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The Deceptively Disparate Treatment of Business and Investment Interest Expense Under a Cash-Flow Consumption Tax and a Schanz-Haig-Simons Income Tax

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I. INTRODUCTION

A cash-flow consumption tax is assessed annually on individuals. In simplified terms, the base is calculated for each taxpayer by combining the year's gross receipts and savings withdrawals and then subtracting the year's business and investment expenses and the year's additions to savings.[1] Progressive rates are applied to the resulting sum.[2] These computations are intended to confine the cash-flow tax burden to an individual's annual consumption and to remove nonconsumption expenses and current savings from the tax base.[3]

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1. See 1 U.S. Treas. Dep't, Tax Reform for Fairness, Simplicity and Economic Growth 191-93 (1984) [hereinafter Treasury I]; U.S. Treas. Dep't, Blueprints for Basic Tax Reform 113-43 (1977) [hereinafter Blueprints]. For lawyers, at least, the leading explanation and defense of a cash-flow consumption tax is still William D. Andrews, A Consumption-Type or Cash Flow Personal Income Tax, 87 Harv. L. Rev. 1113 (1974).

2. A flat-rate could be employed instead of progressive rates under a cash-flow tax. See Treasury I, supra note 1, at 191. But if a flat-rate consumption tax were desired, it would generally be much simpler to use a value added tax, which cannot practically employ progressive rates, instead of the more complex cash-flow tax. See J. Clifton Fleming, Jr., Scoping Out the Uncertain Simplification (Complication?) Effects of VATs, BATs and Consumed Income Taxes, 2 Fla. Tax Rev. 390, 419-21 (1995). Thus, a cash-flow consumption tax is often understood as implying progressive rates. See Michael J. Graetz, Implementing a Progressive Consumption Tax, 92 Harv. L. Rev. 1575, 1579 (1979). Nevertheless, the cash-flow consumption tax examples in this article will all assume a flat-rate tax in order to simplify the analysis.

3. See ABA Section of Taxation Committee on Simplification, Complexity and the Personal Consumption Tax, 35 Tax Law. 415, 416 (1982); Blueprints, supra note 1, at 113, 135.

By contrast, the base for a theoretically correct Schanz-Haig-Simons (SHS) income tax[4] is each individual's annual consumption plus current additions to savings.[5] Thus current receipts which are otherwise taxable remain in the tax base, even if they are saved, and withdrawals from earlier savings are not currently taxed since they were assessed in a prior year.[6] Stated differently, the SHS tax base has two components—current consumption and current savings (including current appreciation accruing to earlier investments)—whereas a cash-flow consumption tax has only a single component—current consumption.[7]

In spite of their differences, however, both a cash-flow consumption tax and an SHS tax require that dollars paid out as business or investment expenses be eliminated from the base. This is necessary under a cash-flow consumption tax because business and investment expenses are not consumption[8] and it is necessary under an SHS tax because these expenditures are neither consumption nor additions to savings.[9] Since business and investment outlays have no place in the base of either tax, intuition suggests that

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4. We are accustomed to applying the name "Haig-Simons" to a classical accretion income tax. But before Robert Haig and Henry Simons had popularized an income tax base equal to the sum of consumption and savings, Georg Schanz had already advocated a similar approach. (For those who are curious about Schanz's formulation, get out your German-English dictionaries and see Georg Schanz, Der Einkommenbegriff und die Einkommensteuergesetze, 13 Finanz Archiv 23 (1896).) Thus, fairness suggests that Schanz's name should be linked with Haig and Simons and should come first. Schanz-Haig-Simons is, however, a mouthful and this article will use the abbreviation "SHS." Although, the present federal income tax is often described as an SHS system, it departs in many ways from the SHS model. See, e.g., Jerome Kurtz, The Interest Deduction Under Our Hybrid Tax System: Muddling Toward Accommodation, 50 Tax L. Rev. 153, 158-61 (1995); Edward J. McCaffery, Tax Policy Under a Hybrid Income-Consumption Tax, 70 Tex. L. Rev. 1145, 1149-55 (1992); Andrews, supra note 1, at 1128-40.

5. The most famous description of the SHS tax base is the following: "Personal income may be defined as the algebraic sum of (1) 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).

6. See Joseph M. Dodge et al., Federal Income Tax: Doctrine, Structure and Policy 27, 33 (1995); Andrews, supra note 1, at 1116.

7. Kurtz, supra note 4, at 161; Treasury I, supra note 1, at 191; ABA, Sec. of Tax'n, supra note 3, at 416; Alvin C. Warren, Jr., Would a Consumption Tax Be Fairer Than an Income Tax?, 89 Yale L.J. 1081, 1084 (1980); Blueprints, supra note 1, at 2, 113. "The income-versus-consumption tax debate is about the treatment of savings." McCaffery, supra note 4, at 1155.

8. See David F. Bradford, Untangling the Income Tax 94, 96 (1986); Blueprints, supra note 1, at 119-20; Andrews, supra note 1, at 1149, 1151. See also, Treasury I, supra note 1, at 191; ABA, Sec. of Tax'n, supra note 3, at 419.

