

# Northwestern Journal of Law & Social Policy

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Volume 5 | Issue 1

Article 3

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Spring 2010

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### Recommended Citation

Edward D. Kleinbard, *An American Dual Income Tax: Nordic Precedents*, 5 *Nw. J. L. & Soc. POL'Y.* 41 (2010).  
<http://scholarlycommons.law.northwestern.edu/njlsj/vol5/iss1/3>

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# An American Dual Income Tax: Nordic Precedents

Edward D. Kleinbard\*

## I. RETHINKING THE INCOME TAX BASE

### A. *What is the Tax Base?*

¶1 The U.S. income tax system rests on two conceptual pillars: a comprehensive definition of income and a single schedule of progressive tax rates to which that income is subject. Thus, section 61 of the Internal Revenue Code (IRC) famously defines “gross income” to mean, in general, “all income from whatever source derived.”<sup>1</sup> Since income is generated primarily from the application of human effort (i.e., labor), from returns to capital already owned, or from a combination of the two, the essence of a comprehensive tax system can be expressed as a belief in the general desirability of a unified tax rate schedule imposed on income from both labor and capital inputs.<sup>2</sup> Moreover, that tax system generally is progressive by design, in two senses: first, marginal tax rates on individuals increase with increasing incomes, and second, in the more technical sense of the term, average tax rates increase with an individual’s income by virtue of fixed dollar exemptions and income-based phase-outs of various deductions and credits.<sup>3</sup>

¶2 This Article is the first in a series of articles that inquire whether U.S. policymakers should consider abandoning the comprehensive progressive income tax base as an aspirational goal, and instead adopt as the conceptual underpinnings of the U.S. tax system, not a consumption tax base, but rather a “dual income tax.” The hallmark of a “dual income tax” is its two-pronged schedular design under which capital income is taxed more lightly than is labor income.<sup>4</sup>

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\* Professor of Law, University of Southern California Gould School of Law. I wish to express my great gratitude to Peter Birch Sorensen, the Chief Economist and Assistant Governor of the Danish Central Bank, and Michael Riis Jacobsen, Senior Advisor to the Norwegian Ministry of Finance, for their help and advice on both the technical details and policy implications of Nordic dual income taxes. I also wish to thank my indefatigable research assistant, William Kessler, for his many contributions to this Article, and to thank as well the participants in Loyola Law School’s tax policy colloquium and the many colleagues who have offered comments and advice about this Article and the larger project. All errors of course remain solely my own.

<sup>1</sup> I.R.C. § 61(a) (2006).

<sup>2</sup> This Article ignores as a component of income transfer payments from the government to individuals, on the theory that the taxation of such payments is simply a mechanism for adjusting the net amount of any such transfer. The Article further ignores private transfers of existing wealth and cases of windfalls or “treasure troves” as systematically inconsequential.

<sup>3</sup> See Louis Kaplow, *Taxation and Redistribution: Some Clarifications*, 60 TAX L. REV. 57 (2007).

<sup>4</sup> Wolfgang Eggert & Bernd Genser, *Dual Income Taxation in EU Member Countries*, CESIFO DICE REP., Jan. 2005, at 43 (2005) (“The [dual income tax] is a schedular tax regime which divides total income into capital and labour income and regards them as different tax bases.”). In practice, a dual income tax can be implemented in such a manner that there is no risk of some unspecified type of income failing to be taxed under either schedule.

