

1980

# Accelerated Depreciation Revisited—A Reply to Professor Blum

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## Recommended Citation

Kahn, Douglas A. "Accelerated Depreciation Revisited—A Reply to Professor Blum." *Mich. L. Rev.* 78 (1980): 1185-99.

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# ACCELERATED DEPRECIATION REVISITED — A REPLY TO PROFESSOR BLUM

*Douglas A. Kahn*\*†

Professor Blum's comment<sup>1</sup> addresses the proper or neutral tax treatment to be accorded three of the items discussed in my recent article<sup>2</sup> on accelerated depreciation — namely, annuities, prepaid expenses, and exhaustible assets. Blum disputes my analysis in all three cases. While Blum's article is eminently readable, I do not believe that it refutes my earlier work to any extent. In this reply to Professor Blum, I will deal separately with each of the three items he examines. First, however, it is useful to consider the meaning of the term "tax neutrality" and to set forth my views as to the nature and proper function of the neutrality principle.

A tax provision is neutral if it is compatible with some "correct" or "ideal" definition of net income. Where a tax provision fails to conform to a particular commentator's notion of an ideal income tax, that commentator says it provides a tax preference or a tax subsidy to those persons who benefit from it. Such subjective tax preferences often are called "tax expenditures." A neutral provision is one that does not generate a tax expenditure.

Much of the literature on tax neutrality treats the issue as an all or nothing proposition. Relying on some variation of the much discussed Haig-Simons definition of income, commentators conclude that a tax provision either is tax neutral or is not. My view of neutrality is more relativistic. One of the points of my recent article is that there is no single ideal (or correct) definition of net income for income tax purposes. Rather, the determination of net income rests on value judgments that not all people share and that change over time as societal values change. Instead of a rigid, narrow concept bordered by fine, clear lines, net income can be viewed as a concept defined by broad and changing boundaries. Any tax treatment consistent with such a broadly defined concept of net income can be

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1. Blum, *Accelerated Depreciation: A Proper Allowance for Measuring Net Income?!!*, 78 MICH. L. REV. 1172 (1980).

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

considered to be within the zone of tax neutrality. Under this expansive view, a variety of different tax treatments of a single transaction can qualify as tax neutral because they can all lie within the neutral zone. In some cases, Congress permits a taxpayer to elect among several tax neutral provisions — to choose, for example, among several permissible methods of depreciation.

Once it is determined that several proposed tax treatments are tax neutral, the choice of one over the others, or the choice of whether to adopt any or all of them, is made by weighing economic, political, and social policy considerations. For example, there are substantial grounds for characterizing medical expense deductions and casualty and theft loss deductions as tax neutral, although these deductions often are classified as tax expenditures. A neutral characterization, however, does not compel the allowance of deductions for those items. While consistency with tax neutrality weighs in favor of granting a deduction, the decision to allow or to deny deductions ultimately rests on broader policy considerations. As a result, the tax law forbids many deductions that, nevertheless, would be consistent with tax neutrality. The clearest example is the § 162(c) denial of a deduction for unlawful business expenses.<sup>3</sup> Another example is the failure to grant a tax deduction for liabilities incurred for causing damages to others in a nonbusiness setting (this is admittedly more controversial, for many persons would not deem such a deduction to be tax neutral).

The zone of tax neutrality can be divided into concentric sub-zones of differing proximity to the core of the net income concept. For example, a deduction for most types of business expenses is more essential to determining net income than is a deduction for the cost of tax consultations. The closer a particular tax provision is to the essence of the net income concept, the greater the presumption in favor of adopting that provision. Thus, the weight of negative policy considerations required to justify rejecting a tax neutral provision is not the same for all such provisions. A slight negative factor may suffice to reject provisions falling near the boundaries of the net income concept, but such negative factors should be quite substantial to warrant rejecting provisions that are integral to the net income concept. Some tax provisions lie within the hazy zone at the borders of neutrality; no affirmative or negative weight should be accorded these provisions on the basis of their purported neutrality or non-neutrality. Where a tax provision falls outside the broadly defined

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3. I.R.C. § 162(c).

zone of neutrality, it nevertheless may be proper to adopt it if policy considerations warrant it, but the contravention of tax neutrality is a negative factor to be weighed against adopting such a provision. There must be stronger policy grounds for adopting a tax provision that contravenes tax neutrality than otherwise would be required.

