Interest Deductibility

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The proper tax treatment of interest expense has been a subject of disagreement since the inception of the modern income tax in the early twentieth century. On one view, the purpose of the financing transaction dictates the tax treatment, so that interest paid on borrowing used to finance consumption should be nondeductible, whereas business interest should be deductible. On another view, interest paid does not constitute a consumption item but rather a mere shift in resources and therefore should be deductible at all events, assuming the recipient includes in income the interest received.

Both of these views lead to conundrums that cannot be resolved without considering the broader question of why some expenses are deductible at all. Focusing on that question, it turns out that business interest, like any other business expense, should generally be deductible as a timing or an accounting principle under an income tax. That principle does not apply to personal interest expense. Nevertheless, there may be an independent basis to permit a deduction for personal interest expense that is grounded in considerations of vertical equity.

A related question arises in the business setting when loan proceeds finance the purchase of business assets that are taxed under consumption tax norms. Congress has lately sought to limit interest deductibility in this setting, but a better approach would be to apply consumption tax norms more consistently to the overall arrangement. Under consumption tax norms, business interest remains deductible but loan proceeds are includible in gross income.

Interest Deductibility Under the Income Tax

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Introduction

The tax treatment of interest expense is something of a muddle. In the earliest years of the income tax, interest expense generally was deductible, though borrowing was relatively uncommon and most of the borrowing that did occur was for business purposes.[1] Since that time, the rules have fluctuated considerably as borrowing also has become more commonplace.[2] Congress has sometimes limited the deduction for interest paid on debt to finance personal consumption ("personal interest expense," or PIE) and sometimes expanded it, though more recently Congress has confined the deduction for PIE to "qualified residence interest" and some interest paid on student loans.[3] Relatedly, Congress has imposed varying limitations on deductions for interest paid for other kinds of borrowing, such as debt incurred to finance investment activity,[4] debt incurred in connection with certain "passive activities"[5] and activity not "at risk,"[6] and debt incurred to finance the purchase or carrying of bonds that generate interest excluded from gross income.[7] Most recently, Congress has placed substantial limitations on the deductibility of business interest expense (BIE) for certain highly-leveraged taxpayers.[8]

This article reconsiders the proper treatment of interest expense, both under an income tax and under a consumption tax. For the most part, the debate has focused

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[1] Dennis J. Ventry, Jr., *The Accidental Deduction: A History and Critique of the Mortgage Interest Deduction*, 73 LAW & CONTEMP. PROB. 233, 240-41 (2010).

[2] For a brief discussion of the history through the Tax Reform Act of 1986 ("TRA 1986"), see John Y. Taggart, *Denial of the Personal Interest Deduction*, 41 TAX LAW. 195, 199-205 (1988). Unless otherwise stated, all section citations herein are to Title 26 of the U.S. Code, and all citations to regulations are to Treasury regulations promulgated thereunder.

[3] TRA 1986 adopted a general non-deduction rule for personal interest. § 163(h). The exception for qualified residence interest is found in section 163(h)(3); that for interest paid on student loans in section 221. Whether and to what extent student loan interest in fact is "personal" in nature are further questions. See, e.g., Stuart Lazar, *Schooling Congress: The Current Landscape of the Tax Treatment of Higher Education Expenses and a Framework for Reform*, 2010 MICH. S. L. REV. 1047, 1068-74, for a discussion of the issue. For the sake of discussion I treat it as such. Regulations under section 163 have long classified it as personal in nature. Reg. § 1.163-5.

[4] § 163(d).

[5] § 469.

[6] § 465.

[7] § 265(a)(2). *See* § 103(a) (excluding interest earned on certain indebtedness issued by state and local governmental entities from gross income).

[8] § 163(j).

on the treatment of PIE under the income tax, specifically on whether or not PIE itself represents a consumption outlay. If so classified, PIE should not be deductible under standard income tax norms; if classified as non-personal in nature, it would seem that a deduction ought to be available, possibly on analogy with the treatment of business expenses, including business interest expense (BIE). On the BIE side, a separate set of questions has arisen in connection with Congress's frequent forays into consumption-tax treatment of debt-financed business investment as a method to stimulate the economy.[9]

With respect to PIE, strong intuitions support both a general rule of deductibility and one of non-deductibility. The opposing intuitions may explain why the question so far has gone unresolved. This paper attempts to gain some clarity by taking a broader view of the nature of expenses generally and then situating PIE within that broader framework. One advantage of such an approach is that it helps to explain the opposing intuitions on PIE, including most importantly why they may go astray. Another is that it helps to clarify the actual policy choices that the tax treatment of PIE presents. To foreshadow, it turns out that PIE occupies a kind of middle ground between most types of personal expense and most types of business expense, assuming the income tax itself takes vertical equity considerations into account, as nearly all do.[10] As a consequence, there is no right answer to the question of the proper treatment of PIE under an income tax. At the same time, different policy choices will make greater or less sense depending on the norms that underlie the tax system more generally. If, for example, vertical equity is of significant concern, PIE should be deductible, at least in part. On the other hand, if we value formal equality more than equality of outcomes, the proper answer may be to deny a deduction for PIE, at least for the most part.

The issue is somewhat different on the BIE side. BIE is widely understood as properly deductible under an income tax and under a consumption tax (assuming that interest income is includible[11]), but the question arises whether the rule of full deductibility should extend to debt financing of investments that are tax-favored under the income tax. A number of provisions in the Tax Code provide for accelerated cost recovery for property used in a trade or business.[12] Accelerated cost recovery represents a taxpayer-favorable departure from a normative income tax because it

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[9] §§ 168(k)(6) (expensing for certain property placed in service before 2023), 179 (expensing for certain depreciable property, subject to dollar limitations).

[10] Any graduated income tax takes vertical equity into account by more heavily burdening those who have a greater ability to pay. Graduation has always been a feature of the U.S. income tax. *See* § 1.

[11] Some proposals in both the income tax and the consumption tax literature would disregard financial transactions entirely so that interest income is not includible and interest expense is not deductible. [CITE.]

[12] *E.g.*, §§ 168(b) (providing for the "double declining balance" method of depreciation for most tangible property not subject to immediate full deduction ("expensing"), 168(k) (expensing, through 2022, of certain tangible property used in a trade or business), 179 (expensing of certain tangible property and computer software used in a trade or business).

treats the acquisition of business property in a value-for-value exchange as though it represented an immediate loss for tax purposes. As developed below, the treatment provides a time-value benefit that pushes the tax toward, and at the limit is equivalent to, cash-flow consumption tax treatment for investments, which is to say an exemption from tax of the risk-free rate of return.[13] Meanwhile, the borrowing transaction remains taxable under income tax norms, which is to say loan proceeds are disregarded by both the borrower and the lender for tax purposes. Congress and commentators have recognized that borrowing effectively turbocharges the consumption-tax benefit by enabling the borrower to dramatically enlarge investment in tax-favored assets, and Congress has placed some limitations on the extent to which the interest deduction for debt is available as a result.[14] The limitation, however, quite imperfectly cabins the benefit, and the question arises whether other methods might be superior. Below I argue that a better approach would be to complete the consumption tax treatment of borrowing that finances the purchase of assets that also enjoy consumption treatment. Rather than counsel a limitation on the interest deduction, this approach would require an inclusion in gross income of loan proceeds (in whole or part), coupled with an offsetting deduction when the loan was repaid. A unifying principle throughout the article is the idea of treating the loan transaction as separate from the financing transaction regardless of the base (income or consumption).