9. Alvin C. Warren, Jr., Accelerated Capital Recovery, Debt, and Tax Arbitrage, 38 Tax Law. 549, 557 (1985); Blueprints, supra note 1, at 3, 64, 133; Stanley S. Surrey, Pathways to Tax Reform 20-21, 259 (1973). See also Simons, supra note 5, at 54.

business and investment interest expenses would be treated identically under a cash-flow consumption tax and an SHS tax. But they are not. This article will investigate why the SHS tax and the cash-flow consumption tax take different structural approaches to the treatment of business and investment interest outlays in spite of the fact that both systems share the general objective of removing current business and investment costs from the tax base.[10]

II. CASH-FLOW CONSUMPTION TAX TREATMENT OF BUSINESS AND INVESTMENT INTEREST EXPENSE

The relevant literature uniformly concludes that there are two theoretically correct, economically equivalent methods for handling interest expense under a cash-flow consumption tax—(1) give the debtor a deduction for *both* interest expense and principal payments if the borrowed funds are included in the debtor's tax base (the Inclusion/Deduction approach) and (2) deny the debtor a deduction for *both* interest expense and principal payments if the borrowed funds are excluded from the tax base (the Exclusion/No Deduction alternative).[11] At the theoretical level, at least, these alternatives are regarded as applicable regardless of whether the borrowed money is put to a personal use or applied to an income-producing activity.[12]

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10. This article does not address the issue of whether an SHS tax should allow a deduction for interest on debt incurred to finance personal consumption. With respect to that controversy, see, e.g., Kurtz, supra note 4; Marvin A. Chirelstein, Federal Income Taxation: A Guide to the Leading Cases and Concepts 164-69 (7th ed. 1994); Stanley A. Koppelman, Personal Deductions Under an Ideal Income Tax, 43 Tax L. Rev. 679, 713-28 (1988); William D. Andrews, Personal Deductions in an Ideal Income Tax, 86 Harv. L. Rev. 309, 376 (1972). Nor does this article address the controversy over whether interest expense incurred on debt related to tax favored income should be deductible under an SHS tax against only the favored income. See, e.g., Chirelstein, supra, at 130-33; Calvin H. Johnson, Is an Interest Deduction Inevitable?, 6 Va. Tax Rev. 123 (1986); Surrey, supra note 9, at 259-63.

11. Kurtz, supra note 4, at 164; Warren, supra note 9, at 553 n.16; ABA, Sec. of Tax'n, supra note 3, at 417-18; Blueprints, supra note 1, at 124-25, 135; Graetz, supra note 2, at 1600, 1618-19; Andrews, supra note 1, at 1137, 1154-55. It must be noted, however, that the theoretical equivalence of these two methods for handling debt under a cash-flow tax is dependent on conditions, such as constant tax rates, that may not always exist in the real, nontheoretical world. See generally Warren, supra note 9, at 551-52; ABA, Sec. of Tax'n, supra note 3, at 418; Graetz, supra note 2, at 1600, 1602. Nevertheless, this caveat is not discussed herein because this article focuses on whether doctrines applicable to a perfectly functioning cash-flow consumption tax demonstrate that business and investment interest should be nondeductible under an SHS tax.

12. See authorities cited supra note 11.

III. SHS TREATMENT OF BUSINESS AND INVESTMENT INTEREST EXPENSE

An SHS regime provides a sharp contrast to the cash-flow consumption tax's alternatives for handling business and investment interest expense. First, an SHS tax does not have alternative methods. There is only one SHS approach to business and investment interest outlays. Under this single approach, genuinely borrowed amounts are never included in the tax base[13] but the related interest expense is, nevertheless, deductible if the borrowed funds are used for income producing purposes.[14] Clearly, this SHS allowance of a deduction for interest expense with respect to debt excluded from the tax base is a construct that fits neither the Inclusion/Deduction approach nor the Exclusion/No Deduction option for handling interest payments under a cash-flow consumption tax.

IV. WHY IS INTEREST DEDUCTIBLE IN AN SHS REGIME EVEN THOUGH THE RELATED DEBT IS EXCLUDED FROM THE TAX BASE?

The preceding observation raises the central issue of this article. It is settled that a fully-implemented SHS income tax would exclude all bona fide borrowing from the tax base but would, nevertheless, allow an explicit deduction for interest paid on debt employed in business activities and investments.[15] This is because debt used in this way would generate gross income inclusions from which related interest expense should be subtracted to arrive at the net amount available for consumption or saving. But is this settled view correct in light of the cash-flow tax command that there be no explicit interest deduction, not even with respect to debt employed in profit-making activities, if the debt proceeds are excluded from the tax base at the time of the borrowing? Does the cash-flow tax teach that one of the most accepted conventions of SHS taxation—deductibility of business and investment interest outlays—is wrong and that all interest expense should be nondeductible in an SHS regime since all bona fide debt is excluded from the tax base? An answer to this question requires a closer look at the operation of a cash-flow consumption tax.

V. BORROWING UNDER A CASH-FLOW CONSUMPTION TAX

The effects of the apparently disparate approaches to handling borrowing under a cash-flow consumption tax can be illustrated in a debt-financed consumption setting by considering their application to the following example:

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13. See Andrews, supra note 1, at 1137.
14. See, e.g., Chirelstein, supra note 10, at 129, 164-65; Kurtz, supra note 4, at 159; Warren, supra note 9, at 557-59; Surrey, supra note 9, at 259.
15. See authorities cited supra note 14.

Example 1: Individual A wishes to engage in $100 of debt-financed consumption on 1/1/1. The loan principal and 10% interest will be due on 1/1/2. A 40% flat-rate cash-flow consumption tax is applicable. Assume that the tax is immediately payable whenever a tax base item is received[16] and that 10% per annum is the correct interest rate for time value of money calculations.

Illustration 1A—Inclusion/Deduction: A's borrowing goes into the tax base on 1/1/1 so that a 40% tax is immediately due. Thus, A must borrow $166.67 on 1/1/1, pay a $66.67 tax ($166.67 x .40)[17] and consume the remaining $100. On 1/1/2, A earns $183.34 of wages and pays off the lender ($166.67 of principal and $16.67 of interest). Because A is allowed a full deduction for this payment, no tax is due on the 1/1/2 wages. Consequently, $183.34 of earnings has been required to support $100 of debt-financed consumption and $66.67 of tax has been paid.

