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Chapter 11

The Deduction of Interest Payments in an Ideal Tax on Realized Business Profits

Michael J. McIntyre

1 Introduction

Many countries impose a tax on the business profits of their residents and on nonresidents operating within their geographical borders. These taxes on business profits invariably include a realization rule—a rule that allows taxpayers to defer tax on certain accrued gains and prevents taxpayers from deducting certain unrealized losses. This realization rule, to function properly, requires that the deferred income be quarantined and that any deductions relating to that deferred income be capitalized or otherwise deferred until the related income becomes taxable.

For the most part, the need for capitalization in a realization system is well recognized by policy makers and tax analysts alike. The broad consensus breaks down, however, with respect to interest payments. Some tax analysts have argued that interest is inherently a current expense and ought to be deductible currently except in rather special circumstances. This viewpoint apparently is widely

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* Wayne State University Law School; Senior Fellow; Taxation Law and Policy Institute, Monash University.


accepted in accountancy. Other commentators would impose significant limitations
on the interest deduction. Whatever the views of tax analysts and accountants may
be, the simple fact is that all countries imposing a tax on business profits fail to
apply to interest payments the capitalization rules that are routinely applied to other
types of rental payments. As discussed below, this permissive and special treatment
of interest payments compromises the integrity of a tax on realized income and
results in the substantial undertaxation of business profits around the world.

For some tax analysts, the term ‘ideal realization tax’ is an oxymoron. In their
view, the realization rule itself is unprincipled, and a tax system that embodies it is
an odd hybrid of a Kaldor/Andrews consumption tax and a Haig/Simons income
tax. Perhaps. Claiming that a particular set of tax rules constitutes an ideal or model
tax, however, is not an endorsement of that tax. The articulation of the basic features
of an ideal tax on realized income is a useful step in understanding how a realization
system would work if the principles it embodies are applied consistently. My narrow
concern in this paper is to see how those principles would affect the deduction for
interest payments.

Despite my narrow focus, Part 2 of this paper raises and offers answers to
questions that go to the foundations of the income tax – indeed, to the foundations
of any broad-based redistributive tax. In that part, I analyze the policy goals and
basic features of an ideal tax on realized income. I conclude that an ideal realization
tax has some significant practical advantages in taxing business income over either

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5 For discussion of the realization rule in the context of a normative income tax, see D.H. Schenk, ‘A Positive Account of the Realization Rule’ (2004) 58 Tax Law Review 355, at 396 (‘a realization rule is an inevitable feature of our hybrid tax’); see also J. M. Dodge, ‘Exploring the Income Tax Treatment of Borrowing and Liabilities, or Why the Accrual Method Should Be Eliminated’ (2006) 26 Virginia Tax Review 245 at 251 (‘any rule or doctrine that pertains to when changes in wealth are taken into account for income tax purposes can be characterized as a “realization” rule’).
a Haig/Simons income tax or a Kaldor/Andrews consumption tax, whatever the relative merits of a realization tax may be in some utopian world of our imagination. In particular, I argue that a realization system is better able to deal with certain realities – valuation issues and cross-border issues – that alternative income and consumption tax systems do not deal with very well.

I examine in Part 3 the proper treatment, in a tax on realized income, of interest costs incurred by a taxpayer engaged in business activities. In brief, I argue that interest costs should be treated in much the same way that other types of rental costs are treated. Section 3.1 discusses interest incurred to acquire or produce inventory property. Section 3.2 discusses the proper treatment of interest paid to earn current income when some of that income is not subject to current taxation because it has been earned through a foreign affiliate. Section 3.3 offers some brief notes on the debt/equity issue. I suggest in that part that the perceived overtaxation of equity-financed income is due in significant part to the undertaxation of debt-financed income. A brief conclusion is provided in Part 4. An appendix provides an algebraic expression of a source-based Haig/Simons system, an ideal realization system, and a Kaldor/Andrews consumption tax.

My defense of a realization rule is not intended as a defense of the broad realization requirement found in most tax systems. My defense is limited, first of all, to the taxation of business profits. I do not deal here with the usefulness of a realization rule in taxing other forms of income, such as wages, returns on investment, and income from new financial instruments.6 Second, I do not contend that a realization rule should always apply in taxing business profits. Indeed, as discussed in Part 2, I would employ the rule only when a Haig/Simons accrual system is not likely to work properly due to valuation issues and cross-border issues.

2 FEATURES OF AN IDEAL TAX ON REALIZED INCOME

Tax provisions are means to ends, not ends in themselves. Their merits depend entirely on their efficacy in advancing the goals of the tax system in which they operate. Tax systems also are means rather than ends. They are not good or bad absolutely. They are instruments of politics, and they cannot be justified except in terms of the political goals that they would advance. In this context, I am not using the term ‘political goals’ in a disparaging way. Instead, I am speaking of the goals that have been articulated by some theory of social justice, such as, for example, the theory of justice articulated by John Rawls.7

To determine whether a particular tax provision would advance a set of political goals, tax theorists must establish, by assumption or otherwise, the features of the

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tax system in which that provision would operate. They cannot defend a particular tax provision in the abstract because every tax provision depends on other tax provisions to have consequences. There is no such thing, for example, as an ideal rule for defining income or for relating income to a particular taxable period except as features of an ideal tax system.

In discussions of minor reform of an existing tax system, it may be convenient for tax theorists to assume that all features of that system, other than the one under scrutiny, would remain unchanged. They could then argue for or against a particular reform by reference to the likely changes that the proposed reform would have on the existing distribution of tax burdens. For a tax theorist to make valid arguments for or against more fundamental reforms, a model of an ideal tax system is a practical prerequisite. That model would organize the assumptions that the theorist was making about the tax system in which a particular provision under scrutiny would operate.