The analysis begins in Part I with a review of the arguments that commentators have typically advanced for and against a deduction for PIE. It shows that common intuitions about the nature of interest expense generate apparently irresolvable inconsistencies. Part II turns to the larger question of the proper treatment of expenses generally under an income tax and situates PIE within the framework of deductible outlays. Part III turns to the treatment of BIE in light of the explication of expense deductibility under an income tax and how the adoption of consumption tax principles affects, or does not affect, the analysis.

I. Arguments for and Against the PIE Deduction

In a simple borrowing transaction, the borrower pays interest on outstanding loan proceeds during the loan term, and the lender includes the interest in gross income.[15] When the loan finances the purchase of an asset for personal use, interest payments are not deductible,[16] except in the case of "qualified residence interest," which, roughly speaking, is interest used to purchase (or refinance the purchase of) a residence.[17] As noted in the Introduction, commentators have advanced arguments in

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[13] E. Cary Brown, *Business-Income Taxation and Investment Incentives*, in INCOME, EMPLOYMENT AND PUBLIC POLICY: ESSAYS IN HONOR OF ALVIN H. HANSEN 300, 309-10 (1948).

[14] § 163(j).

[15] § 61(a)(4). Certain exceptions apply, such as interest paid on certain municipal bonds. § 103(a).

[16] § 163(h)(1).

[17] § 163(h)(3).

favor of the existing basic regime and in favor of one in which all interest payments are deductible (assuming the interest is includible).

A. Non-deductibility

1. Accurate measurement of income

Perhaps the most widely shared intuition regarding the tax treatment of PIE is that no deduction should be available because the expense is a cost of consumption.[18] The argument for non-deductibility of consumption outlays is grounded, in turn, in the nature of a normative income tax as a tax on the net change in wealth during the taxable period. Amounts expended on consumption do not reflect a change in wealth but the conversion of tangible wealth into a personal benefit of at least equal value.[19] Because PIE is paid in connection with the acquisition of a consumer good or service, it seems plainly to be a cost of consumption and therefore to fall under the general rule for consumption outlays, at least as a theoretical matter. In contrast, BIE does not purchase a personal benefit, and for this reason is considered to be deductible under an ideal income tax and, in general, under the actual income tax.[20] For reasons developed below, the "non-personal" rationale for providing a deduction for BIE is susceptible to criticism, though it does not defeat the general argument that BIE should be deductible.[21]

The principal problem with the cost of consumption argument is that it is unclear exactly how borrowing for personal purposes constitutes consumption. Borrowing is in essence the purchase of liquidity, or the moving forward in time of the use of funds by the borrower; it is not a cost of whatever the funds are used for.[22] Strictly speaking, for PIE to qualify as paid for a consumption item, the taxpayer would have to consume the liquidity—perhaps celebrate, on an ongoing basis, the larger contents of her bank account. Instead, liquidity merely changes the timing of an outlay. Consider that the market price for any good—whether it be for personal or for business use—is the same for the borrower and the non-borrower. It is therefore difficult to see how payment for liquidity would qualify as an expense of the thing financed rather than simply for the liquidity itself. Moreover, characterizing the tax treatment of the interest expense based on the use of loan proceeds is inconsistent

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[18] Cheryl D. Block, *The Trouble with Interest: Reflections on Interest Deductions After the Tax Reform Act of 1986*, 40 U. FLA. L. REV. 689, 720 (1988).

[19] Henry Simons's well-known formulation has come to be regarded as canonical: "Personal income may be defined as the algebraic sum of (i) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question." HENRY C. SIMONS, PERSONAL INCOME TAXATION 50 (1938). *See also* William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 320 (1972) [hereinafter Andrews, *Personal Deductions*] (referring to this language as "the most widely accepted definition of personal income for tax purposes, . . .").

[20] § 163(a).

[21] See Part II.

[22] Andrews, *Personal Deductions*, at 376 n.116.

with the widely-accepted (and, I shall argue, accurate) principle that, under an income tax, the borrowing transaction is treated without regard to the fate of the loan proceeds.[23] This principle forms the basis for such venerable rules as not treating the receipt of the loan proceeds as income, not treating their repayment as deductible, and not tying the treatment of debt cancellation to the consequences of the debt-financed transaction.[24]

Respecting the principle that the financing transaction is analyzed on its own, the precise question therefore becomes whether the use of liquidity constitutes an item of consumption. But the answer to this question, in turn, seems to depend on definitions rather than on fundamental income tax norms. It also seems to lead to a quandary. The definitional issue is that we have the choice of considering the purchase of liquidity taken on its own to be a consumption activity or not. If it is, then PIE is a nondeductible personal outlay. If it is not a consumption outlay, then it is deductible. The question remains, however, which rule is correct, and the answer is unclear; it depends on how we feel about the benefit that liquidity provides. The quandary is that once one separates the financing transaction from the fate of the loan proceeds, it seems one must apply the same rule to all forms of interest: either all of it should be deductible, or none of it should because both types of borrowing purchase liquidity. But the notion that BIE would not be deductible seems to be clearly incorrect. It therefore seems that PIE should be deductible, but for reasons that are murky. What drives the result are the convictions that BIE should be and that it is hard to distinguish BIE from PIE assuming that the financing transaction is separate from the purchase transaction. The alternative would be to say that the financing transaction is not separate from the financed one, but, as noted, that runs into problems as well.

2. PIE as a cost of generating tax-favored returns

In a recent article, Yonatan Givati points to a method of analysis that would seem to avoid these difficulties. Givati argues that a focus on income measurement such as the one just discussed is misplaced; what actually matters is the extent to which providing a deduction creates inefficiencies given the treatment of economic substitutes under the income tax.[25] The rationale for this approach is perhaps familiar under the widespread influence of principles of economic analysis in law.[26] The case for diminishing the importance of income measurement is that market effects will offset the mismeasurement in whole or part, reducing the horizontal inequity from treating normatively indistinguishable outlays differently. At the limit (for certain more-elastic goods), demand shifts may fully compensate for the lower after-tax cost of one arrangement relative to economic substitutes, thereby eliminating the inequity.

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[23] See BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS ¶ 7.1 (online version), for a discussion of the history and basic principles of the treatment of financing transactions under an income tax.

[24] *Id.*

[25] Yonatan Givati, *Theories of Tax Deductions: Income Measurement Versus Efficiency*, 5 J. LAW, FIN., & ACCOUNTING 107, 123 (2020).

[26] *See generally* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW (9th ed. 2014).

