generally on the cash method.

A competing approach to the timing of gross income and expense deduction items, called the accrual method, is that of the fixing of the right or obligation to receive or pay cash, provided that the amount to be received or paid in the future is reasonably ascertainable.[37] Accounting for business income generally follows the accrual method where the taxpayer keeps its books according to Generally Accepted Accounting Principles ("GAAP").[38] Inventory acquisitions and dispositions are accounted for under the accrual method.[39]

b. Property Transactions

In the case of (non-inventory) property transactions, realization

35. Inventory dispositions are accounted for by separately reckoning aggregate gross receipts and aggregate costs of goods sold for the taxable year, *see* Reg. § 1.61-3, whereas non-inventory property dispositions are accounted for item by item by subtracting basis from amount realized, *see* Reg. § 1.61-6(a).

36. I.R.C. § 446(c)(1).

37. I.R.C. § 446(c)(2).

38. *See* I.R.C. § 446(a).

39. Reg. § 1.446-1(c)(2)(i).

occurs, if at all,[40] on the sale or other complete disposition of the property.[41] Here, the gain or loss is realized when the sale or disposition occurs, even if what is received is property rather than cash.[42] The issue of cash versus accrual accounting for gains and losses arises where the consideration takes the form of a right to future cash. Under current law, however, the default rule is one of immediate realization and recognition. This future right to cash is taken into amount realized at its face amount, in what amounts to an "accrual" rule-of-convenience,[43] although in some cases recognition of a realized gain (but not loss) can be deferred until the receipt of cash.[44]

2. Accrual as an Ersatz Realization Principle

The accrual notion qualifies as a realization principle in the sense that it does not entail annual reckonings. Additionally, like the cash method, it avoids fair market valuations because accrued rights and obligations are reckoned at their face (principal) amounts.

However, unlike the cash method, where reckoning occurs on final closure of a transaction, accrual is not a final reckoning, but instead is

---

40. A disposition for *contingent* cash consideration is not considered a realization event; the amount of the gain or loss is held open so long as the stream of payments continues. *See* Regs. §§ 15a.453-1(d)(2)(iii); 1.1001-1(a). Additionally, a gratuitous transfer is not considered a realization event, unless the donor is relieved of debt. *See* I.R.C. §§ 102(a); 61(a)(12). An alternative and perhaps better explanation for this result is that a gratuitous transfer results in a realized loss, with the loss not being deductible because it is a personal loss (i.e., does not contribute to the production of the donor's income). *See* I.R.C. § 165(c).

41. I.R.C. § 1001(a) (explaining the calculation of gain or loss upon a sale or upon a disposition that results in realization).

42. I.R.C. § 1001(b) (stating that "the amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received").

43. The statute, I.R.C. § 1001(b), states that property received, including a future payment right, is to be included in amount realized at its fair market value. But the Treasury now takes the position that it will be taken into amount realized at its (principal) face amount, unless below-market interest is charged (in which case a present-discounted-value rule applies for determining the "correct" principal amount). *See* Reg. § 1.1001-1(g).

44. The installment method may, in some cases, allow the taxpayer to defer the recognition of gain from a sale, but here the *amount* of the gain is fixed (realized) at the time of sale and recognition of the gain is pro-rated to principal cash payments received. *See* I.R.C. § 453. Another gain deferral rule is the "open-transaction" method for contingent-cash-consideration dispositions. *See supra* note 40. Here the gain or loss is not fixed at the time of the transaction giving rise to the right to contingent payments.

ultimately closed by the receipt or payment of cash. Thus, if a gross income item is accrued at $10x, based on reasonable estimates, and the cash finally received is (say) $11x, then the difference has to be accounted for. Technically, the inclusion of $10x marks the receipt of an asset (the claim to future cash) that results in an income inclusion of $10x and a basis in the asset of $10x. Upon liquidation of the claim in return for $11x, an additional $1x of collection gain is realized. [45] Even if the cash received is the same as the amount accrued, a two-step process is still required in principle.

Two other fundamental timing rules apply to all taxpayers, regardless of accounting method. The first is the exclusion for borrowed money: the receipt of cash (positive wealth) is offset by the accrual of the liability (negative wealth) to repay principal in the future. The second is annual depreciation for determinable-life assets involved in income production, which superficially appears to be based (at least historically) upon the accrual notion of creating a reserve for the future cost of replacing the asset, but is really an accretion feature embedded in a realization income tax.

B. Inconsistent Realization Rules Distort the Current System

For individual taxpayers earning compensation and making investments, the existing system allows mostly deferral of income until cash realization while also accelerating a key deduction (depreciation) and allowing cash borrowing to be excluded from gross income.

Under the *Crane* doctrine,[46] acquisition borrowing is not included in income but is included in the asset's basis, which then may be depreciated, or even expensed. In effect, deductions are obtained with before-tax dollars of a taxpayer, a deviant result in the context of the income tax as a whole, even assuming that the deductions are proper on their own. Aggravating the problem is the fact that the current system allows widespread accelerated depreciation and expensing of major categories of capital expenditures.[47] Additionally, phony debt and attendant illegitimate interest deductions have

45. Reg. § 1.451-1(a).

46. *See* Crane v. Commissioner, 331 U.S. 1 (1947) (standing for the proposition that acquisition debt, whether recourse or nonrecourse, is immediately included in basis).

47. *See, e.g.*, I.R.C. §§ 168 (providing for accelerated depreciation), 174 (expensing of research and experimentation expenditures), 179 (expensing of depreciable assets), 263(c) (expensing of intangible drilling and development costs), 263A(h) (expensing of capital outlays for authors, photographers, and artists).

plagued the system.[48] And legitimate interest may be currently deducted while the related income is deferred.[49] An egregious abuse is borrowing against unrealized appreciation, resulting in de facto realization of gain without tax consequences. Finally, the *Crane* doctrine allows depreciation to be "assigned" to a higher-bracket taxpayer making a minimal investment (and possibly not bearing the economic risks of ownership).[50]

Mismatches can also occur in two-party transactions, creating "tax floats" whereby private parties can gain at the expense of the government.[51] A prime example is an installment sale where one party defers gain while the other obtains current deductions. Another example is where one party can accrue (accelerate) deductions for payments that are deferred income to the cash-method recipient.

These discrepancies are not mere aesthetic discords, but can result in negative tax and severe economic distortions. Numerous ad hoc statutory provisions address some of these problems,[52] but the band-aids are leaky, and fail to address the underlying disease of inconsistent realization (and pseudo-realization) rules.

C. Which Realization Principle Should Be the Norm?

If one realization principle is to be adopted for the sake of uniformity, which should it be? For individual taxpayers, the accrual notion of realization can never be the norm, because it would require mastery of financial accounting principles and of the statutory deviations therefrom. All

48. *See* I.R.C. § 465 (limiting deductions to amounts at risk); Commissioner v. Tufts, 461 U.S. 300 (1983); Knetsch v. United States, 364 U.S. 361 (1960); Estate of Franklin v. United States, 544 F.2d 1045 (9th Cir. 1976).

49. Some ad hoc provisions limit this opportunity. *See* I.R.C. §§ 163(d) (deferring investment interest deductions in excess of net investment income); 469 (deferring net passive activity losses). However, no restrictions apply to the current deduction of business interest.

50. An example is the infamous case Frank Lyon Co. v. United States, 435 U.S. 561 (1978).

51. The parties in such a case obtain a net tax benefit at the expense of government revenue. For a full explanation, see Calvin H. Johnson, *Silk Purses from a Sow's Ear: Cost Free Liabilities under the Income Tax*, 3 AM. J. TAX POL'Y 231 (1984). A simple example involves alimony, deductible by a higher-bracket taxpayer and included in income by a lower-bracket taxpayer. Whatever the merits of these rules, their effect is to shift income into a lower tax bracket, allowing the parties to increase the amount of the pre-tax transfer.

52. *See, e.g.*, I.R.C. §§ 83(h), 267(a)(2), 404(a)(5), 465, 1272, and authorities cited *supra* note 47.

compensation income is accounted for on the cash method.[53] Additionally, the accrual notion deviates from the ability-to-pay principle that underlies the cash method, which is intuitively understood by laypersons, if perhaps on a basic level.

IV. ABOLISHING ACCRUAL

In this Part it is proposed that consistent application of the realization principle to individual taxpayers commands universal adoption of the cash method of accounting.

A. Independence of Tax Accounting

It clear by now that tax theory and rules are independent of business accounting, from which the accrual method derived.[54] Accrual doctrine in the income tax is a set of *rules* (the "all-events" test plus assorted statutory exceptions and modifications), rather than standards, such as the "matching" (of costs to revenue) principle, that govern accounting. Matching is not inherently a tax value.[55] Although capitalization (followed by deferred cost recovery) produces outcomes that resemble matching, capitalization in the income tax is not founded on matching but on the idea of taxing the acquisition of new wealth.[56] The principle that drives timing issues under the current income tax is realization.

B. Reasons to Abolish Accrual

The accrual method accelerates the tax realization of gross income and expense deduction items to the time the right to receive cash or the obligation to pay cash is fixed.[57] It is contrary to the cash-realization income tax.

---

53. There is a cash-method doctrine called the "economic benefit doctrine," partially codified in I.R.C. § 402(b)(1) in the case of nonqualified deferred compensation, that lies somewhere between accrual and in-kind compensation; however, wage-earners rarely are subject to it unintentionally.

54. *See, e.g.*, Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 542–43 (1979).

55. *See generally* Deborah A. Geier, *The Myth of the Matching Principle as a Tax Value*, 15 AM. J. TAX POL'Y 17 (1998) [hereinafter Geier, *Myth of the Matching Principle*]; Alan Gunn, *Matching of Costs and Revenues as a Goal of Tax Accounting*, 4 VA. TAX REV. 1 (1984) [hereinafter Gunn, *Matching of Costs and Revenues*].

56. *See infra* text accompanying note 91.

57. *See* Reg. 1.446-1(c)(1)(ii). Since 1984, expense deductions cannot be accrued any earlier than "economic performance," which depends on the context. *See*

1. Accrual Is Not Necessary

It might be claimed that the notion of accrual in tax is proper under the "change in net wealth" aspect of the Simons preliminary income definition, since rights to future cash are "assets" and obligations to pay cash are "liabilities" (negative wealth) in the world of business accounting. However, accretion requires *annual* valuations of assets.

Another peg might be the "accession to wealth" notion that is a core characteristic of gross income as expressed in the famous *Glenshaw Glass* case.[58] However, *Glenshaw Glass* involved the receipt of cash and cannot be cited for the proposition that in-kind accessions of rights to future cash must immediately be included in gross income. Moreover, the same sentence of the opinion referred to the necessity of realization. Additionally, in cases where in-kind items are included in gross income, the measure of inclusion is fair market value, not (as required by the accrual method) the face amount. Although it is claimed that fair market value and face amount are the same if market-rate interest is charged, accrual doctrine is not contingent on the actual or implicit charge of interest.[59]

In business accounting, accrual is a *standard* that is derivative of the "matching" principle, which itself is vague, in part because it is often impossible to establish connections between income and costs.[60] It is not even clear that accrual is particularly linked to the matching principle. For example, a deduction for a reserve for future costs is hardly a cost of current income. In the income tax, the operative test for accrual, the "all events" test,[61] operates independently on the income and deduction side.

