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## A GUIDE TO THE FLAT TAX: WHAT EVERYONE IN BUSINESS SHOULD KNOW

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**A**merican companies are burdened with one of the world's most anti-business tax systems. The U.S. tax code is littered with provisions that seem designed to undermine competition, entrepreneurship, risk-taking, and investment. And because the tax system's abundant flaws are so deeply ingrained, no amount of tinkering or modification is likely to solve its problems. Instead, the entire Internal Revenue Code should be repealed and replaced by a simple, fair system that taxes all income just one time at one low rate—a system known as the flat tax.

Because most of the changes in the tax system that have taken place in the past have made the tax code even worse, many people in the business community have become apprehensive about tax reform. Some believe that a flat tax would increase the tax burden on their business income. Such fears are unfounded. Calculations of business tax liability using Internal Revenue Service data indicate that, with a flat tax, corporate tax burdens would drop by an average of 9 percent.<sup>2</sup> There are some areas of legitimate concern about the flat tax, but these largely involve the transition from the current system and almost surely will be addressed by policymakers when reform occurs.

- <sup>1</sup> The author would like to thank William W. Beach, John M. Olin Senior Fellow in Economics at The Heritage Foundation, for his contributions to this analysis.
- <sup>2</sup> This percentage decrease in business tax liability assumes a flat tax of 17 percent. The figures have been derived from The Heritage Foundation Corporate Tax Model, which is built around data contained in the 1991 Internal Revenue Service Corporate Tax Returns data file. See Table 1, below, for an analysis of how business tax liability can vary depending on the period of accumulated depreciation and the percentage of additional business investment.

## WHY THE CURRENT TAX SYSTEM IS ANTI-BUSINESS

It is hard to imagine how anything could be worse than the existing Internal Revenue Code. Part of the problem, of course, is that the tax burden is too high, but high tax rates are just the tip of the iceberg. One of the most egregious features of current tax law is its systematic bias against savings and investment. Capital, the lifeblood of business expansion and the key to higher wages, is subject to as many as four layers of taxation.

Adding insult to injury is the complexity of the code. Individual taxpayers might have a hard time believing that the business side of the tax code makes the 1040 form, with its various attachments, seem simple by comparison. And all this complexity carries a hefty price tag. According to the Tax Foundation, businesses incur more than \$100 billion in compliance costs from the income tax code. Small businesses are hit hardest of all, facing more than \$7 in compliance costs for every \$1 the government collects in taxes.<sup>3</sup>

The anti-business provisions of the current tax code are well-known. Some of the most damaging are:

- **Depreciation.** In the logical world, annual profits are defined as total revenue for the year minus total costs for the year. The current tax code, however, deviates from this commonsense understanding by prohibiting businesses from deducting the full costs of their investments when these costs are incurred. Instead, investment expenses can be deducted only in small increments (known as depreciation) over a period of as many as 40 years. This not only forces a business to overstate its income at tax time, but also is one of the most complex parts of the tax code.
- **Alternative minimum tax.** Many businesses are forced to calculate their taxes in two different ways, and pay whichever amount is greater. This feature, called the alternative minimum tax (AMT), has no rationale, except perhaps a feeling on the part of some politicians that the regular corporate income tax might not impose quite as heavy a burden on companies as they would like. In addition, this extremely complex provision often takes effect during economic downturns.
- **Estate tax.** Perhaps the greatest threat to family-held businesses is the estate tax. An entrepreneur will spend decades building a company, often becoming the major employer for a community, only to realize that the company will be destroyed or broken up upon his death in order to pay a tax on assets—a tax that can be as high as 55 percent. Moreover, since the income used to build an estate was taxed at least once when first earned, the estate tax is a major form of double taxation.<sup>4</sup>
- **Double tax on dividend income.** Owners of corporations are forced to pay taxes twice on the income they have generated. The first tax occurs at the business level as the corporate income tax, which takes as much as 35 percent of annual income (the actual percent is often higher because of features like the alternative minimum tax

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3 "Tax Foundation's Ways & Means Committee Testimony Puts 1996 Federal Tax Compliance Costs at \$225 Billion," Tax Foundation *Tax Bite*, March 20, 1996.