In my view, considerably fewer tax provisions contravene tax neutrality principles than are listed as tax expenditures in the budgets drawn by several governmental units. Accelerated depreciation is merely one example of the overreaching of such lists. It is noteworthy that Professor Blum also views the tax expenditure concept as "political rhetoric." That is not to say, of course, that Professor Blum concurs with my statements concerning the nature and significance of the tax neutrality principle. I hope to expand on those views of tax neutrality in a later article. As we shall see, however one views the tax neutrality principle, the allowance of an accelerated cost recovery for annuity payments, prepaid expenses, and especially for accelerated depreciation, does not contravene that principle.

*Annuities.* My recent article states that the purchase of a single annuity for years is equivalent to the purchase of a number of separate contracts, each of which represents the right to a stated dollar amount at a specified future date.<sup>4</sup> The article further contends that the part of each annuity payment made to the purchaser which constitutes a return of his capital (*i.e.*, his cost recovery) is equal to the amount that he paid for that segment of the annuity contracts. So, taking the three-year annuity paying a dollar per year to which Blum refers, the annuitant paid 94¢ for the dollar he received in Year One, and thus only 6¢ of that dollar is income to him. Similarly, the annuitant paid 84¢ for the dollar he received in Year Three, and thus 16¢ of that dollar is income to him.

While I believe that the above-described treatment is the most accurate representation of economic reality, my article acknowledges that a colorable claim can be made for treating an annuity purchase as a single investment, and for allocating all accrued interest to each annuity payment.<sup>5</sup> However, my article disputes the contention (which Blum reasserts) that such an allocation is the *only* reporting method that comports with tax neutrality. As to the choice between reporting a declining and an increasing amount of interest, the article shows that the case for crediting lesser amounts of interest (*i.e.*,

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4. Kahn, *supra* note 2, at 22-25.

5. *Id.* at 25.

allocating more cost recovery) in the earlier years of the annuity contract is overwhelming.<sup>6</sup> No insights in Professor Blum's piece appear to warrant a change of that view. For convenience, later in this Comment, I will sometimes refer to the method of income and cost recovery allocation advocated by my recent article as an "accelerated cost recovery method."

Blum makes two points in his attempt to establish that there is an absence of tax neutrality in allocating increasing amounts of interest to annuity receipts and conversely in allocating decreasing amounts of cost recovery to such payments. First, he points out that it is "highly unrealistic to assume that a single annuity contract for three years is equivalent to three separate contracts for one year each."<sup>7</sup> As we shall see, that may be something of an overstatement. Blum correctly states that the prevailing interest rate for a three-year loan will not necessarily equal the interest rate for a one-year loan. This difference arises primarily because the parties involved will build into the long-term rate their view of the likelihood that interest rates will increase or decrease over that period. Thus, if the prevailing rate for a one-year loan is six percent, and if the market indicates that the rate is likely to increase in the next several years, the rate of interest for a three-year loan will be greater than six percent. The rate of return is increased to compensate the lender for the risk that his money will be committed to an investment at a lower rate of return than would otherwise be available. Conversely, if the market indicates that interest rates will be lowered in the next several years, the interest rate payable on a three-year loan will likely be less than the current one-year rate of six percent. Apart from the anticipation of interest rate changes, other market factors can influence the rate on long-term loans. For example, because the lender's funds are committed for a longer period (and, therefore, unavailable for him to consume), and because a long-term loan entails a greater risk of default, the interest rate on long-term loans may be greater than that on short-term loans. Blum opines that a "similar diversity of interest rates might be expected to prevail in pricing term annuities that start at different dates."<sup>8</sup>

Accepting Blum's assumption that the discount rates for annuities will be determined in the same fashion as are interest rates for long-term loans,<sup>9</sup> annuity payments still will bear less interest in the

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6. *Id.*

7. Blum, *supra* note 1, at 1176.

8. *Id.*

9. For commercial annuities, this may not always be the case. A commercial annuity (*i.e.*,

early years of the contract than in later years. The purchase price of an annuity yielding a dollar per year for three years will be the sum of the costs of purchasing three separate contractual rights — the right to a dollar one year hence, a dollar two years hence, and a dollar three years hence. While the *discount rates* for the right to an annuity payment for each of those years will not necessarily be identical, the *total cost* for the three-year contract must equal the sum of the costs for each separate year (with perhaps some reduction for economies of scale, *i.e.*, the savings of cost for clerical and selling expenses).