Accrual in the income tax may have started out purportedly as a rule of convenience for business taxpayers.[62] Since the early days, however, the

---

I.R.C. § 461(h). Taxpayers not required to use the accrual method, *see* §§ 447, 448, can use it if the taxpayer's books are kept accordingly, *see* I.R.C. § 446(a).

58. Glenshaw Glass v. Commissioner, 348 U.S. 426, 431 (1955).

59. The one case where the discrepancy between value and face amount was cited as a ground for denying accrual under § 446(b) ("clear reflection of income") is Ford Motor Co. v. Commissioner, 71 F.3d 209 (6th Cir. 1995).

60. This point is developed further in the discussion of depreciation in Part VI, but other examples would be advertising costs and executive salaries.

61. BLACK'S LAW DICTIONARY 91 (10th ed. 2014) ("A requirement that all events fixing an accrual-method taxpayer's right to receive income or incur expense must occur before the taxpayer can report an item of income or expense.").

62. The 1909 corporate income tax and the 1913 individual income tax appear to assume cash accounting. However, Reg. 33, § 158 (1913), provided that corporations could report income and deductions in accordance with how they kept their books (which was often according to the accrual method). This approach was

tax accrual doctrine has evolved away from simply transferring accounting entries to the tax return. This evolution has been driven by (1) a desire to establish clear rules and (2) prevent tax avoidance. Currently, tax accrual is an elaborate set of rules[63] that differs from business-accounting accrual to such an extent[64] that it cannot be seriously argued that the tax system should allow certain taxpayers to use the accrual method for the "compliance convenience" of taxpayers. Additionally, since business accounting already requires the identification of transactions involving the receipt and payment of cash and consequent adjustments to other accounts, it cannot be claimed that the cash method is inconvenient for tax purposes.[65]

Although the all-events test is supposedly a rule of law, it is sufficiently ambiguous as to have been considered several times by the Supreme Court.[66] Does a right or obligation become "fixed" when a binding contract is entered into, when the income is earned or the liability incurred, when the conditions for performance have been satisfied, or when payment is actually due? Additionally, the all-events test might yield to the "clear reflection of income" mandate of section 446(b).[67] Finally, section 461(h), enacted in 1984, and the regulations thereunder, provide rules for deferring the accrual of deductions, essentially superseding the all-events test.

---

adopted for both individuals and corporations by the Revenue Act of 1916, ch. 463, §§ 8(g), 13(d), 39 Stat. 756, 763, 771. It thus appears that the accrual method entered the income tax primarily on the basis of the compliance-convenience argument, and secondarily on the basis that it was thought that business accounting (although at an adolescent stage) was more advanced than income tax accounting. *See* Gunn, *Matching of Costs and Revenues*, *supra* note 55, at 4–6.

63. *See* I.R.C. § 461(h)(2).

64. For example, receivables, the most commonly-accrued item, are taken into income when the right to receive the cash is fixed under the all-events test, not (necessarily) when the receivables would be included under the matching principle.

65. For example, accruals of deductions cannot occur until "economic performance," a standard that varies with the circumstances.

66. *E.g.*, United States v. Gen. Dynamics Corp., 481 U.S. 239 (1987); United States v. Hughes Props., Inc., 476 U.S. 593 (1986); United States v. Consol. Edison Co. of N.Y., 366 U.S. 380 (1961); Sec. Flour Mills v. Commissioner, 321 U.S. 281 (1944); Dixie Pine Prod. Co. v. Commissioner, 320 U.S. 516 (1944); Helvering v. Estate of Enright, 312 U.S. 636 (1941); Spring City Foundry Co. v. Commissioner, 292 U.S. 182 (1934); Brown v. Helvering, 291 U.S. 193 (1934); N. Am. Oil Consol. v. Burnet, 286 U.S. 417 (1932); Cont'l Tie & Lumber Co. v. United States, 286 U.S. 290 (1932); Lucas v. N. Tex. Lumber Co., 281 U.S. 11 (1930); Lucas v. Am. Code Co. 280 U.S. 445 (1930); United States v. Anderson, 269 U.S. 422 (1926). The above Supreme Court cases constitute just the tip of the iceberg.

67. *See, e.g.*, Schlude v. Commissioner, 372 U.S. 128 (1963); Ford Motor Co. v. Commissioner, 71 F.3d 209 (6th Cir. 1995).

2. Accrual Systematically Favors Income Reductions

Accrual accounting tends to operate favorably for business taxpayers due to the fact that, by reason of its conservatism (eagerness to show the bad news), it tends to accelerate deductions relative to income.

a. Reserves for Future Costs

"Reserve" accounting (showing statistical predictions of future cash outflows to be charged against current income even though not "fixed") has a long history in conservative financial accounting. Certainly accrual in this scenario fails to meet any standard of tax realization.[68]

Reserve accruals would be especially pernicious in the sense that there are no rules that accelerate future expected income, either in accounting or in tax.

b. Receivables and Payables

Accrual of receivables and payables might appear to favor the IRS by accelerating the net income of business taxpayers. However, a more detailed analysis is called for.

First, consider sellers of goods (i.e., merchants and manufacturers) having a slight profit margin and high material costs. The receivables of sellers of goods may well be secured by the goods sold. Also, such receivables occur in large quantities that can be packaged. An entire industry ("factoring") exists to purchase such receivables at a modest discount.[69] In short, receivables of sellers of goods typically are highly liquid, and in fact are frequently sold in commerce. On the other hand, the accounts payable (for acquiring goods, raw materials, supplies, etc.) merely represent an obligation to decrease *future* material wealth. Stated in the abstract, receivables and payables are not truly symmetrical. The cash method better reflects current net income in terms not only of cash but also of real material wealth.

Next, consider sellers of services having low material costs but significant salary costs. Sellers of services cannot secure their receivables with assets, often have trouble with prompt collections, and cannot sell receivables in bulk except with a heavy discount. Additionally, salary costs cannot be accrued even by accrual-method taxpayers. These types of businesses would

68. *See Brown*, 291 U.S. 193; *Am. Code Co.*, 280 U.S. 445.

69. *See* J. DOWNES & J.E. GOODMAN, DICTIONARY OF FINANCE & INVESTMENT TERMS 242 (8th ed. 2010) (defining factoring).

reject the accrual method as unfair. Indeed, professional service businesses have (for that reason) been allowed to avoid the accrual method.[70]

Small-scale farming is also on the cash method,[71] as are other businesses not following GAAP accounting. Yet other businesses are required to be on the accrual method, even if they do not follow GAAP.[72] Requiring different accounting methods for different business types complicates the tax law and enables tax arbitrage.

Although business accounting requires accrual of receivables at face, it also allows partially offsetting write-offs for annual additions to bad debt reserves, which operate to exclude the portion of the reserves estimated to be uncollectible. Bad debt reserves (or their equivalent) are allowed under the income tax to some degree, although not universally.[73] Such reserves are asymmetrical, because no equivalent "unlikely-to-be-paid" rule limits deductions for expenses and accounts payable.[74]

In tax, it would be far simpler to account for receivables and payables on the cash method. Uncollected accounts receivable would never show up as income, and no current deductions would be allowed for receivable bad debts.[75]

C. Cash Realization and Property Dispositions

Would adopting the cash method significantly alter current rules as to property dispositions? The current rule treating any disposition as a realization event is likely based on virtual necessity: a taxpayer cannot logically have basis in an asset the taxpayer no longer owns.

---

70. Professional service corporations are exempt from having to use the accrual method. I.R.C. § 448(b)(2).

71. I.R.C. § 448(b)(1) (exception if farming business is tax shelter). Section 447 requires accrual for large farming corporations.

72. I.R.C. § 448(a); Reg. § 1.446-1(c)(2)(i) (inventories must be on the accrual method unless excepted by (c)(2)(ii)).

73. Such reserves are allowed for some select taxpayers. I.R.C. §§ 585 (small banks), 807, 816 (life insurance). For accrual taxpayers providing professional services, a portion of receivables is excluded. I.R.C. § 448(d)(5).

74. *See Hughes Props., Inc.*, 476 U.S. 593; Ga. School-Book Depository, Inc. v. Commissioner, 1 T.C. 463 (1943).

75. Uncollected receivables would lack an income tax basis by reason of not having been previously included in income. Basis is a prerequisite for any loss deduction. I.R.C. §§ 165(b), 166(b). Bad debt deductions would continue to exist for non-repaid cash loans, which have a basis equal to the excess of the lent cash over principal payments received.

1. Property Exchanges

Cash sales are the norm for dispositions of property having any ascertainable market value. No convincing argument can be made that property exchanges would occur in commerce except to evade tax or to take advantage of tax-free exchange rules, such as section 1031.

Although it is generally expedient to recover an asset's basis no later than its disposition, it is nevertheless the case that gain or loss on an exchange of properties can be, and sometimes is, deferred by not currently recognizing the realized gain or loss and transferring the basis of the formerly-owned asset to the newly-acquired asset acquired in exchange.[76] However, transferred-basis rules are hard to enforce. Assets (especially real estate) do not come with an "acquired in a tax-free exchange" tag,[77] and the transferred basis may itself be hard to ascertain.[78]

Thus, property exchanges should be realization events.[79]

2. Deferred-Payment Sales

Deferred-payment sales are two-party transactions in which the seller finances the sale (in whole or in part) by accepting deferred cash payments, or, to be more accurate, a right to future cash payments, usually bearing interest.[80] Basically, the seller is exchanging the property for a fixed-principal-cash debt obligation. Since the amount of gain or loss is fixed by virtue of the nature of the consideration received, deferred *realization* makes no sense, but the question remains whether it is desirable to defer the *recognition* (taxation) of

76. The term "recognition" refers to a realized gain or loss currently included in gross income or currently eligible for deduction. Recognition is the default rule for sales or exchanges, and nonrecognition occurs only under express statutory provision. I.R.C. § 1001(c).

77. Neither the Schedule D (to the Form 1040, Income Tax Return for Individuals) nor the instructions thereto call attention to this issue.

78. Former I.R.C. § 1034 (1997) was a tax-free rollover provision for personal residences that had a transferred-basis rule, but it was repealed mainly because it was difficult to comply with (and, reading between the lines, because it was not complied with). *See* H.R. REP. NO. 105-148, pt. 2, at 347 (1997). In contrast, transferred-basis for equity interests in corporations can be tracked by brokers and with the aid of Internet services.

79. Exchanges involving equity interests in business entities raise separate issues that are beyond the scope of this Article.

80. Reg. § 1.453-4.

any realized *gain*[81] out of lack-of-liquidity considerations. Basically, deferred recognition of gain should be allowed only where cash buyers are unavailable. This would be the case where the sold property (the collateral) is relatively illiquid *and* bank financing is generally unavailable.[82] In these cases, the fair market value of the installment obligation would be significantly discounted, and it would be inappropriate to tax the seller on the entire realized gain in the year of sale.

