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A PROPOSED REPLACEMENT OF THE TAX EXPENDITURE CONCEPT AND A DIFFERENT PERSPECTIVE ON ACCELERATED DEPRECIATION

DOUGLAS A. KAHN*

I. INTRODUCTION

The concept of tax expenditures has been widely accepted[1] and has even been adopted into federal law, which requires the annual promulgation of tax expenditure budgets.[2] Pursuant to that mandate, several federal governmental offices publish lists of what they deem to be tax expenditures. One such budget is published by the Department of Treasury,[3] and a different budget is published by the Staff of the Joint Committee on Taxation.[4] While there is considerable overlap in those two budgets, they are not identical, and they utilize different norms and baselines for determining what constitutes a tax expenditure.[5] In addition, forty-five states publish their own versions of a tax expenditure budget.[6]

The theme of the tax expenditure concept is that some tax provisions are not elements of a normal or ideal system of income taxation and that such provisions are designed indirectly to finance a program that Congress has chosen to support.[7] The listed tax provisions are designated as

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1. Professor Zelinsky observed in a recent article that the advocates of the tax expenditure concept have prevailed and that the federal government and the governments of forty-five states publish tax expenditure budgets. *See* Edward A. Zelinsky, *The Counterproductive Nature of Tax Expenditure Budgets*, 137 TAX NOTES 1317 (2012).

2. 2 U.S.C. § 622(3) (2012) defines the terms "tax expenditures" and "tax expenditures budget." Section 632(e)(1) requires the Committee on the Budget of both houses of Congress to publish a report each fiscal year, and the report must contain a tax expenditure budget. *Id.* § 632(e)(2)(E). 31 U.S.C. § 1105(a)(16) (2006) requires the president to submit a budget each year, which must include a tax expenditure budget.

3. OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, ANALYTICAL PERSPECTIVES: BUDGET OF THE U.S. GOVERNMENT, FISCAL YEAR 2014, at 241-77 (2013).

4. STAFF OF JOINT COMM. ON TAXATION, 113TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2012–2017 (Joint Comm. Print 2013).

5. *Id.* at 1, 20-22.

6. Frank Shafroth, *Tax Expenditures: A Most Taxing Challenge*, 64 ST. TAX NOTES 327 (2012).

7. STAFF OF JOINT COMM. ON TAXATION, *supra* note 4, at 2 ("Special income tax provisions

disguised expenditures of the government that should be subjected to the same scrutiny as are direct expenditures.[8] While there is considerable overlap in the items listed in the two federal tax expenditure budgets, there are differences because they do not utilize the same baseline. The budgets also provide an estimate of the amount of revenue that the government loses because of the inclusion in tax law of each such designated provision.[9]

There are several questions concerning the premise on which the various tax expenditure budgets rest. First, is there a "pure" or "ideal" income tax system? Second, even if there is one, was there any intention by the legislators to adopt a system that would accord with a pure income tax system? Third, as a matter of policy, would it be desirable to adopt a tax system that comports with a pure income tax system? I will explore these questions in this Essay.

In prior articles, I have expressed my view that the tax expenditure concept is flawed and misleading.[10] In this Essay, I will set forth a view of the structure of the federal income tax system that is different from, and in contravention of, the view underlying the tax expenditure concept. I propose an entirely different standard for measuring the appropriateness of a tax provision. The tax expenditure concept is based on a binary approach in categorizing tax provisions. Under that system, an item either is consistent with normal tax provisions or is inconsistent with them. There are no shades of consistency. Instead, I propose a multivariate standard for evaluating tax provisions.

Over 32 years ago, I published an article on accelerated depreciation in which I concluded that some amount of acceleration was consistent with normal tax principles and should not be classified as a tax expenditure.[11] Over the intervening years, from time to time, I have exchanged comments with authors who have questioned that conclusion.[12] It is time

are referred to as tax expenditures because they may be analogous to direct outlay programs and may be considered alternative means of accomplishing similar budget policy objectives.").

8. There are reasons to question just how much scrutiny is given to direct expenditures. Many governmental programs, such as Social Security, Medicare, and Medicaid dispense large amounts of money without any congressional oversight of the programs. *See* AARON WILDAVSKY, THE POLITICS OF THE BUDGETARY PROCESS 213-16 (2d ed. 1974) (explaining that members of Congress have increasingly become "negligent guardians" of the purse).

9. The two budgets utilize different methodologies in determining the amount of revenue that is lost. STAFF OF JOINT COMM. ON TAXATION, *supra* note 4, at 20-22.

10. *See, e.g.*, Douglas A. Kahn & Jeffrey S. Lehman, *Tax Expenditure Budgets: A Critical View*, 54 TAX NOTES 1661 (1992) (criticizing the tax expenditure concept's assumption of "[a]n ideal Internal Revenue Code").

11. Douglas A. Kahn, *Accelerated Depreciation—Tax Expenditure or Proper Allowance for Measuring Net Income?*, 78 MICH. L. REV. 1 (1979).