Illustration 1B—Exclusion/No Deduction: A's borrowing is excluded from the tax base so that she needs to borrow only $100 which she immediately consumes on 1/1/1. Since her 1/1/2 $110 payment ($100 of principal and $10 of interest) to the lender is nondeductible, she must earn $183.34 of taxable wages on 1/1/2, pay a $73.34 tax ($183.34 x .40) and pay the remaining $110 of after-tax wages to the lender.

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16. This assumption applies throughout the examples in this article. It creates an obvious departure from a real-world cash-flow consumption tax because in the real world, tax liability would be computed on the basis of sumative computations made at the end of a 12 month accounting period and tax would be payable after the close of the period. Nevertheless, this assumption is employed because it reduces the number of time value of money adjustments that are required. Additionally, this assumption eliminates the need to deal with distortions that can occur where a debt-financed investment is made at the beginning of a year and then liquidated at the close of the same year under a cash-flow regime that calculates tax exclusively at year-end. For examples, see ABA, Sec. of Tax'n, supra note 3, at 424; Graetz, supra note 2, at 1604. Furthermore, this assumption does not interfere with the basic inquiry of this article which is whether a perfectly functioning cash-flow consumption tax demonstrates that the deduction of business and investment interest should be disallowed in an SHS regime.

17. The examples in this article assume that funds used to pay the tax are, themselves, included in the tax base. This is the approach employed in the current federal income tax and it is followed here because it is familiar and it does not distort the results of the simple examples used in this article. Thus, to have $100 for consumption after tax, A must borrow $166.67 before tax ($166.67 - [$166.67 x .40] = $100). For a discussion of this issue in the context of a more complex cash-flow consumption tax, see ABA, Sec. of Tax'n, supra note 3, at 431-33; Graetz, supra note 2, at 1582-84.

In other words, both approaches to the treatment of borrowing require $183.34 of wages to support $100 of debt-financed consumption. Granted, the tax payments in the two scenarios look different—$66.67 in Illustration 1A and $73.34 in Illustration 1B. The difference is illusory, however, because the $66.67 tax is due on 1/1/1 while the $73.34 tax is paid on 1/1/2. Applying our 10% interest assumption, $66.67 is simply the 1/1/1 cost of a $73.34 payment on 1/1/2. Consequently, in present value terms, the amount of tax paid under the two approaches to handling debt-financed consumption is identical in each case.[18]

Thus, a comparison of the two methods for handling debt-financed consumption under a cash-flow tax shows that they are indeed equivalent in terms of wages required to fund consumption and in terms of tax liability. For purposes of this article, however, it is more important to note that these approaches have an additional point of equivalence. To be specific, under our 10% after-tax interest assumption, the $183.34 of principal and interest that is deducted on 1/1/2 in Illustration 1A has a 1/1/1 value of $166.67 which exactly equals the $166.67 of loan proceeds that were included in the 1/1/1 tax base in Illustration 1A. In other words, the 1/1/2 deduction of principal

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18. See Blueprints, supra note 1, at 124-25.

An alternative way to understand the equivalence of the tax payments in Illustrations 1A and 1B is to note that at the time money is borrowed on fair-market terms, the principal amount of the loan equals the present value of the wages required to pay off the loan principal and interest at maturity. See Dodge et al., supra note 6, at 411-12, 414. Thus, in present value terms, a tax on the loan proceeds at the time of borrowing (as occurs under the Inclusion/Deduction approach) is equal to a tax on the wages required to pay the principal and interest ultimately due on the loan (as occurs under the Exclusion/No Deduction method). See Blueprints, supra note 1, at 133.

Yet another way to see the equivalence of the tax payments in Illustrations 1A and 1B is to note that if individual A had used 1/1/1 wages to finance her $100 of 1/1/1 consumption, $166.67 of 1/1/1 wages would have been required. The treasury would have immediately collected a $66.67 tax ($166.67 x .40) and would have had no further financial interest in A's consumption out of those wages. Debt-financed consumption works in a similar way under a cash-flow tax. Thus, in Illustration 1A, individual A used $66.67 out of $166.67 of loan funds to make the 1/1/1 tax payment. At that point, the treasury's financial interest in A's consumption use of the borrowed $166.67 was fully satisfied. When A earned $183.34 on 1/1/2 and paid off the lender ($166.67 of principal and $16.67 of interest), no tax liability should have attached because the treasury's claim was fully satisfied by the 1/1/1 tax payment out of borrowed funds. The only way to achieve this correct result is to allow A to offset the $183.34 of 1/1/2 wages with a 1/1/2 deduction for the $183.34 payment of principal and interest to the lender. This is precisely what the Inclusion/Deduction approach does. By contrast, in Illustration 1B, the exclusion of A's borrowed funds from the tax base allowed A to finance the $66.67 tax payment due on the $100 of 1/1/1 consumption by effectively borrowing the $66.67 from the treasury until 1/1/2. Accordingly, under our 10% after-tax interest assumption, A owed $73.34 to the treasury on 1/1/2. A's 1/1/2 tax payment of that amount satisfied this obligation.

and interest effectively offsets the 1/1/1 inclusion of loan proceeds so that the taxpayer is left as if none of the borrowed money had been taxed in Illustration 1A.[19]

Conversely, the $100 of loan proceeds excluded from A's income on 1/1/1 in Illustration 1B has a 1/1/2 value of $110 – exactly equal to the nondeductible amount of principal and interest paid to the lender on 1/1/2. Thus, the 1/1/1 exclusion of principal and the 1/1/2 nondeduction of principal and interest cancel each other and leave A as if the $100 borrowing had never affected the tax base in Illustration 1B.[20]

In short, both methods for handling debt-financed consumption under a cash-flow consumption tax effectively eliminate consumer borrowing from the tax base even though the Inclusion/Deduction method (Illustration 1A) engages in the formality of treating loan funds as income in the borrowing year.[21] The result is the same–i.e. borrowing is effectively eliminated from the tax base–where the loan funds are used for business or investment purposes.[22] Nevertheless, the allowance of an interest expense deduction under the Inclusion/Deduction method (Illustration 1A) is not based on the rationale that the interest is an income producing cost. This is clearly apparent from the fact that the deduction permitted in Illustration 1A relates to consumer debt.