In cases where recognition of gain is deferred, the issue remains how the gain should be allocated among cash payments. The current installment method prorates the gain to the principal payments.[83] Alternative methods do not offer much to warrant recommending them.[84]

3. Contingent-Payment "Sales"

Contingent-payment dispositions are common with respect to unproven property of a speculative value, such as mineral reserves and intellectual property. In such cases deferral of *realization* is appropriate, because these transactions are more like leases or licenses than sales, on account of the transferring party retaining what amounts to an equity interest in the underlying property.[85] In short, such a transaction does not really amount to a disposition.[86]

---

81. It makes no sense for taxpayers to defer deductibility of a realized loss, especially given the fact that deductions of capital losses are governed by the separate deferral regime of I.R.C. § 1211.

82. Current law treats certain installment sales as not eligible for deferred recognition under the installment method for reasons having to do with liquidity. *See* I.R.C. § 453(b)(2), (f)(4), (k). Other prohibitions have to do with installment sales to related parties. I.R.C. § 453(e), (g).

83. I.R.C. § 453(c).

84. For example, one could treat the installment note as an original issue discount obligation (apart from the interest component), reportable on the cash method. *But cf.* I.R.C. § 483(a). But logic would dictate that any down payment would be fully offset by basis (since no discount would have accrued).

85. In the case of mineral interests (not of a fixed quantity), the tax law has developed the idea that a "seller" retains an "economic interest" that renders the transaction into a lease for tax purposes, rather than a sale. *See* Reg. § 1.611-1(b)(1) (explaining that this approach allows the "seller" to obtain depletion deductions). This economic-interest doctrine does not apply elsewhere, and the sale versus lease (or license) issue is important. *See* I.R.C. §§ 1235, 1253.

86. Regardless, the capital recovery issue must be, and is, faced in Part VI.C below in the context of the discussion of depreciation.

V. REVAMPING THE TAX TREATMENT OF BORROWING

The tax treatment of borrowing should be completely revised along cash-realization lines.

A. Is the Borrowing Exclusion Fundamental to the Income Tax?

The accrual notion is the basis for the existing tax treatment of borrowing, which is that borrowed money is viewed as non-income (not an increase in wealth) due to the simultaneous accrual of an offsetting liability to repay the principal.[87] The exclusion of the borrowed cash is then offset, or balanced, by the nondeductibility of principal payments.[88] This treatment follows standard business accounting practice. Since this rule applies even to cash-method taxpayers, it is not considered a "tax accounting" rule as such, but a basic, even "inherent," feature of an income tax not even provided for in the Code. The tax treatment of borrowing is the mirror image of the tax treatment of lending, based on the capitalization principle.

Is capitalization itself an accrual concept? It is not, because the capitalization requirement applies beyond borrowing or lending transactions involving fixed rights or obligations to receive or pay fixed amounts of cash in the future. Capitalization extends to all cases where the expenditure produces significant economic value beyond the current year.[89] The value need not reside in a discrete or identifiable cash flow. Eliminating the capitalization principle (allowing a current deduction for business and investment capital expenditures) would be the crucial step in converting the income tax into a consumption tax.[90] In simplistic terms, capitalization means that an income tax is a tax on one's current-year increase in wealth (whether consumed, saved, invested, transferred, or wasted),[91] with due subtraction for currently realized costs of producing income.

---

87. The accounting liability-to-repay-principal theory of exclusion underlies the seminal Supreme Court case United States v. Kirby Lumber Co., 284 U.S. 1 (1931).

88. Another description is that the exclusion of borrowed cash creates a "negative basis" in the cash used to repay the principal—basis in an outlay being a necessary (in principle) predicate of a deduction. This description is not convincing, because cash has a basis (equal to its amount) elsewhere in the income tax, even in the case of excluded cash (such as cash received by gift).

89. *See* INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 87–88 (1992).

90. *See supra* note 4 for a brief description of a consumption tax.

91. Since amounts expended on current consumption (and gratuitous transfers) decrease wealth without being deductible, income is often described as the sum of the current year's net increase in wealth plus consumption. This formulation is somewhat misleading in implying that consumption is a separate category of income. In fact, it is a nondeductible decease in wealth, as are transfers and economic waste.

Additionally, revamping the tax treatment of borrowing as proposed below is not identical to consumption tax treatment, under which borrowed money is includible, both principal repayments and interest are *per se* deductible, and the concept of cost basis is wholly absent. Under the proposal made herein for cash borrowing, interest would not be *per se* deductible, but only deductible if an expense of income production. Also, the treatment of purchase-money debt would not at all resemble consumption tax treatment.

In short, capitalization is a foundational principle of an income tax. In contrast, accrual is a specific timing rule, like other tax accounting rules. It follows that the borrowing exclusion, based on the accrual notion, is not fundamental to the income tax.

B. The Economics of Borrowing

Turning to the merits of the borrowing exclusion, in value terms the principal-repayment liability is worth less than the borrowed cash under straightforward present-value analysis. In other words, a borrower realizes instant gain upon borrowing equal to the excess of the borrowed amount over the (present) value of the repayment obligation. In order to render the borrowing and repayment obligation equal in the current year, thus possibly justifying exclusion of the borrowed amount under an income tax, it would also be necessary to add into the equation the present value of the interest obligation. This move poses problems for accrual theory, because interest only accrues with the passage of time.[92]

Thus, the exclusion for borrowed money implicitly entails a current deduction (offset against borrowed cash in present-value terms). In cases where interest is *not* deductible when paid or accrued, the taxpayer has already obtained a deduction for it (in present-value terms) *ex ante*. In cases where the interest *is* deductible when paid or accrued, the borrower obtains a double deduction, once in real time and the other in present-value terms. It is true that this double-deduction phenomenon is the mirror image of the so-called double taxation of investment income. This point raises the issue whether it is feasible to modify, in isolation, the tax treatment of borrowing used by the borrower to acquire an investment. Stay tuned.

C. Unsecured Cash Borrowing

Cash borrowing is, by stipulation, debt not undertaken in connection with the acquisition of an investment. Therefore, the possible asymmetry between the tax treatment of borrowing and investing is not a concern here.

Cash borrowing should be included in gross income. The cash received is current realized cash income, whereas the liability to repay

92. Reg. § 1.446-2(a)(1).

principal (and interest) represents an expected or predicted future, but as yet unrealized, cost. An accounting liability does not tie up a taxpayer's current cash funds or render one's assets unusable or valueless. The corollary of including the borrowed cash would be allowance of a *per se* deduction of principal repayments as they occur.[93] Interest would continue to be deductible, as paid, if connected with business or the production of income.

A collateral benefit of the proposed approach would be the elimination of cancellation-of-debt ("COD") income.[94] The concept of COD income is tied to the borrowing exclusion: the extinguishment of the liability leaves the borrower of excluded cash wealthier. COD income (which typically occurs in bankruptcy) interferes with bankruptcy policy by adding a tax debt to existing debt. In order to deal with that issue and others, Congress has had to enact section 108.[95] Also, the scope of the doctrine is unsettled.[96] If cash borrowing were included, the COD income concept would disappear in that context and income and deductions would be slotted into the proper taxable years: the borrowing would be income when received, and the extinguishment of the repayment obligation would foreclose principal-repayment deductions.

D. Purchase-Money Debt

1. Immediate Inclusion Leads to Bad Results

The proposed approach appears to render many debt-financed investments that are profitable before-tax into unprofitable after-tax investments, an unacceptable economic result. In tax-academic speak, this distortion would result from eliminating the "double deduction" for interest costs, while allowing the "double taxation" of investment income to remain. This phenomenon is illustrated in Table A immediately below, which assumes a tax rate of 35 percent, a wholly-debt-financed investment of $10,000, and a rate on interest paid of 6 percent per year.

---

93. Interest is considered an expense relating to the asset or activity financed by the borrowing, and would be deductible or not deductible accordingly. *See* I.R.C. § 163(a), (h)(1).

94. *See* I.R.C. § 61(a)(12); Reg. § 1.61-12.

95. I.R.C. § 108 often operates to postpone the recognition of COD income by disallowing income and instead reducing beneficial tax attributes of a taxpayer, such as net operating loss carryovers and asset basis.

96. In principle, COD income should exist only if the taxpayer earlier received cash or received an asset tax free. It is debatable whether relief from consumer debt, or accrued interest, should result in COD income. Relief from "bare" liabilities (such as taxes and fines) should not be COD income. *See generally* Richard C. E. Beck, *Cancellation of Debt and Other Incidental Items of Income: Puritan Tax Rules in the U.S.*, 49 *N. Y. L. SCH. L. REV.* 695 (2005).

TABLE A—DEBT-FINANCED INVESTMENTS UNDER THE CASH REALIZATION METHOD
(all numbers represent dollars)

Net Income Invest. Ret.	Year 1	Year 2	Pre-tax Net	Net Tax[97]	After-Tax Net
6%	+10,000	+600 – 10,600	0	210	-210
7%	+10,000	+700 – 10,600	100	245	- 145
8%	+10,000	+800 – 10,600	200	280	- 80
9%	+10,000	+900 – 10,600	300	315	- 15
10%	+10,000	+100 – 10,600	400	350	+ 50

As can be seen, break-even (6 percent) investments yield an after-tax loss, and this loss exists for investments (at 7 to 9 percent) that yield a before-tax profit.

Next consider debt-financed consumer assets, such as homes. Suppose a home purchase is wholly financed by a mortgage debt of $100,000. A proposal that required an initial income inclusion of $100,000 in such a case would be considered a political joke (or suicide), even if principal and interest payments were deductible.[98]

2. The Solution: Creeping Basis

It turns out that both of these apparent problems can be solved by treating debt-financed property acquisitions as a deferred investment, which is precisely what purchase-money debt entails. Both two-party and three-party purchase-money debt would not be included in the borrower's current income on the ground that no cash is actually or constructively received by the credit purchaser and re-transferred to the seller.[99] Instead, the tax consequences of a liability would be realized by the debt-financed borrower only as and when cash payments are made to reduce the principal amount of the obligation. Only then does the buyer invest in the purchased item.[100]

---

97. In present-value terms (assuming a discount rate of 6 percent), and assuming a constant tax rate, the inclusion of $10,000 (the borrowed cash) in Year 1 is fully offset by a deduction of $10,600 (principal and interest payment) in year 2. Thus, the "net tax" is the product of the Year 2 positive return (e.g., $600 assuming a before-tax return rate of 6 percent) and the tax rate (assumed to be 35 percent).

98. *See* Joseph M. Dodge, *Exploring the Income Tax Treatment of Borrowing and Liabilities, or Why the Accrual Method Should Be Eliminated*, 26 VA. TAX REV. 245 (2006).

99. In a real estate closing or a securities margin account, the funds from the purchaser's lender go directly to the seller (and/or seller's lienholders) and not to the purchaser.

100. The tax treatment of the seller would be as described *supra* at IV.C.

To illustrate, suppose that K borrows $1 million to invest in 10-year bonds yielding an interest rate equal to that of the interest rate on the loan. The "borrowed" $1 million would not be includible as income, and the interest income and interest expense would wash out, but principal payments would constitute the bond's basis, which would eventually total $1 million, fully offsetting the $1 million received upon maturity of the bond. These results correctly reflect the economic wash.