12. *See, e.g.*, Walter J. Blum, *Accelerated Depreciation: A Proper Allowance for Measuring Net Income?!*, Comment, 78 MICH. L. REV. 1172 (1980); Douglas A. Kahn, *Accelerated Depreciation Revisited—A Reply to Professor Blum*, 78 MICH. L. REV. 1185 (1980).

to revisit that topic and renew the consideration of how tax depreciation may properly operate.

This Essay's analysis of depreciation provides one example of how the tax expenditure budgets are flawed. The treatment of some accelerated depreciation as a tax expenditure is based on a view that any acceleration conflicts with normal tax principles.[13] I will show in this Essay that when the structure of depreciation is examined, it becomes clear that there is more than one way to determine what allowance for depreciation should be made. Furthermore, allowing acceleration does not contravene any established tax principles.

It is not the thesis of this Essay that acceleration is the only proper method of tax depreciation. To the contrary, it is my view that many forms of depreciation are proper and comply with normal tax principles, and that accelerated depreciation is merely one of the appropriate methods that can be authorized.

II. REPLACEMENT OF THE TAX EXPENDITURE CONCEPT

Even those that admire the tax expenditure concept acknowledge that there is a problem in identifying many of the items that constitute expenditures because there is not universal agreement as to what constitutes a pure income tax system. Such a system is the base against which tax provisions are measured to determine whether they are "pure" tax provisions or tax expenditures.[14] Nevertheless, these commentators note that there are many clear examples of what are and are not tax expenditures, so they approve of the concept and regard any questionable inclusions in the budgets as minor discrepencies.[15] It is noteworthy that some of the items that are regarded by the concept's proponents as clearly constituting expenditures are not so regarded by some other commentators. For example, Professors Chirelstein and Zelenak state that all personal deductions, such as charitable contributions and medical expenses, are clearly tax expenditures.[16] On the other hand, a number of commentators have concluded that some personal deductions are consistent with a normal tax system.[17] That conflict of

13. The commentary in the budget promulgated by the Staff of the Joint Committee states that any depreciation provision that allows for a deduction in excess of what would be permitted under straight-line recovery using the recovery periods set forth in the alternative depreciation system established in I.R.C. § 168(g) will be treated as a tax expenditure. STAFF OF JOINT COMM. ON TAXATION, *supra* note 4, at 6. The commentary indicates that economic depreciation is deemed to be the model. Economic depreciation is explained *infra* Part III.A.

14. *See, e.g.*, MARVIN A. CHIRELSTEIN & LAWRENCE A. ZELENAK, FEDERAL INCOME TAXATION 206 (12th ed. 2012).

15. *Id.*

16. *Id.*; *see also* Gregg D. Polsky, *Rationally Cutting Tax Expenditures*, 50 U. LOUISVILLE L. REV. 643 (2012) (arguing that charitable deductions, certain retirement accounts, child tax credits, and the home mortgage interest deduction are all types of tax expenditures).

17. *See, e.g.*, William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV.

views illustrates that even if the premise of the expenditure concept were correct, the classification of many such tax items as expenditures is controversial.

To quarrel with the inclusion of some of the items in the budgets may not be sufficient to justify abandoning the expenditure concept. While such commentary casts doubt on the reliability of parts of the budgets, it leaves open the question of whether the concept itself is viable. The more items that are questioned, the greater the skepticism over the reliability of the budgets; but the flaw in the concept is more fundamental than the difficulty encountered in identifying those items that are expenditures.

It is the thesis of this Essay that the controversial aspect of some of the items listed in the budgets is a symptom of the fact that the underlying premise of the expenditure concept is unsound. The failure of the expenditure concept is not merely that many of the inclusions in the budget are questionable. Rather, its failure lies in the fact that the entire concept is based on an erroneous view of the income tax system. It is not sufficient to correct individual items of the budget; the entire tax expenditure concept should be discarded. I discuss below the view of the tax system on which the expenditure concept is based and describe a different view of the tax system that more accurately comports with how tax law actually operates and should operate.

The tax expenditure concept rests on the view that an ideal or normal tax system exists. Tax provisions are then compared to that ideal or normal system to see if they conform or not. The ideal system is usually described as one that assesses taxes on some modified version of the Haig-Simons definition of income—i.e., that income is equal to the sum of a person's accumulation of wealth and the market value of that person's personal consumption during a specified period.[18] Whatever may be said about that definition as an ideal, it does not take into account the administrative practicalities of overseeing an income tax system for millions of people engaged in a great variety of economic activities. The various tax expenditure budgets, however, do exclude provisions that serve administrative functions.[19]

L. REV. 309 (1972); Jeffrey H. Kahn, *Personal Deductions – A Tax "Ideal" or Just Another "Deal"?*, 2002 L. REV. M.S.U.-D.C.L. 1; Joel S. Newman, Commentary, *Of Taxes and Other Casualties*, 34 HASTINGS L.J. 941 (1983); William J. Turnier, *Personal Deductions and Tax Reform: The High Road and the Low Road*, 31 VILL. L. REV. 1703 (1986).

18. HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 50 (1938). Treasury's tax budget expressly adopts the Haig-Simons definition as its model. OFFICE OF MGMT. & BUDGET, *supra* note 3, at 242.

19. The Staff of the Joint Committee's budget expressely states that it excludes provisions that serve administrative feasability. STAFF OF JOINT COMM. ON TAXATION, *supra* note 4, at 5. Treasury's budget excludes some items because of their administrative function. For example, it excludes unrealized income from its budget. OFFICE OF MGMT. & BUDGET, *supra* note 3, at 242.

The two governmental budgets apply different standards for determining the baseline against which tax items are measured.[20] The drafters of one budget create what they consider to be an ideal system for their baseline, and the drafters of the other budget determine what principles they consider to be normal in the current tax system and then characterize some of the current tax provisions as out of place with those principles and, therefore, as tax expenditures.[21] However, both budgets recognize that some basic tax principles are appropriate and do not create an expenditure. For example, the doctrine of realization is treated as a normal and appropriate part of a tax system, and so adherence to that doctrine does not create a tax expenditure for either budget.[22] For accounting purposes, the Joint Committee's budget treats the accrual method as normal except where it is not feasible to use it.[23] The budgets acknowledge that administrative convenience is a proper goal of a tax system, and that is why they generally accept the realization doctrine.[24] In recognition of the importance of administrative convenience to the operation of a tax system, the budgets accept a number of other tax principles, including the measuring of gain without regard to the effect of inflation.[25] The Joint Committee's budget does not treat the failure to tax the imputed income from one's own services or from home ownership as a tax expenditure because the Committee considers them to be excluded from income out of administrative necessity.[26]

The tax expenditure system is based on a binary view of tax provisions. They either conform to normal principles or they do not. There are no degrees of compliance; every tax provision is either black or white. That is an inaccurate picture of how a tax system is actually structured and how it should be structured.

The proponents of the tax expenditure concept are correct in asserting that there is a core of provisions that clearly are part of the structure of an income tax system. The deduction of the expenses of producing income is a necessary part of a tax system if one seeks to tax net in-

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20. STAFF OF JOINT COMM. ON TAXATION, *supra* note 4, at 1, 20-22.

21. *Id.*

22. *Id.* at 5; OFFICE OF MGMT. & BUDGET, *supra* note 3, at 241-42. In a recent article, Professor Calvin Johnson proposes a different baseline for tax expenditures that would include the failure to tax unrealized appreciation as a tax expenditure. *See* Calvin H. Johnson, *Measure Tax Expenditures by Internal Rate of Return*, 137 TAX NOTES 273 (2013). If the tax expenditure concept were to adopt all of Professor Johnson's recommendations, the budget would have very little significance because relatively few tax provisions would be omitted.

23. STAFF OF JOINT COMM. ON TAXATION, *supra* note 4, at 7.

24. *See supra* note 19 and accompanying text.

25. STAFF OF JOINT COMM. ON TAXATION, *supra* note 4, at 7; OFFICE OF MGMT. & BUDGET, *supra* note 3, at 257.

26. *Id.* at 5. However, Treasury's budget does classify some imputed income as a tax expenditure. *Id.* at 5 n.11.

come as contrasted to gross receipts.[27] The number of provisions that fit within that core may be fewer than some imagine, but there is no doubt that there is a core of such provisions. However, it is an error to treat tax provisions as either within that core or outside of it. In reality, most provisions lie on a continuum of varying distances from that core. For example, the expenses of daycare for an infant may be necessary for the parent to work and earn income, but the personal elements of having a child cause that expense to lie further from the core than the expenses of paying an employee to sell the taxpayer's products. Medical expenses may be an appropriate deduction,[28] but they are further from the core than are ordinary business expenses. One of the flaws of the tax expenditure concept is that it ignores the proximity of a provision to the core.

Tax law does not operate in a vacuum. Tax laws affect behavior and can have societal and economic consequences that may be desirable or may be undesirable. For example, the failure to tax imputed income may influence one spouse to stay home to care for a child rather than to earn taxable wages and pay someone else to care for the child. The tax law will have an influence on the parent's decision. The likelihood of the tax system skewing that decision is enhanced by the fact that the secondary spouse's wages may be taxed at a higher rate because of the income earned by the other spouse. If no deduction is allowed for child care, the tax law will create an incentive for one spouse to not be employed. The decision for one spouse to stay home and care for the child may be regarded as desirable or undesirable depending upon one's views on both societal and economic issues. If it were concluded that that decision should be made by the parents, insulated from any outside influence by the government, the tax law's influence could be neutralized by providing a tax deduction for the expense of child care. The parent's decision could then be made independently of tax considerations. Instead of providing a deduction, current tax law gives a tax credit for such expenses.[29] That works less efficiently than would a deduction, but it serves the same function.

