Reply

Do Anti-Tax Shelter Rules Make Sense?
A Reply to Professor Johnson

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I. Introduction

In an article published in this journal earlier this year, I criticized the anti-tax shelter provisions of the Tax Reform Act of 1986 as illogically preventing the use of tax preferences in tax shelters without also preventing the use of tax preferences outside of shelters. The article describes a tax preference as a congressional rule designed to encourage greater investment in an activity by understating the taxable income from that activity. If a taxpayer invests his own money in a tax-favored activity, the preference will normally result in an understatement, for tax purposes, of the income from the investment. If, however, the taxpayer invests borrowed money, the preference and the interest deduction will generally combine to create an artificial loss, which can be used—in the absence of anti-tax shelter legislation—to shelter unrelated income from tax. The anti-tax shelter rules of the 1986 Act—in particular, the passive loss rules of section 469 and the investment interest rules of section 163(d)—generally allow the use of preferences to understate income from equity-financed investments, but prevent the sheltering of unrelated income through the use of preferences in debt-financed investments. My earlier article argues that prohibiting the use of preferences in shelters is inconsistent with the purpose of preferences—to encourage investment in certain activities. A system designed to encourage allocation of resources to a tax-favored activity should grant preferences equally...

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3. See Zelenak, supra note 1, at 502-08.
4. See id. at 508.
5. See id. at 509-10.
7. See Zelenak, supra note 1, at 511-12.
whether the activity is equity- or debt-financed.\textsuperscript{8}

In a reply to my article, also published earlier this year in this journal,\textsuperscript{9} Professor Calvin Johnson argued that my analysis is flawed because it is based on a misunderstanding of the purpose of preferences—or at least of the one preference most commonly used in tax shelters, the Accelerated Cost Recovery System (ACRS).\textsuperscript{10} Professor Johnson claims that the purpose of ACRS is not to channel investment to ACRS assets,\textsuperscript{11} but rather to increase overall savings and investment.\textsuperscript{12} If ACRS is correctly understood, he contends, antishelter rules do make sense.\textsuperscript{13}

8. See id. at 512.


11. See Johnson, supra note 9, at 594-603.

12. See id. at 604-07.

13. Professor Johnson claims that an additional purpose of ACRS was to counteract the devaluation of depreciation deductions by inflation. See id. at 607-08. He notes that, in the case of debt-financed investments, "[o]verdeductions of purely inflationary interest . . . tend to offset any devaluation of depreciation deductions." Id. at 608. From this he concludes, reasonably enough, that limitations on the ability to use ACRS in connection with debt-financed investments would be appropriate, if the primary purpose of ACRS was to offset the effects of inflation. See id.

Professor Johnson is correct in noting that concern about inflation was one of the stated reasons for the enactment of ACRS. See Senate Comm. on Finance, Economic Recovery Tax Act of 1981, S. Rep. No. 144, 97th Cong., 1st Sess., 47 (1981) [hereinafter S. Rep. No. 144]. It is difficult, however, to take ACRS very seriously as an anti-inflation measure, because it is such a crude tool for that purpose. It would be the sheerest accident if ACRS even came close to adjusting depreciation allowances correctly to offset the effects of inflation. Moreover, if Congress truly had been concerned about this problem, alternatives were available which would have served much better. These included the Auerbach-Jorgenson first-year capital-recovery system described in Auerbach & Jorgenson, Inflation-Proof Depreciation of Assets, Harv. Bus. Rev., Sept.-Oct. 1980, at 113, 113-18, and indexing depreciation allowances for inflation described in 2 Office of the Secretary, Dept. of the Treasury, Tax Reform for Fairness, Simplicity, and Economic Growth 152-72 (1984).

In any event, Professor Johnson seems to view the inflation rationale for ACRS as being decidedly secondary to the general savings preference rationale, since his discussion of ACRS as a general savings preference precedes, and is about four times longer than, his discussion of the inflation rationale. See Johnson, supra note 9, at 604-08. I agree with Professor Johnson that counteracting inflation was a secondary rationale (at least a stated one) for the 1981 version of ACRS. Our disagreement, however, is on the primary rationale, and it is by the primary rationale for ACRS that the logic of antishelter rules must be judged. If Professor Johnson is correct that the primary purpose of ACRS is to serve as a general savings preference, then antishelter rules make good sense. If I am correct that the primary purpose of ACRS is to encourage investment in ACRS assets, then antishelter rules make little sense. The focus of this Reply, therefore, is on our disagreement concerning the primary purpose of ACRS.

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In this Reply to Professor Johnson, I first explain his argument that ACRS is really a general savings preference, and the ramifications of that argument for the evaluation of antishelter legislation. Next, I explain why both the legislative history and the structure of ACRS compel the rejection of Professor Johnson's understanding of its purpose. I close with an observation that, despite their logical incoherence, antishelter rules might be preferable to their politically likely alternative.