Relief from property debt would not be included in the amount realized upon sale or other disposition, because the seller is really only selling her equity in the property, with the settlement of the debt being a separate transaction. In the foregoing example, suppose that $600,000 of principal had been paid off, so that K's basis in the property (worth $1 million) is $600,000, at which time it is sold to J for $1 million cash, with $400,000 being used by K to pay off the remaining principal. K is being paid $600,000 for her (net) investment, resulting in no gain or loss. The other $400,000 received and then used to settle K's debt would be includible and deductible, resulting in a second wash-out. If, alternatively, K does not pay off the $400,000 principal immediately, the $400,000 received should be income (by reason of the remaining debt being reduced to cash), and future principal payments would be deductible.

Suppose the same facts as before, except that J pays K $600,000 in cash for the bonds and assumes or takes subject to K's debt. Here, K should have no gain (as before) and no income: K receives no cash and simultaneously foregoes deductions for paying the remaining principal.

Now suppose that D borrows $1 million to purchase raw land, which appreciates to $1.3 million and is then sold for $1.3 million cash to Q, when D's basis is $450,000 and the remaining mortgage debt is $550,000. Here D has a "property" amount realized of $750,000 ($1.3 million reduced by $550,000), resulting in gain of $300,000 (the appreciation), and the remaining $550,000 of cash consideration is allocated to D's outstanding debt, with the analysis proceeding as before.

Relief from future principal repayment obligations would neither result in COD income nor reduce current basis,[101] although future basis would be affected.

The foregoing would render both sides of the *Crane* doctrine[102] obsolete, and tax shelters based upon debt financing would cease to be viable.

---

101. Either result (COD income or basis reduction) is possible under current law. *See* I.R.C. § 108(a)(1)(D) & (E), (e)(5); Rev. Rul. 91-31, 1991-1 C.B. 19.

102. *See Crane*, 331 U.S. 1 (standing not only for the proposition that purchase-money debt is immediately included in basis, but also for the proposition that shucking off a property-secured debt is included in amount realized).

The knee-jerk objection to such a system would be one noted in the *Crane* decision itself: if depreciation were keyed to principal payments, then depreciation would have to be re-computed upon each principal payment.[103] Of course, this problem disappears if the deduction for depreciation is abolished, as is proposed in Part VI below.

Another possible solution would be to take depreciation on the value of the property when placed in service (as under the current *Crane* rule). It could happen that depreciation deductions will create a negative basis for purposes of gain or loss, but negative basis would (appropriately) increase the gain (or decrease the loss). For example, suppose X buys equipment for $100,000, putting $60,000 down and borrowing $40,000 to pay the rest. Suppose X takes a section 179 write-off of the entire $100,000, pays principal of $15,000, and sells the equipment for $80,000 cash (its then value). Under current law, X would have a gain of $80,000: (1) amount realized of $80,000, less (2) adjusted basis of $0 ($100,000 – $100,000). Under a cash-realization approach, X would also realize a gain of $80,000, computed as follows: (1) property amount realized of $55,000 ($80,000 cash less $25,000 remaining debt), less (2) a negative basis of ($25,000) [($60,000 + $15,000 cost) less $100,000 write-off]. The $25,000 of cash used to pay off the remaining debt of $25,000 would wash out. Of course, taking depreciation deductions in excess of one's after-tax investment would not conform to the cash-realization ideal, but at least this approach would be a workable accommodation between depreciation and the proposed tax treatment of purchase-money borrowing.

3. Cash Borrowings Secured by Property

So-called after-acquired cash borrowings secured by existing property would constitute gross income, unless such debt is property-acquisition debt. This rule would thwart the current tax-avoidance tactic of implicitly realizing on unrealized appreciation by borrowing cash against appreciated property. However, in order to avoid valuations, this rule should apply regardless of whether the property appreciates. Relief from the secured debt upon disposition should not be included in amount realized. Otherwise, the borrowing would be double-counted on the income/gain side.

To illustrate, suppose M purchases an asset for $100,000 cash, later borrows $30,000 on the security of the asset, and sells the property (unchanged in value) for $70,000 cash, with the buyer assuming the $30,000 debt. M has an initial basis of $100,000 in the property, and receives $30,000 income on the borrowing (which would not also reduce the basis). The amount realized is $70,000, yielding a $30,000 loss on the property transaction. M loses the opportunity to make deductible principal payments. This treatment correctly accounts for the overall economic wash.

---

103. *Id.* at 10–11.

E. Credit Card Transactions

Most credit-card purchases by individuals are for the purchase of services (or for expense items, like household supplies, for which basis would be meaningless). If credit card transactions were treated as two-party credit purchases, the cost (if needed for tax purposes) of any item would be virtually impossible to determine, because credit card payments (if not for the full amount owed), would need to be allocated among all items purchased. Under current law, credit card transactions are treated as third-party cash loans by the credit card issuer.[104] This approach is well-suited to a cash-realization income tax; the taxpayer would include (or deduct) her net increase (or decrease) in credit card debt for the year. Any deductible (or basis-carrying) items would be deemed to have been fully paid for with cash.

F. Deferral of Prepaid Income

This topic could be considered under either the "accrual" or "borrowing" topic headings. Prepaid income is cash income received in advance of when it is earned. Unbelievably, deferral of prepaid income is sometimes, if not usually, allowed for tax purposes.[105] The purported accounting justification for deferral is "matching," but that notion can just as well justify the accrual of a reserve for the future costs of earning current income. Since this acceleration of deductions would not be justified under tax accrual rules, it is hard to justify achieving the same result by deferring cash income in hand that is in no way restricted as to use.

The alternative argument is that prepaid income is really a category of excluded borrowed money. However, the existing income tax exclusion of borrowed money presupposes fixed obligations to pay principal and interest, and such payments must be made to the lender.[106] In the prepaid income concept, the future costs are only estimated (at best), and are paid to third parties under separate arrangements arrived at independently of the arrangements with the customers. The attempt to re-conceptualize the prepaid-income scenario as a loan by the customers is, therefore, pure fantasy. Of course, the taxpayer hopes to make a profit in the sense that the present value of future costs will be less than the cash received, but this profit is made by

---

104. *See* Rev. Rul. 78-38, 1978-1 C.B. 67.

105. *See* I.R.C. § 456; Reg. § 1.451-5; Artnell Co. v. Commissioner, 400 F.2d 981 (7th Cir. 1968); Rev. Proc. 2004-34, 2004-1 C.B. 991. *See generally* RCA Corp. v. United States, 664 F.2d 881 (2d Cir. 1981).

106. Contingent or indeterminate repayment obligations are insufficient to exclude current cash from income. *See* James v. United States, 366 U.S. 213 (1961); *N. Am. Oil Consol.*, 286 U.S. 417.

accurately estimating future demand and keeping future costs low by whatever means possible.

Under a cash-realization income tax, accounting theory and the borrowing exclusion are irrelevant, and the prepaid income would be included when received in cash (or deemed cash).

VI. ELIMINATING DEPRECIATION FOR PRODUCTIVE ASSETS

Under the current income tax, cost recovery with respect to determinable-life assets used in a business or other income-production activity ("productive assets") takes the form of annual depreciation and amortization deductions until the asset's basis is exhausted or the asset is disposed of.[107] Under an accretion income tax, depreciation is legitimate in principle, but it would be measured by the annual decline in value of the asset. Since annual valuations of productive assets are impossible, Congress has enacted formulaic methods for computing depreciation.[108] However, avoiding annual valuations by arbitrary conventions does not itself satisfy the realization principle, as was correctly noted by Simons.[109] Depreciation is a dubious feature of a realization income tax: allowing depreciation while ignoring unrealized appreciation—even appreciation that (like depreciation) occurs with the passage of time—creates an asymmetry in which taxpayers systematically win at the expense of the government. Here, it is proposed that depreciation should, with exceptions, be abolished.

A. Irrelevant Justifications for Depreciation

1. Reserve Theory

Tax depreciation had its origins in trust and business accounting. In trust accounting, depreciation is an offset against income for the purpose of preserving "principal" against erosion, effectively setting aside cash to replace the depreciating asset.[110] The purpose of depreciation in trust accounting is to

---

107. Section 167(a) allows the series of annual deductions for "exhaustion," "wear and tear" and/or "obsolescence," all of which are taken to reflect the "wasting" of the asset over a period of time. Non-wasting assets (such as land and shares of stock) are not depreciable, and neither is property held for personal use.

108. I.R.C. §§ 168, 197.

109. SIMONS, PERS. INCOME TAX'N, *supra* note 13, at 86–88 (critiquing E.R.A. Seligman).

110. Suppose that a trust, in which net income is payable to B for life, remainder to C, is funded with a building worth $1 million, which generates net rents (before depreciation) of $70,000/year. The trust adopts a depreciation reserve, which

balance the interests of (net) income beneficiaries and remainder-interest beneficiaries by, in effect, shifting a portion of the income return "forward" to the remainder interest. In tax, however, the competing interests of taxpayers and the government are both simultaneous and continuous. Depreciation, in the economy as a whole, operates to produce continuous deferral of income for an indefinite period of time.

In business accounting, depreciation, as a charge against income, served a somewhat similar purpose by reducing amounts payable as dividends and increasing funds committed to reinvestment. However, this function is very nineteenth century in its aim to "preserve capital," because—as long as creditors are protected—no real reason exists to constrain a business enterprise from contracting. Around the dawn of the twentieth century, business accounting took on an anti-puffing function of informing potential investors (and other outsiders) of a business firm's finances, including the bad news. Depreciation was somewhat controversial in early business accounting, partly because it affected utility rate-making (in an uncertain manner)[111] and partly because depreciation reduced book profits. Acceptance of depreciation appears to have been cemented by the income tax, where depreciation reduces the income tax base.[112]

In any event, the reserve rationale of depreciation, cited by the Supreme Court in a 1943 tax case,[113] might appear to have derived from the general accrual notion, whereby current deductions can be taken for expected future costs. However, depreciation is a deduction for past cost,[114] so that it cannot logically also be a deduction for future costs. Additionally, the future costs could well vary from the historical costs. Finally, the accrual method as it has developed in the income tax does not otherwise allow reserves for

---

entails debiting $40,000/year against income per year for 25 years. The effect is to reduce the cash distributions to B to a net of $30,000/year while adding $40,000/year to principal. After 25 years, the building is worthless, but the trust has $1 million cash with which to buy a new building.

111. *See* Harrop A. Freeman, *Public Utility Depreciation*, 32 CORNELL L. Q. 4 (1946).

112. *See* David W. Brazell, Lowell Dworin, & Michael Walsh, *A History of Federal Tax Depreciation Policy* 1 (Office of Tax Analysis, OTA Paper 64, 1989), http://www.treasury.gov/resource-center/tax-policy/tax-analysis/documents/ota64.pdf. The paper points out that depreciation was recognized for regulatory purposes in the same year (1909), *see* Knoxville v. Knoxville Water Co., 212 U.S. 1 (1909), as the enactment of the corporate income tax, which allowed a deduction for wear and tear.