¶3 The term “capital income” as used here refers to all returns on capital and is not synonymous with “capital gain.” Interest income is one paradigmatic example of capital income. Other examples include rents, royalties, dividends, and capital gain. The corporate income tax largely functions as a tax on capital income, because labor inputs are deducted in calculating the corporate income tax base; the same point can be extended to non-corporate net business income, so long as labor inputs are properly identified and subtracted.<sup>5</sup>

¶4 The term “dual income tax” comes from the tax systems of the four Nordic countries: Denmark, Finland, Norway and Sweden. Beginning with Denmark in 1987,<sup>6</sup> these countries have experimented with variations on the dual income tax theme.<sup>7</sup> More

<sup>5</sup> The corporate income tax actually functions as a tax on labor income when applied to the nonqualified deferred compensation income of employees of public companies. As Daniel Halperin has shown, the value of deferred compensation is that the cash compensation retained by the corporation for the deferral period compounds its returns at the corporate rather than individual rates. See Daniel Halperin, *Rethinking the Advantage of Tax Deferral*, 62 TAX LAWYER 535, 537–39 (2009). That portion of the firm’s returns, however, are earmarked for future payouts to employees with respect to labor income, and logically should be deducted when determining the fraction of the corporate income tax base that falls on capital income.

In addition, some portion of the corporate income tax, as currently constituted, might function as a tax on labor income that owner-managers of closely held “C” corporations choose not to extract from their corporations in the form of arm’s length compensation rates. In that case, owner-managers are weighing the current cost of incremental 2.9% hospital insurance (Medicare) payroll taxes (which are not subject to any wage cap) against the future cost of incremental dividend or capital gains taxes with respect to their share of the firm’s retained earnings. For most such owner-managers, the calculus favors extracting income as current wages. See generally Richard Winchester, *Working for Free: It Ought to Be Against the (Tax) Law*, 76 MISS. L.J. 227 (2006) (analyzing the tradeoffs of extracting income as dividends compared with extracting it as compensation). Moreover, the bulk of the corporate income tax is paid by large public corporations; electivity in the form by which corporate earnings are extracted is more attenuated in the case of these taxpayers.

The corporate income tax base includes not simply returns to marginal investments, but also returns to risky ones, including the risk premium such investments demand, as well as rents. As a result, the observation that the corporate income tax is largely a tax on capital income should not be misconstrued as suggesting that the revenues collected today through the corporate tax would entirely disappear in a consumption tax.

<sup>6</sup> Peter B. Sorensen, *From the Global Income Tax to the Dual Income Tax: Recent Reforms in the Nordic Countries*, 1 INT’L TAX & PUB. FIN. 57, 60 (1994) [hereinafter Sorensen, *Global Income Tax*].

<sup>7</sup> Sijbren Cnossen, *Taxing Capital Income in the Nordic Countries: A Model for the European Union?*, in TAXING CAPITAL INCOME IN THE EUROPEAN UNION: ISSUES AND OPTIONS FOR REFORM 180 (Sijbren Cnossen ed., 2000) [hereinafter Cnossen, *Taxing Capital Income*] (offering a particularly helpful overview of the Nordic experiments).

There is a large English-language literature on the Nordic dual income taxes, but that literature nonetheless does not yet figure prominently in American tax policy debates. The Nordic taxes are, however, very briefly described in WILLIAM A. KLEIN ET AL., FEDERAL INCOME TAXATION 15 (15th ed. 2009).

The leading authors in the English-language literature on this topic include Sijbren Cnossen (see, e.g., Sijbren Cnossen, *Reform and Coordination of Corporation Taxes in the EU: An Alternative Agenda*, 58 BULL. INT’L FISCAL DOCUMENTATION 134 (2004) [hereinafter Cnossen, *Reform and Coordination*]; Cnossen, *Taxing Capital Income*, supra note 7); Bernd Genser (see, e.g., Bernd Genser & Dirk Schindler, *Dual Income Taxation as a Stepping Stone Towards a European Corporate Income Tax* (Ctr. for Fin. & Econ., Univ. of Konstanz, CoFE Discussion Paper 07/05, 2007), available at <http://cofe.uni-konstanz.de/?cont=papers&subcont=Papers/2007/index&lang=en>; Bernd Genser & Andreas Reutter, *Fiscal Policy in Action: Moving Towards Dual Income Taxation in Europe*, 63 FINANZARCHIV 436 (2007); Eggert & Genser, supra note 4); and Peter Sorensen (see, e.g., Peter B. Sorensen, *Dual Income Taxes: A Nordic Tax System* (March 2009) (paper presented at conference on New Zealand Tax Reform—Where to Next?, Feb. 11–13, 2009), available at <http://www.econ.ku.dk/pbs/diversefiler/DUAL%20INCOME%20TAXES%20OUCBT.pdf> [hereinafter Sorensen, *Nordic Tax System*]; Peter B. Sorensen, *The Nordic Dual Income Tax: Principles, Practices, and*