II. ACRS as a General Savings Preference

A. Income Tax and Savings

An income tax disfavors savings, relative to consumption, by imposing a "double tax" on savings. Earnings put into savings are subject to income tax, and the income generated by the savings is also taxed. Thus, a taxpayer who saves his income for later consumption bears a greater tax burden than one who consumes his income immediately.14 Although an income tax reduces the return on savings, it is not clear what effect the reduced return has on the overall level of savings in the economy.15 People may be discouraged from saving by the reduced return (and shift from savings to consumption), or they may be encouraged to save more in order to reach a particular predetermined level of savings-generated income.16 Despite this theoretical difficulty, it is widely assumed that the income tax depresses aggregate savings below the optimal level.17

Unlike an income tax, a consumption tax does not decrease the after-tax return on savings below the pre-tax return. Under a consumption tax, the cost of acquiring an income-producing asset is immediately deductible,18 and such a deduction is equivalent under certain conditions to

called the Incentive Depreciation System (IDS). See House Comm. on Ways and Means, Tax Reform Act of 1985, H. Rep. No. 426, 99th Cong., 1st Sess. 147-54 (1985) [hereinafter H. Rep. No. 426]. The House version would also have provided for adjustments to depreciation allowances to account (partially) for inflation. See id. at 154-55. The fact that the version provided for accelerated depreciation (IDS) in addition to an inflation adjustment demonstrates that the House believed that accelerated depreciation was justifiable without reference to inflation concerns. For additional discussion of IDS, see infra note 49.


18. See Blueprints, supra note 14, at 107-08. Alternatively, a consumption tax might not allow a deduction for the purchase of a particular asset, but instead exempt all income produced by the asset from tax. See id. at 103, 108-09.
exempting from tax the income generated by the asset. Consumption tax proponents argue that because a consumption tax does not disfavor savings, it is superior to an income tax.

B. Professor Johnson’s Analysis

Professor Johnson argues that the 1981 enactment of ACRS was inspired, not by a desire to increase investment in ACRS assets in particular, but rather by a desire to increase savings and investment generally by moving toward the consumption-tax ideal. If ACRS was a move toward a consumption tax, it was a fairly modest move. A true consumption tax would eliminate the tax burden on all income from capital. ACRS, however, applies to income from only certain kinds of assets and then often only reduces the tax.

Nevertheless, it would not have been unreasonable to expect ACRS to increase the overall level of savings in the economy. The lower tax on ACRS assets would increase those assets’ after-tax rate of return. The

19. See id. at 110-11. Suppose, for example, a taxpayer in the 50% bracket buys a $100 bond which produces $10 interest income annually. If the interest income is exempt from tax, the taxpayer’s annual after-tax return on his $100 investment will be $10. What if the interest income from the bond is taxable, but the cost of purchasing the bond is deductible? If the taxpayer still desires to make an investment with the same $100 after-tax cost, he will now buy a $200 bond: the $200 deduction will save the 50% bracket taxpayer $100 in taxes, resulting in a $100 net cost of investment. The 10% annual return on $200 will be $20. The $20 will be taxed at the rate of 50%, leaving the taxpayer with a $10 annual after-tax return. Thus, the deductible investment method yields the same result as exempting the investment income from tax: $100 net cost of investment, and $10 annual after-tax income from the investment. On the conditions necessary for the equivalency to hold, see Graetz, Implementing a Progressive Consumption Tax, 92 Harv. L. Rev. 1575, 1602 (1979).


22. See Johnson, supra note 9, at 604-07.

increased return would lead to an increased demand for ACRS assets. Thus, investment would flow into ACRS assets (and away from other assets) until the after-tax return on ACRS assets equaled the after-tax return on other assets. This after-tax rate of return on investment would be higher than the after-tax rate of return on investment before the enactment of ACRS. Assuming that a higher after-tax rate of return causes increased savings, ACRS should increase total savings. But any increase in total savings would be a secondary effect of ACRS relative to increased investment in the specific ACRS assets. Generally, preferences for investments in particular assets affect the composition of the capital stock more than its size.

C. Ramifications for Antishelter Rules

Professor Johnson argues that, viewing ACRS as an attempt to increase savings generally through partial implementation of a consumption tax, antishelter rules make good sense. Congress intends to encourage savings generally, not the channeling of resources into particular kinds of investments. If there has been no net savings, nothing has happened which Congress intends to subsidize. Debt-financed investments do not increase savings; therefore, Congress justifiably enacted antishelter rules that deny preferences to debt-financed investments. Put another way: Consumption tax theory supports the elimination of taxes on income from savings, but it does not support tax shelters for consumed earned income. To the contrary, consumed earned income is precisely what must be taxed—and cannot be sheltered—under a consumption tax. A properly designed consumption tax would prevent the use of tax-free investment income to create tax shelters for consumed earned income, either by including borrowed money in the tax base or by disallowing the interest deduction. Given that the 1986 Act’s antishelter rules prevent sheltering earned income by directly or indirectly denying interest deductions associated with tax-preferred income, Professor Johnson views the antishelter rules as perfectly consistent with ACRS if ACRS is understood as a general savings preference, motivated by con-