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19. See Blueprints, supra note 1, at 133.

20. See Blueprints, supra note 1, at 124-25, 133. As mentioned in the text at supra note 17, the $73.34 tax paid in Illustration 1B is simply the 1/1/2 value of the $66.67 tax paid on 1/1/1 in Illustration 1A.

21. What, then, is included in the cash-flow tax base with respect to debt-financed consumption? Illustrations 1A and 1B show that the 40% tax actually applies to the taxpayer earnings that are ultimately used to pay for the consumption and tax thereon. (As indicated in supra note 16, Example 1 assumes that funds used to pay tax are included in the tax base.) Thus, in Illustration 1A, the $100 of 1/1/1 consumption and the applicable tax were ultimately paid for with $183.34 of 1/1/2 wages when the debt was retired. Forty percent of $183.34 is $73.34 which, under our 10% after-tax interest assumption, is simply the 1/1/2 value of the $66.67 tax that was paid with borrowed money on 1/1/1. In other words, in 1/1/2 value terms, the 1/1/1 tax paid in Illustration 1A equals 40% of the $183.34 of 1/1/2 wages used to fund the 1/1/1 consumption and tax thereon. To complete this analysis, note that the 60% after-tax portion of the $183.34 wages is $110, which is merely the 1/1/2 value of the $100 consumed on 1/1/1.

Likewise, in Illustration 1B, the 1/1/1 consumption was ultimately paid for with $183.34 of 1/1/2 wages when the taxpayer delivered $110 to the lender and $73.34 to the treasury on 1/1/2. This $73.34 1/1/2 tax payment is simply 40% of the $183.34 of 1/1/2 wages used to pay off the lender and the tax collector. The 60% after-tax portion of the $183.34 1/1/2 wages is $110, which equals the 1/1/2 value of the $100 consumed on 1/1/1.

To recapitulate, Illustrations 1A and 1B show that both methods for handling debt-financed consumption under a cash-flow tax have the effect of (1) excluding the consumer debt from the tax base and (2) applying the tax to the earnings that are ultimately used to pay for the consumption and the tax thereon.

22. See authorities cited supra note 11; Blueprints, supra note 1, at 133.

Instead, interest expense is deductible under the Inclusion/Deduction method because the deduction is a component of a mechanism which effectively eliminates from the cash flow tax base the earlier inclusion of related loan proceeds.

VI. THE NEED FOR A BUSINESS AND INVESTMENT INTEREST EXPENSE DEDUCTION UNDER AN SHS TAX

Unfortunately, a deduction for business and investment interest outlays cannot be explained under an SHS tax as a mere component of a mechanism which cancels out the earlier tax base inclusion of borrowed money. This is because bona fide loan proceeds are always excluded from SHS income on the front end[23]—no back end mechanism is needed to negate an earlier inclusion. Thus, the cash-flow tax justification for an interest deduction does not work under an SHS regime. Nevertheless, a deduction for business and investment interest outlays is required under an SHS tax regardless of the fact that the related debt is not part of the SHS base. Example 2 illustrates this seeming conflict between the treatment of business and investment interest expenses under a cash-flow consumption tax and an SHS tax.

> *Example 2:* Individual A borrows $100 on 1/1/1. The loan principal and 10% interest are due on 1/1/2. A uses the borrowed money to make a 1/1/1 purchase of a bond paying $100 of principal and 10% interest on 1/1/2. An SHS tax regime is applicable. Thus, the $100 of loan proceeds are excluded from gross income and A takes a $100 basis in the bond. On 1/1/2, A collects $100 of bond principal that is offset by her $100 basis and she makes a nondeductible $100 principal payment to the lender. On 1/1/2, A also collects $10 of bond interest but there is no profit because A must pay $10 of 1/1/2 interest expense to her lender. Under a cash-flow consumption tax, A would not be allowed to deduct the $10 1/1/2 interest expense because the related debt was excluded from her 1/1/1 income. But the bond investment is an economic wash and the only way to make the SHS tax system reflect this fact is to allow A a $10 1/1/2 deduction. Denial of the deduction for interest expense leaves A with $10 of taxable income from an investment that yielded no economic gain. Thus, the correct SHS answer requires A to be allowed a deduction for her 1/1/2 interest outlay regardless of the 1/1/1 exclusion of the loan proceeds for her tax base.[24]

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23. See Andrews, supra note 1, at 1137.
24. See Warren, supra note 9, at 557-59.

Why does Example 2 work this way? To some thoughtful analysts, the answer comes quickly because it flows obviously from a simple metaphor—borrowing is negative saving and since the positive return on positive saving (interest income) is part of SHS income, the negative return on negative saving (interest expense) is clearly deductible in computing the SHS tax base.[25] This metaphor does not, however, readily explain the apparent conflict between the SHS system, which allows an interest deduction in Example 2, and a cash-flow consumption tax, which would not allow an interest deduction in Example 2 inasmuch as the related debt is excluded from A's income. In addition, the preceding metaphor would compel an unlimited deduction for personal interest expense[26] under the current federal income tax, and this result is strenuously resisted by some thoughtful commentators.[27] For these reasons, this article chooses not to rely on a metaphorical justification for the outcome of Example 2. Instead, this article looks for an explanation that (1) reveals why Example 2 correctly gives rise to an interest expense deduction when a cash-flow consumption tax would deny a deduction but (2) does not require the controversial conclusion that personal interest should be deductible under the current federal income tax.