Nevertheless, the same phenomenon simultaneously makes the case for focusing on efficiency. The economic costs of tax-motivated allocations can be substantial and are generally unrecoverable. Specifically, if pretax allocations are efficient, tax rules that are asymmetrical with respect to a given arrangement vis-à-vis other arrangements can induce material departures from the efficient allocation that reduce total social welfare. Accordingly, substantive policy should be guided by the extent to which a given treatment minimizes this misallocation, sometimes termed "deadweight loss" or "excess burden." Especially in the case of arrangements for which demand is more elastic, parity in treatment as compared to economic substitutes is important. [27] If parity in treatment has adverse distributional consequences, the government can address it with transfer payments.[28]

The commonly-cited case of municipal bonds illustrates the general phenomenon, albeit imperfectly. Interest received on most such bonds is excluded from gross income,[29] whereas interest received on other bonds is taxable.[30] The horizontal inequity between investors in municipal bonds and in taxable bonds is partly erased by the lower interest rate payable on municipal bonds that results from the increased demand for them.[31] Generally speaking, municipal bonds pay interest at a discount to the rate paid on comparable taxable bonds.[32] The discount partly makes up for the tax benefit so that the advantage accorded to investors in tax-free bonds largely disappears. The real problem is that the additional investment in municipal bonds diverts borrowing from where it is economically most productive. There is too much borrowing by municipalities and too little by taxable issuers.

Givati's argument is not focused on the broad question of which items should be taxable and which tax-favored. For example, he does not engage the debate over whether Congress should repeal the exclusion for interest received on municipal bonds. Instead, he examines deductions in light of the tax treatment of the associated income item. Taking that treatment as given, the general rule he proposes is symmetry. If the income item is fully taxable, associated costs should be deductible; if the income item is tax-favored, deductions for associated expense should be reduced or eliminated.[33] In the case of municipal bonds, for example, non-taxation of interest received suggests a rule of non-deductibility for interest paid to finance the

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[27] *Id.*, Ch. 18.

[28] LOUIS KAPLOW & STANLEY SHAVELL, FAIRNESS VERSUS WELFARE Ch. 2 (2002).

[29] § 103(a). Exceptions apply to certain municipal bonds. *See*, *e.g.*, § 103(b)(1), (2) (interest received on nonqualified "private activity bonds" or on "arbitrage bonds" does not qualify for the exclusion).

[30] § 61(a)(4).

[31] Calvin H. Johnson, *Repeal Tax Exemption for Municipal Bonds*, TAX NOTES 1259 (Dec. 24, 2007).

[32] *Id.*, at 1260.

[33] Givati, at 107-12 (explaining his approach).

acquisition of the bond, which rule in fact is codified.[34] Givati argues that in the case of PIE, a non-deduction rule is similarly appropriate because items purchased on consumer credit generate benefits to the borrower that are not subject to tax. The familiar example of renting versus owning one's home illustrates the phenomenon. A person who purchases a home that she occupies will annually receive its rental value without paying any tax on that value. A person who instead invests the same dollars in a taxable vehicle and uses the proceeds to pay rent will also have to pay tax on the investment return. A deduction for the financing costs of the latter but not the former is appropriate. Similarly, in the case of a loan to purchase one's own home, the "untaxed benefit could be the imputed income from housing, or simply the utility derived from the consumption of goods and services earlier rather than later."[35] Neither of these items is taxable.

Givati's argument faces the same objection raised in the preceding discussion. It conflates the purchase transaction with the financing transaction. The loan does not purchase the consumer good; it purchases liquidity. Under an income tax, liquidity is not taxable; that is, the loan proceeds are not included in gross income. It therefore seems that no deduction should be available for PIE. Unfortunately, it also seems that no deduction should be available for BIE or, for that matter, for any kind of interest expense, since all loans purchase liquidity. While the conclusion that PIE should not be deductible is consistent with Givati's mode of analysis and his conclusion, the idea that BIE should be deductible, which he justifies on the familiar ground that the income thereby financed is taxable, seems incorrect.[36]

B. Deductibility

1. Symmetry

Arguments in favor of deductibility for PIE tend to focus on either of two related points. First, the taxability of interest income suggests a parallel rule for interest expense. Given that borrowing consists of moving the borrower's activity forward in time (either consumption or income) and the lender's back rather than the creation or destruction of an identifiable asset, on a system-wide basis it seems that a deduction rule is appropriate given an inclusion rule for the lender. Borrowing is a form of "dis-saving" that parallels savings.[37] Intuitively, borrowing is merely the movement of resources between two parties that on net produces neither income nor

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[34] § 265(a)(2). Givati is not considering parity in treatment on the two sides to the borrowing transaction (borrower and lender) but rather parity in treatment of income and expense for the individual taxpayer, in this case the borrower.

[35] Givati, at 123.

[36] Givati, at 125.

[37] Daniel N. Shaviro, "Economics of Tax Law," 3 OXFORD HANDBOOK OF LAW & ECON., 107, 115 (Parisi, ed. 2017) ("[I]nterest deductions generally should be allowed in a comprehensive, well-functioning income tax, as they are (negative) returns to (dis-)saving, and thus the mirror image of positive returns to saving that an income tax reaches.").

loss. If the fee associated with the shift is includible, it seems the payment should be deductible.[38]

In a similar vein, a number of commentators have argued that borrowing has no real effects, in particular no effect on the borrower's overall power to consume resources. They argue that, as a consequence, PIE should be deductible because it does not purchase the consumption of anything. As Jerome Kurtz put the argument:

> [O]ne who finances current consumption out of accumulated savings reduces those savings and the future income that those savings would have produced, in effect, excluding from income the yield from the funds consumed. Since all income would be taxable under the Haig-Simons regime, the same tax result should obtain whether the taxpayer chooses to borrow and pay back out of future income, or to use savings now.[39]

Kurtz illustrates the point with a comparison of two individuals, one of whom finances current consumption out of savings and the other of whom finances current consumption with an identical amount of borrowing while leaving the same amount of savings in the bank to earn interest. The first individual forgoes interest income on the expended amounts, while the second both receives and pays interest. In real terms, each does the same thing: consumes an amount in the present period. In order for the two individuals to be treated identically for tax purposes, a deduction for the borrower's interest expense is necessary, assuming that the interest earned is taxable.[40]

Unfortunately, Kurtz's example illustrates nothing more than the settled proposition that equal and offsetting positions are generally disregarded for tax purposes, which is to say that interest income and expense should be netted before characterizing the excess expense, if any, as PIE or BIE (or in any other manner, for that matter). This principle is already codified in certain circumstances where inconsistencies would otherwise create a tax arbitrage,[41] and one well understood under such equitable tax doctrines as substance over form and the step transaction

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[38] *Id.*; *see also* B&L, ¶52.2.

[39] Jerome Kurtz, *The Interest Deduction Under Our Hybrid Tax System: Muddling Toward Accommodation*, 50 TAX LAW REV. 153, 159 (1995).