4 For more information on the estate tax, see William W. Beach, "The Case for Repealing the Estate Tax," Heritage Foundation *Background* No. 1091, August 21, 1996.

and depreciation). When the remaining after-tax profit is then distributed to the owners, it is taxed yet again by the individual income tax, with the rate rising to nearly 40 percent depending on the total income of the individual. Needless to say, the real tax on this income is the combination of the two levies, a penalty that results in sharply reduced incentives to invest in American corporations.

- **Foreign tax rules.** Choosing the most ridiculous tax provisions would be difficult, but the foreign tax rules certainly would be on such a list. The Internal Revenue Code not only taxes companies on their American income, but also taxes them on income they earn in other countries. Since other countries tax that same income, however, the tax code provides a credit for taxes paid to a host country. The tax burden in America is often lower than the tax burden in other countries, so the net result of all these complicated calculations is that the U.S. government collects very little money. In effect, the staggering amount of paperwork caused by foreign tax rules means that American businesses trying to compete overseas are hit with a meaningless compliance tax.

Nor are these the only bizarre, complicated, anti-growth provisions to be found in the current tax code. Businesses also are burdened by pension rules, capital gains taxes, expense allocation rules, uniform inventory capitalization, and economic performance rules that impose huge economic and compliance costs. Perhaps the best way to explain how bad the tax code has become for business, however, is to see how it has mutated over the years. Between 1954 and 1994, the number of "code sections" (each of which deals with a major section of tax law) expanded from 103 to 698, an increase of 578 percent. The number of words contained in the tax laws and IRS regulations grew even faster, rising by 647 percent.<sup>5</sup>

In addition to hindering national competitiveness, destroying jobs, and slowing growth, the problems inherent in the current tax code share another characteristic: They all would be solved if America changed to a flat tax system.

## WHAT A FLAT TAX WILL MEAN

The key principle behind the flat tax is equality. Regardless of how a taxpayer earns income, how a taxpayer spends income, or how much income a taxpayer makes, the law is applied evenly.

### Three Key Features of a Flat Tax

A flat tax contains three core features, each designed to fix a major problem with the current tax code. These key features can be summed up in a single sentence:

*All income should be taxed at one low rate and only one time, and the tax should be collected in the least intrusive way possible.*

- **A single flat rate.** Under the flat tax, income is taxed at one low rate. This ensures that taxpayers are treated equally while also addressing the problem of high marginal

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<sup>5</sup> Arthur P. Hall, "The Compliance Costs and Regulatory Burden Imposed by the Federal Tax Laws," Tax Foundation *Special Brief*, January 1995.

tax rates. The one low rate in the flat tax will promote faster growth by minimizing the tax penalty against work, risk-taking, and entrepreneurship.

- **No bias against savings and investment.** A flat tax eliminates the current tax code's bias against capital formation by ensuring that no income is taxed more than one time. Since double taxation of capital income is a pervasive problem under current law, this reform will stimulate higher incomes and faster growth by minimizing the tax penalty on savings and investment.
- **Simplification.** The flat tax eliminates provisions of the code that result either in tax preferences or in tax penalties on certain behaviors and activities. In addition, a large amount of income is taxed at the source rather than at the recipient level, dramatically lowering paperwork and compliance costs. These changes would solve the problem of complexity, allow taxpayers to file their tax returns on a postcard-size form, and ensure that the tax code affects everyone equally.

#### **Four Key Benefits for America**

The obvious national benefits of a flat tax include:

- **Faster economic growth.** A recent conference on tax reform hosted by Congress's Joint Committee on Taxation highlighted the work of the country's top economic forecasters. They agreed that the flat tax would boost economic activity and estimated that the nation's gross domestic product (GDP) would grow between 5 percent and 14 percent.<sup>6</sup>
- **Increased national wealth.** All income-producing assets would increase in value because the after-tax stream of income they generated would increase, causing national wealth to climb instantly as well.
- **An end to micromanaging and political favoritism.** By getting rid of all deductions, loopholes, credits, preferences, shelters, and exemptions, the flat tax would deprive politicians of the ability to pick winners and losers, reward friends and punish enemies, and use the tax code to impose their values on society through the economy.
- **Enhanced civil liberties.** Under current law, people charged with murder have more rights than taxpayers who must deal with the Internal Revenue Service. With a simpler, fairer tax code, infringements on freedom and privacy would decrease dramatically.