The explanation that seems to satisfy the foregoing criteria is that Example 2 mandates a $10 interest expense deduction simply because the related $10 of 1/1/2 bond interest is includable in A's SHS income. This is dramatically different from life under a cash-flow consumption tax which effectively exempts income from property so that there is no need to deduct related interest expense in order to arrive at net income.

VII. DEBT-FINANCED INVESTMENT UNDER A CASH-FLOW CONSUMPTION TAX: THERE'S MORE GOING ON THAN MEETS THE EYE

The validity of the preceding explanation can be usefully tested by starting with a consideration of the cash-flow tax's handling of cash investments. Discussions of the cash-flow consumption tax typically recognize that investments can be accounted for thereunder with equivalent results by either (1) allowing a deduction for the cost of the investment but taxing all of the returns (including recovery of "principal") when consumed (the Deduction/Return Inclusion method) or (2) disallowing a deduction for the investment's cost but excluding all returns thereon from the tax base (the

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25. See Melvin I. White, Proper Income Tax Treatment of Deductions for Personal Expense, 1 Comm. on Ways and Means, Tax Revision Compendium 365, 366 (Comm. Print 1959).

26. See id.

27. See, e.g., Kurtz, supra note 4, at 230-33; Johnson, supra note 10, at 127-29.

No Deduction/Return Exclusion method).[28] For purposes of this article, the most important point about these two alternatives is that when tax rates are constant, they both exclude returns on capital from the tax base.[29] The exclusion is implicit under the Deduction/Return Inclusion method and explicit under the No Deduction/Return Exclusion method. Example 3 illustrates these points.

> *Example 3*: Individual A has $166.67 of 1/1/1 taxable wage income
> to invest pursuant to the Deduction/Return Inclusion alternative under
> a 40% cash-flow consumption tax that is immediately payable on tax
> base items.[30] Ten percent per annum is the correct interest rate for
> time value of money calculations. If A decides to consume the
> $166.67, she will deliver $66.67 of tax to the treasury ($166.67 x
> .40) and will have $100 left for consumption. But on 1/1/1, she uses
> her wages to purchase a $166.67 face amount bond which pays
> principal and 10% interest on 1/1/2. Since the amount paid for the
> bond is deductible, the taxpayer does not incur a 1/1/1 $66.67 tax
> and she has the full $166.67 available for investment. She collects a
> total of $183.34 ($166.67 principal and $16.67 interest) on 1/1/2,
> pays a $73.34 tax ($183.34 x .40) and has $110 left. Now assume
> that A makes the 1/1/1 bond purchase under the No Deduction/Return
> Exclusion approach. In this scenario, she does not claim a deduction
> for the purchase price and the tax applies. Thus, she pays $66.67 of
> her $166.67 of wages to the treasury on 1/1/1 ($166.67 x .40 =
> $66.67) and uses the $100 remainder to buy the bond. On 1/1/2 she
> collects $110 of principal and interest, pays no tax thereon and has
> the full $110 available for consumption—the same result as under the
> Deduction/Return Inclusion alternative.[31] (Furthermore, the tax
> payments are the same in both situations when measured on a present
> value basis—the $73.34 tax paid on 1/1/2 under the Deduction/Return

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28. See Kurtz, supra note 4, at 163; Dodge et al., supra note 6, at 416-20; Bradford, supra note 8, at 68; Warren, supra note 9, at 551-52; Treasury I, supra note 1, at 191, 194; ABA, Sec. of Tax'n, supra note 3, at 417-18; Blueprints, supra note 1, at 123; Andrews, supra note 1, at 1126, 1150. See also Nicholas Kaldor, An Expenditure Tax 76-77, 196-98 (1955).

29. See William D. Andrews, Fairness and the Personal Income Tax: A Reply to Professor Warren, 88 Harv. L. Rev. 947, 954 (1975); Alvin C. Warren, Jr., Fairness and a Consumption-Type or Cash Flow Personal Income Tax, 88 Harv. L. Rev. 931, 938-41 (1975) and authorities cited supra note 28.

30. See supra note 16.

31. See Bradford, supra note 8, at 68; ABA, Sec. of Tax'n, supra note 3, at 417. For a discussion of the conditions that must exist in order for these equivalent results to occur, see Warren, supra note 9, at 551-52; ABA, Sec. of Tax'n, supra note 3, at 418, 425; Graetz, supra note 2, at 1601-02; Andrews, supra note 29, at 953.

Inclusion alternative is simply the 1/1/2 value of the $66.67 tax paid on 1/1/1 under the No Deduction/Return Exclusion approach.[32] This means that the higher tax due under the Deduction/Return Inclusion alternative is actually the same as under the No Deduction/Return Exclusion approach but with an interest charge imposed for the later payment.) In short, capital income is expressly excluded from the tax base by the No Deduction/Return Exclusion method and is effectively excluded from the tax base by the Deduction/Return Inclusion approach.[33]

The preceding analysis has the same effect with respect to income in an active business setting. Example 4 illustrates this point.

> *Example 4*: As in Example 3, individual A has $166.67 of 1/1/1 wages that would be subject to a 40% cash-flow consumption tax that is immediately payable on tax base items.[34] Ten percent per annum is the correct interest rate for time value of money calculations. However, the wages are used on 1/1/1 to pay current business expenses of a one-shot venture conducted by A as a sole proprietor. Since these expenses are deductible, no 1/1/1 tax is due on the wages and A has the full $166.67 available to put into the venture. This is the only capital involved. The venture terminates on 1/1/2 and yields a 10% profit so that total proceeds from the enterprise are $183.34 ($166.67 + [.10 x $166.67]). A pays a $73.34 tax ($183.34 x .40) at that point and has $110 left for consumption. The same result would occur if no deduction were allowed for the 1/1/1 expenses but the venture proceeds received on 1/1/2 went untaxed. With no 1/1/1 deduction, a $66.67 1/1/1 tax would be due ($166.67 x .40) and only $100 would be available to fund the 1/1/1 expenses of the one-shot venture. Assuming a 10% profit, the enterprise would yield $110 of tax-free proceeds on 1/1/2 and A could consume $110—the same result as when the 1/1/1 expenses were currently deducted and the 1/1/2 venture proceeds were taxed. Furthermore, the tax liabilities are the same on a present value basis under the two alternatives for handling the business expenses.[35]