The issuer of an annuity is unlikely to compute the cost of each year's annuity payment separately. Rather, it will apply a single discount rate determined as a weighted average of the discounts for each of the separate years. A single weighted discount rate is administratively easier to apply than separate rates for each year, but the net result is merely a short-cut method of determining the aggregate cost of the several segments of an annuity contract.

In sum, the cost of rights to future annuity payments will reflect the risk that interest rates will change during the contract period. But the fact that interest rates affect the cost of rights of future payments does not alter the proposition that the net cost of an annuity contract is equal to the aggregate costs of its segments. The question then becomes whether the possible application of different discount rates is inconsistent with an accelerated rate of recovery of capital.

If the discount rate for a right to a payment three years hence is greater than the discount rate for a right to a payment only one year hence, the proportion of capital recovery to be allocated to Year One is even greater than it would be if the discount rates for Years One

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an annuity contract sold by a person who is in the business of writing and selling such contracts) sometimes provides a guaranteed rate of interest sufficiently low that there is no meaningful risk that it will be greater than the prevailing current rate in any year in which the policy is in effect. The contract provides for the risk of a rise in interest rates by adjusting the aggregate amount payable to the annuitant to reflect the proper current interest rate. This is done by increasing either the amount or the number of the periodic payments made to the annuitant. For example, an annuity contract might guarantee payments of a specified amount computed at a four percent interest rate for a specified period. If the proper return for a given year of the contract (as determined by market conditions) is six percent, the additional two percent of interest will be paid to the annuitant. Of course, any amount paid to an annuitant in excess of the guaranteed payment constitutes interest income and should be so treated. Since this method of adjusting interest rates is not a uniform practice, especially among private annuities, I accept Blum's premise that discount rates for annuities will probably be determined in the same manner as are interest rates on loans, and I will deal directly with Blum's contention that such a treatment negates the analysis employed in my article. In any event, I am virtually compelled to adopt Blum's premise on this matter since the type of annuity contract I discussed in my article was not the adjusting interest variety, but rather was a contract to pay fixed sums at pre-established dates.

and Three were identical. This means that even less of the first year's payment would constitute income than would be true under the accelerated cost recovery pattern that my article espouses. On the other hand, if the discount rate for the later years of an annuity is less than the discount rate for the earlier years, a higher proportion of the total cost of the annuity contract is allocable to the later years than would be the case if the discount rate was constant, and a smaller proportion of the cost will be allocated to the earlier years of the contract payments. Even in that case, it is virtually inconceivable that the difference in discount rates would be of such magnitude as to preclude an accelerated cost recovery method; a significantly reduced rate for payments due in later years merely reduces the extent of the acceleration that is proper. Even in the case of an unrealistically high differential in rates, a substantially greater portion of the annuitant's cost is allocable to payments made in the early years.<sup>10</sup>

As previously noted, the question of whether the discount rate for the later years of annuity payments will be less than the discount rate for the earlier years turns in large measure upon the market's evaluation as to whether rates are more likely to fall than to rise. At any particular time, the economic indicators may point toward a likely increase or decrease in interest rates. There is no apparent reason to believe that, over the long term, investors will expect a decline in rates more often than they will expect an increase. Unless the discount rates for the later annuity payments are typically substantially