### **HOW A FLAT TAX WILL BENEFIT BUSINESS**

From the business perspective, the structure of the flat tax is remarkably simple. Wage, salary, and pension income is taxed at the individual level. Taxes on all other types of income are collected and paid at the business level. Chart 1 illustrates just how easy it will be for a business to comply with the flat tax.

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<sup>6</sup> Joint Committee on Taxation Conference on Dynamic Revenue Estimating, January 17, 1997; papers available upon request.

## How a Business Fills Out a Flat Tax Form

Form 2		Business Tax		1997	
Business name			Employer identification number		
Street address			County		
City, town, or post office, state and ZIP code			Principal product		
1	Gross revenue from sales	1			
2	Allowable costs				
	(a) Purchases of goods, services, and materials	2(a)			
	(b) Wages, salaries, and retirement benefits	2(b)			
	(c) Purchases of capital equipment, structures, and land	2(c)			
3	Total allowable costs (sum of lines 2(a), 2(b), and 2(c))	3			
4	Taxable income (line 1 less line 3)	4			
5	Tax (17% of line 4)	5			
6	Carry-forward from 1996	6			
7	Interest on carry-forward (6 percent of line 6)	7			
8	Carry-forward into 1997 (line 6 plus line 7)	8			
9	Tax due (line 5 less line 8, if positive)	9			
10	Carry forward to 1998 (line 8 less line 5, if positive)	10			

### Instructions

**Line 1:** The first step is to write in gross receipts from sales.

**Line 2(a,b,c):** The second step involves calculating a) the company's purchases of goods, services, and materials; b) the company's payments of wages, salaries, and pensions; and c) the company's purchases of capital equipment, structures, and land.

**Line 3:** The third step is to add 2a, 2b, and 2c to calculate allowable costs.

**Line 4:** The fourth step is calculating taxable income, which involves simply subtracting line 3 from line 1.

**Line 5:** The fifth step is to multiply the taxable income figure in line 4 by the tax rate (presumably 17 percent) to ascertain the annual tax bill.

**Lines 6-9:** The actual tax liability, if any, is determined after including any unused deductions ("carry-forwards") from the previous tax year.

**Line 10:** The final step is to record the amount of unused deductions, if any, that will be carried over into the following tax year.

### The Benefits

Simply stating how the new tax system would work, however, does not necessarily indicate whether businesses will embrace it. There are some things that businesses will find very attractive and others that will not be welcome. The beneficial aspects of the flat tax for businesses include:

- **Full expensing each year.** Instead of complicated depreciation, under a flat tax all investments are given an immediate first year write-off. This will lead to dramatic simplification and lower the tax penalty on investments.

## WHY ALL TAXES ON "BUSINESS" ARE REALLY TAXES ON PEOPLE

Contrary to political rhetoric, a "business" does not really pay taxes; individuals bear the burden of all taxes sent to the government by business. The corporate income tax, for instance, is a tax on the income of the owners of the corporation (and then this same income is taxed a second time at the "individual" level). Federal income tax withholding is a tax on workers even though the business sends the money to Washington.

This practice of having businesses pay taxes on behalf of individuals is known as taxing income at the source. When combined with the principle of taxing income only one time, taxation at the source can be used to simplify the tax system dramatically. Under current law, for instance, more than one billion 1099 tax forms circulate each year to help the IRS track interest and dividend income. This massive paperwork burden is necessary only because the current code taxes this income at the individual level. If the income is taxed only one time and the point of collection is at the source (i.e., the bank, corporation, or other business sending the income to the individual), all this red tape and complexity disappears. This is a major benefit of the flat tax, and one of the reasons why compliance costs would fall by more than 90 percent when the flat tax is instituted.

It should be noted that taxing income at the source does have a few negative aspects. It probably contributes to the popular misconception in Washington

that taxes, regulation, mandates, and other burdens imposed on business do not hurt individuals. Taxing income at the source also has the effect of hiding the true extent of the tax burden from some individuals. A good example is income tax withholding; while it makes the tax system simpler, many Americans fail to grasp just how much of their income is being confiscated because they never see it in their paychecks in the first place.