Examples 3 and 4, when combined with Example 1, demonstrate that there are two factors at work in the cash-flow consumption tax's treatment of debt-financed business expense and debt-financed investment. First, the

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32. See Blueprints, supra note 1, at 123.
33. See authorities cited supra note 28.
34. See supra note 16.
35. See supra text accompanying note 32.

two methods for handling yields (Deduction/Return Inclusion and No Deduction/Return Exclusion) have the effect of excluding capital income from the tax base.[36] Second, the two methods for handling debt (Inclusion/Deduction and Exclusion/No Deduction) have the effect of excluding borrowing from the tax base.[37] This means that the explicit interest deduction allowed under the Inclusion/Deduction method is part of the mechanism for removing debt from the cash-flow consumption tax base and is not part of the computation of net taxable income from capital because business and investment capital income is fully excluded from the base by the normal workings of the cash flow tax. This proposition is illustrated by Example 5.

> *Example 5*: Individual A borrows $100 on 1/1/1 with which to pay 1/1/1 current business expenses of a one-shot venture conducted by A as a sole proprietor. No other capital is involved in the enterprise. The loan principal and 10% interest are due on 1/1/2. A 40% cash-flow tax is immediately payable on tax base items.[38] Assume that the correct interest rate for time value of money computations is 10%. On 1/1/2 the venture terminates and yields $110 of proceeds which are immediately delivered to the lender in satisfaction of A's principal and interest obligation. The venture is an economic wash and no tax should be due. Both methods for handling the loan reach this result.

> *Illustration 5A—Inclusion/Deduction*: A's $100 borrowing goes into the tax base on 1/1/1 but A gets a simultaneous $100 business expense deduction because the $100 outlay is like savings or investment—i.e. it is not consumption. Consequently, no 1/1/1 tax is due.[39] Indeed, $40 of 1/1/1 tax is saved because of the deduction. On 1/1/2, A adds the $110 of venture proceeds to the tax base but claims an offsetting $110 deduction for her payment to the lender of $100 of principal and $10 of interest. Accordingly, there is no 1/1/2 tax liability. In fact, it looks like $44 of 1/1/2 tax is averted by the 1/1/2 deduction. But something different has actually happened. Since the initial proceeds of a market rate loan have a present value equal to the principal and interest ultimately due thereon,[40] the $110 of 1/1/2 deductible principal and interest is nothing more than the 1/1/2 value of the $100 borrowed on 1/1/1. This means that the 1/1/2 principal and interest deduction of $110 merely appeared to shelter

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36. See supra text accompanying notes 28-31.
37. See supra text accompanying notes 18-22.
38. See supra note 16.
39. See ABA, Sec. of Tax'n, supra note 3, at 422.
40. See Dodge et al., supra note 6, at 411-12, 414.

the $110 of venture proceeds from a 1/1/2 tax of $44. No 1/1/2
shelter was needed for the venture proceeds because the 1/1/1 $100
business expense deduction had already effectively removed the $110
of 1/1/2 proceeds from the tax base.[41] Instead, the actual effect of
the 1/1/2 deduction is to cancel the 1/1/1 inclusion of loan pro-
ceeds.[42] In other words, the 1/1/2 $110 deduction for the principal
and interest payment retroactively removed the $100 of 1/1/1
borrowed money from the tax base and the $100 1/1/1 business
expense deduction prospectively eliminated the $110 of 1/1/2 venture
proceeds from the tax base.

Illustration 5B—Exclusion/No Deduction: The $100 borrow-
ing does not go into the 1/1/1 tax base. (This effectively offsets the
nondeduction of the 1/1/2 $110 principal and interest payment.)[43]
Nevertheless, A gets a 1/1/1 deduction for the $100 business
expenditure. This deduction shelters $100 of otherwise taxable 1/1/1
wages and saves $40 of 1/1/1 tax. On 1/1/2, A adds the entire $110
of venture proceeds to the tax base. There is no offsetting deduction
for the 1/1/2 principal and interest payment because the 1/1/1
exclusion of the borrowed $100 has eliminated the need for the 1/1/2
principal and interest deduction. But this means that the 1/1/2 tax
base is $110 and that A incurs a $44 1/1/2 tax. However, under our
10% interest assumption, the $40 of 1/1/1 tax savings from the 1/1/1
business expense deduction have a $44 1/1/2 value that effectively
reduces A's tax liability to zero—the same as in Illustration 5A.[44]

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41. See supra text accompanying notes 28-35. An alternative way to make this point
is to note that the 1/1/1 $100 business expense deduction sheltered $100 of otherwise taxable
1/1/1 wages and produced a $40 1/1/1 tax saving. The 1/1/2 value of this saving is $44, which
exactly cancels out the tax that would otherwise be due on the $110 of venture proceeds once
the 1/1/2 deduction for the $110 principal and interest payment is understood as sheltering the
1/1/1 loan amount instead of the 1/1/2 venture proceeds.

42. See Blueprints, supra note 1, at 133; supra text accompanying notes 19-22.

43. See supra text accompanying notes 19-20.

44. Some analysts and commentators have argued that taxpayers should not be
permitted to use the Exclusion/No Deduction approach with respect to loans that finance
deductible investments because the creation of current savings deductions with excludable
borrowed money would create an appearance problem, would permit tax deferral that disrupts
the timing of government receipts and would result in tax savings if the taxpayer were in a
lower bracket in the year that the investment is liquidated and the loan is paid off. See
Treasury I, supra note 1, at 192; ABA, Sec. of Tax'n, supra note 3, at 435. See also Graetz,
supra note 2, at 1606-09. These arguments and any responses are outside the scope of this
article. The point of Illustration 5B is simply that the Exclusion/No Deduction treatment of
borrowing can be combined with current deduction of business and savings outlays to produce
a theoretically correct result when tax and interest rates are constant.