recently, other European countries, such as the Netherlands (with its unique “box” system), Italy, and Germany have consciously adopted, or at least considered adopting, dual income tax principles, but arguably none has done so as consistently as have the Nordics.<sup>8</sup>

¶5 Under one of a dual income tax system’s two tax rate schedules, capital income is comprehensively defined and taxed at one relatively low proportional (flat) rate. Under the other schedule, labor income is taxed at progressive rates in both senses of the term. The top marginal rates of the labor income schedule in turn are materially higher than the flat rate imposed on capital income. For example, in a dual income tax environment, and depending, of course, on the specific rate brackets chosen, a taxpayer whose taxable income comprises \$300,000 in interest income will be taxed at a lower (flat) rate than will a taxpayer whose taxable income comprises \$300,000 in wages. Similarly, a taxpayer whose income comprises \$150,000 in interest income and \$150,000 in wages will pay tax on the wage component of her income at a higher rate than the tax imposed on her capital income.

¶6 The Nordic countries adopted dual income taxes without radically changing the customary distinction between corporate and personal incomes. Relying on the observation that the corporate income base is largely a measure of capital income,<sup>9</sup> their dual income taxes retained a corporate income tax, but set the tax rate on personal capital income to equal (or be very close to) the corporate income tax rate.<sup>10</sup> Ideally, the corporate income tax in turn would be fully integrated with shareholder-level capital income taxation with respect to the company’s stock to prevent the double taxation of earnings on corporate equity, but in this respect dual income tax countries have shown less unanimity in their approaches.<sup>11</sup> As a result, dual income tax systems in practical application superficially look very similar to the U.S. model.

¶7 In implementing their dual income taxes, the Nordic countries also generally did not disturb the customary distinction between capital and labor incomes with respect to self-developed assets. For example, imagine that an individual opens a local food shop (“Bergen Bagels”) and through years of hard work develops the value of the shop’s tradename and goodwill. The individual then sells the business at a price that reflects the value of those self-developed intangibles. The dual income taxes originally implemented by Nordic countries, like the U.S. tax system, generally treated the gains attributable to the sales of those intangibles as capital income.<sup>12</sup> Arguably, however, some portion of

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*Relevance for Canada*, 55 CAN. TAX J. 557 (2007) [hereinafter Sorensen, *Nordic Dual Income Tax*]; Peter B. Sorensen, *Can Capital Income Taxes Survive? And Should They?*, 53 CESIFO ECON. STUD. 172 (2007) [hereinafter Sorensen, *Capital Income Tax*]; Peter B. Sorensen, *Dual Income Taxation: Why and How?*, 61 FINANZARCHIV 559 (2005) [hereinafter Sorensen, *Dual Income Taxation*]; Soren B. Nielsen & Peter B. Sorensen, *On the Optimality of the Nordic System of Dual Income Taxation*, 63 J. OF PUB. ECON. 311 (1997); Sorensen, *Global Income Tax*, *supra* note 6).

<sup>8</sup> See, e.g., Genser & Reutter, *supra* note 7, at 448–52; see generally Cnossen, *Reform and Coordination*, *supra* note 7 (proposing that every European country adopt a dual income tax).

<sup>9</sup> See *supra* note 5.

<sup>10</sup> See *infra* Part III.B.2.

<sup>11</sup> For example, abstracting from actual Norwegian practice in the recent past, shareholders could be permitted to “write up” the tax basis in their stock to reflect retained corporate profits, and a full imputation system could be applied to prevent the double taxation of distributed profits. See *infra* Part III.B.3.