Taxing income at the source also creates an unfortunate opportunity for political mischief by opponents of tax reform. Ill-informed or dishonest opponents of the flat tax, for instance, frequently charge that the proposal would allow "fat cats" living off interest and dividends to escape taxation. Needless to say, this charge is baseless because interest and dividends received under a flat tax are after-tax payments, and hence completely analogous to a worker's pay under the current withholding system.

At the cost of adding complexity, supporters of sensible tax policy could try to negate this attack by shifting collection of the tax from the source to the individual. This tactic, however, would still leave an opening for demagogues to complain that the flat tax was a windfall for corporations. What these opponents really favor, of course, is taxing the income twice as is done under current law. Thus, there is little to be gained and much to be lost by catering to those who are ideologically opposed to a fair and simple flat tax.

- **No alternative minimum tax.** The AMT disappears under the flat tax. No longer would businesses be forced to calculate their tax liabilities two separate ways and then pay the larger of the two amounts.
- **No estate tax.** Family-held businesses will be much more stable with the elimination of the estate tax, which destroys capital and imposes an unjustifiable additional tax on income that already has been taxed at least once.
- **No double tax on dividends.** By taxing corporate income just one time and at the source, the flat tax eliminates the current code's bias against corporate investment.
- **No double tax on interest income.** The flat tax eliminates the present practice of taxing income when it is first earned and then a second time if it is invested and earns a return. Eliminating this anti-savings bias will increase the pool of capital for business.
- **No foreign tax provisions.** The flat tax is a strictly territorial system. Income earned in other countries will be taxed by other countries, but there will be no need to go through the ridiculously complex process of reporting that income to the IRS.
- **A single, low rate.** The one low tax rate under a flat tax will give businesses the proper incentive to invest in income-generating activities.
- **No capital gains tax.** Instituting a flat tax will end one of the most pernicious forms of double taxation: the capital gains tax. More specifically, elimination of the levy will end the bias against new investment or business earnings that are reinvested.
- **Simplification.** Businesses will realize significant savings because complying with the tax code under the flat tax will be so simple. Talented lawyers, accountants, and financial planners will be able to shift their abilities to projects that help increase the company's earnings and the nation's wealth.
- **Faster economic growth.** Even the economic forecasts put together by critics of the flat tax show that it will increase economic growth. The consensus is that the economy will grow somewhere between 5 percent and 14 percent within five years. For businesses other than bankruptcy law, this will mean more income and higher profits.<sup>7</sup>
- **Lower interest rates.** Interest income will be taxed at the source under a flat tax, with interest payments made non-deductible for the payer but non-taxable for the recipient. This approach, which is the same as giving all interest the tax treatment now reserved for municipal bonds, will mean lower interest rates (i.e., the tax premium disappears). Estimates of the reduction in rates vary, but they generally fall somewhere between 1 percent and 2 percent.

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<sup>7</sup> While it attacked the flat tax in 1995, DRI/McGraw-Hill, one of this country's top economic consulting companies, announced at a recent Joint Committee on Taxation Conference that the flat tax would boost economic output by at least 5 percent.

Table 1

**With a Flat Tax, Amount of Taxes Paid by Businesses  
Would Decline 9% in Middle-Case Scenario**

Business Investment Scenarios: Level of Business Investment Three Years After Passage of a Flat Tax	Change in Total Taxes Paid by Businesses by Transition Period for Accumulated Depreciation		
	No Carryover	10 Years	5 Years
No Change	32%	-2%	-34%
5% Higher	24%	-9%	-40%
10% Higher	17%	-16%	-45%

Note: The figures in this table are derived from The Heritage Foundation Corporate Tax Model, which is built around the data contained in the 1991 Internal Revenue Service Corporate Tax Return data file. The change in total corporate tax liability as a result of introducing a 17 percent flat tax is estimated. Three possible treatments of accumulated depreciation in the period following the introduction of a flat tax are modeled: 1) allowing no carryover of accumulated depreciation; 2) allowing firms to write off their accumulated depreciation against taxable income in equal yearly amounts over the ten years following the introduction of the tax; and 3) allowing firms to write off their accumulated depreciation against taxable income in equal yearly amounts over the five years following the introduction of the tax. Three assumptions are used regarding the growth in the level of business investment following the introduction of a flat tax: 1) 0 percent growth in business investment; 2) 5 percent increase in business investment; and 3) 10 percent increase in business investment.