24. See Hulten & Klayman, supra note 17, at 319.
25. See id. at 319-20.
26. See id. at 320 n.3.
27. See Johnson, supra note 9, at 605.
28. See id. at 606-07.
29. See BLUEPRINTS, supra note 14, at 111-12; Johnson, supra note 9, at 606.
30. Section 163(d) explicitly disallows the deduction of investment interest in excess of investment income. Section 469, by contrast, does not expressly focus on the interest deduction. Nevertheless, its disallowance of passive losses ordinarily has the same effect as would a section 163(d)-type express disallowance of the interest deduction. See Zelenak, supra note 1, at 563-64.
summation tax ideals.31

III. A Reply to Professor Johnson

I agree with Professor Johnson that some sort of antishelter rules should limit a preference, enacted to bolster general savings, by increasing the after-tax return on investment. I disagree, however, with his conclusion that ACRS is such a preference.

A. Why 1981 ACRS?

To begin with, I am puzzled by Professor Johnson’s narrow focus on ACRS’s purpose as first enacted in 1981. Until 1986, the investment tax credit (ITC)32 was an important part of the tax subsidy for investment in ACRS assets other than structures.33 The 1986 Act’s subsidies for investment in ACRS assets are much smaller than the subsidies under the 1981 Act due to the repeal of the ITC34 and the decrease in ACRS benefits for buildings.35 The important question is whether antishelter rules make sense in connection with the preferences created or retained by the 1986 Act,36 and that question is best answered by examining the purposes of the 1986 Act’s version of ACRS. Presumably, Professor Johnson’s unstated assumption is that the 1986 version of ACRS is a modest remnant of the 1981-style ACRS (and ITC) and continues to partake—in a reduced way—in the purpose of the 1981 legislation. Assuming that is what Professor Johnson has in mind, I now turn to an examination of the purpose of the 1981 ACRS and ITC.

31. See Johnson, supra note 9, at 604-07.
33. See supra note 23.
35. See id. § 201.
36. Because an asset is depreciated for its entire taxes life according to the cost recovery rules that were in effect when the asset was placed in service, section 469 can apply to losses created by the 1981 version of ACRS. Nevertheless, the application of section 469 to such losses is a relatively minor transitional matter; the much more important matter is the application of section 469 to losses created by the 1986 version of ACRS.
B. The Purpose of ACRS

1. Legislative History.—Even before 1981, Congress had a long history of using accelerated depreciation and investment credits for the stated purpose of encouraging investment in plant and equipment. The 1981 Act continued in that tradition. The most authoritative source concerning the purpose of ACRS and ITC in the 1981 Act is the Senate Finance Committee Report. Professor Johnson supports his claim that ACRS was intended as a general savings incentive, with a citation to a passage in the report which states that “a substantial restructuring of depreciation deductions and the ITC will be an effective way of stimulating capital formation.” Professor Johnson seems to assume that the Report’s reference to “capital formation” means general savings. This is incorrect. At another point in the Report, the Committee follows its observation that “[b]usiness investment in new plant and equipment is crucial for increasing productivity,” with the statement that “a restructuring of depreciation allowances for tax purposes would be an

37. The ITC was first enacted by the Revenue Act of 1962, Pub. L. No. 87-834 § 2, 76 Stat. 960, 962. The legislative history makes abundantly clear that the purpose of the credit was to channel investment into machinery and equipment. The Senate Report stated that the purpose of the ITC was “to restore to past levels the proportion of the annual national output devoted, through investment in machinery and equipment, to capital formation,” and “to encourage modernization and expansion of the Nation’s productive facilities.” Senate Comm. on Finance, Revenue Act of 1962, S. Rep. No. 1881, 87th Cong., 2d Sess. 11 (1962), reprinted in 1962-3 C.B. 707, 717. Similarly, the House Report referred to the ITC as an “investment stimulant . . . for new production facilities,” and explained that “greater emphasis is placed on equipment and machinery because it is believed the need for such investment is the major requirement of the economy.” House Comm. on Ways and Means, Revenue Act of 1962, H. Rep. No. 1447, 87th Cong., 2d Sess. 9 (1962), reprinted in 1962-3 C.B. 405, 413.