[40] Specifically, Borrower borrows $10,000 at five percent to finance consumption and leaves $10,000 invested at five percent, while Saver simply spends $10,000 on consumption. Providing a deduction for Borrower's interest expense puts her in the same position as Saver, who plainly is not taxable on the $500 of forgone interest income. *Id.*

[41] *See, e.g.*, §§ 1092(a) (disallowing a deduction for losses realized in the case of certain straddle transactions until the associated gain is recognized), 1231(c) (recharacterizing as ordinary income gain on the sale of "section 1231 property" when the taxpayer has had net losses on the sale of such property during the previous five years). Basketing regimes, such as those for capital gains and losses under section 1(h), and recapture rules, such as those for gains on certain business assets sold at a gain under section 1245, operate on a similar principle. In all of these cases, equal and offsetting items are netted to determine tax consequences.

doctrine.[42] The example does not say anything about genuine borrowing, much less about borrowing for personal purposes; the consumption feature of the example is spurious. To see the point, consider the following case, which differs only in that it involves rent rather than interest. Taxpayers *A* and *B* each own a reproduction of the same Chagall painting. The reproductions hang in their living rooms. *B* borrows a third version of the same reproduction from *Dealer*, which she then leases to *Enthusiast* for one year on precisely the same terms on which she borrowed it. *Enthusiast* hangs the reproduction in her home for her enjoyment. *B* can deduct her rental payment, and indeed to put her in parity with *A*, who simply enjoys the painting in her home, must be able to. But it does not follow that someone who rents the reproduction for personal use, such as *Enthusiast*, may deduct the rental cost. Unlike an interest payment, there does not appear to be any reason to treat a personal rental payment as deductible.

One might respond that the example is fanciful. It is hard to imagine why someone who owns the reproduction already would borrow a copy for the purpose of lending it, in turn, to someone else on precisely the same terms as the borrowing. The total effect is the same as what would arise in the absence of both the borrowing and the lending: Each of *A* and *B* enjoys the reproduction in her home with no tax consequences. The answer is that there is no reason why one would do this, just as there is no reason for the borrower in Kurtz's example to borrow. The borrowing is completely offset by the associated lending; the two together in effect are a non-arrangement. Meanwhile, the analysis of this non-arrangement in no way informs the nature of borrowing, just as the analysis of *B* in no way informs the nature of rental expense. Similarly, it is beside the point that the borrower/lender in Kurtz's example spends amounts on consumption; the analysis would be the same if neither party spent any money on consumption, just as would the example of the Chagall reproduction be unchanged if neither *A* nor *B* owned the reproduction. In those cases, each party in each respective situation would still be in the identical position as the other party in that situation: The non-borrower in Kurtz's example would have \$x interest income, while the borrower would have \$2x of interest income and \$x of interest expense. Similarly, in the reproduction example *A* would have literally nothing (no consumption, no income and no expense), and *B* would have an arrangement that nets to nothing (no consumption, \$x income and \$x expense).

What about Kurtz's related idea, also advanced by other commentators,[43] that because the interest outlay reduces "[accumulated] savings and the future income that those savings would have produced,"[44] a deduction is necessary to reflect the taxpayer's overall cost? This argument evidently is motivated by the idea that because liquidity is not literally a consumable item, its use does not constitute consumption.

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[42] *See, e.g.*, Rev. Rul. 2002-69, 2002-2 C.B. 760.

[43] *See, e.g.*, Andrews, *Personal Deductions*, at 376 ("Funds spent for either interest or [state and local] taxes are not available for bread, wine, or travel. If differences in amounts spent for these items do not reflect differences in standards of living, then a deduction would be quite proper." (internal citation omitted)).

[44] Kurtz, at 159.

The problem is that the argument applies with equal force to plainly personal outlays that, as personal, are nondeductible.[45] Any such outlay reduces accumulated savings and the future income that those savings would have produced. The difference, if there is one, between PIE and outlays for more tangible items is that the borrower does not receive any particular thing that is then transformed into a personal satisfaction when she makes the interest payment; all she receives is the intangible benefit of moving consumption forward in time. That benefit, however, is quite real; if it were not, there would be no reason to borrow. The argument therefore amounts to the assertion that the term "consumption" does not include the enjoyment of intangible benefits even when the benefit involves another's forgoing of a benefit. Perhaps the basis for this claim would be that consumption does not arise when resources are not destroyed. That is, possibly, a defensible claim, but it is not obvious why it is more than a policy choice as opposed to following from the nature of a tax on income. For example, the rental of vacant land or, as in the earlier example, of a piece of art, does not involve any destruction of resources; in both cases, there is a mere shift of resources from one person to another in exchange for a payment that is not deductible under the income tax.

2. Separation of the financing transaction from the purchase transaction

A final, related argument for deductibility concerns the relationship between the financing transaction and the associated purchase transaction. As a general matter, the treatment of interest expense hinges on the use of the loan proceeds:[46] if for a personal outlay, the expense is treated as (generally) nondeductible PIE; if for a business outlay, it is (generally) deductible BIE.[47] A line of authority in the cancellation of debt (COD) setting, however, suggests that the same rule should apply to both BIE and PIE (as well as to other kinds of interest expense): either deductible or not, but whatever the rule, the same for both (all) types. The rationale is that the financing transaction is unrelated to the purchase transaction thereby financed so that any differences in the treatment of interest expense would not be traceable to whether the financed item was personal or business in nature.

The tax law has long treated COD income as included in gross income,[48] but the standard for what counts as COD income has evolved over time. In the first several decades of the income tax, courts tended to look to either of two standards, both of which link the treatment of the discharge to other features of the taxpayer's position. Under the "freeing of assets" theory, the question was whether the discharge released

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[45] § 262(a).

[46] Temp. Reg. § 1.163-8(a)(3) (1987).

[47] § 163(a), (h). Both rules are subject to qualifications. For example, "qualified residence interest" is personal in nature but deductible, subject to limits. *See* § 163(h)(3). BIE of certain highly-leveraged taxpayers paid to offshore related parties may not be deductible or deductible only in part. *See* § 163(j). Special limitations apply to other types of interest expense, such as investment interest. § 163(d).

[48] The rule has been codified in § 61(a) since the adoption of the 1954 Code. Prior to that time the Supreme Court's ruling in *Kirby Lumber* generally stood for the same proposition. U.S. v. Kirby Lumber Co., 284 U.S. 1, 3 (1931).

funds (or their equivalent) to the taxpayer formerly unavailable because owed to the creditor.[49] In many situations, debt discharge does not free assets because the debtor is insolvent in an amount at least equal to the canceled debt. In these cases courts tended not to find COD income.[50]

A similar approach applied under the "overall transaction" theory. In this mode of analysis, the question is whether the loan together with the associated purchase transaction represented a gain or a loss for the taxpayer.[51] A taxpayer that borrowed $100 to finance a business transaction that ended up losing $150 would not have COD income on cancellation of the $100 debt because, taken in its entirety, the transaction (loan plus investment) represented a loss. The overall transaction theory differs conceptually from the freeing of assets theory in that it confines the analysis to the financed transaction rather than to the taxpayer's overall position as positive or negative. Nevertheless, both approaches link the treatment of the debt cancellation to aspects of the consequences of the financing transaction.