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10. A significant variance among discount rates cannot occur unless the term of the loan or the deferral of the annuity payment is substantial; and the longer the period of deferral of repayment, the greater the proportion of capital to be allocated to the earlier annuity payments (or loan installment payments). For example, suppose that the discount rate for an annuity payment to be made in one year is six percent and the discount rate for a payment to be made in five years is only three percent. The cost of a one dollar annuity payment to be made one year hence at a six percent discount is 94.3¢. The cost of a one dollar annuity payment to be made five years hence at a three percent discount is only 86.3¢. It is *extremely* unlikely that the discount rate for a four-year additional deferral of repayment would be so great — the three percent rate that is used in this illustration for the five-year deferred annuity payment is only half of the six percent rate for the one-year deferred payment. Even in that unlikely extreme circumstance, there is a substantially greater capital cost for the payment received in Year One than for the payment received in Year Five. Accordingly, an accurate method of reporting income from such annuity payments would still reflect less income in the early years and greater income in the later years.

It is significant that since interest rates on annuities typically are relatively low, it is unlikely that the discount rate for a long-deferred annuity payment will be substantially lower than the rate for an immediate payment. And the longer the period of deferral, the greater the acceleration of capital recovery in the early years. For example, if the discount rate for a one dollar payment one year hence were six percent and the rate for a one dollar payment due ten years hence were as little as three percent, the cost of the first year's payment would be 94.3¢ and the cost of the tenth year's payment would be 74.4¢ — in other words, assuming level annuity payments, the amount of capital recovery allocable to the first year's payment is greater than that allocable to the tenth year's payment by an amount equal to 19.9% of the payment received in each year.

less than the discount rates for the earlier annuity payments, the possibility of differences between short- and long-term rates does not contravene the accelerated cost recovery analysis. And as demonstrated earlier, even if long-term discount rates were usually lower than short-term rates, that difference would only slightly reduce the acceleration of capital recovery; it would not preclude such acceleration.<sup>11</sup> Since at any particular moment during a long time interval the likelihood that the market will anticipate an increase in interest rates is at least as great as the prospect that it will anticipate a reduction in rates, it is reasonable to disregard differences between long- and short-term rates when analyzing the proper breakdown of the payments received by an annuitant. Because the rate of acceleration of cost recovery is at least as likely to be increased by applying differentiated discount rates as it is to be reduced, and because the amount of any differentiation of rates is difficult to ascertain, it is reasonable to treat the short-term discount rate as a constant — *i.e.*, to use the short-term rate as the effective discount rate for the entire period of the annuity.

Blum's second reason for rejecting my article's characterization of annuity payments is that the article's analysis rests on an allegedly erroneous application of the cash accounting method. Blum asserts that cash accounting reporting is permitted for two reasons — administrative ease and financial convenience — and that neither of those considerations applies in the case of annuities. As to financial inconvenience (the burden imposed by taxing a person on income accrued but not yet available to him), Blum states that

should the annuitant be required to use sinking-fund reporting, he already would have the dollars in hand that reflect the amount of interest he reports for tax purposes. In the illustration, the 16¢ interest in year one resulting from a sinking-fund calculation is amply covered by the one dollar received by the annuitant at the end of that year.<sup>12</sup>

In essence, Blum contends that where there is clear evidence that a cash method taxpayer has sufficient capital available to pay the taxes arising from the accrual of income to him, and where the amount of such income can easily be calculated, the taxpayer should not be permitted the deferral that attends cash method reporting, but rather should be compelled to report such income in the year that it accrues. Referring again to our hypothetical three-year annuity, 94¢ of the dollar collected by the annuitant in Year One was a return of his own capital and 6¢ was the income derived from that capital.

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11. See note 10 *supra*.

12. Blum, *supra* note 1, at 1177.

Blum would not only tax the annuitant on the 6¢ of income that he collected but also on the 10¢ of income that had accrued to him because of the deposit he had made for dollars to be paid to him in Years Two and Three.

My recent article points out that the economic position of an annuitant who purchases an annuity for a term of years is the same as if he had purchased a separate contract right for each year of the annuity term.<sup>13</sup> The purpose of that comparison was to demonstrate the economic reality of the single purchase of a long-term annuity contract and the receipt of annuity payments thereunder. Blum's assertion that the purchase of three separate contracts presents tax avoidance issues rests on his *premise* that the correct method of reporting income from a single purchase of a three-year annuity contract is different from the result my article advocated. This begs the question. Since Blum believes that such a comparison raises tax avoidance questions, let me set forth a slightly different circumstance that better serves to illustrate the same point.