39. Id. at 47 (cited by Johnson, supra note 9, at 604 n.50).

40. Id. at 12.
effective way of stimulating capital formation."\textsuperscript{41} From this context, it is clear that the Report uses "capital formation" to mean investment in business plant and equipment.\textsuperscript{42}

Professor Johnson is correct that Congress intended the 1981 Act to increase total savings, but the increase was to be accomplished primarily through lowering marginal individual tax rates, not through ACRS. Lower rates on earned income would leave taxpayers with more money to save,\textsuperscript{43} and lower rates on investment income would increase the after-tax return on savings and so increase the incentive to save.\textsuperscript{44} ACRS and ITC were then intended to channel the increased savings into investment in plant and equipment.\textsuperscript{45}

The reduced ACRS benefits available after the 1986 Act\textsuperscript{46} continue to be designed to channel investment into plant and equipment. Although Congress believed that the pre-1986 preferences were too large, it also believed that smaller preferences were appropriate. The Senate Report stated:

The committee believes some further acceleration in the rate of recovery of depreciation deductions should be provided to compensate partly for the repeal of the ITC. The committee is cognizant that other nations heavily subsidize business investments through tax and other policies, and the committee does not believe such

\textsuperscript{41} Id. at 13.


\textsuperscript{44} See S. REP. NO. 144, supra note 13, at 25.

\textsuperscript{45} Professor Gann, whom Professor Johnson cites with approval, see Johnson, supra note 9, at 604 n.49, has aptly summarized the congressional intent:

Congress expected these provisions [primarily the individual rate reductions] would increase the after-tax rate of return on savings and thus also increase the level of savings. These savings were then to be directed into business capital formation by the inclusion of substantial incentive provisions to invest in business capital, causing a shift in the allocation of investment.

Gann, supra note 16, at 80.

\textsuperscript{46} See supra notes 34-35.
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policies can be completely ignored.\textsuperscript{47} The ITC was designed to channel investment into machinery and equipment,\textsuperscript{48} and accelerated depreciation, intended as a partial substitute for the credit, must have the same purpose.\textsuperscript{49}

2. \textit{Logic}.—In addition to the legislative history, logic also supports the position that ACRS and ITC were intended to channel investment into plant and equipment and not to increase the overall level of savings. The 1981 Act, with ACRS and ITC, was highly distorting. The 1981 Act greatly favored ACRS asset investment over many other kinds of investments, including investment in business inventories, goodwill and other intangible property, and training of employees.\textsuperscript{50} Among ACRS assets, the 1981 Act favored some assets over others\textsuperscript{51}—particularly machinery and equipment over structures.\textsuperscript{52}

\textsuperscript{47} S. Rep. No. 313, supra note 13, at 96.
\textsuperscript{48} See supra note 37.
\textsuperscript{49} The House version of what became the 1986 Act would have repealed the ITC and replaced ACRS with the Incentive Depreciation System (IDS), another form of accelerated depreciation. Like the Senate Report, the House Report approved of tax preferences for depreciable property as long as the preferences were not too large. After criticizing pre-1986 preferences, the Report stated: "The Committee is not of the view, however, that the current tax advantages for investment in depreciable property should be replaced by a system having no preferences at all." H. Rep. No. 426, supra note 13, at 146. An interesting feature of the House Report is its unequivocal statement that pre-1986 ACRS and ITC were intended as channeling preferences: "Proponents of massive tax benefits for depreciable property have theorized that these benefits would stimulate investments in such property, which in turn would pull the entire economy into more rapid growth." Id. at 145. Apparently the House Report also viewed IDS as a channeling preference, albeit on a much smaller scale than pre-1986 ACRS and ITC.
\textsuperscript{50} For criticisms of tax policy for its narrow focus on subsidizing investments in plant and equipment, see D. Bradford, supra note 20, at 209; Steuerle, \textit{Building New Wealth by Preserving Old Wealth: Savings and Investment Tax Incentives in the Postwar Era}, 36 NAtL \textit{TAX J.} 307, 308-14 (1983).
\textsuperscript{51} Congress was well aware of the distortions within ACRS, because the distortions were repeatedly brought to the attention of Congress in the hearings leading up to the 1981 Act. President Carter's Treasury Secretary, G. William Miller, testified against the ACRS proposal in 1980, because it would provide different levels of benefits for different assets and industries. See \textit{Tax Cut Proposals: Hearings Before the Comm. on Finance}, 96th Cong., 2d Sess. 15, 33-34 (1980) [hereinafter \textit{Tax Cut}]. Dale Jorgenson, a Harvard economics professor, repeatedly testified against ACRS because of the distortions it would create in the allocation of resources among different ACRS assets, and proposed an alternative system which would provide equal benefits for all depreciable assets. See \textit{Tax Cut}, supra, at 792-830; see also \textit{Tax Aspects}, supra note 43, at 1615-791 (statement of Dale W. Jorgenson, Professor of Economics, Harvard University, accompanied by Martin A. Sullivan) (summarizing parts of Jorgenson & Sullivan, \textit{Inflation and Capital Recovery in the United States}, reprinted in \textit{Tax Aspects}, supra note 43, at 1688-786); \textit{Tax Reduction Proposals: Hearings Before the Comm. on Finance}, 97th Cong., 1st Sess. 347-48 (1981) (statement of Dale W. Jorgenson, Professor of Economics, Harvard University) (testifying in favor of three alternatives to ACRS). Economist Henry Aaron of the University of Maryland voiced similar objections to ACRS. See \textit{Tax Aspects}, supra note 43, at 535, 538, 543. Congress chose to retain the distortions among ACRS assets, despite the existence of a number of ways of providing equal benefits for all depreciable assets. For a discussion of some ways of providing equal benefits for all depreciable assets, see infra text accompanying notes 56-62, 71-74.
\textsuperscript{52} See supra note 23. The greater preference for personal property over real property cannot
Such distortions make sense if Congress intended ACRS to change the allocation of resources.\(^{53}\) By contrast, such distortions are extremely unfortunate if Professor Johnson is correct that the purpose of ACRS was to increase investment generally, without affecting the allocation of resources among different types of investments.\(^{54}\) Professor Johnson seems to believe that the massive distortions caused by ACRS were simply an unintended byproduct of a plan to increase savings. That analysis makes sense only if there were no less distortional means of using the tax system to increase savings. In fact, as the next section demonstrates, there are a number of much less distortional alternatives. The existence of these alternatives makes Professor Johnson’s explanation of the purpose of ACRS highly implausible.\(^{55}\)