The child care example is one where a tax provision could be adopted to prevent another tax position (the failure to tax imputed income) from influencing behavior when it is determined that such influence is undesirable. It seems to me that a provision designed to negate a negative influence of the tax law should not be regarded as a tax expenditure

27. There are good reasons not to base a tax system on gross receipts. Such a tax would impose greater taxes on businesses with high costs than on those with low costs. That would violate the doctrine of horizontal and vertical equity.

28. To the contrary, as previously noted, there are those who conclude that medical expenses should not be deductible. The issue is controversial. *See supra* note 16 and accompanying text.

29. I.R.C. § 21(a)(1), (b)(2)(a).

even if the provision is deemed to differ from an ideal tax. Provisions of that nature should be classified differently.

In contrast to neutralizing tax influences, a tax provision could be adopted in order to induce or deter certain behavior. Some provisions clearly were designed to further a non-tax objective. For example, providing tax benefits for the purchase of anti-pollution devices has programmatic goals. The tax expenditure proponents would claim that a tax provision that is designed to induce behavior is a subsidy and should be characterized as an expenditure.[30] That view is too simplistic.

As noted above, relatively few tax provisions fit within the core of measuring and taxing net income. Instead, most lie on a continuum in which some are close to that core and some are far from it. Legislators take into account the effect that a proposed tax provision will have on behavior and consider whether that behavior will have societal or economic consequences that are desirable or undesirable. It would be foolish to ignore the influence of taxation on the economy and on societal decisions and simply to allow good and bad consequences to occur in any way they happen to arise. That is not what occurs.

The considerations that go into the adoption of tax provisions are multifaceted. The proximity of the provision to the core of a tax system is one factor, but only one factor. The further a provision is from the core, the greater the policy considerations must be to justify its retention. The closer the provision is to the core, the less relative weight that is accorded to policy considerations. However, policy considerations are never entirely absent from the equation. Even a core provision may be removed from the tax law because of the prominence of adverse policy considerations. For example, a deduction for an expense that directly produces income is a core provision. But, there are circumstances where no deduction is allowed for such expenses because they contravene non-tax policies. One such exception is for illegal expenses, which are denied deductibility by I.R.C. § 162(c). While, for several reasons, I think that § 162(c) is a bad provision, its legislative purpose obviously rests on non-tax considerations. A fine that arises out of an activity conducted in operating a business is nondeductible because of I.R.C. § 162(f). Another example is unreimbursed employee business expenses, which are treated as miscellaneous itemized deductions and so are subjected to limitations on their deductibility[31] or even disallowed entirely if the AMT applies.[32] There is no aspect of accurate income measurement that would

30. The thesis of the tax expenditure concept is that tax provisions that are designed to implement a program, as contrasted to a measurement of net income, are equivalent to a direct expenditure of governent funds and should be accorded the same treatment. *See* STAFF OF JOINT COMM. ON TAXATION, *supra* note 4, at 2; STANLEY S. SURREY & PAUL R. MCDANIEL, TAX EXPENDITURES 1 (1985).

31. *Id.* §§ 67-68.

32. *Id.* § 56(b)(1)(A)(i) (disallowing a deduction for miscellaneous itemized deductions in

justify that treatment of business expenses, the full deductibility of which is clearly within the core of proper tax provisions.

This picture of taxation explains one of the reasons why tax provisions need to be altered from time to time. The consequences of a provision can change as societal and economic conditions change. The values that society holds can change so that consequences that once were thought desirable are now viewed as undesirable, or vice versa.

There is another fundamental flaw in the tax expenditure concept. Not only does it posit that there is a pure income tax system, it is based on the assumption that the current tax law is designed generally to conform to that system so that variances from it can be seen as departures that often represent disguised expenditures.[33] To the contrary, the current system is not designed to be purely a taxation of net income nor did its drafters aspire to that exclusive goal. The current system is far more pragmatic. It is designed to be a combination of taxation of income and consumption.[34] In their excellent casebook, Professors Bankman, Shaviro, and Stark state, "it is often said that our system is as much a consumption tax as an income tax, or more precisely some sort of impure hybrid of the two."[35] More broadly, the tax system can be seen as a hybrid of income tax and consumption tax systems infused with a pragmatism that takes into account various policies and values.

The pragmatic approach that Congress has adopted in enacting the tax law is illustrated in Subchapter K, which contains the principal provisions dealing with the taxation of partnerships and partners.[36] There are two very different views of the nature of a partnership. It can be viewed as a separate entity distinct from its partners. Alternatively, it can be regarded as a mere convenient representative of the aggregate of interests of the partners. The exclusive adoption of either view would result in a quite different tax system from the one that would be applied if the other view were taken. Congress chose not to adopt either view

determining the alternative minimum taxable income of an individual); *see also id.* § 67(b) (outlining what constitutes a "miscellaneous itemized deduction").