Three persons, *X*, *Y*, and *Z*, all of whom report on the cash method, purchase a nonrefundable annuity from the Friendly Insurance Company. The company determines the cost of the annuity by discounting at a six percent rate. *X* purchases the right to receive a dollar one year hence, and *X* pays 94¢ for that right. Obviously, when *X* receives his dollar at the end of a year, he will have 6¢ income and the remaining 94¢ will constitute a return of his original capital investment. *Y* purchases the right to a dollar to be paid three years hence, and *Y* pays 84¢ for that right.<sup>14</sup> Again, it is obvious that of the dollar that *Y* receives in Year Three, 16¢ represents interest to him and the remaining 84¢ is a return of his capital investment. Under current tax practice, which permits cash method reporting in such cases, *Y* will not report any of his interest income until he collects the dollar in Year Three.<sup>15</sup> *Z* chooses to purchase a contract

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13. Kahn, *supra* note 2, at 24.

14. For the reasons stated previously, the same discount rate (six percent) is applied to the right to a payment three years hence as is applied to a one-year deferral. As shown above, the principle under discussion changes little if different discount rates are applied to each year.

15. It seems unlikely that I.R.C. § 1232 would apply to *Y*'s transaction. As noted in Kahn, *supra* note 2, at 10 n.42, Congress amended § 1232 in 1969 to require a cash method taxpayer to accrue annually a pro-rata portion of the original issue discount on corporate bonds or other corporate evidences of debt. In effect, this provision requires the bondholder (or other corporate debt holder) to report the accrued interest income attributable to original issue discount. The stated purpose of that provision was to require parallel reporting of the interest deduction by the corporation and of the interest income by the bondholder. For that reason, the provision does not apply to bonds issued by a governmental body since governments do not take tax deductions. My article questioned why Congress mandated parallel treatment in that one circumstance when the use of cash and accrual methods by different taxpayers necessarily results

right to receive a dollar one year hence and to receive another dollar three years hence. The cost of that contract right is  $94¢ + 84¢ = \$1.78$ . At the end of Year One, when *Z* receives his first dollar under the contract, the portions of that dollar which represent income and capital surely are the same as they were for *X* — namely, 6¢ interest and 94¢ return of capital. Similarly, the dollar that *Z* receives in Year Three has the same economic characteristics as did the dollar that *Y* received — 16¢ interest and 84¢ return of capital.

In the illustration above, at the end of one year the \$1.78 that *Z* paid to the insurance company will have earned interest equal to six percent of \$1.78, or almost 11¢. Of that 11¢ of earned interest, 6¢ was actually paid to *Z* and therefore is taxed to him. Blum would tax *Z* on the additional 5¢ of earned interest that was not paid to *Z* (and is not then available to *Z*) because *Z* has recovered 94¢ of his original capital. *Z*'s recovery of his capital demonstrates that he has funds available to pay the tax on the 5¢ of accrued but unreceived income. Although Congress could conceivably tax *Z* as Blum suggests, there is no reason to characterize an alternative tax treatment that conforms with both economic reality and cash method reporting as lacking neutrality and therefore amounting to a subsidy for *Z*.

I must emphasize that I am not recommending that annuitants be taxed in accordance with economic reality — that is, on an ascending rate of interest income. The current tax law does not operate in that fashion for good and sufficient policy reasons. I contend only that current tax practice does not constitute a tax preference for annuitants because of its failure to adopt a sinking-fund method of allocating interest income. Similarly, an accelerated cost recovery method does not constitute a tax preference to annuitants. So, if Congress were to permit a cash method annuitant to report only the amount of cash income that he actually or constructively receives, that method of reporting would not contravene tax neutrality.