3. Less Distortional Alternatives

\(a\) Elimination of the tax burden on investment income.—The simplest nondistortional way for the tax system to encourage savings

be dismissed as an accident or an unexpected result. First, the magnitude of the difference was simply too great for such an explanation. Second, the difference was largely attributable to the conscious decision of Congress to allow the ITC for personal property, but not for buildings.

Legislation subsequent to the 1981 Act has reduced, but has not eliminated, the inequality in the tax benefits afforded to different types of ACRS assets. For a table showing the various effective corporate tax rates on income from different types of assets, before and after the Tax Reform Act of 1986, see J. GRAVELLE, TAX REFORM ACT OF 1986: EFFECTIVE CORPORATE TAX RATES 4 (1987), reprinted in Hulten & Klayman, supra note 17, at 323. Before the 1986 Act, effective corporate tax rates on equipment ranged from a low of 1\% on some asset types to a high of 28\%, with an average of 6\%. See id. Rates on structures ranged from a low of 11\% to a high of 45\%, with an average of 34\%. See id. After the 1986 Act, equipment rates ranged from a low of 22\% to a high of 40\%, with an average of 31\%. See id. Rates on structures varied from a low of 12\% to a high of 40\%, with an average of 32\%. See id.

53. Eugene Steuerle has suggested that "[t]he increasing historical importance of plant and equipment, and its susceptibility to measurement, show why incentives to purchase plant and equipment would be appealing" to Congress. Steuerle, supra note 50, at 313. Steuerle is, however, highly critical of the decision to focus tax incentives so strongly on plant and equipment. See id. at 311-14.

54. One kind of investment for which ACRS is not available is investment in depreciable property used predominantly outside of the United States. I.R.C. § 168(g)(1)(A) (Supp. V 1987). (Special rules for foreign assets were also a part of the 1981 version of ACRS. See Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 201, 95 Stat. 172, 203-19.) This restriction on the availability of ACRS is entirely sensible if the purpose of ACRS is to channel investment into depreciable property used within the United States; this restriction, however, would make no sense if the purpose of ACRS were to encourage savings generally.

55. Professor Johnson argues that ACRS could not have been intended to channel investment towards ACRS assets, essentially because the revenue loss to the government from ACRS far exceeded (in Professor Johnson’s view) any possible public benefit from the channeling of investment to ACRS assets. See Johnson, supra note 9, at 594-603. I tend to agree with him that the costs of ACRS exceeded its benefits (see infra text accompanying note 90), but that is not the question. The question is why Congress enacted ACRS. Quite plausibly, Congress enacted ACRS to encourage investment in ACRS assets, even though Professor Johnson and I think it was a bad idea. It is not plausible that Congress enacted a highly distortionary ACRS-ITC package to encourage savings generally—with the distortion as merely an undesired side effect—if there was a less distortional way for Congress to achieve its goal.
would be to eliminate entirely the tax burden on income from savings. A consumption tax would do this by allowing an immediate deduction for the cost of acquiring a capital asset. This deduction is the equivalent of exempting the asset's income from tax.\textsuperscript{56} An income tax on only earned income, with a total exemption for income from property, would also achieve this goal. For reasons of administrative convenience, the most practical solution might be a hybrid system in which the cost of some capital assets is immediately deductible (but the income from the assets is taxed), while the income from other capital assets (the cost of which is not deductible) is tax-exempt.\textsuperscript{57}

Any such system would encourage savings by removing the tax burden on investment income. Furthermore, such a system would not distort the allocation of resources among assets because it would totally remove the tax burden on \textit{all} investment income.

