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Tax Fairness Fabrications

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The predictable rants that the president's tax proposals are unfair and benefit the rich have begun. The fact is that the president's proposals make the tax code fairer by any reasonable standard. Most Americans would agree, as a matter of fairness, that taxpayers making equal income should pay the same tax; that legitimate business expenses should be deducted before calculating taxes on profits; and that people should not be penalized for working harder.

The president is proposing a reduction in the double taxation of dividends. Business is conducted under a variety of legal forms, such as a sole proprietorship, a limited partnership (LP), a limited liability company (LLC), a limited liability partnership (LLP), and a corporation. Legal liability and business capital requirements dictate the form of ownership.

The vast majority of business corporations are actually small and medium-sized businesses. These corporations are typically owned by a relatively small number of people and not listed on public exchanges. LPs and LLCs, like corporations, have limited liability, but the owners of LPs and LLCs do not have to pay a corporate tax or its equivalent. This is why it is fair to reduce the double tax on corporate dividends.

Assume for the moment that a medical doctor develops a new device that will save thousands of lives each year. He sets up a corporation to manufacture the device, keeping 30 percent of the ownership for himself, while the rest is owned by a score of investors. At the same time, a trial lawyer sets up a legal business as an LLP whereby he owns 30 percent of the business and the other lawyers own the rest. Assume that both businesses are very successful and each business makes the same multimillion-dollar pretax profit and that all profits are paid to the owners on a pro-rata basis.

Each tax is paid on the remaining income that results in the doctor/medical device entrepreneur paying an effective tax rate of approximately 65 percent while the trial lawyer only pays 42 percent on the same before tax income. How is this fair?

The doctor is limited as to how big a salary he can pay himself because, under the Clinton administration, limitations were placed on salary deductibility for corporate executives. These same restrictions do not apply to distributions from LLCs, LLPs and LPs that are most often used by trial lawyers, rock and movie stars, and payments to newscasters (who just happen to lean more to the Democrats).

As most everyone understands, you should be able to deduct the cost of business expenses before calculating the profit upon which you pay tax. But the tax law restricts the amount of deduction for capital expenses (expensive, necessary tools, like trucks and machines) that a business can take each year. Hence, capital-intensive firms are forced to pay taxes on inflated income (because not all the expenses have been deducted currently). Eventually, companies are allowed to deduct the face amount of the capital expenditure but, as everyone knows, a dollar in the future is not as valuable as a dollar today (both because of inflation and the ability to invest current dollars), hence the future deductions are worth less than current ones. Again, the capital-intensive medical device company is at a tax disadvantage to the low-capital trial lawyer business. This is why it is fair to speed up depreciation allowances.

Many argue, "it is only fair" that the rich pay a higher percentage of their income in taxes. However, assume there are identical twins brought up in the same home. They both become master plumbers who can earn $75 an hour. One is lazy and likes to party and only works on average 20 hours per week. The other is a good family man trying his best to take care of his wife and kids and works 50 hours per week. As a result of the progressive state and federal tax system, the lazy brother only has to pay 25 percent on each extra dollar of income, while the hard-working brother has to pay 40 percent on each extra dollar of income. How is this fair?

A progressive income tax system is premised on the notion that differences in income are a matter of luck, and not a matter of choice, skill and perseverance. Luck may play some part, but the other factors are key.

The Bush plan is trying to partially correct some of the objectively unfair aspects of the present tax code. The unfairness in the code resulted from economic ignorance and the failure of the Republicans to both articulate and have the guts to take on Democratic demagogy. The Republicans now have a chance to show they favor both tax fairness and economic growth. It will be interesting to see who rises to the occasion and who wimps out.

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