In other words, the $100 1/1/1 business expense deduction effectively eliminated the $110 1/1/2 venture proceeds from the tax base.[45]

The 1/1/2 interest deduction allowed in Illustration 5A, when coupled with the 1/1/2 $100 principal deduction, simply equals the 1/1/2 value of the $100 of loan proceeds that were included in the 1/1/1 tax base. Stated differently, the 1/1/2 interest expense deduction in Illustration 5A is not grounded on the view that it is a current expense of A's one-shot venture. The 1/1/2 interest deduction is simply part of a 1/1/2 adjustment that cancels out the 1/1/1 debt inclusion, thus effectively excluding the loan proceeds from the tax base so that Illustration 5A constructively accomplishes the same result that is directly accomplished by the explicit 1/1/1 exclusion of the debt proceeds in Illustration 5B. If the rationale for allowing the 1/1/2 interest deduction in Illustration 5A were that the interest expense was a cost of the venture that had to be deducted in order to calculate the venture's net yield, then the same rationale would require a $10 1/1/2 interest expense deduction in Illustration 5B so that the 1/1/2 tax base would be $100 instead of $110. This would create a $40 1/1/2 tax liability which, when matched against the $44 1/1/2 value of the 1/1/1 tax savings, would leave A with $4 of net tax savings instead of the tax wash that she ought to have.

To recapitulate, the explicit interest deduction in Illustration 5A is part of an adjustment that causes the related loan proceeds to be effectively excluded from the tax base—a result identical to that accomplished by the express 1/1/1 exclusion of the borrowed money in Illustration 5B. The loan interest is not deducted as a business expense under either Illustration 5A or 5B because, as explained in connection with Examples 3 and 4, the operation of the cash-flow consumption tax effectively removes the entire yield on A's $100 of business expense from the tax base. Thus, a business expense deduction for the loan interest is neither necessary nor appropriate.

Now return to Example 2. If a cash-flow consumption tax were applicable there, the $10 of bond interest would either be constructively excluded from A's income because A would claim a $100 savings deduction on 1/1/1 (which effectively shelters the 1/1/2 interest receipt from tax even though a nominal tax would be applied on 1/1/2)[46] or A would claim no 1/1/1 deduction for the bond purchase but would then be allowed to expressly exclude the 1/1/2 interest receipt from income. Since the interest receipt is entirely tax-free in both cases, a deduction for the related interest expense is not necessary for purposes of calculating net taxable income. Thus, the cash-flow tax would not permit a 1/1/2 interest expense deduction unless A had

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45. See supra text accompanying notes 28-36.
46. See supra Examples 3 and 4.

first included the $100 of borrowed funds in her 1/1/1 income so that an interest deduction, combined with a 1/1/2 principal deduction, was required to cancel the earlier inclusion. By contrast, an SHS tax requires A to report her 1/1/2 interest receipt in Example 2 regardless of the fact that she was not allowed a 1/1/1 savings deduction to effectively shelter the 1/1/2 receipt.[47] This absence of shelter for A's 1/1/2 interest receipt means that a 1/1/2 deduction of the related interest expense is necessary for purposes of computing net taxable income even though the related debt was excluded from the SHS tax base. Otherwise, A will be taxed on nonexistent gain.

The points demonstrated by Example 2 are equally applicable where borrowed money is used to finance business operations instead of to acquire an investment. Example 6 illustrates this point.

> *Example 6*: As in Example 2, individual A borrows $100 on 1/1/1 under terms requiring the payment of principal and 10% interest on 1/1/2. The loan funds are used on 1/1/1 to pay business expenses of a one-shot venture conducted by A as a sole proprietor. The only capital in the venture is the $100 provided by A. The venture terminates on 1/1/2 and yields $110 of ordinary business income which is immediately paid to the lender. Assume that, under the applicable rule for distinguishing between capital expenditures and currently deductible business outlays, the $100 1/1/1/ expenditure is deductible on 1/1/1 even though the related income is not reported until 1/1/2.[48] A 40% SHS tax is applicable but since there is no economic profit, no tax should be due.

With an interest deduction, A's 1/1/2 SHS tax base is $100 ($110 venture proceeds - $10 interest) because no deduction is allowed for the $100 principal payment. Thus, A owes a $40 1/1/2 tax with respect to a venture that was an economic wash. However, the 1/1/1 tax deduction saved $40 of tax which, assuming a 10% after-tax interest rate, has grown to $44 on 1/1/2 so that A has no net tax liability on 1/1/2 and, indeed, has $4 left over.

A's $4 surplus in Example 6 does not indicate that the 1/1/2 interest deduction was improper. Instead, it reflects a timing problem with the

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47. See generally Andrews, supra note 1, at 1121, 1126, 1150.

48. The current federal income tax frequently allows a present deduction for expenses that produce future income. See, e.g., Rev. Rul. 96-62, 1996-53 I.R.B. 6 (training costs are currently deductible even though they benefit future business activities); Rev. Rul. 94-12, 1994-1 C.B. 36 (incidental repair expenses are currently deductible even if they provide benefits to future income producing activities); Rev. Rul. 92-80, 1992-2 C.B. 57 (expenditures for institutional or goodwill advertising are currently deductible even though they benefit future business activities).

deduction of the business expenses. This point can be illustrated by considering the results if the $100 business expense deduction had been delayed from 1/1/1 to 1/1/2 when the related income was realized and the interest expense was paid. A's 1/1/2 tax base would have then been zero[49] and there would have been nothing left over. By contrast, if the business expense deduction had been moved to 1/1/2 but the 1/1/2 interest expense was not deductible, then A would have had a $10 1/1/2 tax base[50] and a $4 tax liability with respect to a zero profit venture. Thus, A's 1/1/2 interest deduction is proper. The $4 surplus in Example 6 is attributable to the fact that $100 of expenses were deducted one year before the related income was taxed;[51] it does not impugn A's 1/1/2 interest deduction.