In the last several decades, a consensus has emerged that the financing transaction and the purchase transaction should be viewed as separate for income tax purposes, in contrast to both the freeing of assets and the overall transaction approaches.[52] The more recent consensus focuses exclusively on the loan transaction itself, asking the question whether the cancellation causes the taxpayer to derive a benefit that would not have existed had the entire nature of the loan arrangement been known at the inception of the loan.[53] Under this approach, COD income is taxable on a kind of "tax benefit" or transactional consistency theory. Looking back from the point at which the loan is discharged to the time at which the creditor extended the loan, the cancelled portion of the loan represents an amount transferred to the borrower that would never be returned. Such a transfer constitutes an accession to wealth because it need not be returned. As an accession to wealth it is taxable, but because the fact of the accession is first known in the period of cancellation, the inclusion takes place in that period, just as any other item does that is recognized under the tax benefit theory.

Elsewhere I have criticized the tax benefit approach to COD income,[54] but the underlying intuition that the tax consequences of the cancellation should not hinge on the characteristics of the associated purchase transaction seems correct. The receipt of the cash constitutes a benefit that the borrower would pay for in the ordinary course—that is, if the loan were repaid according to its terms. When the debt is canceled, the "pay-for" disappears and the benefit becomes an accession to wealth.

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[49] Kirby Lumber.

[50] [CITE.] Now, a separate provision, section 108(a)(1)(B), excludes COD income to the extent the taxpayer is insolvent, subject to possible recapture in future years by means of reductions in tax attributes. § 108(b).

[51] Kerbaugh-Empire.

[52] B&L, ¶ __.

[53] B&L, ¶ __.

[54] David Hasen, *Debt and Taxes*, 12 COL. J. TAX L. 89, 103-04 (2021).

The analysis holds without regard to the consequences of the purchase transaction. To be sure, those consequences may wipe out the inclusion, but for separate reasons relating either to the taxpayer's overall position, such as where the taxpayer has an operating loss in excess of items of gross income, including COD income, or where Congress has for independent policy reasons chosen to exclude the COD income, such as in bankruptcy.[55]

Remaining with the idea that the cancellation triggers an item of gross income regardless of the nature of the associated purchase transaction, one might conclude that the entirety of the loan transaction similarly should be treated without regard to the fate of the loan proceeds. On this view, interest might be deductible or it might not, but whatever the answer, it would not vary according to the use to which the borrower put the loan proceeds. Two circumstances would, in turn, support a rule of deductibility. First, it seems a greater distortion to disallow a deduction for BIE than to allow one for PIE, and, secondly, liquidity, which is what the interest pays for, is not literally a consumption item; rather, in the case of consumer debt, the consumption item is what the liquidity purchases.

II. Expenses and Loans Under an Income Tax

What drives the quandary described in Part I is the apparent incompatibility of the following three propositions, all of which somehow seem to be both settled and true: 1. an income tax permits a deduction for non-personal expenses; 2. an income tax does not permit a deduction for personal expenses; and 3. an income tax treats the financing transaction separately from whatever the transaction finances.

Any two of the propositions can be true, but it seems that all three cannot. Specifically, if 1. and 2. are true, then the treatment of the financing transaction is partially dictated by what is financed and 3. is false. If 3. is true, then either 1. or 2. must be false because the treatment of the financing transaction dictates that the treatment for PIE and BIE be the same: both are either deductible or non-deductible. This part unpacks the logic behind the quandary and offers a way to dissolve it.

A. Expenses Under an Income Tax

As discussed in Part I, a normative personal income tax reaches the individual's net change in wealth during the taxable period. Net change in wealth under the widely-accepted Haig-Simons income definition equals the sum of the change in explicit on-hand resources plus amounts spent on personal consumption. The inclusion of the latter in turn reflects the idea that personal consumption is merely the transformation of the thing consumed into some personal benefit to the consumer, or what is the same, that the voluntary aspect of the conversion of wealth into a consumption experience signals that the consumer is no worse off by reason of the expenditure. If two individuals each earn $100k of salary income during the taxable period but one of them spends $30k on consumption and the other $60k, it is not

[55] § 108(a)(1)(A).

appropriate to tax them differently. One has chosen to defer more consumption than the other, but that is not a reason to tax that person more heavily.[56]

Within this framework, outlays incurred to produce income enjoy separate treatment. Amounts expended on supplies, utilities and related items to generate net positive incomes in the current taxable period must be subtracted from income to avoid overstating, perhaps dramatically overstating, the individual's true income during the period.[57] An obvious reason is that the outlay does not reflect the transformation of wealth into something of equal personal value but rather to be motivated by business exigency as a means to create wealth that at some future point will be converted into consumption (whether by the individual or by someone else of her choice). As contrasted with a home utility bill, amounts paid for electricity to run the factory do not confer a personal benefit to the taxpayer, except perhaps incidentally.[58]

Commentators have sometimes invoked the absence of a personal benefit to business outlays as a basis to conceptualize them as "losses" that must be subtracted from receipts to arrive at a proper measure of income.[59] The idea is reflected in the notion that a deduction for wear and tear or obsolescence is appropriate as an offset to income thereby produced.[60] This formulation, however, is more a source of

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[56] The point applies to the $100k earned in the period, not to returns that the saver may receive on amounts invested.

[57] The main provision in the Code that ensures a deduction is section 162(a). Section 212 provides an analogous deduction for outlays to finance income-producing activity that does not rise to the level of a trade or business. Deductions under section 212 are more limited than are those under section 162. *See* § 67(a) (generally allowing a deduction for "miscellaneous itemized deductions," (MIDs) of which the § 212 deduction is one, only to the extent they exceed 2 percent in the aggregate of the taxpayer's adjusted gross income), 67(g) (disallowing all MIDs for tax years prior to 2025).

[58] The personal/business distinction has come under fire from some quarters on the basis that it reflects a legal conclusion rather than supports one. That is, accepting that business outlays should be deductible and personal not does not always decide whether an outlay is business or personal. Tsilly Dagan has forcefully made this point with respect to commuting expenses. Tsilly Dagan, *Commuting*, 26 VA. TAX REV. 185 (2006). Commuting expenses are treated as nondeductible personal expenses, Reg. § 1.162-2(e), but the basis for the rule is the presumption that one would live near work if personal decisions played no role in where to live. Dagan, at 188. But one could equally take one's residence as given and consider commuting expenses a cost of earning income. *Id.*

Dagan's argument addresses an issue different from that raised in the text, which supposes that the outlay has been correctly classified as business or personal and then examines why allowing a deduction for the former but not the latter is appropriate.

[59] *See, e.g.*, Deborah Geier, *The Myth of the Matching Principle As a Tax Value*, 15 AM. J. TAX POL. 17, 58 (1998) (describing the role of the depreciation deduction as "allow[ing] the deduction of final, passage-of-time losses of income-producing property.").