113. *See* Detroit Edison Co. v. Commissioner, 319 U.S. 98, 101 (1943).

114. Depreciation is a series of deductions derived from a prior (nondeductible) capital expenditure that created a cost basis in the asset. I.R.C. § 167(c)(1).

estimated future costs.[115] Thus, depreciation is not really a reserve-accrual feature of the income tax.

2. Matching Theory

The reserve rationale for depreciation has been superseded in business accounting by the notion that depreciation "matches" costs with related income. Since matching is a standard, rather than a rule, it is acceptable to use formulas, based on estimates and statistics to implement this aim.[116] However, as previously noted,[117] matching (and the related concept of "earning") is not a tax value.[118] In a case highly relevant to the discussion of tax depreciation, *Hort v. Commissioner*,[119] the Supreme Court denied accelerated cost recovery to be taken as a match to accelerated rental income from a building. Although the Supreme Court in a 1960 case did cite the matching principle as a rationale for depreciation, the rationale was that of Congress and not underlying tax norms.[120]

Matching cannot really be the rationale for tax depreciation, because the cost of an indefinite-life asset *can* be matched (assigned) to future years of

115. The Supreme Court has held repeatedly that statistics and estimates are not sufficient to justify the accrual of expense deductions. *See Brown*, 291 U.S. 193; *Schlude*, 372 U.S. 128.

116. Depreciation formulas under the existing income tax are based on assignments of a fixed useful life to broad categories of assets, but these stipulations of useful life are only tenuously based on statistics. *See* I.R.C. § 168(c), (e). Depreciation rates, *see* I.R.C. § 168(b), which ignore estimated salvage, are also arbitrary.

117. *See supra* note 55.

118. The Supreme Court, in the seminal case United States v. Anderson, 269 U.S. 422 (1926), seemed to follow the matching principle, but its embrace of the matching principle was simultaneously superseded by its creation of a rule of law, the all-events test, which evolved independently of the matching principle.

119. 313 U.S. 28 (1941). In accord with *Hort* are Commissioner v. Gillette Motor Transport, 364 U.S. 130 (1960) (no basis recovery against "sale" of carved-out term interest) and Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958) (no basis offset for carve-out sale of right to royalties up to fixed amount). Likewise, taxpayers cannot obtain depreciation deductions by carving out and retaining a term interest in a non-wasting asset. *See* § 167(e); Lomas Santa Fe, Inc. v. Commissioner, 74 T.C. 662 (1980), *aff'd*, 693 F.2d 71 (9th Cir. 1982), *cert. denied*, 460 U.S. 1083 (1983) (holding that no depreciation would be allowed for a retained term interest in land).

120. *See* Massey Motors, Inc. v. United States, 364 U.S. 92, 104 (1960).

the asset *ad infinitum*,[121] whereas tax depreciation is confined to assets that have a limited (and ascertainable) useful life.[122] This point indicates that any plausible tax rationale for depreciation must focus on the asset itself, rather than on some related income stream.

B. Realization of Partial Losses?

The only plausible tax rationale for depreciation is that it accounts for "realized" partial losses. But does this rationale withstand scrutiny?

1. Partial Losses Apart from Depreciation

Partial losses (apart from depreciation itself, which is conferred by Congress) are not generally allowed under the existing income tax prior to complete disposition (or constructive disposition, such as obsolescence or worthlessness) precisely because such losses are not "final," i.e., are not realized.[123]

2. Disposition of Physical Portions of Tangible Assets

Scenarios in which the basis of the asset can be rationally allocated among physical sub-assets (acres, tons, barrels, gallons, component parts) of the larger whole, and deducted as and when such sub-assets are disposed of, do not involve partial losses, but instead total losses of separate physical items. This analysis justifies cost depletion of exhaustible mineral deposits.[124]

Deductions for casualty and theft losses would appear to fall in this category, because such losses amount to a physical destruction (or, in the case of theft, a disposition) of all or a portion of the physical property, the only difference being that basis in the asset is unitary and not assigned to particular physical components or sub-units. However, the lesser-of-lost-value-or-basis rule in the regulations[125] is conceptually erroneous in the case of appreciated

---

121. If the cost of an indefinite-life asset is the sum of the present values of all future receipts to infinity, then a present value can be assigned to each future year *ad infinitum*.

122. I.R.C. § 167(a) (requiring exhaustion, wear and tear, or obsolescence).

123. *See* Lakewood Assocs. v. Commissioner, 109 T.C. 450 (1997) (regarding restrictive re-zoning); Pulvers v. Commissioner, 48 T.C. 245 (1967) (access to land cut off), *aff'd*, 407 F.2d 838 (9th Cir. 1969).

124. I.R.C. §§ 611; 612. *See* United States v. Ludey, 274 U.S. 295 (1927) (explaining rationale).

125. Reg. § 1.165-7(b)(1).

property.[126] Suppose that a personal residence purchased for $100,000 appreciates to $200,000 and is subject to an uninsured fire reducing the value to $120,000. Disregarding threshold rules,[127] the regulations allow a deduction of $80,000, which reduces the basis to $20,000. However, it is not at all plausible to claim that the taxpayer has lost 80 percent of her investment. At best, the taxpayer has lost 40 percent of the investment, meaning that the taxpayer should deduct 40 percent of the property's basis.[128] The argument that the taxpayer lost none of the investment, because the value after the casualty still exceeds the cost, is also erroneous (because a fraction of the value has been lost) and has been properly rejected.[129] The deduction for personal casualty losses is taken up again later.[130]

Another candidate for partial write-offs is the category of relatively-long-life items that physically are consumed with use (such as cutting tools and auto tires, or perhaps a large quantity of fuel paid for in advance). These assets are not common, as most tangible assets can be maintained in operating condition indefinitely with repairs (including the replacement of worn-out components).[131] Assets of this type should be amortized on a unit-of-use basis.

3. Costs Allocable to Future Time Periods (Prepaid Expenses)

Capitalization followed by partial write-offs is also proper in the case of those intangible assets in which basis can be allocated to time periods, provided that the benefit that is purchased for the time period expires at (or before) the end of the period. Accordingly, a prepaid (e.g., rental, insurance, interest) expense that covers designated future periods is entitled to partial write-offs.[132] As each taxable year expires, the cost of that period's benefit expires.

---

126. In the case of depreciated value property, the rule correctly disallows a deduction for pre-casualty losses. For example, suppose a personal automobile is purchased for $40,000, declines in value to $24,000, and is involved in an uninsured wreck resulting in a total loss. The tentative amount deductible is $24,000, not $40,000, a result that was upheld in Helvering v. Owens, 305 U.S. 468 (1939).

127. The first $100 of otherwise-deductible personal casualty and theft loss is disallowed, and the excess of personal casualty and theft losses over gains is disallowed to the extent of 10 percent of adjusted gross income. I.R.C. § 165(h)(1), (2). Additionally, the loss is not "realized" to the extent that a reasonable prospect of recovery, etc., exists. *See* Reg. § 1.165-1(d)(2).

128. Thus: (200 – 120)/200 x 100 = 0.4.

129. *See* Cox v. United States, 537 F.2d 1066 (9th Cir. 1976).

130. *See infra* text accompanying note 174.

131. *See infra* text accompanying note 151.

132. A prepaid expense is a capital expenditure, unless the benefit does not extend beyond 12 months. Reg. § 1.263(a)-4(d)(3), (f)(1).

4. Loss of the "Temporal" Components of Two-Party Financial Assets

Another legitimate partial write-off scenario involves an asset that is a bundle of claims to fixed cash payments to be received at fixed dates, as occurs with bonds, notes, mortgages, and term annuities. Here, the collection of each payment represents a realization of a discrete sub-asset (claim to money) with respect to the larger bundle of rights. When the money is received, the claim to that money ceases to exist, justifying basis recovery for that discrete money claim. The issue is how basis recovery should proceed.

The basis recovery problem can be illustrated by a hypothetical in which Lender lends $300,000 to Borrower, under which it is agreed that Borrower will make three *equal* annual payments set at an amount that will return Lender's $300,000 principal in installments over the three-year loan period with market-rate interest. Since neither party desires to be shortchanged, the amount of each payment is calculated so that both the present cost (Borrower's vantage point) and the present value (Lender's vantage point) of the entire (principal and interest) obligation equals $300,000. Using a discount rate of 10 percent compounded annually—the rate on comparable loans—each annual payment would be $120,634 (this figure and other numbers in the tables below being rounded off).

TABLE B1—PRESENT VALUE OF 3-YEAR LEVEL-PAYMENT OBLIGATION AT 10%

Due at End of Month	Amount	Present Value at Inception
12	$120,634	$109,668
24	120,635	99,698
36	120,634	90,634
	Total: $361,903	Total: $300,000

At least four basis-recovery schemes present themselves as possibilities. The basis could be allocated: (1) first to the cash receipts to the extent thereof,[133] (2) ratably among the receipt rights,[134] or (3) according to their respective present values when the asset is purchased.[135] Of these three methods, the first two ("recovery of capital" and "straight line") approaches

133. Thus, the basis of $300,000 would be allocated as follows: $120,632 to payments 1 and 2, and $58,736 to payment 3, resulting in the entire income being slotted into year 3. This method is used for contingent-payment sales, discussed *supra* Part IV.C.3 and *infra* note 167.

134. Thus, $100,000 would be allocated to each payment. This straight-line method is the one used for prepaid expenses, *see supra* note 132, and annuities, *see* I.R.C. § 72(a), (b).

135. This method produces increasing amounts of net income over time, because the basis allocated to earlier receipts is greater than that allocated to later receipts.

are easy to apply, because no mathematical or financial sophistication is required. The third ("allocated basis" method) would be clearly correct if the transaction consisted of three separate $100,000 loans for periods of one, two, and three years respectively. But, although the loan in Table B1 could have been structured that way, it was not.

The fourth method is to treat cash as coming first out of earned but untaxed interest. The earned interest is obtained by multiplying the interest rate against the principal amount. This measures the amount of income to a cash-method taxpayer that is realized by reason of the receipt of $120,634 in cash. The rest of the cash payment comes out of the $300,000 investment basis, and is not income. Basis recoveries reduce the basis of the remaining bundle of claims (the remaining principal amount). This method, called the declining-balance method, is illustrated in Table B2 below.

TABLE B2—DECLINING-BALANCE METHOD OF AMORTIZING A FIXED-PAYMENT OBLIGATION

	Beginning Balance	Interest Earned @10%	Payment	Principal Portion	Ending Balance
1st 12 months	$300,000	$30,000	$120,634	$90,634	209,366
2nd 12 months	209,366	20,937	120,635	99,698	109,668
3rd 12 months	109,668	10,967	120,634	109,667	0

Again, the "interest earned," i.e., the interest portion of each payment received at the end of the period, is calculated simply by applying the interest rate (10 percent) against the principal balance at the beginning of the period. The remainder of the payment received is treated as a return of principal, which is a tax-free basis recovery. The principal balance (adjusted basis) is the initial principal (cost basis) reduced by the principal (basis) recovery amounts of all previous payments (if any).