I employ here, with some modifications, a system for classifying tax rules by function that I developed earlier and have employed in various contexts, including the evaluation of family taxation rules under a Haig/Simons income tax, a Kaldor/Andrews consumption tax, and an endowment tax. Tax rules can be classified in an unlimited number of ways, and no one way is a priori the best. As with any classification scheme, mine has value only to the extent that it is useful. I present the classification scheme in section 2.2, below. Before discussing that scheme, I endeavor in section 2.1, below, to set forth the basic organizing principles or political goals, broadly defined, of an ideal tax on realized income.

2.1 Political Goals of a Redistributive Tax on Realized Income

The distribution of income that typically results from market forces is not necessarily desirable. According to Henry Simons, that distribution is ‘distinctly evil or unlovely’. The most effective mechanism for changing that distribution, at least with respect to undesired income concentration at the top of the income scale, is through a redistributive income tax. A redistributive tax system may be defended both on moral and aesthetic grounds. The morality issue (that the market distribution is ‘evil’) should be resolved by reference to some political theory of justice. Certainly, a redistributive tax regime would find support in almost any


political theory in which equality is given a high value. The aesthetic defense (that
the market distribution is ‘unlovely’) is more personal and may vary from citizen to
citizen. The long endurance of a graduated income tax in most democratic societies
suggests that Simons’ perspective is widely shared. Support for redistributive taxes,
nevertheless, is far from universal.

Tax discussions about the design of a redistributive income tax often start with
a discussion of the Haig/Simons income definition. From Simons’ perspective, that
definition was formulated precisely to support income redistribution – to contribute
to a society in which the distribution of material goods was decidedly less ‘evil or
unlovely’. Simons sought to liberate the case for redistribution from the shackles of
the utilitarian framework that was prevalent among his contemporaries, and which,
amazingly, remains prevalent in some circles even now.

According to Simons, the definition of income (1) should be objective rather
than subjective; (2) should be quantitative and measurable; and (3) should have a
minimum number of implicit arbitrary distinctions. Simons’ own definition gets
reasonably good marks on these three tests. Still, his definition requires that the
tax department or the taxpayer determine annually the value of assets, including
intangibles. Admittedly, no country has actually tried to implement fully a Haig/
Simons income tax. They have, however, tried to monitor and correct the transfer
prices set by multinational companies on transactions with related parties, and
they have largely been unsuccessful in determining the proper prices on transfers
involving valuable intangible property.

The normative foundation of the realization rule rests significantly on the
difficulties, especially in a business setting, of determining Haig/Simons income
in some circumstances. I suggest that a realization rule is appropriate whenever
Haig/Simons income cannot be determined, for theoretical or practical reasons. I do
not contend that a realization rule is the only possible alternative to the accrual rule
of Haig/Simons, nor do I contend that the realization rule is a second-best solution
to the measurement problems presented in some circumstances by the Haig/Simons
rule. We all know that it is usually impossible to prove that any departure from an
ideal constitutes the second-best solution. I do claim that the realization rule is an
nth best solution, where n is some positive number. I also claim that it is the only
alternative that has been tested and is known to work at least tolerably well in some
circumstances.

If the realization rule is adopted because of problems in measuring accrued gains
in a business context, then the realization rule should not be applied in circumstances

10 Id. at 42–43. The transfer pricing rules promoted by the OECD, for example, do not meet
Simons’ requirement that income be measured ‘according to objective market standards.’ Id.,
at 51.
11 Nor can they establish its source. See I. Benshalom, ‘Sourcing the “Unsourceable”: the Cost
Sharing Regulations and the Sourcing of Affiliated Intangible-related Transactions’ (2007) 26
Virginia Tax Review 631.
in which an accrual rule operates effectively. Various commentators have suggested that an accrual rule should be applied to marketable securities, forward contracts, and various other assets with an ascertainable market value.\(^\text{12}\) In such circumstances, a Haig/Simons rule is not only workable but it also avoids many of the disadvantages long associated with a realization rule.

I suggest that the realization rule be applied narrowly, primarily in the following three circumstances: (1) when the volume of assets that needs to be valued is exceedingly high; (2) when the assets to be valued under a Haig/Simons rule involve valuable intangible property that is difficult to value accurately and has no market analogue; and (3) when the income to be measured arises from a cross-border transaction. The first two of these circumstances can be defended by reference to Simons’ second criteria, set out above, for a good definition of income. In my view, it is highly impractical to measure gains from holding inventory property through annual valuations, due to the sheer volume of the assets to be valued. It is certainly possible, as a theoretical matter, to value inventory property at market at the beginning and end of each year, as required under the Haig/Simons definition of income. I am highly confident, however, that a tax administration charged with this task would be frustrated and ineffective. Inventory accounting under the current realization rule is far easier to administer, for taxpayers and tax officials alike, and the results achieved do not compromise significantly the redistributive goal of the income tax.

My endorsement of a realization rule for property involving intangibles is based both on practical and theoretical concerns. The worldwide experience of tax departments with transfer pricing strongly suggests the impracticality of valuing large quantities of intangible property or tangible property that takes much of its values from associated intangibles. The theoretical concern is that intangible property is often difficult even to identify with the precision needed for tax purposes.