<sup>12</sup> Cf. Kristian Kvamme, *Taxation of Salary versus Capital Gain in Norway of Persons in Dual Relationships*, 56 BULL. INT’L FISCAL DOCUMENTATION 448, 449–50 (2002) (discussing certain “earn-outs” and other exceptions to this general rule).

those gains are further compensation (from the buyer of the business rather than buyers of its bagels) for the past labor efforts of the owner-entrepreneur.

¶8 A “best practices” dual income tax along the lines of the Nordic models, like an ideal comprehensive income tax, would adopt a comprehensive measure of capital income. For example, tax depreciation would follow economic depreciation schedules. Unlike the actual U.S. income tax, however, Nordic dual income taxes in practice have been relatively successful in defining and defending from political depredation a broad construct of capital income—subject to the perennial problem that the realization doctrine poses for measuring capital income—including, in the case of Norway, for example, a tax on the imputed rental value of owner-occupied housing (at least until recently).<sup>13</sup> This difference arguably may not simply reflect different political environments, but also the fact that consistency is more easily purchased in a low flat rate tax environment than in a high progressive rate one.

¶9 In the Nordic countries, the lowest labor income tax bracket is much higher than in the United States, and so the lowest labor tax bracket, the personal capital income tax bracket, and the corporate income tax can all be set at the same rate. As so constructed, the dual income tax can be characterized as a uniform proportional tax on *all* income, combined with a progressive labor tax surcharge on labor incomes exceeding specified thresholds.<sup>14</sup>

¶10 A “best practices” dual income tax permits the deduction of losses on capital investments against capital income. There is less agreement as to whether net losses from capital investments should offset positive labor income; different instances of dual income taxes have reached different conclusions on this point.<sup>15</sup>

### B. *Reasons for the Project*

¶11 The dual income tax is an exercise in applied tax engineering. It is informed by insights from public finance economics, but is unambiguously pragmatic in its aspirations. In light, however, of both the revenue needs of the United States and the sorry state of the current U.S. regimes for taxing capital income,<sup>16</sup> it is an appropriate academic enterprise to analyze the possible merits of a dual income tax for the United States. The underlying hypothesis is that, on balance, the dual income tax is technically viable, and its outcomes, with respect to the taxation of capital income, are likely to be superior to those that the United States will obtain if it continues on its present course. Moreover, unlike more ambitious reform proposals, a dual income tax could be implemented in the immediate future. Doing so would require political will comparable, perhaps, to that mustered for the Tax Reform Act of 1986, but not more.

<sup>13</sup> See *infra* Part III.B.1.

<sup>14</sup> A design issue for an American dual income tax would be to decide what to do with capital income earned by low-income households, given that the lowest labor tax rate in the United States is only 10%. See *infra* Part IV.

Note that the formulation above addresses the concern that a dual income tax, as an instance of schedular taxation, necessarily exposes the fisc to the risk that some unspecified income will fail to be taxed under either schedule.

<sup>15</sup> Eggert & Genser, *supra* note 4, at 43; see also Clossen, *Taxing Capital Income*, *supra* note 7, at 182.

<sup>16</sup> See, e.g., U.S. Department of Treasury, *Business Taxation and Competitiveness*, 116 TAX NOTES 399 (2007).

¶12 A dual income tax poses two fundamental gating issues for policymakers interested in considering alternatives to the current U.S. system for taxing capital income. The first is whether a dual income tax, in fact, can be implemented in practice. The second is whether the distribution of tax burdens that an ideal dual income tax would impose is desirable as a matter of economic efficiency or equity norms.

¶13 This Article focuses on the first of these gating issues. Critically, as a schedular system, the dual income tax requires a reliable mechanism to distinguish its two categories of income (i.e., labor and capital income) when the two are mixed together as net business income. This is particularly the case for the “owner-manager”—an individual who both provides labor inputs to an enterprise and owns a significant interest in that enterprise. A dual income tax raises many other important design issues, but all are of second-order importance in comparison to this issue. This Article refers to the hypothesized tax administrative device for separating net business income into its constituent parts as the “labor-capital income centrifuge.” Policymakers rationally must have confidence that such a device can be constructed and applied in the United States before they are willing to consider a dual income tax further. There is no constituency for an avowedly pragmatic exercise that cannot be made to work.