The declining balance method makes eminent sense, because no shrinkage of the investment base occurs until cash in excess of the earned income has been withdrawn, thereby reducing the earnings base. The declining balance method is familiar to anybody who has made level-payment home-mortgage payments or purchased interest-only bonds.[136]

It happens that the results produced by the declining-balance method can be replicated by a present-value approach. That is, the tax-free "principal"

136. In an interest-only bond, the payment equals the earned interest on the initial principal, and (therefore) the principal balance is not reduced. In tax terms, no basis is offset against the interest.

portion of each payment equals the decrease in the present value of the package attendant upon the current receipt.[137]

TABLE B3—LOSS IN PRESENT VALUE OF TABLE OF TABLE B1 OBLIGATION

	PV Payments	Payment	Loss in PV	Interest
Begin Investment	$300,000			
After 12 months (1st payment)	$209,366	$120,634	$ 90,634	$ 30,000
After 24 months (2nd payment)	$109,668	$120,635	$ 99,698	$820,937
After 36 months (3rd payment)	$0	$120,634	$109,667	$ 10,967

In order to achieve these results, *the same discount rate used in valuing the obligation at its inception must be used throughout*. Otherwise, if discount rates varied from time to time, the three losses in present value would fail to add up to the initial cost basis of $300,000.

The approach taken in Table B3 is appealing to accretion income tax advocates, because investments producing fixed and determinable cash flows can be valued at an amount equal to the sum of the present discounted values of the remaining cash flows. It is easy to make the assumption that actual fair market values are the same as obtained by present-value calculations. If so, then the basis recovery mechanism for debt obligations described in Table B3 appears to be an accretion tax feature of a realization income tax.

How reliable is the equation of fair market value with sum of present values of future cash flows? Although fair market value might be affected by the creditworthiness of the obligor, the latter can (in principle) be factored into the discount rate. However, creditworthiness would only be an estimate or prediction. Also, interest rates are rarely the result of two-party negotiations. In transactions between non-sophisticates, the interest rate might be pulled out of the hat, and not be reflective of risk. Another problem is that future changes in the discount rate will create a discrepancy between the actual fair market value of the investment and its present value using a constant discount rate.[138] Moreover, the constant discount rate used in the present-value calculations is itself a prediction.[139] Other factors, such as non-negotiability of the note, or

137. This method, producing decreasing net income amounts over time, is used for identifying interest on debt obligations notwithstanding designations of stated interest in the contract to the contrary. Regs. §§ 1.446-2, 1.461-4(e).

138. A reduction in the discount rate below the stated interest rate would, *ceteris paribus*, increase the value of the debt obligation, and an increase in the discount rate would reduce such value.

139. The core discount rate might be described as the sum of the "natural" interest rate (on wholly-secure debt), which itself is influenced by the supply and demand for money as influenced by government policy, plus an adjustment for anticipated future inflation over the debt term.

illiquidity of the collateral securing the note, could well aggravate (or reduce) the discrepancy between fair market value and present value.

These points should be of interest to those advocating an accretion tax. Present-value analysis might provide a useful heuristic in an accretion income tax where determining actual fair market values is not worth the effort, but one should be wary of simply equating present value with actual fair market value.

In any event, under a realization income tax, changes in market values are generally ignored. The justification for basis recovery in the present context must be that the loss (through liquidation in cash) of a payment right is a realization event in which a final, irrevocable shrinkage (loss) in the principal investment on which interest accrues occurs where the cash exceeds the interest earned to date. The fair market value of the instrument may deviate from the remaining principal balance, but that appreciation or depreciation is ignored unless it is separately realized. The liquidation of a portion of the principal is akin to the disposition of, say, lots in a subdivided ranch. In the latter case, a basis is assignable to the lot sold *ex ante*, and such basis stays constant (in the absence of depreciation itself) until the lot is disposed of. In the case of bonds, notes, mortgages, and term annuities, the basis adheres to the principal, and a disposition (by way of cash liquidation) of a portion of a principal entails a basis offset. In a real estate subdivision, the dispositions are unpredictable. In the case of debt obligations, the dispositions are regular and predictable because of the way the investment is structured.

5. Samuelson Depreciation for Productive Assets

If "matching" costs against revenues were the rationale of depreciation, then any of the four methods described above (except the first one), and perhaps many others, would suffice.[140] The theory and rationale of tax depreciation currently favored in tax academic circles is known as Samuelson depreciation, named after Paul E. Samuelson, the author of a 1964 economics paper on the subject.[141]

---

140. *See* Douglas A. Kahn, *A Proposed Replacement of the Tax Expenditure Concept and Different Perspective on Accelerated Depreciation*, 41 FLA. ST. U. L. REV. 143, 155–57 (2013).

141. *See* Paul E. Samuelson, *Tax Deductibility of Economic Depreciation to Insure Invariant Valuations*, 72 J. POL. ECON. 604 (1964) [hereinafter Samuelson, *Deductibility of Econ. Depreciation*]. This paper, less than three pages long, is mostly carried out through equations. For a more user-friendly version, *see* Theodore S. Sims, *Income Taxation and Asset Valuation (I): Economic Depreciation, Accrual Taxation, and the Samuelson Theorem*, 66 *TAX L. REV.* 217 (2012).

a. The Thesis and Its Implications

The thesis as stated by Samuelson is as follows: "*Fundamental theorem of tax-rate invariance*.—If, and only if, true loss of economic value is permitted as a tax-deductible depreciation expense will the present discounted value of a cash-receipt stream be independent of the rate of tax."[142]

This thesis, expressed in terms of discounting cash streams to present value, is simply a version of Table B3, *supra*. The added wrinkle is that, since both the income stream and the discount rate are stipulated to be after tax,[143] present values are independent of the tax rate.[144] It follows from the model and its assumptions that this method of cost recovery would not distort prices, i.e., is economically "neutral." This conclusion ties depreciation of assets producing cash streams to the tax norm of economic efficiency. The broader implication is that an accretion income tax is efficient, at least relative to a realization income tax.

b. The Samuelson Model Cannot Stand In for Fair Market Values

The Samuelson model assumes values of productive assets are the sum of the present values of future cash flows. As noted above, present value analysis does not describe the fair market value of even bonds, notes, mortgages, and term annuities. The Samuelson framework, combined with stipulations of finite useful lives, leads to the absurdity of depreciating an asset that in fact appreciates in value, such as sometimes occurs with buildings and collectibles having utilitarian use.[145] Even if the productive asset does not actually appreciate, it is unlikely that its fair market value (for which

---

142. *See* Samuelson, *Deductibility of Econ. Depreciation*, *supra* note 141, at 604.

143. Accordingly, the conclusion that prices are independent of tax rates is circular due to these assumptions, plus that of no equilibrium effects. *See* Strnad, *Periodicity and Accretion Tax'n*, *supra* note 26, at 1830.

144. Assume that the investment described in Table B1 exists in a tax-free world. Instead assume that the tax rate is 20 percent, so that the after-tax discount rate would be 8 percent (instead of 10 percent). The same $300,000 investment would consist of three annual after-tax receipts of $116,410, partially composed of after-tax net income amounts of $24,000, $16,607, and $8,623 for years 1, 2, and 3 respectively. The before-tax income amounts are $30,000, $20,759, and $10,779, virtually the same as in Table B3.

145. An example of a collectible used in the business and subject to wear and tear was the subject of Simon v. Commissioner, 103 T.C. 247 (1994) (reviewed), *aff'd*, 68 F.3d 41 (2d Cir. 1995), in which depreciation was allowed. I.R.C. § 1250 assumes that depreciable buildings often appreciate in value.

Samuelson depreciation is a proxy) will follow the declining-balance model.[146] Certainly, no single mathematical model could be empirically descriptive of all productive assets, especially since the market for certain kinds of used equipment, etc., is very thin, particularly if made to specifications or if requiring major installation costs (in which case the items would be fairly useless for anyone other than the initial purchaser).

The failure of Samuelson depreciation to track fair market values should be somewhat troubling for one who favors that model as a proxy for accretion taxation of productive assets.

c. Productive Assets Do Not Generate Cash Flows

Another problem with Samuelson depreciation is that a productive asset cannot be equated with a financial instrument, because it does not itself yield a cash flow. Productive assets (along with other fixed costs), together with direct labor costs and direct material costs, are combined in an operation that generates revenue. Productive assets are but one factor of production. The profitability of a business may derive from factors apart from the productive asset, such as intellectual property (including franchise trademarks), location, goodwill, management strategy, skilled labor, and so on. Business decisions of the widget manufacturer are made in a cost accounting (as opposed to financial accounting) mode, that is, the aim is to suppress costs relative to incremental revenue in order to make (or increase) profits.[147]

Moreover, the revenue stream of, for example, a widget manufacturing business is not provided by the producers of productive assets (equipment, etc.). The latter offer a product on which they (in turn) hope to make a profit relative to the costs incurred by them. If the productive asset is made to order, the price may well be "cost plus." The revenue stream of the widget manufacturer is provided by unrelated persons who are indifferent to the inner workings (costs) of the manufacturer and its suppliers of equipment. In contrast to the pricing of a two-party financial instrument, the price of equipment is not an equal bargain in which a rate of return must equal the (adjusted) discount rate. In other words, businesses, unlike a debt obligation, are not guaranteed to be profitable.

The fact that the value of a business can (or, for tax purposes, must) be allocated among its component assets does not mean that the component assets generate a cash flow that is proportional to their respective values (if

146. For another and different critique of the assumptions underlying Samuelson depreciation, see MARVIN A. CHIRELSTEIN & LAWRENCE A. ZELENAK, FEDERAL INCOME TAXATION 187–88 (12th ed. 2012).

147. *See, e.g.*, LARRY M. WALTHER & CHRISTOPHER J. SKOUSEN, MANAGERIAL COST ACCOUNTING 42, 57, 68–69 (2009).

liquidated separately). Allocations of this sort exist only because of the need for purchasers and sellers of a going business to allocate its total cost among various assets with various "character" attributes and capital recovery schemes for tax purposes.[148] As a justification for depreciation, this asset-by-asset approach (in part based on the fact that assets vary by depreciation lives, etc.) would be a case of the tail wagging the dog. In the world of commerce, an ongoing business is valued as a whole, with reference to its future expected profit stream (or perhaps stock values of comparable enterprises).[149] If the entire business were treated as a unitary asset, it would not be depreciable at all, because it could continue indefinitely. In contrast, a failed business is truly an aggregation of second-hand assets precisely because of the absence of a discountable profit stream.[150]

Since a productive asset does not generate a cash flow on its own, such an asset cannot be considered a bundle of rights to cash that are liquidated with the passage of time.

d. Productive Assets Are Not an Aggregation of Temporal Components

The alleged partial loss under formula depreciation only *seems* irreversible because the underlying mathematical models *assume* irreversibility by assigning portions of the cost to various years, *the number of which is fixed in advance*, and treating the passage of any year as resulting in an irretrievable loss of the cost allocated to that year. As noted immediately above, since a productive asset does not represent a bundle of discrete rights to receive cash, it cannot be said to be an aggregation of temporal components that are lost with the passage of time.