Consider, for example, an Australian company that is highly successful in selling widgets in the United States. Do we assume that this success is due to the existence of some intangible property – perhaps some special marketing scheme or a particularly effective organization of its workforce? Are we then required, under Haig/Simons principles, to identify that intangible and determine whether its value has increased, decreased, or stayed the same during the taxable year? I do not see how a tax system can be charged with this task and still meet Simons’ second criteria for a minimally acceptable definition of income.

In sum, I do not think a country should adopt a tax system in which the tax department can assume the existence of some intangible asset and then impose tax based on its view that this asset appreciated in value during the year. Nor should a country want a system in which the taxpayer can assume the existence of an

\(^{12}\) See, e.g. Schenk, above, n. 4 at 396 (‘a pure realization rule is indefensible in a system intended to impose a tax on capital’).
asset and then claim a reduction in its tax otherwise due based on its assertion that the assumed asset declined in value. Better, in my view, to base taxation on the existence of gains and losses that can be identified unambiguously.

I endorse the use of a realization rule in the international arena, at least in some circumstances, because I do not see how a Haig/Simons system can work effectively in that environment, as it currently exists. The Haig/Simons income definition implicitly assumes that all of the taxpayer’s income is subject to tax. It is anti-schedular. That is, by design, it does not provide for the quarantining of income or deductions. Gross income from all sources is added up, and all deductions, from whatever source, are deducted from that income.13

In contrast, a realization system, at its heart, is a schedular system. At the extreme, income generated by each asset is computed by subtracting the accumulated deductions (tax basis) from the gross revenue generated by the sale of that asset. The amount of tax due from the taxpayer is calculated by adding up the net income derived from all of the taxpayer’s assets. In practice, a realization system allows for some useful grouping of assets. For example, the accounting conventions applicable to the computation of gain from the sale of inventory property are best understood as grouping rules.

At their current low level of development and lack of coordination, international income tax rules need to have some schedular features. In my view, it is easier to meld those schedular features into an inherently schedular realization system than into an inherently global Haig/Simons system. For example, in a Haig/Simons system, all amounts paid out, other than those incurred to finance consumption, are deductible. If those deductions result in the creation or augmentation of an asset that is on hand at the end of the year, then the deduction is offset by an income inclusion. I do not see how that system works in an international setting when many gains are simply not taxed. Better, in my view, to disallow deductions whenever the related income is not taxable. The disallowance of ‘unrealized’ deductions is an inherent part of a realization system, whereas it is entirely foreign to a Haig/Simons system.14

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13 A Haig/Simons system defines income in terms of its two uses – consumption and savings. Any practical Haig/Simons income tax, nevertheless, would seek to measure consumption and savings from information obtained from income sources. The definition of Haig/Simons income, as measured by income sources, is set forth in the appendix.

14 An endowment tax also is designed without schedular features and, for that and many other reasons, would not work in an international environment. Indeed, the same flaw exists with almost any tax that rests primarily on its alleged efficiency benefits because of the inefficiency that results when taxpayers seek to avoid the tax by leaving the taxing jurisdiction. For my spoof of an ‘optimal’ lump-sum levy, see M.J. McIntyre, ‘Optimal Tax Act Passes; Income Tax Replaced by Lump Sum Levy,’ (1980) 10 Tax Notes 436, available at: <http://www.law.wayne.edu/mcintyre/text/archives/Optimal%20Tax%20Act%20Passes.pdf>.
2.2 Classification of Tax Provisions

My schema for classifying provisions of an ideal tax system adopts three categories of tax rules: (1) sorting rules, (2) imposition rules, and (3) tax expenditure rules. The sorting rules are divided into three subcategories, each with a clearly defined function, and two of those subcategories are divided again. For my system to be useful, I should be able to place any tax provision of an ideal tax system into one and only one of the system’s categories. Of course, the assumption is that the ideal system is coherent. I do not suggest that tax provisions adopted through political compromise can be classified unambiguously, although I believe that I could do so if allowed to rewrite the statute by reclassifying tax provisions based on hypothetical transactions, as is done with the familiar tax-expenditure analysis.

The function of sorting rules in my model is to rank taxpayers according to their economic well-being, however defined. The first of the sorting rules are the tax-base rules. Those rules define the relevant standard for measuring well-being. In a Haig/Simons income tax, well-being is defined in terms of accrued gains derived from the marketplace. A realization system also focuses on marketplace gains, but limits the gains relevant for sorting purposes in some circumstances to gains that have been realized.

The second set of sorting rules are the taxable period rules, subdivided into the rules that define the taxable period (the year in virtually all income tax systems) and the rules that attribute income to a particular period. Those latter rules are underdeveloped, to say the least, in a Haig/Simons income tax. In principle, those rules should attribute taxable gains to the period in which those gains are consumed or saved. In the business context, where consumption is not an issue, the basic rule should be that income becomes taxable when it can be identified as an asset that provides the taxpayer with a savings benefit. A similar rule should be applied in a realization system, with the caveat that certain gains are deemed not to provide a savings benefit prior to their realization. For better or worse, the rules for attributing income to a particular taxable period draw heavily from accountancy.

The third set of sorting rules are the taxable person rules, subdivided into the rules that define the taxable person and the rules that attribute income to particular persons. I do not address the design of the taxable person rules in this paper. I simply assume without discussion that income is taxable to the business enterprise, however defined, that earns it. I leave for another day the complex problem of attributing business income to particular individuals.