The proper treatment of borrowing in a system with no tax burden on investment income would automatically prevent tax shelters. If the system allowed an immediate deduction for all investments, all borrowed funds should be included in income (and all interest and principal payments should be deductible).\textsuperscript{58} Such a system would not involve the complexities of current law in allocating borrowing to particular investments.\textsuperscript{59} Because all investments would receive the same tax treatment, all borrowing would be treated the same, regardless of the investment associated with the borrowing. If the system exempted all property income from tax, all interest expense would be nondeductible.\textsuperscript{60} Again, no allocation of debt among assets would be required. If the system were a hybrid, allocation might be desirable in order to tax borrowed funds associated with deductible investments and to disallow interest expense associated with investments producing tax-exempt income.\textsuperscript{61} If the system simply treated all borrowing as taxable, however, even a hybrid system could prevent sheltering without debt allocation.\textsuperscript{62}

\textsuperscript{56} See supra note 19.

\textsuperscript{57} See BLUEPRINTS, supra note 14, at 101-28.

\textsuperscript{58} See id. at 111-12.

\textsuperscript{59} On the complexities involved in allocating borrowing under current law, see Zelenak, supra note 1, at 570-76.

\textsuperscript{60} See BLUEPRINTS, supra note 14, at 112.

\textsuperscript{61} See Graetz, supra note 19, at 1606-09.

\textsuperscript{62} See id. at 1609. The only possibility of sheltering in a hybrid system would arise if a taxpayer could receive interest deduction denial treatment for debt associated with deductible investments. See id. at 1606-09. Even then, however, the taxpayer would receive no net benefit, because he would pay the equivalent of the market interest rate on any deferred tax. Suppose, for example, a 30% bracket taxpayer borrows $100 at 10% in order to purchase a $100 bond paying 10%. If the $100 investment is immediately deductible, while the borrowing is not taxable, the taxpayer will have a sort of tax shelter. The $100 loss will reduce his tax liability by $30. In each subsequent year the taxpayer pays $10 interest on the loan and collects $10 income from the bond (no principal
(b) Reduction of the tax burden on investment income.—Perhaps Congress would consider totally removing the tax burden from investment too generous or too expensive. But there are several possibilities for a less dramatic, nondistortional general savings preference which would reduce (but not eliminate) the tax burden on savings generally without favoring some investments over others.

(i) Rate reduction or partial exclusion.—Simply lowering the tax rate on investment income is a neutral way of encouraging greater savings. Although such a tax rate decrease can be a part of an overall tax rate reduction, applicable to both labor income and property income, a rate reduction for property income only would be a more focused and less expensive means of encouraging greater savings.

Either a lower rate for property income than for labor income, or a partial exclusion of property income from tax, could be used. There are several practical problems with implementing such approaches, but these problems may be solved.

One practical problem is that neutrality in the taxation of income from capital would require at least approximate solutions to measurement problems—in particular, valuing unrealized appreciation and determining economic depreciation. A possible solution regarding unrealized appreciation is to tax gains only on realization, but to impose an interest charge to eliminate the benefit of deferral (with the interest charge based on the assumption that the appreciation occurred ratably over the time the asset was held). Although a completely accurate measurement of economic depreciation is impossible, studies indicate that a reasonable approximation can be obtained. The final measurement hurdle is ac-

payments are made on the loan or the bond). Although this is a pre-tax wash, it is not a tax wash. The income is taxable, while the interest expense is not deductible. Thus the taxpayer has $10 in income, and will pay the government $3 in taxes every year. In effect, the taxpayer has borrowed $30 from the government, at 10% interest. Assuming the taxpayer could have done the same with a bank, the supposed tax shelter is really of no value to the taxpayer. Nevertheless, Congress might want to prevent this possibility, either because it does not care to be in the business of lending money to taxpayers, even at a fair rate of interest, or because of the possibility that the taxpayer might be in a higher tax bracket in the year of the $100 deduction than in the later years of $10 inclusions. For an additional criticism of combining expensing of investments with nondeductibility of interest expense on the grounds that this treatment of borrowing ignores price changes in loans, see Gann, supra note 16, at 120.

63. In fact, encouraging savings by increasing the after-tax return on savings was one reason for the 1981 Act’s lowering of individual tax rates. See supra note 44.

64. See Gann, supra note 16, at 109 n.3; see also Shakow, Taxation Without Realization: A Proposal for Accrual Taxation, 134 U. PA. L. REV. 1111, passim (1986) (arguing that a practical system for taxing unrealized appreciation could be developed).

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counting for inflation; there has been considerable discussion of how adjustments for inflation could be made.66

Another practical problem is that a system with different tax rates for property and labor income requires the ability to distinguish between these two types of income. The distinction is not always easy to make, especially in the case of owner-operated businesses. Rules to prevent taxpayers from disguising earned income as capital income probably would be needed.67

A final problem would concern imputed income from owner-occupied housing and other consumer goods.68 Taxation of such income may not be absolutely impossible, but it would involve great administrative and political difficulties. The best course might be to abandon conceptual rigor and allow such income to escape tax entirely.