33. The only plausible justification for characterizing some tax provisions as falling outside of pure income measurement is that the legislative purpose for having an income tax system is to measure and tax income, such that any actual tax provisions that fail to measure income accurately and that further a non-tax policy objective constitute a utilization of the tax system to finance a program that the legislature desires.

34. For example, the tax law does not apply to some significant accessions to wealth such as imputed income and unrealized appreciation of the value of assets, and the tax law's view of consumption appears to be different from the one contemplated in the Haig-Simons definition. For example, commentators have questioned whether the deduction for medical expenses and charitable contributions conflict with Haig-Simons because they should be treated as consumption expenses. *See supra* note 16 and accompanying text.

35. JOSEPH BANKMAN, DANIEL N. SHAVIRO & KIRK J. STARK, FEDERAL INCOME TAXATION 14 (16th ed. 2012).

36. LAURA E. CUNNINGHAM & NOEL B. CUNNINGHAM, THE LOGIC OF SUBCHAPTER K 1 (4th ed. 2010).

exclusively. Instead, Congress adopted a hybrid view that treats a partnership as a separate entity for some purposes and as an aggregate of interests for others.[37] Rather than adhering to a fixed model, Congress chose a more flexible and nuanced approach. When the tax law operated better by treating the partnership as an entity, Congress did so; and when the tax law operated better by treating the partnership as an aggregate of the partners' interests, it did so.

The pragmatism of the tax system is reflected throughout the Code. Another example is the treatment of spouses. For some purposes, they are treated as two separate individuals.[38] For other purposes, they are treated as a single unit.[39] Repeatedly, Congress shows that it is not seeking to adopt some idealized system, but rather seeks to have a system that carries out its policies and goals. The discussion in Part III.B of this Essay notes that Congress has shown that same pragmatism in its treatment of depreciation. In some circumstances, Congress has chosen to ignore unrealized appreciation in measuring the amount of an asset's depreciation.[40] In other circumstances, it has disallowed any depreciation deductions because it has taken unrealized appreciation into account.[41] In other words, in some circumstances, Congress has adhered to the realization doctrine in determining depreciation, and in other circumstances it has rejected the realization doctrine.

Given the hybrid and pragmatic nature of the country's income tax system, it is folly to speak of provisions departing from some fixed, ideal view of income. Such so-called departures can be as much a proper part of the system as those that are seen as core provisions. There are numerous factors to be considered in determining whether any tax provision should be retained, but its relationship to some ideal tax system is not one of them.

Once it is accepted that the tax law does not seek to adhere to a single view of taxation, it seems clear that any purported departures from an ideal system cannot be characterized as impure. A provision that does not conform to an imagined ideal tax system could be a provision that complements other provisions that do not conform. Once a variance

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37. *See, e.g.*, KAREN C. BURKE, FEDERAL INCOME TAXATION OF PARTNERS AND PARTNERSHIPS 1-2 (4th ed. 2013).

38. For example, spouses are not required to file a joint income tax return under I.R.C. § 6013, but they can each file separately, reporting his or her own income and deductions.

39. *See, e.g.*, I.R.C. § 318(a)(1)(A)(i) (treating a taxpayer as owning stock owned by the taxpayer's spouse); *id.* § 469(h)(5) (treating the participation of a taxpayer's spouse as participation of the taxpayer).

40. As noted in Part III.B *infra*, the allowance of accelerated depreciation effectively ignores the unrealized appreciation in the remaining life of the asset.

41. No depreciation is allowable for a non-wasting asset (such as land) because the appreciation of the value of the remaining life of the asset offsets the value that was exhausted in the year in which the asset was used.

from a system has been adopted, there can be good reasons not to follow that system when adopting other provisions.

The proponents of the tax expenditure concept do not contend that the items listed in the budgets necessarily should be repealed or changed. They contend that since the items do not conform to established tax principles, each should be repealed unless a convincing case can be made for its retention on the basis of serving some valuable societal or economic purpose whose benefit justifies the amount of revenue that is lost because of that provision.[42] In other words, because of their equivalence to a direct expenditure, they should meet the same process of review that is applied to determine whether to continue making a direct expenditure.[43]

By singling out some tax provisions because they serve non-tax policy functions, the concept obscures the fact that non-tax policy considerations have a role in the question of the adoption or retention of virtually all tax provisions.[44] The inclusion of some items on the list suggests that the items that are not on the list are free of policy considerations. Also, by placing all so-called tax expenditures in a single category of non-neutral, the concept ignores the different status of provisions that lie on different points of the continuum. Since the adoption or retention of virtually all tax provisions is influenced by non-tax considerations, the selection of some such provisions to be designated as having a programmatic function is misleading because it suggests those provisions are significantly different from the many other provisions that also serve a programmatic function.