VIII. INCLUSION OF BORROWED FUNDS IN THE SHS TAX BASE

The conventional conception of an SHS tax base is that borrowed funds are excluded. However, our analysis of cash-flow consumption tax treatment of borrowing and SHS treatment of business and investment interest expense suggests the possibility of a different approach. Could we get proper SHS results by following the consumption tax alternative of including business and investment loan funds in the tax base while allowing a deduction for principal and interest payments (thus neutralizing the initial taxation of the borrowed money) coupled with a second deduction of the interest payments (thus avoiding the over-taxation of income that would otherwise occur under an SHS tax)? Example 7 indicates an affirmative answer.

> *Example 7:* Individual A plans to finance the purchase of a $100, 10%, one-year bond by borrowing for one year at 10%. Obviously, this investment will be a wash that produces no economic gain. Under the normal SHS practice of excluding borrowing from the tax base but allowing a deduction for business and investment interest expense, A will get the same results as in Example 2—i.e. A's 1/1/2 interest expense deduction will offset A's 1/1/2 receipt of bond interest and leave A with zero taxable income from an investment

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49. $110 gross receipts
   - 100 business expense deduction
   - <u>10</u> interest expense
   - <u>0</u> taxable income
50. $110 gross receipts
   - <u>100</u> business expense deduction
   $ 10 taxable income
51. See authorities cited supra note 48.

that produced zero economic gain. Now assume that A is under an SHS regime requiring inclusion of borrowed funds in the tax base but permitting a deduction for payments of principal and interest. She borrows $166.67 for one year at 10% interest on 1/1/1, pays a $66.67 tax ($166.67 x .40) and uses the remaining $100 of loan funds to make a 1/1/1 purchase of a bond paying $100 of principal and 10% interest on 1/1/2. When 1/1/2 arrives, A pays $183.34, consisting of $166.67 of principal and $16.67 of interest, to her lender and deducts both amounts. The deductions save $73.34 of tax ($183.34 x .40) which is the present value (assuming a 10% interest rate) of the $66.67 tax that A paid on 1/1/1. In other words, when the $16.67 interest expense deduction is combined with the $166.67 principal deduction on 1/1/2, the effect is a recovery by A of the 1/1/1 tax paid on the loan proceeds. This is a correct outcome because the borrowed money was not an accession to wealth that triggers an SHS tax. But this means that A's 1/1/2 $16.67 interest expense has been "used up" in correcting for the 1/1/1 taxation of the borrowed money. There is nothing left to offset A's 1/1/2 bond interest receipt. Thus, A is facing a 40% tax on $10 of interest income from an investment that yielded no economic gain. The path to the correct tax result is to allocate the $16.67 of 1/1/2 interest expense between the $66.67 of 1/1/1 debt that was used to fund the 1/1/1 tax payment and the $100 of debt that was invested in the bond. Assuming that federal income tax payments would be nondeductible under this SHS regime, no deduction should be allowed for the $6.67 of 1/1/2 interest expense allocable to the $66.67 of debt that funded the 1/1/1 tax payment. The $10 of 1/1/2 interest expense allocable to the $100 of borrowed money invested in the bond should, however, be deducted a second time. This partial double deduction will exactly offset the $10 of 1/1/2 interest income and leave A with neither a tax gain nor loss on an investment that was an economic wash.

As Example 7 illustrates, if we make A include her borrowing on the front end, we can get her to the correct SHS results by allowing a deduction on the back end for her principal payment plus a partial double deduction of her interest expense. Stated differently, it is possible to operate an SHS tax regime which requires that borrowed amounts be included in income. This observation invites an inquiry into how the structure of our current income tax would change if debtors were required to include borrowed funds in gross income but that is a complex matter beyond the scope of this article.

For present purposes, the principal role of Example 7 is to emphasize that an interest expense deduction can serve two discrete functions–it can be part of an adjustment that removes previously-included debt from the tax base

and it can be a device for reducing gross income to net income. If a particular tax regime requires the performance of both functions, then Example 7 also shows that a partial double deduction for business and investment interest outlays is appropriate.

IX. CONCLUSION

The cash-flow consumption tax and the SHS income tax employ seemingly conflicting approaches to the deduction of business and investment interest expense. To be specific, the cash-flow regime allows a deduction for such interest only if the related debt is included in the tax base whereas business and investment interest is always deductible under an SHS tax even though the related debt is never part of the base (unless the debt is bogus or is ultimately canceled). The apparent conflict is, however, deceptive because the interest expense deduction serves different functions in these two different taxing regimes. In the cash-flow system, business and investment capital income is wholly excluded from the tax base with the result that a deduction for related interest expense is not required to arrive at a net taxable amount. Instead, the cash-flow consumption tax employs an interest expense deduction as part of an adjustment mechanism that removes previously included borrowings from the tax base. Thus, an interest deduction is not appropriate under a cash-flow regime unless the related debt was part of the base at an earlier time. By contrast, an SHS tax always excludes borrowed amounts from its base so that no interest expense deduction is necessary to assist in canceling the prior inclusion of borrowed sums. But an SHS regime invariably includes business and investment income in the base. Consequently, an SHS deduction for business and investment interest expense is required to reduce related gross income to a net amount even though the debt which generated the interest outlay was not a previously included item. This illustrates the point that the propriety of an interest expense deduction depends on the role which is assigned to the deduction in the particular tax system.