If Congress decided to encourage savings by establishing a reasonably uniform rate reduction (or partial exclusion) for capital income, then dealing with interest expense would be simple: interest would be deductible at the same rate that capital income was taxable.69 Allocating interest expense among investments to prevent sheltering would be unnecessary because all investments would be identically taxed.70

(ii) Extension of neutral incentives for depreciable property.—Economists have proposed methods of providing incentives for investments in depreciable property that would be neutral among different kinds of depreciable property. For example, Arnold Harberger has demonstrated that this could be done quite simply, by giving each depreciable asset partial consumption tax treatment and partial income tax treatment.71 That is, a stated percentage of the cost of each asset would developing its 1984 proposal for a “Real Cost Recovery System.” See 2 OFFICE OF THE SECRETARY, DEPT OF THE TREASURY, supra note 13, at 160.


67. This problem would also exist—and would assume even greater importance—in a tax system in which all investment income was totally exempt.

68. This would also be a problem under a consumption tax allowing for the immediate deduction of capital expenditures. One solution, in the context of a consumption tax, is not to apply normal consumption tax treatment to consumer durables. Instead, no deduction would be allowed for the purchase of durables, and the income from durables would be tax exempt. See BLUEPRINTS, supra note 14, at 108-09.

69. Or, if a partial exclusion were used, the percentage of interest expense eligible for deduction would be the same as the percentage of capital income subject to tax.

70. Allocation of interest expense among investments would be desirable to the extent that the taxation of capital income was not uniform. Allocation might also be desirable to the limited extent necessary to deny any deduction for interest expense on borrowing associated with current personal consumption.

71. See Harberger, Tax Neutrality in Investment Incentives, in THE ECONOMICS OF TAXATION
be immediately deductible, and the remaining cost would be recovered according to economic depreciation. The result would be no tax burden on income from the portion of the asset receiving consumption tax treatment and full taxability of income from the portion receiving income tax treatment.

The Harberger proposal was designed only to achieve neutrality among investments in depreciable assets; it was not intended to achieve neutrality among all investments.72 It might be possible, however, to extend the Harberger approach, effectively giving all investments partial consumption tax and partial income tax treatment.73 Borrowing could be given equivalent partial consumption, partial income tax treatment.74 If all investments were given equivalent treatment under this system, there would be no need to allocate interest expense among different investments.

4. The Significance of the Existence of Less Distortional Alternatives.—I have discussed these nondistortional ways of reducing the tax burden on investment income, not because I favor any of these approaches, but rather because these possible approaches indicate what Congress might have done, instead of enacting the massive distortions of ACRS, if Congress had had the purpose ascribed to it by Professor Johnson. In fact, I do not favor a reduction in the tax burden on investment income.75

299, 307-09 (H. Aaron & M. Boskin eds. 1980). Another proposal for an investment incentive which would be neutral among depreciable assets is based on the Auerbach-Jorgenson first-year capital-recovery system. (This system would replace depreciation deductions with a single deduction in the year an asset was purchased equal to the present value of economic depreciation. Its major advantage over economic depreciation is that it requires no inflation adjustment. See Auerbach & Jorgenson, supra note 13, at 117.) The proposal, by E. Cary Brown, would supplement the first-year deduction with a neutral tax credit (in order to achieve neutrality, it would be necessary to vary the credit percentage among different asset classes). See Brown, The "Net" Versus the "Gross" Investment Tax Credit, in DEPRECIATION, supra note 65, at 133, 133-34.

72. See Harberger, supra note 71, at 303-07.
73. One obvious difficulty with such a system is that, to the extent that it retains income tax treatment, it involves all the problems of accurately measuring income from capital. See supra text accompanying notes 64-68.
74. Bradford has described how the Harberger method could be combined with an appropriate partial disallowance of the interest deduction. See Bradford, Issues in the Design of Savings and Investment Incentives, in DEPRECIATION, supra note 65, at 13, 28-29. As discussed, however, there are reasons for Congress to be wary of a consumption tax that combines expensing of investment with disallowance of interest expense deductions. See supra note 62. For a criticism of the Bradford proposal on these grounds, see Gann, supra note 16, at 119-20. An alternative to the Bradford proposal would be to include in the tax base a percentage of loan proceeds equal to the percentage of investments eligible for consumption tax expensing. Subsequent interest and principal payments on this portion of the loan would be deductible. The remainder of the loan would receive normal income tax treatment (loan proceeds nontaxable, interest deductible, and principal repayments nondeductible).
75. For an indication of the reasons for my position, see Zelenak, supra note 1, at 546-47 n.158.
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Legislation designed to encourage savings, by reducing the tax on investment income, would be characterized by an attempt to be as neutral as possible in its treatment of different investments. Rules to prevent sheltering—either by limiting the interest deduction or by taxing some borrowed funds—would be an appropriate part of such legislation. Some distortion might be inevitable because Congress would probably find it impossible to devise a perfectly neutral general savings preference. But the distortions would be much less than those caused by ACRS. Given the availability of less distortional means to encourage savings, it is inconceivable that Congress would enact ACRS as a general savings preference. ACRS must have been intended to encourage investment in ACRS assets, not to encourage savings generally.