The expenditure concept serves more of a political purpose than it does provide any useful information. By classifying some provisions as tax expenditures, it suggests that they do not belong in the tax system and makes them prominent targets for repeal whenever Congress needs to increase revenue.[45] This labeling could alter the debate on listed items by marking them with a scarlet letter. Moreover, the question of where the items belong on the continuum, which should be a factor, might be

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42. SURREY & MCDANIEL, *supra* note 30, at 26-27.

43. As previously noted, some authors have questioned the extent to which direct expenditures are scrutinized. *See, e.g.*, Zelinsky, *supra* note 1, at 1320.

44. As previously noted, even core provisions, such as business expenses, are subject to non-tax considerations. *See supra* notes 27-32 and accompanying text. In that case, as contrasted to inducing the adoption of a provision, the presence of undesirable non-tax consequences can lead to eliminating or limiting the item.

45. Despite the promulgation of tax expenditure budgets, the number of items that are classified as expenditures has continued to grow. Some have concluded, therefore, that the tax expenditure budgets have been ineffective. Indeed, Professor Zelinsky contends that the budgets have been counterproductive and have actually stimulated the increase in tax expenditures. Zelinsky, *supra* note 1, at 1317. While that seems an unlikely consequence and other explanations are available, I make a different point in this Essay. My thesis is that the expenditure concept is based on a false premise and should be discarded regardless of its efficacy.

overlooked. The following discussion of accelerated depreciation provides an example of a designated expenditure provision that can be seen to be within the core itself. The characterization of accelerated depreciation as an expenditure reflects the rigidity of the expenditure concept and its failure to reflect the flexibility of the tax system, which accommodates a variety of approaches for the determination of income.

III. Depreciation Deductions

The cost of acquiring an asset that will be used in a trade or business or for the production of income is deductible.[46] However, if the asset is to be used by the taxpayer for more than one year, the entire cost generally cannot be deducted currently, but instead it must be capitalized.[47] The capitalized cost can be allocated among the years of the asset's useful life, and a portion of the cost can be deducted in each year.[48] Certain types of amortization of cost are referred to as depreciation.[49] If an aliquot amount is allocated equally to each year of the recovery period, the depreciation is referred to as "straight-line" depreciation.[50] Some methods of depreciation allocate a greater amount of cost to the earlier years of the recovery period than to the later years. Those types are called "accelerated depreciation." The most commonly used accelerated depreciation method authorized by the Code is the "declining balance method."[51]

While there is little dispute as to the appropriateness of allowing depreciation deductions, there are issues as to the methods of depreciation that should be available and as to the choice of a recovery period. In general, the tax expenditure budgets treat accelerated methods as expenditures to the extent that the amount of deduction in a year exceeds what would be allowed under either straight-line or economic depreciation.[52] The source of the view that accelerated depreciation is excessive is an approach to depreciation called "economic depreciation" or "sinking-fund depreciation."

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46. I.R.C. §§ 162(a), 212(1).

47. *Id.* § 263; *see* Indopco v. Commissioner, 503 U.S. 79 (1992). The one-year standard is a rule of thumb that has been adopted by the Service. *See* Rev. Rul. 73-357, 1973-2 C.B. 40; Rev. Rul. 69-560, 1969-2 C.B. 25.

48. I.R.C. §§ 167-168.

49. *Id.*

50. Treas. Reg. § 1.167(b)-1(a).

51. I.R.C. § 168(b).

52. Staff of Joint Comm. on Taxation, *supra* note 4, at 6; Office of Mgmt. & Budget, *supra* note 3, at 258 (utilizing economic depreciation, a decelerated method, as the normal tax baseline).

A. Economic Depreciation

Economic depreciation is based on the premise that the correct amount of depreciation allowable for a year is the amount by which the asset declined in value by the end of the year.[53] It is not based on the actual decline in the asset's value, which would require appraisals to be made. Rather, it is based on the decline that occurs because of the passage of time without regard to changes that may have taken place in market conditions. Apart from the administrative difficulty in measuring market changes, tax law has firmly established that changes in market value do not affect the amount of depreciation that is allowable.[54]

Economic depreciation concludes (quite reasonably) that the value of an asset is the sum of the present values of the income stream that it is assumed the asset will produce. The calculation of economic depreciation is illustrated in an example in the treatise on federal income taxation that is co-authored by Professors Chirelstein and Zelenak.[55] I will use their example since it provides such a clear explanation of that approach to depreciation.

In that illustration, a machine is purchased for $4000 to be used in a business. The machine is expected to last for 5 years and to produce (after maintenance expenses) income of $1200 each year. While it is unrealistic to assume an equal amount of income production each year, that assumption makes the calculations easier. I will also assume, unrealistically, that the entire $1200 is received at the end of each year, rather than being earned throughout the year.

