COSTLY MISTAKES: UNDERTAXED BUSINESS OWNERS AND OVERTAXED WORKERS

Mary Louise Fellows,
Minnesota Law School

Lily Kahng,
Seattle University Law School

Abstract

Our central thesis is that the current income tax regime undertaxes business owners and overtaxes workers in unexamined and unjustifiable ways. We show how the income tax system can and does lead to misallocations of economic resources, including the perpetuation of gender, race, and class inequalities. Our analysis focuses primarily on outlays and their classification as either costs of producing income or items of consumption – a foundational distinction under the Haig-Simons definition of income. We find that the tax law is too generous and deferential in classifying business owners’ outlays as incurred in the production of income. Conversely, the law too readily dismisses workers’ costs of producing income, instead classifying them as consumption items. We show this first by analyzing tax jurisprudence with respect to outlays that are immediately deductible under Section 162 and then by examining the rules governing capitalized costs. We go on to explain how the systematic bias in the tax treatment of business owners and workers reflects the cultural values of the first half of the twentieth century, the very period when the foundational principles of the income tax took shape. By relying on empirical evidence and a range of interdisciplinary research, we next demonstrate how the tax law reinforces and further entrenches these cultural values through allocative inefficiencies that overvalue business owners and undervalue workers. Finally, we propose solutions to rebalance the tax treatment of business owners and workers.