Additionally, the "fixed useful life" assumption on which depreciation is based is a fiction. Unlike a term debt obligation, a productive asset generally has no fixed duration. Most tangible assets can be operated indefinitely with repairs.[151] So long as an asset is operating, it does so at full capacity. The passage of time does not diminish capacity. Hence, depreciation cannot be said to be the mirror of a capital expenditure that increases an asset's productive capacity.

---

148. Williams v. McGowan, 152 F.2d 570 (1945). *See* I.R.C. § 1060.

149. *See e.g.*, SHANNON PRATT, ROBERT F. REILLY, & ROBERT P. SCHWEIHS, VALUING A BUSINESS 55 (5th ed. 2008).

150. Thus, an aggregation of asset values yields the minimum value of a business. Aggregation is also appropriate where the business is an investment holding company.

151. This point was made by nineteenth century opponents of accounting depreciation. *See supra* text accompanying note 131.

Of course, businesses often dispose of (and replace) productive assets, sooner or later. These asset turnovers are generally caused not by wear and tear, but by "obsolescence," a term that refers to the fact that a replacement item is better than the replaced item on account of one or more of (1) increasing productivity, (2) decreasing variable costs, or (3) keeping up with changes in tastes. Obsolescence simply describes an *ad hoc* managerial decision. It is not a function of the passage of time simply because it occurs later in time than the purchase of the item to be replaced. Nor does obsolescence occur with the passage of time just because the duration of use might be predicted on the basis of economy-wide statistics or the taxpayer's own business plan. But even if the business life could be predicted with near certainty, obsolescence would still fail to describe a series of annual realized partial losses of the asset itself. No loss is realized until actual disposition by the taxpayer. Accordingly, although time itself is irreversible, the passage thereof does not necessarily entail a permanent loss of any portion or component of a typical productive asset.

Samuelson depreciation uses present-value analysis as a proxy for fair market values. It is not an especially good proxy, but in any event, for our purposes, does not establish that depreciation represents realized partial losses with the passage of time for productive assets. At best, Samuelson depreciation would be a plausible second-best feature of an accretion income tax.[152] The Samuelson model does not prove that depreciation is compatible with a realization income tax.

C. Normative Bases for Depreciation

The usual norms deployed in discussing tax provisions are derived from a matrix in which "means" and "ends" are cross-cut against "internal-to-tax" ("IT") and "external-to-tax" ("ET") concepts. These norms include: (1) "pragmatism" (means, IT), sometimes referred to as "administrative efficiency"; (2) "allocative fairness" (ends, IT), sometimes referred to as "horizontal equity"; (3) "economic efficiency" (means, ET), often referred to as "neutrality"; and, (4) among others but central to tax discussions, "distributive justice" (ends, ET), sometimes referred to as "equity." The norms of allocative fairness and social justice (redistribution) have already been invoked as a basis for preferring a realization income tax over either a personal consumption tax or an accretion income tax.[153] Since depreciation does not satisfy the realization principle, no need exists to revisit those norms. Whether

152. Samuelson depreciation is typically trotted out in opposition to the kind of accelerated/straight-line depreciation methods currently allowed by section 167, 168, and 197. *See* Johnson, *Soft Money Investing*, *supra* note 16, at 1041–53.

153. *See supra* note 11 and accompanying text. For a fuller discussion, see note 31.

or not one agrees that a realization income tax is supported by these norms, it is the template of the current income tax except for accrual, borrowing, and depreciation. The issue below is whether the case for tax depreciation is made persuasive, independently of a universal realization income concept, under the norms of economic efficiency and pragmatism.

1. Economic Efficiency

Ultimately, the normative claim for formula depreciation in general, and Samuelson depreciation in particular, is economic efficiency. Specifically, the argument is that tax depreciation (especially of the Samuelson variety) is a second-best feature of an accretion income tax, which is claimed to be economically neutral among investments. It was argued above that depreciation (even of the Samuelson variety) may not be a very good descriptor of market values. In any event, assuming the Samuelson claim to be reasonably correct, it does not follow that conforming one feature of an income tax (depreciation) to an economic-neutrality model renders the tax as a whole "more" neutral.[154] Depreciation is the anomaly within a realization income tax, and overall neutrality suffers if income/gain is deferred under a cash realization principle while deductions are accelerated under accrual, the borrowing exclusion coupled with the *Crane* rule, and formula depreciation.[155]

Depreciation is also an anomaly in the narrow sense, as the income tax fails to tax *gain* analogues, i.e., gains attributable to the passage of time, except in the narrow case of accrual of original issue discount ("OID"),[156] a rule that itself was adopted to achieve consistent tax treatment of borrowers and lenders.[157] Internal consistency with the tax accrual basis for depreciation would require income accruals with respect to all rights to future cash or expectations of receiving future value, such as (for example) the inside build-up of life insurance contracts, remainder interests, market discount bonds, and (most importantly) rights to deferred compensation. None of these income-deferral features of the income tax are likely to be overturned. Depreciation—along with the current tax treatment of debt—tilts the playing field of the

154. The basic insight of the "theory of the second-best" is precisely this. *See* R.G. Lipsey & Kevin Lancaster, *The General Theory of Second Best*, 24 REV. OF ECON. STUD. 11 (1956).

155. *See supra*, Part III.B.

156. *See* I.R.C. §§ 1272(a)(1), 1373(a)(1).

157. Lenders, mostly on the accrual method, were systematically accruing OID as an annual expense, *see* Reg. § 1.163-7(a), whereas individuals on the cash method were deferring OID income. *See* STAFF OF J. COMM. ON TAX'N, 98TH CONG., GENERAL EXPLANATION OF REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 110–12 (1984).

current income tax towards systematic understatement of income, however defined.

An agenda of creeping accretionism is a lost cause; apart from depreciation, no really major moves (such as mark-to-market taxation of marketable securities) have been made towards an accretion income tax, nor is this likely to occur.

In sum, assertions that depreciation in general (or Samuelson depreciation in particular) advances the cause of neutrality are unpersuasive. Even if they were somewhat persuasive, economic neutrality is just one norm pertinent to the discussion of taxes

2. Pragmatism

Also to be weighed on the side of eliminating depreciation is the considerable simplification of the income tax that can result. Depreciation calculations themselves require effort, especially for an asset that is devoted only in part to business or investment (as opposed to personal) use[158] or which is converted mid-stream to such use.[159] Depreciation deductions may throw a taxpayer into a complex loss-restriction regime, such as those mandated by sections 183 (not-for-profit-activities), 280A (business or rental use of home), 465 (at-risk rules), or 469 (passive activity rules), and many of these regimes entail carryover of unused deductions to future years.

Further issues result from the fact that depreciation reduces basis for purposes of gain and loss.[160] Loss-restriction provisions again raise issues here: since depreciation that is disallowed does not reduce basis, priority-of-deduction rules are required.[161] Basis adjustment rules are hard to comply with, especially for real estate, because records may have to be kept for a long time. It is in taxpayers' interests not to keep track of basis reductions. Moreover, reported adjusted basis of productive assets is likely to be unreliable, because no third-party intermediaries are involved (as would be the case with securities held in brokerage accounts).[162]

In short, compliance and enforcement, especially for rental real estate held by individuals, would be greatly simplified if depreciation were eliminated.

158. Proration is required in these cases. *See* I.R.C. § 280A(c)(5), (e).

159. *See* Reg. § 1.167(g)(1).

160. *See* I.R.C. § 1016(a)(2).

161. *See* Reg. § 1.183-1(b). Apparently, depreciation that is "allowable" but not deducted under a loss-carryover rule (such as I.R.C. § 469) reduces basis.

162. *See* I.R.C. § 6045(g) (requiring third-party reporting of basis for security transactions).

D. Rental and Royalty Property

Depreciation repeal would apply to all indivisible assets. As already noted, cost depletion, depreciation of assets that are physically used up, amortization of prepaid expenses, and "principal" offsets against fixed-amount cash flows of a fixed duration would continue to be allowed.

It might be argued that rental property should be exempt from depreciation repeal because such property directly produces an income stream. However, neither the income stream nor its duration is truly fixed.[163] Also, unlike amortizable financial instruments, other inputs contribute to the income stream. Thus, a rental receipt does not entail any realized investment loss.

The same issue arises with respect to property that generates royalties. The capital-recovery issue here is often moot, because royalty rights from self-created intellectual property typically have a zero basis.[164] Under current law, capital recovery depends on whether the transaction is a license[165] or an open-transaction sale.[166] The return-of-basis-first rule for open-transaction sales is clearly wrong, because it treats the transaction as a complete disposition before the income-producing capacity for the investment has expired.

In my view, contingent-consideration transactions should not be treated as dispositions of the underlying property, because the "transferor" has not truly surrendered all interests in the property, whatever the terms of the transaction state. The contingent-payment right is itself an economic or equity-like interest in the property. This point is accepted in contingent-payment mineral leases,[167] and should be extended to non-mineral contingent-payment licenses. Such a move would also remove the capital-gains option from these

---

163. However, a leasehold interest with no renewal options would have a fixed duration, but the costs of acquiring such a lease (apart from periodic rent itself) would be minimal. *See* Reg. § 1.162-11 (explaining amortization of leasehold acquisition costs). *See also* I.R.C. § 178 (allowing period of amortization where lessee can renew lease).

164. Research and experimentation costs are expensed under I.R.C. § 174, and one's own labor is not a cost in the tax sense. In instances where the intellectual property is itself paid for by royalties, the royalties paid can, and are, treated as current expenses, the *Crane* doctrine being inoperable due to the inability to determine the purchase price.

165. A license is essentially a lease; the licensor has not disposed of the underlying property. The licensor's basis is amortized under I.R.C. § 197, or, if not, over its duration.

166. An open-transaction sale is one where the disposition is not treated as a realization event, and basis is recovered against payments received to the extent thereof. In other words, basis is recovered before any gain is realized.

167. *See* Palmer v. Bender, 287 U.S. 551 (1933); Reg. § 1.611-1(b)(1).

transactions. Fixed-payment sales would continue to be treated as dispositions, possibly subject to installment reporting.

Regardless of whether the royalty right results from a disposition of property, the royalty (or other payment) right could well expire after a fixed period, and in that case the question is whether the right is sufficiently analogous to a prepaid expense or fixed-return financial investment as would justify amortization of basis. However, because the royalty stream is not a series of fixed payments, it is impossible to calculate any annual loss of present value. Unlike a financial instrument (or prepaid expense), the future payments (or benefits) have no *ex ante* relation to the invested amount (basis). In other words, one cannot discern any equivalent of "earned interest." A retroactive basis assignment to a payment based on an imputed return, although mathematically feasible,[168] misrepresents the nature of these transactions,[169] and would often result in complete cost recovery long before the expiration of the royalty period.[170] To the contrary, the receipt of a given royalty payment does not necessarily diminish the income-generating capacity of the investment. In short, no persuasive reason exists for excepting fixed-period variable royalty rights from depreciation/amortization repeal.

E. Collateral Consequences of Depreciation Repeal

Repeal of depreciation/amortization for productive assets would—in addition to facilitating the dismantling of the *Crane* doctrine—imply other changes that would usually operate in a taxpayer-friendly fashion and certainly advance the cause of simplification.