To calculate the value of each year's income stream to a purchaser, the market will discount the $1200 for that year by a figure that represents the rate of income that the market deems appropriate for the risk involved in purchasing the machine. The discount rate that is used to establish the price of an asset is set by the market. Since the purchaser paid $4000 for a machine that will produce $6000 over a 5-year period, the discount rate was about 15%.

The value of the machine will decrease by the end of each year since the remaining life of the machine will be one year less. But, simultaneously, the value of the remaining years of use will increase because they are one year nearer to occurring. The latter increase in value will offset some of the reduction in value caused by the expiration of one year's life. Chirelstein and Zelenak illustrate this effect by setting forth the following schedule:[56]

53. CHIRELSTEIN & ZELENAK, *supra* note 14, at 187.

54. Fribourg Navigation Co. v. Commissioner, 383 U.S. 272, 277 (1966).

55. CHIRELSTEIN & ZELENAK, *supra* note 14, at 187-88.

56. *Id.* at 188.

	Present Value of Investment	Present Value of Remaining Payments					Annual Loss in Present Value
		1	2	3	4	5	
Start Year 1	$4000	$1045	$905	$790	$687	$573	
End Year 1	$3427		$1045	$905	$790	$687	$573
End Year 2	$2740			$1045	$905	$790	$687
End Year 3	$1950				$1045	$905	$790
End Year 4	$1045					$1045	$905
End Year 5	$0						$1045
						Total	$4000

As you can see from that schedule, the decline in value of the machine at the end of Year 1 was $573. In the next year, the machine declined in value by $687. The decline in value was larger in each subsequent year until the fifth year when the decline was $1045. If depreciation deductions were to follow that schedule, there would be only $573 of depreciation in the first year and increasing amounts each year until the last year would have $1045 of depreciation. Instead of straight line or accelerated depreciation, there would be decelerated depreciation. In a nutshell, that is economic or sinking-fund depreciation.

Because economic or sinking-fund depreciation is based on several unrealistic assumptions, no one advocates the adoption of that system. Indeed, Chirelstein and Zelenak themselves acknowledge that the assumptions are unrealistic for the depreciation of tangible assets, and they note that if more realistic assumptions were made, "the proper depreciation method would be less decelerated than sinking fund, or possibly even straight-line or accelerated."[57] While the tax expenditure budget proposed by the Joint Committee on Taxation considers economic depreciation to be the model, they treat straight-line depreciation as the normal baseline for their budget.[58]

B. Proper Method of Depreciation

Let us ignore the unrealistic assumptions that go into economic depreciation and focus on whether it is the only proper view of depreciation when accepting those assumptions.

Referring to the schedule above for the machine that was purchased for $4000, we can see that of the $4000 that the purchaser paid for the machine, $1045 of it was attributable to the income he expected to earn in the first year of using the machine. If he paid $1045 for the first

57. *Id.* at 189.

58. *See* STAFF OF JOINT COMM. ON TAXATION, *supra* note 4, at 6.

year's use of the machine, why doesn't economic depreciation allow him to deduct that amount for the use of the machine in that year? Why does economic depreciation allow him to deduct only $573? The answer is that while he used up the first year of the machine's life for which he paid $1045, the value of the remaining four years of the machine's life increased due to the fact that they are all one year closer in time to being earned. So, we can see that economic depreciation is based on offsetting the exhaustion of the $1045 paid for the first year's use of the machine by the increase in value of the remaining life of the machine due to the passage of time.

The increase in the value of the remaining life of the machine is unrealized appreciation. The doctrine of realization is a basic element of the federal income tax system, and the tax expenditure budgets do not treat the application of that doctrine as creating an expenditure.[59] If the increase in value of the remaining life were not taken into account in determining depreciation because of the realization doctrine, the machine would be depreciated on an accelerated method. The first year's depreciation would be $1040, the second year's would be $905, and so on, until the fifth year's depreciation would be $573.

Does that accelerated method violate normal principles of federal income taxation? It is the thesis of this Essay that it does not. It rests on an application of the realization doctrine that is widely used in the federal income tax system and clearly is part of the normal tax system.

As previously noted, it is not my position that accelerated depreciation is the only permissible method under normal taxation rules. While the realization doctrine is generally applied in the tax system, there are a few circumstances when Congress has chosen not to apply it.[60] If Congress chose not to take the unrealized appreciation of the remaining life of an asset into account when determining depreciation deductions, that would not violate any neutral principles of taxation. Similarly, if Congress chose to calculate depreciation by offsetting the appreciation of the remaining life of an asset against the amount paid for one year's use, even though that would not comport with the realization doctrine, that treatment also would be consistent with normal tax principles. While the realization doctrine is a normal part of tax law, there is no requirement that it be used. Ignoring the realization doctrine is just as "normal" as following it. There is no "correct" method; either one is permissible.

Indeed, Congress has rejected the realization doctrine for purposes of determining depreciation in certain circumstances. Generally, no depreciation deduction is allowable for assets that are not subject to wear and

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59. *See supra* note 22 and accompanying text.

