

10 Recommendations for Business Tax Reform

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The following are my recommendations for business tax reform for President Obama:

1. *Tax all businesses in the same way.* Although individuals engage in business in many different forms for business law purposes, in general all businesses should be taxed in the same way for income tax purposes because they have the same basic ontological nature (that is, they are various ownership arrangements for assets and liabilities). There is no conceptual reason for taxing them differently. Advantage: Distinctions between corporations, S corporations, partnerships, and sole proprietorships would be eliminated for income tax purposes.

2. *Apply mandatory amalgamation to determine a business tax unit.* A business tax unit for income tax purposes would consist of: (a) a business entity (generally as defined by reg. section 301.7701-1(a) and -2(a) but also including a sole proprietorship) and all business entities wholly owned by that business entity; together with (b) all business entities that have the same owners as the first-described business entity. Advantages: The proposal would (1) eliminate the possibility of different U.S. tax results depending on how many wholly owned business entities a business sets up; (2) reduce the need to determine arm's-length pricing for transactions between related persons; (3) reduce the number of returns required to be filed and make enforcement easier for the IRS; and (4) eliminate the need for complicated consolidated return regulations.

3. *Tax all business tax units at the unit level.* Advantage: The proposal would greatly simplify compliance because owner-level taxation (aka "partnership" taxation) can be very complicated when just a few owners are involved, let alone hundreds.

4. *Eliminate the distinction between U.S. and foreign business tax units.* There is no logical reason for taxing business tax units differently depending on the law under which they were formed; tax them all in the same way. Advantage: U.S. business tax units and foreign business tax units would be placed on a level playing field.

5. *Use U.S. generally accepted accounting principles (or international financial reporting standards) to determine the worldwide earnings of a business tax unit.* Advantages: A business tax unit would need to keep only one set of books (subject to adjustments, such as adding back foreign income taxes) and not at least three additional sets of books (for determining taxable income, alternative minimum taxable income, and earnings and profits); and book/tax differences would be minimized.

6. *Use formulary apportionment to determine the taxable base to which U.S. tax rates apply.* The taxable base to which U.S. tax rates apply would be determined by applying an apportionment formula (for example, using property, payroll, and sales) to a business tax unit's worldwide earnings, as determined under U.S. GAAP (or IFRS). The United States would adopt this approach unilaterally but would also work with the OECD to develop a model apportionment formula to reduce the incidence of double taxation. Advantage: The extremely murky topics of whether a U.S. trade or business (or permanent establishment) exists and the amount of profits attributable thereto would be avoided.

7. *Apply a flow-through rule to income of a passive foreign investment company.* In the case of income whose derivation does not require much in the way of people and tangible property, a special flow-through rule would be needed (otherwise, an allocation of the income to a low-tax jurisdiction would be fairly easy to accomplish). The income of a business tax unit that constituted a PFIC (generally as defined under current law, but with the term "passive income" adjusted to exclude income that would generally be tax exempt (such as dividends; see next recommendation)) would flow through to the owners. (Publicly traded PFICs would be marked to market.) Advantage: The law would retain

an antiabuse rule, but the complicated controlled foreign corporation rules (which also attack some active business income) would be eliminated.

8. *Eliminate double taxation of income earned at the unit level.* All distributions from a business tax unit and all gain on the sale of an interest in a business tax unit would be free of tax. Advantage: Double taxation of earnings would be avoided with maximum simplicity. (Ideally, to equalize their taxation, both dividends and interest should be tax exempt and nondeductible.) Alternatively, an owner's basis would be adjusted for the owner's pro rata share of earnings derived by the business tax unit during the shareholder's holding period, and distributions would reduce basis first. A return in excess of basis, and gain on the sale of an interest in a business tax unit, would be subject to a reduced rate of tax in order to reduce the burden of double taxation of earnings.

9. *Eliminate the general concept of capital gain.* Favorable treatment of capital gain (other than gain on the sale of an interest in a business tax unit) makes no conceptual sense and would be eliminated. Advantage: The entire code would be vastly simplified.

10. *Eliminate withholding taxes on fixed or determinable annual or periodic (FDAP) payments to foreign persons.* Withholding taxes on certain payments (FDAP payments) to foreign persons would be eliminated because: (a) income realized by business tax units would be taxed under formulary apportionment, and withholding on payments to them would thus be inappropriate; (b) individuals should normally be taxed on a residence basis; and (c) income tax should not be imposed on a gross basis. (Under current law, most FDAP interest paid to foreign persons is already exempt from tax; dividends should be exempt for everyone to reduce the incidence of double taxation of earnings.) Advantage: Under current law, a payer must try to apply sourcing rules that are often arcane, try to determine the true status of the payee, determine the possible application of an income tax treaty, and then comply with complicated reporting requirements; elimination of the withholding tax regime would result in significant simplification (including for qualified intermediaries). ■