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Thanks to Richard Musgrave, tax analysts often begin their discussion of tax equity by bifurcating that issue into two parts: horizontal equity and vertical equity. Unfortunately, many analysts casually assume, incorrectly, that horizontal equity is a function of the tax base. In fact, it is a function of the sorting rules, of which the tax base rules are but a part. This confusion is exacerbated by the claim that the tax base is ‘the number to which the tax rates are applied’. That claim is misleading at best. The tax rates are applied to a number. That much is true. This number is calculated for each taxpayer by applying the three sets of sorting rules – tax base rules, taxable period rules, and taxable person rules. If the tax base really were ‘the number to which the tax rates are applied,’ then the tax base would be customized for every taxpayer, and the number of tax bases in the tax system would equal the number of taxpayers subject to tax in that system. It is far better to view the tax base, not as a number, but as a set of rules defining the economic benefits subject to tax.

The imposition rules serve to impose tax burdens on taxpayers with respect to their ranking by the sorting rules. In my model, each taxpayer would employ the sorting rules to compute its taxable income. The taxpayer then would employ the imposition rules to determine the amount of tax due with respect to that taxable income. The rate schedule is the paradigmatic imposition rule. Many tax systems, however, also employ tax credits as imposition rules.

The imposition rules properly address the issue of vertical equity, if that concept is understood to mean the appropriate treatment of taxpayers whose income, as determined under the sorting rules, is not the same. I am assuming in this paper that the function of a Haig/Simons income tax and a realization tax is to redistribute market rewards in accordance with some moral or aesthetic standard established through democratic principles.

In some sense, I am assuming that vertical equity requires that the rates applicable to taxpayers increase with income, and increase sufficiently to achieve the desired redistribution of income. I recognize that, in principle, a Haig/Simons income tax is more progressive than a tax system employing a realization rule. Nevertheless, I think the apparent loss in progressivity is illusory, assuming that the realization rule is used only when a pure Haig/Simons system is unlikely to function properly. I do not deal in this paper with progressive rates because I am focusing on the computation of business income without reference to the ultimate taxpayer on that income.16

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16 I do not mean to suggest that I accept the claim often made by economists and business lobbyists that ‘only people can pay taxes’. Economists make that assertion because, in their view, the proper measure of the effect of a tax is its impact on the welfare of individuals. If tax incidence is so defined, then it follows that only individuals can pay taxes. That viewpoint, however, is exceedingly parochial and is not maintained consistently by economists. It is commonplace, for example, for economists to attempt to determine the impact of taxes on corporate behavior. As I have noted elsewhere, if we defined the incidence of a tax as its effect on the ability of a taxpayer to pay dividends, then only corporations could pay taxes. See M.J. McIntyre, ‘Thoughts on the Future of the State Corporate Income Tax,’ (2002) 25 State
The residual category of rules in my system is the tax expenditure rules. A tax expenditure is a provision of an income tax system that has not been designed to serve either a sorting function or an imposition function. Tax expenditure rules are not an essential feature of an ideal personal income tax and are not discussed further in this paper.

3 Interest Payments in a Practical Tax System

This section explores at a fairly high level of generality the proper treatment of interest payments in some of the circumstances identified in Part 2 as requiring, at least in practice, the use of a realization rule. Section 3.1 discusses the need to capitalize interest paid with respect to a loan that was incurred to acquire or produce inventory property, assuming that the gains from inventory property are not taxable until that property is sold or otherwise disposed of.

Section 3.2 discusses the proper treatment of interest payments when income earned through a foreign affiliate is not currently taxable. Again, the interest payments should be capitalized.

In Section 3.3, I discuss how a reform of the interest-deduction rules would go a long way towards reducing the familiar disparity in the treatment of debt and equity. I suggest that interest payments relating to the purchase of stock and to the acquisition of intangible and depreciable property all should be capitalized in an ideal realization system.

3.1 INTEREST ON LOANS USED TO ACQUIRE INVENTORY PROPERTY

All tax systems of my acquaintance generally require taxpayers to capitalize the costs of acquiring or producing inventory property. Those costs become deductible when the inventory property is sold or otherwise disposed of. An exception to the general rule applies to interest payments. For whatever reason, taxpayers are allowed to deduct currently the interest paid with respect to loans used to acquire inventory property. This treatment of interest payments is improper in an ideal realization system.

Footnotes:


According to the model realization system presented in Part 2, above, all of the costs that have been incurred to acquire or produce inventory property should be capitalized. Tax systems do not always conform to that standard even for payments other than interest. For example, tax systems are quite lax in requiring a proper allocation of overhead expenses to inventory property. But interest is the only inventory cost that is exempted from the capitalization requirement merely because of its status.

The special treatment of interest under current law cannot be explained under any broadly held principle of taxation. Consider, for example, the treatment afforded to rental payments other than interest. If a taxpayer rents equipment to build widgets, the rental payments routinely would be capitalized and recovered only when the widgets are sold. Although not every tax system gets this result, I think most tax analysts would agree that the cost of renting a building for the storage of property held for sale to customers should be capitalized and recovered when the goods stored in the rented building have been sold. Since interest is simply the cost of renting money, there is no obvious reason why that particular rental payment should not be capitalized when it has been incurred to produce or acquire inventory property.

As discussed above, tax analysts have sometimes sought to justify special treatment of interest payments on the ground that money is fungible. No one should fall for the Fungibility Fallacy in the treatment of inventory property, given that most inventory property is itself fungible. Tax analysts have dealt effectively with the fungibility of inventory property by devising simple accounting formulas, such as FIFO, LIFO, and average costing, that actually make inventory accounting quite simple. Indeed, if inventory property were not fungible, the accounting rules would have to be considerably more complex.