1. Repair Expenses

Under current law, the "theory" of a repair expense (as opposed to a capital expenditure) must be that it maintains or preserves the asset for its expected depreciation life. This standard is an impossible one to apply in practice, as repairs can maintain an asset in operating condition indefinitely, even after expiration of its depreciation life. Thus, under the theory, most

168. *See* Reg. § 1.483-4 (providing the method of computing interest component of contingent-payment sale).

169. *See id.* The imputed-return approach assumes that each payment is a separate investment, an approach that is contrary to fact, and contrary to the approach underlying Samuelson depreciation.

170. *See id.* The imputed-return approach assumes a low rate of return (the applicable federal rate), resulting in a high rate of basis recovery. A high discount rate, reflective of the riskiness of the investment, would be more appropriate. Even so, the determination of such a rate would be arbitrary.

repairs should really be capital expenditures, yet under current law this is not the case.[171] However, if depreciation is abolished, then all expenditures with respect to maintaining existing assets, extending their period of use, or adapting them to a different use (which is how useful life might be extended in the face of obsolescence) would be treated as repair expenses. Only expenditures that expand "spatial" income-producing capacity (such as new motel units) would be capital expenditures.

2. Casualty Losses

Although section 1001(a) states generally that realization means a sale or disposition, section 165(a) states that a loss can be realized when it is "sustained" (notwithstanding an absence of a sale or disposition).[172] This apparent (if slight) relaxation of the general realization rule covers "constructive disposition" scenarios, such as abandonment, withdrawal from use due to obsolescence, and worthlessness (of intangibles).[173] Additionally, it covers losses due to casualty in cases where no disposition of the entire asset has occurred.[174]

Although it was stated earlier that a casualty loss deduction (in the absence of a complete disposition) can be assimilated to the loss-of-physical component category,[175] that characterization is not wholly satisfactory, because no disposition occurs of a sub-asset or component (such as a car fender), that possesses an allocated basis. The options realistically facing the taxpayer are to repair the item, sell it to a junkyard, or leave it around in the yard or storage space. No significant market (apart from junkyards) exists for damaged goods. Consequently, no meaningful value can be assigned to a significantly damaged item. The "decline in value due to casualty" rule is a joke, and in virtually all cases restoration costs are used as a proxy.[176] (But, since such costs are the measure of a deductible loss, they cannot also be

171. Under current law, an expenditure on a productive asset is capitalized if it expands the asset's productive capacity, alters its use or function, or, by itself, significantly extends its useful life. *See* Temp. Reg. § 1.263(a)-3T(h)(1), (4), Ex. 15, (j).

172. The term "sustained" appears in the Revenue Act of 1913, Section II, B, 38 Stat. 114, 167. Under current law, a loss is sustained by "closed and completed transactions and as fixed by identifiable events occurring in [the] taxable year." Reg. § 1.165-1(d)(1).

173. *See* Reg. §§ 1.165-2, -4.

174. *See* Reg. § 1.165-7(a)(2). This regulation applies to all casualty losses, not just personal casualty losses.

175. *See supra* text accompanying note 127.

176. *See* Reg. 1.165-7(a)(2)(ii).

deductible as expenses.) Finally, as a general matter, valuations should be avoided under an income tax wherever possible.

The solution to this mess is to cease treating partial casualty losses as realized losses, and instead to treat restoration costs as expenses. In continuance of the (questionable) policy behind the deduction for casualty and theft losses on personal-use property, such expenses would be deductible even if the property is not business or investment property, if the partial loss results from casualty or theft. Restoration costs paid for by an insurance company, or for which an insurance claim exists, are not costs paid by the taxpayer, and would not be deductible. This solution would avoid adjustment-of-basis issues,[177] which are probably ignored by most individual taxpayers in any event.

3. Indirect Production Costs

Another area that should be re-examined is capitalization of indirect production costs of inventory and tangible assets. Under current law, direct *and* indirect production costs (including depreciation) are required to be capitalized.[178] Obviously, depreciation of productive assets, if no longer allowed, would not be capitalized into the cost of produced assets. The

177. The loss reduces basis. I.R.C. § 1016(a)(1). But is the basis reduced by only the deductible amount of the casualty loss? (The personal casualty loss deduction is subject to two (partial) disallowance rules. I.R.C. § 165(h)(1), (2).) If the basis reduction is only the amount of the deductible loss, then the disallowance rules are undermined. IRS PUB. NO. 547, CAUSALITIES, DISASTERS AND THEFTS, at 15, http://www.irs.gov/pub/irs-pdf/p547.pdf, states that the basis shall be reduced by any insurance recovery and by any deductible loss, and shall be increased by restoration expenditures. These rules could well yield a basis higher than original cost.

178. *See* I.R.C. § 263A. The latter section was added in 1986 as a codification of the principle of Commissioner v. Idaho Power Co., 418 U.S. 1 (1974), which required depreciation on equipment used to construct the taxpayer's own facilities to be re-capitalized to the facilities. The opinion in *Idaho Power* is conclusory in stating that the cost of the equipment was assimilated into the cost of the constructed facilities. The *Idaho Power* opinion is also unpersuasive in summarily analogizing the equipment depreciation with the wages of production workers, which are "direct" production costs (along with raw materials). Actually, *Idaho Power* may have reached the right result on the basis of an analogy to the costs of paying an outside contractor to build the facilities. In any event, *Idaho Power* did not involve inventories. Also, even if depreciation should be capitalized to inventory costs, it does not follow that all production overhead should also be capitalized.

purported rationale for capitalization of indirect production costs is "matching,"[179] a non-tax value.[180]

The correct rationale for capitalization is significant value extending beyond the taxable year.[181] Thus, the question is whether the costs in question add value to the inventory. Perhaps this is not an easy question to answer, but it would least appear that candidates for expensing would include (relatively) fixed period costs, such as rent, property taxes, interest, and (perhaps) utilities, even if related to the operation of production facilities, plus indirect labor costs. These are expired costs of operating a business generally, even a services business, and (arguably) do not meaningfully add to the value of the produced assets. Instead, they can be conceptualized as unavoidable costs that reduce current revenue.

4. Inventory Costing

Under current law, inventory costs can, under certain conditions, be written down to market value,[182] which is a rule that accelerates losses in advance of realization by disposition.[183] This rule, of dubious origin,[184] does not belong in a realization income tax.

VII. SHOULD C CORPORATIONS BE EXEMPTED FROM THE PROPOSED CHANGES?

Allocative fairness and distributive justice are norms for the individual income tax but not an entity tax, such as that for C corporations.[185] Additionally, business entities of significant size may not be fazed by accrual

179. *See* S. Rep. No. 99-313, at 142 (1986) (citing matching as a reason to enact I.R.C. § 263A).

180. *See supra* note 55 and accompanying text. As stated so nicely by Gunn, *Matching of Costs and Revenues*, *supra* note 55, at 14 ("[W]hen costs are capitalized, the matching of income and deductions that results is a consequence of capitalization, not a justification for it.").

181. *INDOPCO, Inc.*, 503 U.S. 79.

182. *See* Reg. § 1.471-2(c).

183. The write-off reduces Closing Inventory, which increases Costs of Goods Sold, an offset to "gross income from business." *See* Reg. § 1.61-3.

184. The rule was created by regulation in 1917 simply as a way of reducing business taxes, and was not even a rule of business accounting at the time. *See* Geier, *Myth of the Matching Principle*, *supra* note 55, at 33 n. 47.

185. I.R.C. § 11. A "C corporation" is a corporation treated as a separate taxable entity subject to the I.R.C. § 11 rate schedule. Certain corporations can elect out of this system and be taxed roughly like tax partnerships but under Subchapter S, I.R.C. §§ 1361–1398.

accounting or depreciation. Finally, it might be at least argued that all borrowing of large business entities is purchase-money debt (or at least that it would often be hard to identify non-purchase-money debt). These considerations raise the issue whether such business entities might be allowed to compute taxable income according to current law. Certainly, business entities are likely to push hard for retention of the tax accounting status quo, which is favorable to them, unless a significant rate reduction is offered as bait.

On the other hand, the inconsistency problem would remain at the business-entity level. Additionally, it might be thought that a regime of dual tax accounting systems for individuals and entities tax would enable arbitrage opportunities between entities using existing rules and cash-realization individuals. Although Congress has addressed the problem to some degree, it has done so mainly with respect to accrual vs. cash tax accounting.[186] The problem might mushroom if individual taxpayers had also to forego the *Crane* doctrine and depreciation.

Another problem is that dual tax accounting systems might raise the tax stakes as far as entity choice is concerned, an issue already fraught with tax issues, such as differential rates,[187] double taxation of corporate income,[188] deferral of income,[189] conversion of ordinary income to capital gains,[190] and pass-through of losses.[191]

A possible approach to these issues, especially choice-of-entity, is a mandatory tax-entity rule: all business entities with more than one equity holder would be treated as separate taxable entities under an "imputation regime," wherein an entity withholding tax would be imposed (probably at a flat rate) on entity taxable income computed under rules (possibly based on tax accrual concepts) applicable to all such entities; grossed-up distributions would be taxed to equity holders, who would receive a tax credit for withheld taxes. Constructive-distribution rules could be imposed for investment holding

---

186. *See supra* note 52 and accompanying text.

187. The I.R.C. § 11 rate schedule for C corporations differs from that of individuals, and is "flat" for large C corporations and personal-service C corporations. Also, C corporations enjoy no rate differential on net capital gains.

188. C corporation taxable income is subject to the I.R.C. § 11 tax, and then again to tax (at capital gains rates) at the individual level when distributed as dividends. *See* I.R.C. § 1(h).

189. The individual tax can be postponed indefinitely by not paying dividends. Deferral produces a better overall result than individual taxation if the corporation tax is low, as may occur with foreign corporation operating in a low-tax jurisdiction.

190. The shareholder tax on dividends is at capital gains rates, as (of course) net gains from the sale of stock.

191. C corporation net losses are confined to the corporate level, whereas S corporation and tax partnership losses (as well as profits) are passed through to shareholders and tax partners. *See* I.R.C. §§ 702(a), 1366(a).

companies and other scenarios deemed to be abusive. Exceptions to the mandatory tax-entity rule might lie for general partnerships and (100 percent) family businesses.

VIII. CONCLUSION

The accrual method, the tax treatment of borrowing, and depreciation have been major features of the income tax since their inception. The borrowing exclusion is considered to be "built into" the very concept of income to such a degree that it does not even appear as a statutory exclusion from gross income. These features have mostly been taken for granted in the literature, despite being inconsistent with the core realization principle, and despite operating in a way that systematically erodes the income tax base. Since the realization principle is politically sacrosanct, the only feasible way forward is to eliminate the accrual method and depreciation, and revamp the tax treatment of borrowing in a way that eliminates the *Crane* doctrine.

Although one might view the existing scenario as one where an unstoppable force (the realization principle) meets immovable objects (the features discussed herein), the unstoppable force can prevail if significant tax rate reductions are offered across the board. In any event, it is time to start the discussion.