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in a lack of parallel treatment in many circumstances. One possible explanation for singling out corporate bonds and debt instruments is that it was one of a number of actions taken by Congress in 1969 against the use of debt by conglomerates in taking over small corporations. In essence, it was an anti-conglomerate step taken for financial and social policy reasons. While Blum is correct that the purchase of an annuity right for one year (or for that matter, an annuity for a period of years) is similar to acquiring a debt with an original issue discount, it appears unlikely that § 1232 will extend to commercial annuities that are specifically dealt with in a separate Code provision (§ 72). Obviously, on its explicit terms, § 1232 does not apply to private annuities purchased from individuals. Even if § 1232 did extend to cover § 72 annuities, this would not reflect on the principle at issue — *i.e.*, the economic reality of what portion of an annuity payment represents interest and what portion represents a return of capital. Congress can require accrual method reporting if it wishes to do so, but that does not convert a method of reporting that comports with cash method accounting into one that lacks tax neutrality or constitutes a tax subsidy.

While Blum may wish to require annuitants to report income from their annuity contracts on the accrual method, he seems content to tie their recognition of deferred income to the amount of capital returned to them in the taxable year in question.<sup>16</sup> The annuitant's receipt of a return of his capital is no better reason for taxing him on earned but unpaid income than is his possession of cash of an equal amount. In the illustration above, for example, *Y* would have earned interest of over 5¢ at the end of Year One on the 84¢ that he paid to the insurance company for the right to one dollar in Year Three. Under normal cash method reporting, *Y* will not report that income until he actually receives the dollar in Year Three. If it can be shown that *Y* has at least 5¢ of cash in his possession, there is as much reason to tax *Y* on the accrued income as there would be to tax *Z*, who in Year One received a return of some of his capital in cash. But if a cash method taxpayer were to be taxed on unreceived but easily computed income whenever he has an equal amount of cash on hand, there would be little left of the cash reporting method. Presumably, Blum would limit his "available cash" rule to situations where cash was received by the taxpayer in the year in question from the person who is obligated to pay the accrued income to the taxpayer at some future date. The desirability of such a rule seems questionable; in any event it does not negate my article's contention that a cash method annuitant's reporting of only that amount of income from annuity payments that is actually or constructively received by him does not violate the principle of tax neutrality.

*Prepaid Expenses.* Sellers typically allow a price discount for the prepayment of expenses. As an illustration of such prepayments and their proper treatment, my article discusses the case of the purchase of a five-year business fire insurance policy for which the entire premium is paid in advance.<sup>17</sup> The article contends that the purchase price (*i.e.*, the entire premium) is set equal to the sum of the discounted values of the premiums for each of the five years. Thus, the cost of coverage for each year is greater than the cost of coverage for the immediately succeeding year, and accordingly the deductions for the business expenditures should be greatest in the first year and should be reduced in each succeeding year.

Blum disputes this result and states that the analysis "depends on the assumption that, for tax purposes, the insured never need take into account the imputed interest for which he is given credit by the

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16. See Blum, *supra* note 1, at 1177.

17. Kahn, *supra* note 2, at 38-39.

insurance company in computing prepaid premiums.”<sup>18</sup> My article treated the annual increase in value of the taxpayer’s right to future fire insurance coverage as unrealized appreciation, and Blum is correct in pointing out that it might better be characterized as imputed (or constructive) interest from the insurance company. Nevertheless, Blum’s statement is somewhat puzzling. While my article did not expressly deal with imputed income, it obviously is reflected in the amount of the deduction that the article concluded the taxpayer could appropriately take. The item in question was a deductible expense. Each year, assuming that the annual increase in value is to be treated as imputed income, a cash method taxpayer would recognize income in an amount equal to the difference between \$1,000 (the amount of the premium for that year)<sup>19</sup> and the taxpayer’s cost that is allocated to that year. Since this imputed income would be deemed to have been expended immediately for the purchase of business insurance, it would also be deductible and so would wash out the income item. Whether the taxpayer must report this amount as income and take a corresponding deduction or whether the taxpayer can simply exclude this amount from income is an interesting question; but in either event, the ultimate result is that the taxpayer will show a net deduction in an amount equal to the prepaid cost that is allocable to that year’s premium payment. I regret having failed to discuss this matter in my article — I short-circuited the problem by simply dealing with the deduction of the taxpayer’s dollar cost. Nevertheless, the method of analysis I employed in the article has built into it a recognition of the imputed income from the prepayment. Under the article’s analysis, imputed income is reflected in the taxpayer’s tax base whether the taxpayer reports on the cash or on the accrual method, but the timing of recognition *might* be different for an accrual method taxpayer.<sup>20</sup>