[60] The notion is surely advanced by the general provision allowing cost recovery for depreciation, which states in relevant part: "There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) . . . ." § 167(a). *See also, e.g.*, Recent Case, *Income Taxes—Deductions—*

confusion than of clarity.[61] Business expenses do not represent true losses; if they did, business owners would not voluntarily incur them. Instead, the deduction for business expenses implements a timing principle that is justified on the basis that, at best, the outlays immediately represent a subtraction from potential personal satisfaction but only contingently, and quite possibly in a future period, will be restored. Or, more accurately, they reflect a loss in the current period that is expected to, but may not, be made good in the current or a later period. In this respect, deductions for business expenses (as contrasted with losses), simply reflect a presumption shift that is justified by the fact that the benefit they provide is speculative and mediated. The certainty of the lack of benefit now coupled with the speculative status of the benefit later (if the taxpayer is profitable) justifies allowing a provisional loss now. As contrasted with a personal outlay, the realization of a benefit requires the successful conversion of the outlay into an income item, and that conversion may never occur.

Consider that implementing the principle that an income tax reaches net changes in wealth in no way requires a deduction for business expenses. The same result could be reached (and would more obviously and directly be reached) by denying a deduction and simply adding business outlays to the cost of goods or services sold. Indeed, this principle already applies in certain cases in which Congress views the availability of an immediate deduction as inappropriate on timing grounds.[62] Apart from a possible timing mismatch (since goods or services may be sold in a later period), the capitalization of costs method directly implements the idea that an income tax reaches the taxpayer's change in wealth during the period. When already-taxed dollars are spent in an arm's-length market transaction, no change in wealth occurs. Thus, a rule that capitalizes all costs, business and personal, but allows a loss deduction only for the sale of non-personal property would yield the same basic system that a deduction regime implements.

Obsolescence of Goodwill due to National Prohibition, 40 HARV. L. REV 835, 835-36 (1940) (stating that a deduction for wear and tear or obsolescence of business use property is appropriate because of the decline in value of the asset through use or the passage of time).

[61] *See* B&L ¶ 23.1.2 (describing depreciation as a method of cost allocation, not of valuation, and approving the idea that it reflects what is in effect an annual sale of a portion of the depreciated asset). *See also* U.S. v. Ludey, 274 U.S. 295, 301 (1927) ("The theory underlying this allowance for depreciation is that by using up the plant, a gradual sale is made of it.").

[62] Section 263A requires certain taxpayers to capitalize inventory and other costs in lieu of an otherwise available business deduction. Congress enacted section 263A in TRA 1986. The Senate Finance Committee Report explains in relevant part: "[T]he existing rules may allow costs that are in reality costs of producing, acquiring, or carrying property to be deducted currently, rather than capitalized into the basis of the property and recovered when the property is sold or as it is used by the taxpayer. This produces a mismatching of expenses and the related income and an unwarranted deferral of taxes." S. Rept. 99-313, at 92 (May 29, 1986).

The lesson from all of this is that a true and final deduction is allowed only when the taxpayer sustains a loss.[63] Deductions for business outlays are nothing more than a timing rule that reflects a presumption shift: you get the loss now because the outlay itself categorically removes resources available to provide a personal benefit and only contingently makes resources available to make the current outlay good. Because amounts deducted as business expenses are not added to the cost of goods or services sold, the net effect is to recoup the loss (in whole or part) on sale of the associated business item.

These considerations indicate that no deduction for personal interest should be available under a Haig-Simons income tax that seeks merely to identify and tax income without regard to considerations of vertical equity. In other words, if the underlying norm is that income is the very thing we want to tax (and not some notion of well-being or other item associated in a nonlinear way with income), there should be no deduction for PIE. A *sine qua non* for affording a deduction for business outlays is that any associated income will be taxable. Loans to finance personal consumption generate nontaxable consumer surplus. The fact that the business deduction itself is grounded in a timing principle indicates the result. If cost recovery were implemented exclusively by adding expenses to the cost of goods and services sold, the only difference between business and personal outlays would be that a loss deduction would be available for sales at a loss, whereas no loss is available on loss realized on the sale or exchange of property used for personal purposes.[64] Given the equivalence (apart from timing considerations) of that hypothetical regime with the actual cost recovery regime, which of course permits business deductions, a normative income tax supplies no basis for a deduction for consumer interest.

B. Separating the Financing Transaction from the Purchase Transaction

The final piece of the puzzle concerns the relationship between the principle that the financing transaction is separate from the purchase transaction and the conclusion above that PIE should not be deductible even though BIE should. If the financing transaction is separate from the purchase transaction, it seems the same rule should apply to BIE and PIE, contrary to the conclusion reached in Subpart A.

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[63] Section 165 implements the deduction for losses. Although the 2017 tax reform act (TCJA) temporarily disallows deductions for personal losses, *see* § 165(h)(5), the disallowance is controversial in that it appears to be a departure from a normative income tax. *See, e.g.*, Jeffrey H. Kahn, *The Misconstruction of the Deductions for Business and Personal Casualty Losses*, 21 FLA. TAX REV. 621, 630 (2018).

[64] Section 165(a) is the general provision for deduction of losses. Section 165(c) limits the deduction for losses sustained by an individual to those incurred in connection with business activities, in the production of income and, subject to substantial limitations, from casualties. *See* § 165(h) (limitations on casualty losses). In addition, for tax years from 2018 to 2025, the TCJA eliminated the deduction for all casualty losses other than those arising in the conduct of an active trade or business or that result from certain federally-declared disasters. *See* § 165(h)(5).

The discussion in Subpart A stressed that expense deductibility turns on the purpose of the outlay in question. If the purpose is to create an asset (good or service) that will be disposed of in a market transaction, the personal benefit of the outlay presumptively disappears and is replaced by the prospect of a personal benefit that results from the market transaction, and a deduction is allowed (assuming the payment must not otherwise be capitalized[65]). If *A* pays regular employee compensation in the course of her business of advising clients, the consumption value of the services is lost to *A* because she will sell the services rather than consume them. As a general matter, *A* is entitled to a deduction. If *A* uses the services herself, no deduction is appropriate.

In fact the difference in treatment for the two types of outlay reflects different features of the tax system. The transactional approach of COD inclusion follows from the nature of the income tax as an accessions tax. Cost recovery, whether for deductible expenses or depreciable or amortizable assets, follows from administrative features of the tax that could be otherwise without changing the nature of the tax as a tax on accessions.

As discussed in the preceding subpart, expense deducibility (and, for that matter, business cost recovery more generally) results from two features of the tax system: the contingent nature of the benefit afforded and the fact that the contingency may not be resolved in the period in which the outlay is made. If one were unconcerned about the delay associated with the consequence of the payment, one could as easily deny cost recovery entirely and simply add business costs to cost of goods (or services) sold. Doing so is fully consistent with a normative income tax, which taxes all accessions but only once. If Taxpayer sells legal services and makes outlays in doing so, a normative income tax requires cost recovery.