¶14 A future article in the series will consider the second gating issue associated with dual income taxes—whether a dual income tax is desirable on efficiency or equity grounds. Nonetheless, it is worth describing some of the arguments very briefly, so as to convince readers that the case for a dual income tax is not wholly fatuous, even if it is feasible. The case for the dual income tax is not that it is superior in the dimensions of efficiency or equity to those that can be ascribed to ideal tax systems, but rather that an implementable dual income tax is likely to be superior across both these dimensions when compared with the best results one might expect from the continuation of current policies, even in the context of some large-scale “reform.”

¶15 A reasonably implementable dual income tax is likely to be superior to our current progressive comprehensive income tax from an economic efficiency perspective. The core purpose of the dual income tax is to impose a constant and relatively low burden on all capital income, however denominated, subject to the practical constraints (such as the realization principle) within which most income tax systems operate.<sup>17</sup> To accomplish this goal, the implementation of a dual income tax invariably requires a substantial broadening of the capital income tax base, both to ensure that all forms of capital income are fairly measured and captured, and to address equity concerns. The resulting environment would dominate our current rules for taxing capital income, both because of the dual income tax’s consistency in burdens (which necessarily reduces the role of tax thinking in commercial decision-making) and because of its lower rates, which reduces the overall deadweight loss associated with taxing normal returns from capital at all.<sup>18</sup>

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<sup>17</sup> The Author’s proposed “business enterprise income tax” seeks, among other goals, to reduce the relevance of realization principles within a (conceivably) implementable income tax. Edward D. Kleinbard, *Designing an Income Tax on Capital*, in TAXING CAPITAL INCOME 165, 172, 178–91 (Henry J. Aaron et al. eds., 2007) [hereinafter Kleinbard, *Designing Income*]; Edward D. Kleinbard, *Rehabilitating the Business Income Tax* (Brookings Inst., Hamilton Project Discussion Paper 2007-09, 2007) [hereinafter Kleinbard, *Rehabilitating Income Tax*], available at [http://www.brookings.edu/~media/Files/rc/papers/2007/06corporatetaxes\\_kleinbard/200706kleinbard.pdf](http://www.brookings.edu/~media/Files/rc/papers/2007/06corporatetaxes_kleinbard/200706kleinbard.pdf).

<sup>18</sup> Alan Viard, *Two Cheers for Corporate Tax Base Broadening*, 62 NAT’L TAX J. 399 (2009); Martin Feldstein, *The Effect of Taxes on Efficiency and Growth*, 111 TAX NOTES 679 (2006).

¶16 Lower rates on capital income also reduce the attractiveness of tax avoidance through aggressive transfer pricing and other schemes and reduce the benefit of tax arbitrage through leverage. The Nordic countries, for example, which typically allowed generous home mortgage and other personal interest deductions, found that the introduction of dual income taxes actually served to enhance government revenues because personal interest expenses became deductible only against the lower capital income rates.<sup>19</sup> Lower and proportional tax burdens on capital income also reduce the “lock-in” effect on sales of capital assets and can be said to compensate (imperfectly) for the effects of inflation.<sup>20</sup>

¶17 Many economists believe that the income tax itself is a flawed norm, and that economic efficiency can be enhanced (without impairing equity concerns) by adopting a progressive consumption tax as the U.S. model.<sup>21</sup> Dual income tax systems can be understood as moving in the direction of a consumption tax, even if they do not fully achieve all its efficiency goals. Importantly, a dual income tax does so while largely avoiding the extraordinarily difficult transition issues that would be raised by the replacement of our capital income tax with a consumption tax.<sup>22</sup>

¶18 The dual income tax might cynically be described as a Solomonic compromise between two warring camps divided over whether a positive tax on normal returns to capital is desirable. It is fairer, however, to see the underlying principle of the dual income tax as a recognition that capital and labor income are sufficiently different that a desirable tax scheme for one is not necessarily optimal for the other, and that the best evidence to date argues for moderation in the taxation of capital income.<sup>23</sup> By introducing a practical tax system that implements this differential treatment, the dual income tax creates a platform from which evolving views of the relative tax burdens of labor and capital income can be implemented.