Source: 1991 Corporate Tax Return data file, Heritage Corporate Tax Model.

- **Capital Inflow.** By eliminating the multiple taxation of capital, the flat tax will make America a magnet for capital from around the world. Combined with lower interest rates, this influx of capital will make it very easy for businesses to expand and create new jobs.

### The Concerns

Other features of the flat tax, however, have generated concern in the business community. Indeed, it is precisely these features which have caused some businesses to estimate that the flat tax would increase their tax liability. However, many of these estimates are mistaken, largely because of they fail to recognize the actual incidence of certain taxes paid by business.

The issues which cause the most unease in the business community are:

- **Interest deductibility.** Many businesses, particularly those with large debts, fear that the loss of interest deductibility will result in higher tax burdens. It is important to note, however, that all interest under the flat tax will receive the tax treatment currently reserved for municipal bonds. This means, unambiguously, that interest rates



will fall.<sup>8</sup> As a result, the potential tax increase caused by non-deductibility will be offset by the lower level of interest payments on business debt. The actual effects on business tax liability should balance out. There is, to be sure, some concern about the transition period and what businesses would do about outstanding loans and bonds that carry today's higher interest rates. Some loans could be renegotiated at lower interest rates, but policymakers would have to include transition provisions in a flat tax to grandfather the existing debt.

- **Payroll taxes.** Businesses also are worried because the flat tax does not allow a deduction for payroll taxes. This fear is misplaced, however, since the burden of this tax falls on the worker, not on the business. A good analogy is the system of income tax withholding. Businesses today "pay" 100 percent of an employee's income taxes (actually more than 100 percent after income tax refunds are taken into consideration), yet it is universally understood that individual workers are the ones who really pay the personal income tax. Likewise, while the actual collection of the payroll tax may take place at the business level, the cost of the tax is passed on and reflected in workers' pay. This does not mean, incidentally, that workers' after-tax pay will fall under a flat tax. The higher level of investment possible under a flat tax will boost productivity, making workers more valuable to employers and leading ultimately to higher wages.
- **Fringe benefits.** An issue similar to payroll taxes is the tax treatment of fringe benefits. Businesses worry that the inability to deduct things such as health care premiums would boost their tax liability (pensions, incidentally, would be deductible). As with payroll taxes, however, this should not be a concern because the burden of the tax is borne by the worker. Indeed, one of the most desirable features of a flat tax is that workers no longer will have an incentive to use insurance to cover routine health care expenses. By helping to reduce "third-party payments" in health care, the flat tax therefore will help to rein in health care costs.
- **Transition.** One concern that businesses have about the flat tax is warranted: What transition rules will guide tax policy when the current system is replaced by the flat tax? What will happen, for instance, to tax assets such as unrecovered depreciation and unused tax credits? A "cold turkey" shift to the flat tax, by wiping out these assets, would impose a burden on many companies. Needless to say, there should be no doubt that lawmakers will include transition rules to ensure that those who made investment choices under the old law are not left with stranded debts. Unfortunately, there is no way to estimate properly the degree to which the transition rules will protect companies against decisions they made under the old tax regime.

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8 John E. Golub, "How Would Tax Reform Affect Financial Markets?," Federal Reserve Bank of Kansas City *Economic Review*, Fourth Quarter 1995.

## CONCLUSION

The current tax laws are bad for America, bad for business, and bad for America's workers. The Internal Revenue Code is hostile to work, savings, investment, risk-taking, and entrepreneurship. Adding to this burden is the natural inclination among policymakers to keep changing the code—and rarely for the better. This instability in the tax law makes complying with an already complicated tax system even more difficult.

The only long-term solution is to replace the present system with a flat tax. Not only will the flat tax promote growth by minimizing penalties on productive behavior, but it also will yield huge savings in compliance costs for individuals and for businesses. Moreover, because a flat tax treats all taxpayers equally, politicians would have a hard time manipulating the tax code once the new system went into effect. The key question, of course, will be whether the flat tax can overcome opposition from the special-interest groups and income redistributionists who support the current, abundantly flawed tax code.

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