

# Reform the Taxation of Business Income

By Eric M. Zolt

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Choice is good. We choose political candidates, spouses, and different types of consumer products. But freedom to choose, especially within our tax system, brings costs as well as benefits. With apologies to Yogi Berra, whenever taxpayers get to a fork in the road, they take the fork.

The tax code (especially the tax rules that apply to business income) is chock-full of implicit and explicit elections that contribute to the complexity and inefficiencies of the tax system. By eliminating many elections, we could simplify the tax law, make it more efficient, and likely raise substantially the same revenue at lower tax rates.

I offer three proposals to reform the taxation of business income. None are particularly original, and all have been proposed in different forms before. Here are the three proposals:

- apply the same tax regime to all business income regardless of organizational form;
- delink the taxation of income from labor and capital and apply a single flat tax rate to capital income; and
- treat debt and equity the same for tax purposes.

## Single Tax Regime for Business Income

Our legal system provides for several forms of business organization, each with different state law consequences, such as ownership and governance structures and liability rules. Similarly, our tax system allows taxpayers to apply different tax regimes to their business operations — such as sole proprietorships, partnerships (general and limited), cooperatives, S corporations, and C corporations.

Individuals balance the nontax costs and benefits of adopting a particular business form against the costs and benefits of the tax regimes tied to that form. But as Bill Klein and I noted in a 1995 article in the *University of Colorado Law Review*, there is no good reason to link business form and tax regime. Why should taxpayers have to choose a suboptimal organizational form to achieve a favorable tax result? This was the logic behind Treasury's check-the-box rules, adopted in 1996. It also led state legislatures to adopt the limited liability company regimes that paired limited liability status with single-level, passthrough taxation.

But why allow taxpayers to choose their tax regime? Why not just adopt a single set of tax rules that apply to all business income? If we want a tax system that is neutral as to business form, then one size fits all.

Several proposals to reform business income taxation would apply without regard to business form (perhaps with exclusions for small businesses operating as sole proprietorships). Some tax the full return on equity capital, some tax the full return of both debt and equity capital, and others seek to tax only economic rents. These include proposals by President George W. Bush's Advisory Panel on Federal Tax Reform, the comprehensive business income tax from Treasury's 1992 integration study, and the business enterprise income tax. They are all steps in the right direction.

### **Flat Taxation of Capital Income**

The conventional wisdom is that good tax systems are based on a comprehensive income tax model, whereby capital and labor income are treated equally and the combined income is taxed at progressive rates. In reality, income tax systems often turn out to be neither very comprehensive nor very progressive. Different types and forms of capital bear different tax burdens. Taxpayers structure their investments to minimize tax liability.

One response is to continue the slog toward the ideal comprehensive income tax model. This has not been particularly effective. Another approach delinks the taxation of income from labor and income from capital, retaining progressive tax rates for labor income and taxing capital income at a flat rate. With increasing

globalization and tax competition, this so-called dual income tax approach may have greater appeal because countries can reduce tax rates on more mobile capital income while retaining higher and more progressive tax rates on less mobile labor income.

A flat tax regime for capital income has several advantages over the current regime. First, it will simplify the tax rules that apply to income from capital, especially if reforms also eliminate or reduce existing tax preferences and exemptions. Second, it will make the taxation of capital income more uniform and less distortive. Third, a single tax regime can lead to substantial enforcement and administrative gains through provisional and final withholding regimes.

### **Debt and Equity Treatment**

The so-called classic corporate income tax distorts decisions on organizational form, decisions to retain or distribute corporate earnings, and decisions to use debt or equity in the firm's capital structure. Of those three distortions, the preferential tax treatment of debt over equity is the most troubling.

Why allow taxpayers to choose the tax treatment applicable to their investment in a firm? Debt and equity are just different financial claims on the same enterprise. And thanks to the efforts of lawyers, accountants, and investment bankers, it is increasingly difficult to distinguish between them.

Treating debt and equity the same way requires either extending the deductibility of interest to dividends or denying the deductions for interest. Both approaches have merit. In 1992 Treasury put forward a proposal to tax business income once by providing for no corporate-level deduction for dividends and interest paid and no inclusion into income at the investor level for any dividends or interest received. This comprehensive business income tax proposal is simply a form of dual income taxation, a schedular tax on dividends and interest with final withholding at the entity level.

It will not be easy to make fundamental changes to the taxation of debt and equity. There would have to be a period of transition. And it would require coordination with other developed countries to have source-based taxation of interest and dividends. But it would improve how we tax business income.

Choice is not always good. These three proposals share a common theme: Choices made by taxpayers will not change the tax treatment of business income. Eliminating tax electivity will make the tax system simpler and more efficient. ■