Moreover, one can be overly concerned with the timing mismatch that a rule requiring capitalization of all business outlays would create. Permitting a deduction now when the outlay proves unprofitable in a later period properly times the taxpayer's income because what turns out to be a loss takes place in the period of the outlay; waiting until the conversion proves ineffective requires the taxpayer to treat an outlay as having produced a benefit when it hasn't. But denying a deduction now when the outlay proves profitable in a later period also is correct. Meanwhile, the possibility of error for both regimes is similarly symmetrical. Permitting a deduction now when the outlay proves profitable in a later period provides a time-value benefit, while denying a deduction now when it proves unprofitable later on provides a time-value detriment. Undoubtedly these features of the relationship between outlay and benefit lie behind the limitations that apply even to deductible payments (the regime in effect). Both cash-method and accrual-method taxpayer may deduct prepaid (or

[65] In general, business expenditures that purchase or create identifiable assets (tangible or otherwise) having a useful life beyond the taxable period may not be immediately deducted. §§ 263 (general rule for capitalization) 263A (special rules for costs of certain self-created assets) . Instead, the taxpayer must treat the cost as part of her basis and may be eligible for cost recovery over time. *See* §§ 1012 (basis is cost); 167 (cost recovery over time for certain depreciable assets).

pre-accrued) expenses only subject to fairly stringent limitations.[66] Deductions that have effects in later periods end up being accounted for like purchases of business property: not currently deductible because they purchase or create an asset that has marketable value in future periods. Indeed, at bottom the deduction for business outlays is grounded in the non-marketability of what is purchased apart from the good or service that embodies it.

In contrast to business outlays, inclusion of COD income without regard to features of the taxpayer is appropriate because COD is plainly an accession to wealth. Regardless of methods of accounting or the taxpayer's purpose in entering the financing transaction, the cancellation of the obligation to repay the loan proceeds improves the debtor's financial position relative to what it was before the cancellation. The taxpayer has moved from owning a right to use loan proceeds for the current period to the right to use them forever.

III. Interest Deductibility on Debt Incurred to Purchase or Carry Tax-Favored Investment

This Part addresses the proper treatment of BIE in light of Congress's increasingly common employment of consumption tax principles in the Tax Code.[67] The unifying theme of this Part and the preceding discussion of personal interest is the general question of how the Tax Code should treat interest, in this case when Congress has partially shifted the tax base towards consumption. In recent years, Congress has tinkered with the business interest rules as a way to guard against the tax arbitrage that arises when borrowing is taxed under income tax principles and investing is taxed under those for a consumption tax. Put slightly differently, Congress appears to have taken the view that the proper treatment of borrowing under a hybrid tax is largely ad hoc, inasmuch as BIE is normally deductible under both bases. The general question is whether Congress's approach of limiting interest deductions is an appropriate method to control the arbitrage. In what follows, I explain how the arbitrage arises, how Congress has addressed it, and why a different approach that does not tinker with the rules for BIE would be preferable.

A. Tax Treatment of BIE Under Income and Consumption Bases

As explained previously, an income tax generally provides a deduction for BIE (assuming it does not instead require capitalization of interest expenditures into costs of goods or services sold). As a general matter, a cash-flow consumption tax adopts the same approach. Under a pure version of the tax, inflows are included in the

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[66] Cash-method taxpayers may not deduct in the current year expenses that produce a material benefit in a future year. Dunn, Jr. v. IRS, 468 F. Supp. 991 (1979); Reg. § 1.461-1(a)(1) (generally denying a current-year deduction to cash-method taxpayers for outlays to the extent they produce benefits beyond the taxable year). Accrual-method taxpayers may not deduct accrued expenses before "economic performance" occurs. § 461(h).

[67] Examples include longstanding rules for the depreciation of tangible non-real property, *see* § 168(b) (double declining balance method) & 168(c) (short useful lives relative to actual economic life of certain assets), and "section 179 expensing." More recently, Congress has temporarily moved most such property to full-on consumption tax treatment by permitting taxpayers to expense it. § 168(k).

tax base and outflows, including expenses, are deducted except to the extent they pay for current-period consumption.[68] Thus, a pure cash-flow tax would permit a deduction even for purchases of consumer goods to the extent the consumption of the good took place in later tax periods (though the value consumed in later years would be included).[69]

Of particular relevance for present purposes, and as contrasted with an income base, loan proceeds are included in the cash-flow base, but a deduction is available for amounts invested.[70] BIE is deductible as an outflow not used to purchase a consumption good.[71] A taxpayer who borrows $100x would include the $100x in her consumption base because it is an inflow. However, any amounts invested, including any portion of the $100x loan proceeds, would be immediately deducted in full. Similarly, principal repayments, as outflows, are deductible.[72] Thus, in lieu of cost recovery, the tax simply follows cash to determine what is in the base (apart from cash spent on consumption), the idea being that all amounts not consumed are not part of the base.

Under a normative income tax, by contrast, loan proceeds are not includible in gross income.[73] Amounts invested are not deductible, but cost recovery is available either in the form of a deduction for the actual decline in value of business assets over time, or as described previously by adding to the cost of goods or services sold the allocable portion of business assets "converted" into those goods or services during the tax period.

It is widely accepted that the net effect of a cash-flow tax is to exempt the risk-free rate of return—the pure return to waiting—from tax.[74] In consequence, a cash-flow tax imposes a lower burden than an income tax does for any given tax rate. The advisability or not of cash-flow taxation aside, the focus here is on the consequences of combing income and consumption tax features into the actual tax base, as Congress has done. By exempting loan proceeds from income, as an income tax does, while permitting a full deduction for amounts invested, as a cash-flow consumption tax does, Congress in effect creates negative tax rates for certain types of debt-financed investment. However much one might favor consumption tax

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[68] *See, e.g.*, Andrews, *Cash Flow Tax*.

[69] *Id.*, at __.

[70] *See, e,g.*, *id.*, at __.

[71] *Id.*

[72] [CITE.]

[73] The rule is settled although the rationale is not. *See* Hasen, *Debt and Taxes*, at __ (discussing commentary). I have argued at some length that a normative income tax does not include loan proceeds in the base because the taxpayer actually purchases only the use of money (not the proceeds simpliciter) and pays full fair market value for the use by means of interest outlays. *Id.* at __.

[74] *See generally* Bankman & Weisbach for a comprehensive discussion of the properties of a cash-flow tax.

principles over income tax principles, it does not make sense to adopt a tax base with negative rates unless one is doing something other than revenue-raising through the Tax Code.

The following example illustrates. Assume that at the beginning of Year 1 *Investor* purchases *Equipment* for $50x for use in her business of manufacturing widgets. The economically useful life of *Equipment* is 10 years, properly reflected in straight-line depreciation (that is, $5x per year). Interest rates at all times are 10 percent, and tax is imposed at a flat rate of 30 percent. In all years, *Equipment* generates $10x of cash flow and, therefore, $5x of net income (*i.e.*, after depreciation). *Investor* finances *Equipment* entirely with debt. The loan is also payable at 10 percent interest during the 10-year term, with all principal due at the end of the term. To simplify, assume *Investor* puts net cash flows into a non-interest bearing bank account.