To capitalize interest payments incurred to acquire or produce inventory property, a tax system needs to include rules that link the proceeds of a loan with particular uses. Because of the fungibility of money, exact tracing is unnecessary. A reasonable formula will produce satisfactory results. The important point is the establishment of the general rule that the taxpayer cannot get a tax benefit from an interest payment without tracing that payment to a use that justifies that tax benefit.

If the taxpayer is required to capitalize an interest payment on a loan because it cannot establish that it used the proceeds of that loan to earn income currently taxable, it typically would prefer to treat the interest as an inventory cost. The reason is that inventory property typically is not held for an extended period, so that

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19 The proper goal is what is called “full absorption inventory accounting”, which is required for financial reports under generally accepting accounting principles.

20 See McIntyre, Tracing Rules, above n. 18, at 78–81.
the interest cost is likely to be recovered rather quickly. Thus, a well-designed rule for interest would not only require that interest used to acquire or produce inventory property be capitalized, it would also prevent interest that has been capitalized to be treated as an inventory cost when the interest is more properly linked to the acquisition of property with a less favorable recovery period.

In some cases, a taxpayer may use its inventory property as security for a loan. If the loan proceeds were actually used to acquire or produce inventory property, then the interest paid on the loan should be treated as an inventory cost and should become part of the cost of goods sold when the inventory property is sold. The existence of a security interest in inventory property, however, should not be enough to justify the treatment of interest on a loan as an inventory cost. It is the use of the loan proceeds, not the security interest, that determines how interest on the loan should be treated for tax purposes.

Some special accounting formulas are needed when interest relates to an unsecured loan or to a secured loan when the proceeds of that loan were not used to acquire the property serving as security. Assume, for example, that a taxpayer, ACo, borrows $1,000 on its general credit. During the taxable year, it spends $500 on earning current income, $600 to acquire inventory property, and $900 to purchase depreciable equipment. That is, it has $2,000 of expenditures, one half of which are debt financed and one half equity financed. Under these circumstances, the interest payments on the secured loan should not be linked automatically with inventory property. Instead, that interest should be treated the same way as interest paid with respect to an unsecured loan.

The linkage of the loan proceeds with particular purchases should be accomplished according to the rules generally applicable to purchases in a realization system. I have suggested that linkage should be accomplished through what I have described as ‘permissive tracing’. That is, I would allow the taxpayer to make the linkage in the way that gave it the most favorable tax result. I will not repeat the theoretical case for permissive tracing here. Instead, I offer the following example to illustrate that permissive tracing is the accepted rule for rental payments other than interest.

Consider ACo, the taxpayer discussed above. Assume that ACo owns a truck (Truck A) and also rents a truck (Truck B) that is identical in all relevant ways. The rental fee for Truck B is $600, of which $200 is paid to compensate the owner of the truck for depreciation and $400 is to compensate the owner for the time value of money (interest). ACo is allowed to take a depreciation deduction of $200 on Truck A in the current year. For legitimate business reasons, ACo must use one of the two trucks to produce inventory property and the other truck to earn currently taxable income. If it used Truck A for current purposes and Truck B for producing inventory property, it would get a current deduction of $200 (representing depreciation on Truck A) and no other deduction because the rental cost attributable to Truck B must

21 See McIntyre, An Inquiry, above n. 3 at 787–788.
be capitalized and treated as part of the cost of good sold in a later period. Every tax system of my acquaintance, however, would allow ACo to use Truck B for current purposes, in which case ACo would get a current deduction of the $600 rental fee and would capitalize the depreciation deduction associated with Truck A, treating it as an inventory cost.

I see no strong reason for treating interest costs paid by a taxpayer less favorably or more favorably than interest costs embedded in rental payments. Current law generally allows a current deduction for all business-related interest costs, which is unduly favorable. As explained above, I would deny the current deduction whenever the interest cost is appropriately linked to the acquisition of capital assets, as is the rule, in principle, that applies to other rental payments. However, I would not deny the taxpayer the favorable allocation rule that all tax systems apparently use in determining the tax-relevant use of rental property.

3.2 INTEREST PAID TO EARN TAX-DEFERRED FOREIGN INCOME

Many businesses earn income from foreign activities that is not currently taxed, either because the country imposing the tax has some kind of territorial rule or because the income is earned through an entity that, for some reason, is not subject to current taxation. A typical case of deferral arises when a domestic parent company earns income through a foreign affiliate. In such circumstances, all expenses incurred by the parent company to earn the deferred income should be capitalized or otherwise denied a current deduction. Some countries do have appropriate rules for limiting some deductions that relate to the earning of untaxed foreign income. With some limited exceptions, however, they invariably are too generous in their treatment of interest payments.22

Interest costs traced to the earning of currently untaxed foreign-source income should be denied a deduction in an ideal realization system. In effect, the interest cost is ‘unrealized’ because the associated income is treated as unrealized. To deny the deduction, it is necessary to have some rule for apportioning the interest payments between taxable income and untaxed foreign-source income. In my view, a pro rata apportionment formula should be used. In principle, the interest payments should be apportioned pro rata to net income, computed without reference to interest payments. For administrative convenience, however, an apportionment formula based on gross income might be satisfactory, as long as the tax authorities are given the power to depart from that rule to prevent tax avoidance.

The pro rata rule I recommend in this context is considerably less favorable to the taxpayer than the permissive tracing rule I recommend for linking interest payments involving only domestic transactions. The reason is that in the international context, an apportionment rule ought to produce results that are fair to all of the countries in

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which the taxpayer operates. Such a rule, to adopt the terminology used in discussing apportionment among the US states, must be ‘internally consistent’. An internally consistent rule is one that would result in income being taxed once and only once if all of the relevant taxing jurisdictions adopted the same rule. In the vast majority of cases, an internally consistent rule requires that expenses be apportioned pro rata.