60. *See, e.g.*, I.R.C. §§ 336, 1272 (treating "debt instruments having original issue discount[s]" and property acquired during corporate liquidation as a gain/loss of income).

tear.[61] Consequently, no depreciation deduction is allowable for land and for stocks. While such assets do not deteriorate due to wear and tear, the present value of each year's income declines the further the years are from the present. At some point in time, the present value of the remaining years of income will be de minimis. Why then is no depreciation allowable for such assets? The apparent answer is that in those cases, Congress has chosen to reject the realization doctrine and to take into account the appreciation in value of the remaining life of those assets. Once again, Congress has displayed its pragmatism by refusing to be restricted to a single approach.[62]

C. *Illustration of a Flaw in the Tax Expenditure Concept*

The tax expenditure budgets' treatment of accelerated depreciation illustrates the basic flaw in that concept. The budgets rest on the notion that there is a single correct or perfect system of federal income taxation that has no relationship to policy considerations. The error in that view is much more than the great difficulty that exists in determining just what constitutes a perfect system. The error is to assume that such a system exists and that it would be desirable to adopt it. The budget's rigid approach to depreciation illustrates how wrong it is to hold that there is a single correct approach to measuring income. The tax law is and should be far more flexible and pragmatic than that. It should accommodate the needs of the time. Policy considerations are a normal part of the tax system and should not be classified as aberrations.

If accelerated depreciation is more desirable at one point in time, it should be employed. If it is not desirable at another point in time, it should be abandoned. There is no reason to skew that decision by categorizing one of the choices as being inconsistent with normal tax principles. Accelerated depreciation is consistent with normal tax principles, and the decision whether to retain or repeal it should not be influenced by a false characterization that it is not.

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61. Treas. Reg. § 1.167(a)-2.

62. In a recent article, Professor Calvin Johnson contends that accelerated depreciation does not comport with a new baseline that he urges should be adopted in determining tax expenditures in lieu of the baselines that are used currently. *See* Johnson, *supra* note 22, at 273-74. In essence, his contention is that a policy analysis of depreciation would reject accelerated depreciation. As noted above, I do not contend that accelerated depreciation should be adopted; I merely contend that its adoption does not contravene normal current tax principles. Professor Johnson's position that economic policy supports eliminating accelerated depreciation rests on a single consideration (on the merits of which I express no opinion in this Essay) and ignores some of the other factors that might properly be taken into account. For example, the likely effect of inflation on measuring depreciation might be considered. The fact that the value of many personal property items does decline more in the earlier years of the asset's use might be weighed. In any event, it is not my intention to take a side on the question of whether accelerated depreciation is desirable as a matter of policy. I leave that question for others to resolve, but I suspect that answers will differ at different points in time depending upon the needs of that period.

IV. CONCLUSION

I maintain that the tax expenditure concept is grounded on a basic error in its view of the income tax system. There is no "perfect" or "ideal" tax system. The tax system is not divorced from every political, societal, and economic condition that exists, nor is it independent of the values that society holds at given points in time. The tax expenditure concept views the ideal tax system as one that is insulated from non-tax factors rather than being a part of and responsive to them. It is wrong to treat tax as isolated from everything else. The adoption of that view can distort the proper consideration of the passage or repeal of tax provisions.

The advocates of the tax expenditure concept recognize that non-tax policies can properly induce Congress to adopt specific tax provisions. Their contention is that such provisions should be scrutinized as they would if they were direct expenditures. However, by characterizing some provisions as inconsistent with neutral tax principles, they attempt to make it more difficult to defend the listed items. More importantly, by adopting a binary approach in characterizing provisions as either within normal tax principles or outside of them, the concept fails to take into account the greater variety that exists in a properly structured tax system. Provisions that are outside of the core of proper tax provisions are not all distanced from that core to the same extent. Some provisions lie closer to the core than others, and some are far removed from it. The expenditure concept obscures that fact and describes the tax world as containing only two categories—those within the system and those outside of it.

It has been pointed out that while the tax expenditure concept has been widely accepted, it has been notoriously ineffective in changing the tax law.[63] While there has been some speculation as to why that is so, the most obvious reason seems to have been ignored. The likely reason that the concept has not had a greater impact on tax legislation is that even though people purport to approve of the concept, they intuitively realize that it is flawed and should not have any influence.

Some have suggested that even if the tax expenditure concept is flawed, it would be useful to have a list of tax items that might be scrutinized by Congress when it seems appropriate to do so. I have no quarrel with the promulgation of such a list. My quarrel is with the characterization of certain tax items as "impure" because they do not comport with a supposed ideal tax system. It is the stigmatization of certain tax items that is the source of the mischief with which I find fault.

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63. *See, e.g.*, Zelinsky, *supra* note 1, at 1317 (explaining how "tax expenditure budgets . . . have not curbed tax expenditures, as the proponents of those budgets promised").