Under these assumptions, on a pretax basis, *Investor*'s annual economic income from the investment is zero (that is, $10x gross income less $5x depreciation and $5x interest) for 10 years, followed by repayment of the loan principal with the contents of the bank account. The results under both a normative income tax and a normative consumption tax would be the same. Under the income tax, there is no inclusion of loan proceeds but also no deduction on repayment; depreciation and interest expense precisely offset the gross return for zero annual income in every year. Similarly, under the consumption tax, *Investor* includes the $50x loan proceeds in Year 1 but deducts the same amount in that period for the investment. During the life of the arrangement, *Investor* has no cost recovery, but $10x annual gross inflows and $10x annual outflows ($5x interest and $5x into the bank account). Repayment triggers both an inclusion and an immediate deduction of $50x.

Under the actual hybrid tax in effect, however, *Investor* is better off on an after-tax basis. The borrowing generates a $50x current deduction and offsetting taxable income of $5x per year for 10 years (because of the denial of cost recovery in years 2 through 10), which has a present value cost of $30.72x,[75] for an after-tax benefit of $5.75x (that is, 30 percent of the difference between $50x and $30.72x). Reflecting zero real economic benefit, this amount represents a transfer from the government to *Investor*.

If the purposes of the expensing provisions do not extend to subsidizing investments in tangible property, Congress needs to adopt some mechanism to foreclose the arbitrage just described, or at least to limit it. The most significant step Congress has taken in this direction is section 163(j), which limits the deductibility of business interest expense for certain over-leveraged taxpayers. Under the provision, interest expense in excess of interest income plus 30 percent of the taxpayer's taxable

[75] This figure is the amount that would need to be invested at the outset of the 10-year period in a bank account returning 10 percent interest from which a $5x interest payment is made annually. The balance of such an account would fall to 0 at exactly the end of the 10-year term.

income (adjusted somewhat) is disallowed.[76] Amounts disallowed are carried forward to the next tax year and treated as interest paid in that year.[77]

Section 163(j) is plainly inadequate to control the arbitrage just described. It applies only to larger taxpayers[78] and, as noted, only when their indebtedness in the aggregate exceeds the relevant percentage of taxable income. It will not pick up, for example, a taxpayer with a relatively modest debt burden even though the arbitrage is fully in effect for the debt the taxpayer does carry.

As a remedy, one might recommend a strengthened interest limitation, but a better approach is probably one that is more direct.. Congress has sometimes attacked the unintended benefit that a deduction finances directly, and there may be good reasons to do so in this case. For example, section 246A limits the dividend received deduction (DRD) otherwise available to a corporate owner of stock when the stock is debt-financed.[79] It does not limit the deduction for interest paid on the debt. Similarly, section 1059 effectively recharacterizes certain distributions to corporate shareholders that are formally dividends as a return of capital, consistent with their economic substance; it does not deny the DRD itself.

Consistent with a direct approach, Congress could require a partial or full inclusion of loan proceeds for taxpayers who use borrowing to finance the purchase of property that enjoys accelerated cost recovery. That is, Congress could be consistent in its adoption of an alternative tax base for property enjoying accelerated cost recovery. To take the simplest example, a borrower would include loan proceeds in their entirety if all the borrower's business property were fully debt-financed and subject to immediate cost recovery. The borrower would deduct interest just as under the income tax, and would deduct principal as repaid, consistent with cash-flow consumption tax principles.

Of course, things become more complicated given that taxpayers typically fund only a portion of their business investments with debt and given that cost recovery often is accelerated but not to the point of pure consumption tax treatment. With respect to the first of these points, the problem of tracing becomes particularly significant. Money is fungible so that, as is widely recognized, a simple tracing rule for determining whether an item of property is debt-financed is inadequate.[80] A

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[76] § 163(j)(1). Other provisions having more general limitations also can apply. For instance, § 263A(a) and (f) require capitalization of certain interest expense paid in connection with the production of inventory. Section 267(a)(3) limits interest deductibility when the method of accounting of a related payee is such that an arbitrage arises between the timing of the interest deduction and that of the related party's inclusion.

[77] § 163(j)(2).

[78] § 163(j)(3).

[79] § 246A(a)

[80] Congress and Treasury have departed from so-called "mechanical tracing" in a number of situations, including the treatment of interest incurred to purchase or carry municipal bonds and the treatment of interest expense for taxpayers with operations both within and outside of the U.S. *See, e.g.*, __. Treasury implements this principle for interest

taxpayer that uses cash on hand to buy expensible equipment and borrows to finance day-to-day activities still makes use of the debt finance for the equipment—at least if the equipment purchase decision is affected by the availability of the debt finance for day-to-day operations. Without a rule that captures the fungibility of money, a rule for inclusion of loan proceeds in income is likely to be circumvented, especially since virtually all investment is at least partially funded with equity. The taxpayer would simply have to make sure to trace the borrowing to non-tax favored investments.

With respect to the second issue, a rule of inclusion would need to be modulated in a way that accounts for the fact that not all accelerated cost recovery takes the form of immediate expensing. For example, prior to 2018, the use of the double-declining balance method of depreciation (eventually switching to straight-line) was long in effect for most depreciable assets other than real property improvements,[81] and it is scheduled to come fully back into effect in 2027.[82] The double-declining balance method accelerates cost recovery relative to economic reality—and therefore relative to a normative income tax—but is not equivalent to expensing. Therefore a full inclusion of loan proceeds used to finance this type of property would over-correct. Instead a rule that requires some portion of the proceeds to be immediately includible (and deductible on repayment) would be appropriate.

Although both of these considerations require the introduction of some complexity, there is reason to think the complexity is manageable. On the tracing side, Treasury has already developed a similar regime for the allocation of interest expense in the international tax area, and there is no reason to think much of that approach could be not imported to the treatment of tax-favored debt finance. A rule that treats loan proceeds as includible in proportion to the tax benefit enjoyed with respect to all of the taxpayer's business property would be appropriate. With respect to the partial nature of the benefit where accelerated recovery short of expensing was available, a partial inclusion also would be appropriate. Thus, if the double-declining balance method provides twenty percent of the timing benefit that expensing does, then one-fifth of the amount of the loan proceeds that would be includible and deductible on repayment under full expensing would be so treated.

As a final observation, offsetting this complexity would be the simplification from dispensing with computations that provisions such as section 163(j) require. Business interest would remain fully deductible in all cases.

Conclusion

[And that's what I think about that.]

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expense of taxpayers that conduct business activity both within and outside the U.S. Regulations section 1.869-1T states in part: "The method of allocation and apportionment for interest set forth in this section is based on the approach that, in general, money is fungible and that interest expense is attributable to all activities and property regardless of any specific purpose for incurring an obligation on which interest is paid."

[81] § 168(b)(1).

[82] § 168(k)(6)(A).