The result I recommend is achieved almost automatically when the relevant taxing jurisdictions adopt combined reporting with formulary apportionment. If nation states were to adopt that rule, they would first compute the pre-apportionment net income of the combined business group and then apportion that net income among the relevant taxing states by some pro rata formula. The result would be that all currently deductible expenses, including interest expenses, would be apportioned pro rata among those states.

To achieve an acceptable result in today’s tax environment is more of a challenge. For reasons best explained by history rather than logic, all countries generally exempt income earned by a corporate taxpayer if the corporation chooses to earn that income through a foreign affiliate. In many cases, these countries would have taxed the income if it had been earned through a branch, even though the difference between a branch and an affiliate is mere legal form. To deal with certain abuse situations, many countries, including the United States and Australia, have adopted controlled foreign corporation (CFC) rules that tax income earned through a CFC in certain circumstances. Still, the general rule is exemption for income earned through a foreign affiliate. Given that exemption, the proper companion rule in an ideal realization system is that the associated expenses of earning that income should be quarantined and allowed as a deduction only when the income earned through the foreign affiliate becomes subject to tax.

Achieving the result described above is not a trivial matter. In theory, a country could require its corporations to provide detailed information about the income they have earned through their foreign affiliates. With that information in hand, the country could adopt a pro rata apportionment rule that would allow a current deduction for interest payments made to earn currently taxable income and would deny a deduction for interest payments made to earn foreign-source income that is not currently taxable. Note that the apportionment formula would apply only to interest payments that would be currently deductible if the income earned through the foreign affiliate were currently taxable. Interest associated with the acquisition of capital assets would not be apportioned under this rule. Instead, it would be associated with the assets that were acquired with the proceeds of the loan with respect to which the interest was paid.

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Ideally, all countries would adopt the same apportionment rules. Otherwise, corporations would face some risk of double taxation and may have inappropriate opportunities for tax avoidance. In addition to adopting an apportionment rule, countries also need to adopt a cost-recovery rule that would permit the taxpayer to claim the interest deduction when the deferred income becomes subject to tax. Again, uniform cost-recovery rules would advance the principle that cross-border income should be taxed once and only once.

The discussion above deals only with interest payments properly attributable to earning current income. A country ought to have in place domestic rules that sort out interest payments into current expenses and capital costs. These rules should be applied before the apportionment of any interest payments. I illustrated the way capitalization rules for interest payments would work in the case of inventory property. Somewhat analogous rules would be applied for other types of capital costs. Double taxation problems are mitigated when the parent company and its foreign affiliate are taxable under similar rules.

The cross-border apportionment of interest payments that relate to loans used to acquire capital assets is actually less complicated than the rules suggested above for interest payments relating to the earning of current income. The reason is that capitalization rules generally include an appropriate cost-recovery rule. As discussed above, a country ought to allow a deduction for interest payments relating to the acquisition or production of inventory property when the related inventory property is sold and the income from that sale becomes taxable. A country may not tax all of the net income resulting from the sale of inventory property, especially if the sale is made by a foreign affiliate and the profits from the sale are not distributed. In such circumstances, the interest payments relating to the untaxed sales would not qualify for a deduction. That result is achieved with no special rules – the operative rule is the rule that requires the capitalization of interest payments relating to the acquisition or production of inventory property.

3.3 Notes on the Debt-Equity Imbroglio

Many tax analysts have written about the disparate treatment of interest payments and dividends under the typical corporate income tax. In general, interest is deductible and dividends are not. Some countries have adopted integration schemes that permit a corporation to deduct dividends paid or, somewhat equivalently, allow its shareholders to claim a credit for some or all of the income taxes paid by the corporation. The basic premise of these integration schemes is that income derived from equity capital is taxed too heavily and ought to be given some form of relief. Whatever the merits of dividend relief, the fundamental reason for the disparity in treatment of the costs of equity capital and the costs of debt capital is that

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debt capital is treated far, far too favorable under every income tax system of my acquaintance. Most interest payments made by corporations are capital costs and should not be deducted currently. Yet, virtually all countries allow corporations to deduct interest currently except in some rather special circumstances. Fixing the interest deduction would not eliminate all debt/equity issues. Indeed, tax analysts have yet to develop a coherent set of rules for distinguishing debt from equity. In such a chaotic situation, ideal solutions are unattainable.

Still, reform of the interest deduction would go a long way toward diminishing some troublesome debt/equity problems. Consider, for example, a corporation that uses borrowed money to acquire one of its competitors. Should the interest on the acquisition loan be deductible in an ideal tax on realized income? The answer depends on what was acquired with the borrowed money. If the acquiring company received stock, then the interest paid on the acquisition loan should be added to the basis of that stock and recovered when the stock is sold. It should not be deducted currently under current rules applicable to acquisition costs other than interest. If assets are acquired, the interest payments should be allocated to the tax basis of those assets in proportion to their relative value. In many cases, no interest deduction would be allowed until the assets were sold because the assets are intangible, such as the going-concern value of the acquired firm, and have an indefinite life.