What Professor Blum and I dispute is not *whether* imputed income will be taken into account; rather it is a question of *timing*, of what date imputed income will be taken into account by the taxpayer’s reporting method. This question reduces to precisely the same dispute that was discussed above in connection with annuities.

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18. Blum, *supra* note 1, at 1178.

19. Although irrelevant to this Comment, it is interesting to ponder whether the taxpayer would recognize a gain or loss if the cost of fire insurance premiums had risen or fallen at the time that the prepayment is applied in satisfaction of that premium cost.

20. I was remiss in failing to state in my article that the taxpayer in question reported on the cash method. If he reported on the accrual method, the result *might* be different. While the annual increase in value of the taxpayer’s right to fire insurance protection for a future year is similar to the accrual of interest, I am less than certain that it would be so treated for accrual method income tax reporting purposes. See Rev. Rul. 65-199, 1965-2 C.B. 20.

Professor Blum would require the reporting of imputed income on deposits for premium payments for future years. I would not require the reporting of such income by a cash method taxpayer until the prepayment is actually applied to the cost of a year's insurance, unless the taxpayer has the power to withdraw the accrued "interest" at some earlier date. In the latter event, the annuitant likely will have constructively received the "interest" at the time that it is earned. It is possible that the same timing schedule should apply to accrual method taxpayers if the annual increase in value of the taxpayer's interest in the future fire insurance coverage is not so nearly identical to interest as to warrant its accrual, but that possibility is subject to dispute. If the cost of the insurance coverage had been a nondeductible item, the tax issue arising upon prepayment would be the timing of the recognition of the imputed income rather than the deductibility of the cash payment allocable to each year. But that question is simply the converse of the one under discussion — *viz*, whether the amount of imputed income recognized each year will increase or decrease. The Internal Revenue Service has announced its position on this issue, and while the Service's view is not dispositive of the question of tax neutrality, it is worth noting. In a 1965 Revenue Ruling, the Commissioner stated:

Any increment in value of so-called "advance premiums," "prepaid premiums," or "premium deposit funds" which is applied to the payment of premiums due on annuity and life insurance policies, or made available for withdrawal by the policyholder, will result in taxable income to the policyholder at that time.<sup>21</sup>

Thus, the Service's position is that, unless there is a power of withdrawal, the imputed income from a prepayment of nondeductible insurance premiums is taken into account by the taxpayer in his return for the year for which the prepayment was applied. That will result in the recognition of increasing amounts of income each year where prepayment is made for more than one year's premium. It is noteworthy that the ruling is not expressly limited to cash method taxpayers, and makes no mention of different treatment for persons using other methods of accounting. The ruling does not expressly apply to a prepayment for multiple years, but since it indicates that income will be reported in an earlier year if there is a power of withdrawal, it seems clear that the Commission contemplates deferring recognition of such imputed income until it is actually applied against the premium cost as long as no power of withdrawal exists.

*Depreciation.* In light of my discussion of annuities and prepaid

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21. Rev. Rul. 65-199, 1965-2 C.B. 20, 20.

expenses, it should be clear that some form of accelerated depreciation is an accurate reflection of the portion of the cost of an asset attributable to the exhaustion of a year of the asset's useful life. Blum objects to dividing an asset into temporal segments and to allocating the asset's cost according to the discounted value of the anticipated income stream for each segment because he believes that different discount rates must be employed for each temporal division. I have already dealt with that contention in my discussion of annuities.<sup>22</sup>