Moreover, ACRS is only one of many preferences in the Internal Revenue Code designed to channel investment into particular activities. Consider the following: The deduction of research and experimental expenditures,76 the research credit,77 percentage depletion in excess of basis,78 the deduction for mine development expenditures,79 the deduction for mining exploration expenditures,80 the deduction for intangible drilling costs,81 the sixty month amortization of pollution control facilities,82 the low-income housing credit,83 and the exemption for municipal bond interest.84 The existence of ACRS and these other provisions reflects a tax system designed by Congress to channel resources into particular kinds of investment; it is not indicative of a system designed to encourage all investment neutrally.

In sum, I concede that some sort of antishelter rules would be appropriate if tax preferences were enacted for the purpose suggested by Professor Johnson. But I contend that Professor Johnson is wrong in his understanding of ACRS's purpose in particular, and of the Code's incentive preferences in general. The Code's incentive preferences are intended to channel investment into particular areas, and the use of antishelter rules in connection with such preferences makes little sense.

IV. Politics and Damage Control

Professor Johnson explains that “[t]ax law is commonly complex and irrational because the issues are important enough to fight over,”85 and the compromises that result often represent the partial adoption of several inconsistent approaches. This is a point I made in my article when I noted that “[t]he antishelter provisions of the Act are best understood as an exercise in political compromise, not as an exercise in pure logic.”86 The interesting question is what effect this understanding of the politics of antishelter rules should have on critiques of the rules.

One possibility—which I reject—is that the fact that legislation involves compromises absolves it from any obligation to be logical, and makes principled criticism irrelevant. Perhaps we should not hope that the 535 members of Congress will produce the legislation of a philosopher-king, and it may not be realistic to expect legislation to “satisfy an academic desire for tidiness, symmetry and precision,”87 but this does not mean that political compromises are beyond theoretical evaluation. Some compromises make more sense and work better than others. If a particular compromise makes especially little sense and promises to involve especially great practical difficulties, critics are justified in pointing that out.

On the other hand, I must admit that the political realities surrounding the antishelter rules have important implications for the role of academic criticism. My article’s message was that antishelter restrictions make little sense because they result in inconsistent treatment of tax preferences. I noted that consistency could be achieved either by eliminating the preferences themselves (which would have the side effect of eliminating shelters, thus making antishelter rules pointless), or by repealing antishelter rules and retaining preferences.88 I expressed no opinion favoring either solution.89 The question of the preferable alternative seemed beyond the scope of a discussion of the logic of the antishelter rules themselves.

It now seems to me that I might have given more regard to the politics of the situation. In fact, it is my opinion (which I will merely state, without attempting to justify) that most preferences are bad tax policy—that most preferences worsen the allocation of resources, and

85. Johnson, supra note 9, at 618.
86. Zelenak, supra note 1, at 589 (footnote omitted).
88. See Zelenak, supra note 1, at 502.
89. Professor Johnson misreads my article when he assumes that my choice is to eliminate antishelter rules while retaining preferences. See Johnson, supra note 9, at 618.
that almost all preferences are far too expensive. My favored solution, then, is a tax system in which antishelter rules are unnecessary because the vast majority of preferences have been eliminated.\textsuperscript{90}

Such a tax utopia is, however, politically unachievable at the moment, and so the question arises of what to do until the tax policy millennium arrives. On this question, I have considerable sympathy for the argument that defends antishelter rules as "damage control":\textsuperscript{91} that preferences are so harmful to the tax system that any restrictions, no matter how theoretically illogical and practically cumbersome, are better than no restrictions. Criticisms of section 469, such as my article, could be misused as ammunition by those who would like to repeal section 469, while leaving preferences intact. It is that possibility which suggests a certain disregard of politics in my article, given that I would reluctantly choose section 469 over a return to the heyday of tax shelters. If the only politically realistic alternative to section 469 is another tax shelter explosion, then I will take the logical incoherence of section 469 over the coherent disaster of unlimited tax shelters. I am, however, bold enough still to hope that the tax policy millennium will arrive someday.

\textsuperscript{90} In such a system there would be no reason to prevent the use in shelters of the few remaining "good" preferences. See generally Zelenak, supra note 1, at 499-588.

\textsuperscript{91} For the use of the term "damage control" in this context, see Koppelman, Tax Arbitrage and the Interest Deduction, 61 S. CAL. L. REV. 1143, 1194-96 (1988).