For another example, consider the proper treatment of the costs of acquiring depreciable property. Every tax system recognizes an exception to the realization rule – an entirely appropriate exception, I might add – for recovering the costs of acquiring depreciable property. Those costs are deductible periodically, prior to a sale, in order to roughly match the anticipated decline in the value of the depreciable property. Interest payments, however, are generally treated even more favorably. In a few situations, such as interest paid during the construction of a building and before the building has been put into service, interest paid with respect to a loan used to acquire depreciable property is not deductible. The general rule, nevertheless, is to the contrary. The result of that general rule is that debt-financed depreciable assets get much more favorable treatment than assets acquired with equity capital. A proper capitalization rule for interest payments would reduce the anomaly significantly.

As a final example, consider the way interest paid to acquire intangible property is treated. As discussed above, the proper treatment is to capitalize the interest payments and to allow recovery under whatever cost-recovery system is used for the intangible property. In many tax systems, the costs of acquiring intangible property with an indefinitely long life cannot be recovered until the property is sold or otherwise disposed of. The costs associated with wasting intangibles are typically amortized over their assigned life. An exception invariably applies, however, for interest payments, which typically are deducted currently. Removal of that exception would go a long way toward equalizing the treatment of income derived from debt-financed intangibles and income derived from equity-financed intangibles.
4 Conclusion

The realization rule has been much maligned by tax analysts, to the point that the term ‘ideal realization system’ is considered by some to be an oxymoron. The use of a realization rule when gain can be taxed without great trouble under Haig/Simons principles makes little sense, creating an unfair and inefficient bias in favor of those with unrealized gains over taxpayers earning salaries and other realized gains. Applied broadly, the realization rule undermines the ability of the tax system to redistribute market rewards, thereby compromising a central goal of an income tax in a democratic society.

The realization rule has been a persistent feature of income taxation not simply because it favors the rich and powerful. It has survived in significant part because the alternative rules simply cannot work in some circumstances. The goal for tax reformers should be to limit the use of the realization rule to those areas where it actually is needed and then to reform the rule to make sure that it operates properly. A proper operation of that rule requires that all of the expenses relating to the earning of unrealized income be capitalized and allowed as a deduction only when the unrealized income is actually taxed.

Some consumption tax proponents may believe that their favored tax eliminates the problem of unrealized gains by exempting all gains other than gains that have been realized and also converted to personal consumption. Those favoring a redistributive tax policy would make up for the resulting tax cut for the rich and powerful by subjecting them to higher tax rates. This plan presents enormous political difficulties because of the competitive pressures around the globe that tend to keep tax rates moderate or low. In any event, a consumption tax cannot solve the two major problems addressed in this paper – the problem of inventory accounting without a realization rule and the problem of cross-border taxation of businesses without that rule. Indeed, cross-border issues are significantly more formidable in a consumption tax – or its reigning ideal, the endowment tax – than in a Haig/Simons income tax.

A tax on business income may be seen as a technique for taxing currently what otherwise would be the unrealized gains of individual shareholders. Achieving that goal may be seen as one of several strong reasons for including a corporate income tax in the tax mix. Ideally, the corporate income tax would be applied to all business enterprises, without regard for their legal status as corporations. The fact that virtually all multinational enterprises operate in corporate form suggests, nevertheless, that the limited scope of the business tax is a second-order problem.

This paper has not attempted to deal in detail with the relative merits of a pure Haig/Simons income tax, a Haig/Simons income tax with a limited realization rule, or some form of consumption tax. It has addressed those broad issues merely to set the stage for a more detailed discussion of the proper treatment of interest payments in a tax on business profits. That issue is itself a difficult one. It is also an important one, given the widespread use of a business profits tax throughout the world.
As explained in some detail in Part 3 of this paper, interest payments, which are in essence a rental payment made to obtain the use of someone else’s money, are treated far more favorably than other types of rental payments in every business tax system of my acquaintance. That inconsistent treatment of interest payments undoubtedly has significant efficiency costs, although the focus of this paper has been on fairness and administrative economy, not efficiency. More fundamentally, that inconsistent treatment undermines the fairness of a business-profits tax.

Tax analysts may disagree on the goals of a business-profits tax and even on whether a country should employ such a tax. They may disagree on whether a business-profits tax requires a realization rule, even the limited realization rule advocated in this paper. Nevertheless, the realization rule is a feature of every business-profits tax in use throughout the world. For good or for bad, it is the international norm. It ought to be designed properly. A proper design requires not only that certain difficult-to-measure gains be deferred until realized but also that a deduction for the costs incurred in obtaining those gains be deferred.

As discussed in Part 3, most countries that employ a realization rule in their business-profits tax do have some rules for deferring a deduction for costs incurred to earn unrealized income. These rules are often not well designed and are often open to abuse. The worst problems, however, arise with the deduction for interest payments. For whatever reason, countries have failed to apply their general disallowance rules to interest payments incurred to earn tax-deferred or tax-exempt income. That failure seriously compromises the goals that a business-profits tax is intended to serve.

Reform of the interest deduction rules, even in the narrow context of a tax on business profits, is not easily achieved. Obviously, there are political obstacles to any change in tax rules that adversely affect the rich and powerful. Reform is particularly difficult when many tax analysts are prepared to defend the special treatment that interest payments now receive. The major obstacles to reform, however, do not lessen the need for it. Reform of the existing rules ought to be a high priority for policy makers around the globe. Reform of the flawed Australian rules might be a good place to start.
Appendix

Algebraic Expressions of Haig/Simons Income, Realized Income, and Kaldor/Andrews Consumption

Commentators traditionally have formulated the base of their ideal tax by reference to the uses of income (consumption and savings), not to the sources of income (wages, dividends, capital gains, etc.). To design an operating tax system, however, tax specialists must convert a base specified in terms of uses of income into one specified in terms of sources of income. Section 1 of this appendix sets forth a definition of Haig/Simons income in terms of income sources. Using compatible terminology, section 2 provides a definition of the base of a tax on realized income. For completeness, section 3 sets forth in algebraic terms the base of a Kaldor/Andrews personal consumption tax. Section 4 provides a brief note on how to deal with tax expenditures that have been grafted onto one of the ideal tax systems.