Apparently recognizing that the decline in value of an asset over a one-year term is not a proper means to measure the allowable amount of depreciation, Blum offers an alternative explanation for sinking-fund depreciation — an explanation he describes as “equally persuasive.”<sup>23</sup> Depending upon one's viewpoint, Blum's explanation might be described as equally unpersuasive. His alternative explanation is that sinking-fund depreciation takes into account the *imputed interest* on a taxpayer's right to the remaining years of the asset's income stream. Blum describes that “imputed interest” as a lost opportunity cost of the taxpayer — specifically, he states that “[i]n the machine situation the interest factor reflects the loss of income which could have been earned by the businessman (at an assumed fifteen percent rate) had he elected to invest in another comparable opportunity. *The key to the sinking-fund principle in all such situations is imputation of interest.*”<sup>24</sup>

I have difficulty comprehending Blum's extraordinary concept that there is an imputation of interest on a currently unproductive asset simply because the taxpayer could have invested his capital elsewhere. If interest were imputed in such cases, the doctrine of realization would be a dead letter. If an accrual method taxpayer purchases unimproved and unproductive land which he holds in anticipation of appreciation in value, no interest will be imputed to him because he could have invested his capital in productive property. To take an example closer to the depreciation issue, if *Y* (an accrual method taxpayer) were to purchase a remainder interest in an income producing building subject to a five-year term, the value of *Y*'s remainder interest (without regard to market conditions) will increase each year by virtue of the increased proximity of his possessory interest. This constant increase in value constitutes unrealized appreciation and is not reportable by *Y* as current income. For

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22. See text at notes 7-11 *supra*.

23. See Blum, *supra* note 1, at

24. *Id.* at 1182 (emphasis in original).

Blum to describe this appreciation as imputed interest is peculiar in that it does not bear the usual characteristics of interest. Interest is a payment for the use of funds. While the value of *Y*'s interest does rise by predictable percentages, there is no payment to *Y* (imputed or otherwise) for the use of *Y*'s funds.<sup>25</sup> If *Y* does have imputed interest, who is the payor? Note that this situation is easily distinguishable from the circumstance of the prepaid fire insurance premiums, for in that case it is possible to impute an interest payment from the insurance company to the taxpayer who purchased the fire protection.

If, as previously suggested, the purchase of an asset is properly characterized as the purchase of temporal segments, then the value of future segments will increase each year as the taxpayer's right to the income for such years is nearer to realization. Blum asserts that, even taking a temporally segmented approach, the taxpayer should offset the unrealized appreciation of the right to the future income stream (which he designates as imputed interest income) against the deduction allowable for the cost incurred in purchasing the income stream for the year for which his tax return is filed. Whatever argument there might be for requiring cash method taxpayers to report accrued interest income on annuities or prepaid expenses, there is no reason to require any taxpayer — regardless of his reporting method — to report the unrealized appreciation on his right to income that may be earned in a future year. Thus, while there is a strong case for accelerating cost recovery in reporting income from annuities and prepaid expenses, the case for accelerated depreciation is even stronger. Accelerated depreciation rests not on cash method reporting (which Blum describes as essentially a practical accommodation), but rather on the doctrine of realization — which is an integral part of our tax system.

### Conclusion

The case for accelerated cost recovery reporting is powerful. It is especially convincing when determining permissible methods of depreciation. Once one concludes that accelerated depreciation is consistent with tax neutrality, the propriety of recapture of depreciation rules and of other tax rules that deal harshly with those who employ accelerated depreciation is cast into doubt. The principal point of my recent article is that accelerated depreciation is no less tax neutral than straight line depreciation and certainly no less neutral than

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25. See Kahn, *supra* note 2, at 51-53.

sinking-fund depreciation. Congress's choice of the permissible methods of depreciation therefore should turn exclusively on policy considerations. When weighing factors in deciding whether to adopt an accelerated cost recovery method, characterizing such a method as a tax preference or subsidy tips the balance against that method; it will be adopted only where competing economic policy considerations are of sufficient magnitude to override the possible inequity of a tax preference. At present, economic policy probably compels the granting of an even more accelerated rate of depreciation than currently allowed regardless of tax neutrality issues, but that may not always be the case. In striking the balance for or against the acceleration of capital recovery, so-called tax "subsidy" questions should be cast aside as irrelevant except perhaps for the most extreme forms of acceleration.