1 Haig/Simons Income (HSY)

Haig/Simons income (HSY) is usually defined as the algebraic sum of (1) the taxpayer’s personal consumption, measured by market transactions ($C$) and (2) the difference between the net worth of the taxpayer at the end of the assessment period ($NW_1$) and the net worth at the start of the period ($NW_0$). Equation (1) expresses this familiar relationship symbolically.

\[
HSY = C + NW_1 - NW_0
\]

Although commentators may occasionally indulge the fantasy that a tax department could measure the change in each taxpayer’s net worth, no one pretends that personal consumption could be measured directly. Instead, the assumption commonly made is that a tax department would compute consumption indirectly from presumably knowable information about a taxpayer’s income sources. The following equation shows how that computation would be made.

\[
HSY = S + OA_1 - OA_0 + NA_1 - AC - E - PD
\]

where

$S =$ total realized income, including wages, investment income, realized gains, windfalls, and gifts;
OA\(_1\) – OA\(_0\) = the unrealized gains on assets held both at the start and at the end of the taxable period, measured by subtracting the market value of old assets at the start of the period (OA\(_0\)) from the market value of these same assets at the end of the period (OA\(_1\));

NA\(_1\) – AC = the unrealized gain on assets obtained during the taxable period, measured by subtracting the acquisition costs of those assets (AC) from the market value as of the end of the period of the newly acquired assets (NA);

E = the total of the taxpayer’s profit-seeking expenses (i.e. payments that are intended to produce income and that do not either increase the value of an asset already owned by the taxpayer or produce an asset with utility that extends beyond the taxable period);

PD = any personal deductions, such as the deduction for state and local income taxes, that are judged to fall outside a refined definition of consumption.

In the above equation, taxable imputed income, if any, would be included in S as an imputed wage or as an imputed return on an asset. Realized gains on the disposition of assets included in S would be of two types – gains on disposed assets held at the start of the taxable period and gains on disposed assets acquired during the period. The first type would be measured by subtracting the market value of the disposed assets at the start of the taxable period from the proceeds. Gains of the second type would be measured by subtracting from the proceeds their market value at the time acquired.

2 A Tax on Realized Income (RY)

All income tax systems, for good or bad reasons, typically impose tax only on realized income (RY). An income tax based generally on Haig/Simons principles which adopted a realization requirement for accrued gains would define its tax base as the sum of (1) realized income accruing in the current period, plus (2) income that accrued in prior periods but was realized in the current period, minus (3) depreciation on wasting assets held at the end of the period, minus (4) that portion of expenses relating to the earning of realized income, minus (5) the personal deductions. This statement of the tax base yields the following equation:

\[
RY = S + SA_a - B_o - D - Er - PD,
\]

where
\[ SA_0 = \text{the market value at the start of the period of assets on hand at the start of the period and sold during the period}; \]

\[ B_0 = \text{the taxpayer’s basis in assets sold during the taxable year, as of the start of the taxable year}; \]

\[ D = \text{the deduction for depreciation and amortization, representing the taxpayer’s estimated loss (unrealized loss) resulting from a decline in the value of wasting assets (tangible and intangible) held at the end of the period}; \]

\[ E_r = \text{that portion of the profit-seeking expenses (E) allocable to the earning of realized income}; \]

\[ S \text{ and PD are defined as in Equation (2).} \]

3 Expenditure Tax Base (ETB)

The base of an expenditure tax (ETB) is frequently defined by solving Equation (1) for C. This yields the following familiar result.

\[ ETB (or C) = HSY + NW_0 - NW_1 \]

An expenditure base specified by this formula may be called a ‘Kaldor/Andrews consumption tax’. I have also referred to it as a ‘Haig/Simons consumption tax’ because its goal is to tax Haig/Simons income in two separate taxes, the consumption tax defined here plus a tax on saved income imposed by a personal wealth tax.

The statement of ETB in Equation (4) can be specified in terms of income sources by substituting for HSY from Equation (2) and stating NW0 and NW1 in terms of their balance sheet components. Equations (5) and (6) provide the necessary statements of NW0 and NW1.

\[ NW_1 = NA + OA_1 - L_1, \text{ and} \]

\[ NW_0 = SA_0 + OA_0 - L_{op} \]

where

\[ L_1 = \text{the amount of the taxpayer’s liabilities at the end of the taxable period}; \]
\( L_0 \) = the amount of the taxpayer’s liabilities at the start of the taxable period;

\( NA \), (newly acquired assets) \( OA_1 \), (old assets valued at end of period) and \( OA_0 \) (old assets valued at start of period) are defined as in Equation (2).

Equation (4) can now be solved by substituting from Equations (2), (5) and (6) to yield the following.

\[
ETB = S + SA_0 + (L_1 - L_0) - AC - E - PD
\]

4 Tax Expenditures

The three tax base definitions, HSY, RY, and ETB, abstract from the possible presence in a tax system of tax expenditure provisions. To apply these definitions in a tax system that contains tax preferences, analysts must first bifurcate the tax code into two sets of rules – those that seek to advance the revenue raising goals of the income tax and those that seek to achieve spending goals. The formulas presented here would be applicable to the first of those sets of rules but not to the second.