¶19 It might be argued that this efficiency argument unfairly claims as a victory for the dual income tax what really is just the consequence of any thoughtful base broadening

<sup>19</sup> Sorensen, *Nordic Tax System*, *supra* note 7, at 8 (“Paradoxically, the sharp reduction of capital income tax rates thus generated a significant revenue *gain* which enabled the Nordic governments to *lower* the tax burden on labour income.”); *but see* Cnossen, *Taxing Capital Income*, *supra* note 7, at 186 (noting that Sweden’s introduction of a dual income tax “coincided with a deep recession” that may have been caused by this limitation on the deductibility of home mortgage interest).

<sup>20</sup> Cnossen, *Taxing Capital Income*, *supra* note 7, at 188–89 (summarizing and citing Sorensen, *Global Income Tax*, *supra* note 6).

<sup>21</sup> *See, e.g.*, Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax over an Ideal Income Tax*, 58 STAN. L. REV. 1413 (2006); Edward J. McCaffery, *A New Understanding of Tax*, 103 MICH. L. REV. 807 (2005); Daniel N. Shaviro, *Replacing the Income Tax with a Progressive Consumption Tax*, 103 TAX NOTES 91 (2004).

<sup>22</sup> *See, e.g.*, Ronald A. Pearlman, *Transition Issues in Moving to a Consumption Tax: A Tax Lawyer’s Perspective*, in ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM 393 (Henry J. Aaron & William G. Gale eds., 1996) (describing these transition issues in detail).

<sup>23</sup> Cnossen, *Taxing Capital Income*, *supra* note 7, at 187 (explaining that it “should be possible to tax capital income positively but that moderation is advisable”). It should be remembered that many standard consumption tax proposals, in fact, tax returns to capital when those returns constitute rents. *See, e.g.*, McCaffery, *supra* note 21, at 812–16; Shaviro, *supra* note 21, at 98–103. Another way of looking at the dual income tax compromise is that, by taxing all capital income at one low rate, the dual income tax implements a tolerable compromise that avoids drawing a line between normal returns and rents. Conversely, one can argue that this compromise is flawed because the economic case for a significant positive tax burden on rents is much more persuasive than is the case for a positive tax burden on normal returns. Part III.E. of this Article briefly returns to this question, but the issue is largely deferred until the next article in this series.

exercise.<sup>24</sup> This objection, however, misses the logical connections among several related points. First, capital income base broadening (more accurately, capital income burden leveling) is possible as a matter of political economy only if the quid pro quo is lower capital income tax rates. Second, capital income tax rates cannot be lowered so long as those rates are tied to labor tax rates because the government's revenue constraints will not permit it. The dual income tax, but not the comprehensive income tax, satisfies this syllogism: capital income burden-leveling permits lower marginal rates; lower marginal capital income tax rates are a necessary condition to achieving political consensus for base broadening; and lower marginal capital income rates are not feasible if they in turn imply lower labor income tax rates.

¶20 The most persuasive economic efficiency criticism of the original dual income tax systems does not lie along the dimension of their burden-leveling effects or their lower tax rates on normal (marginal) returns—both of which would generally be viewed as efficiency enhancing—but rather in their implicit decision to tax economic rents at the same tax rate as normal returns. A persuasive argument can be made that rents can bear a tax burden higher than normal returns because, even after that higher burden, rents are more desirable than the next best alternative (investing in generally-available marginal returns).<sup>25</sup> The Norwegian dual income tax system in fact was substantially revised in 2004, in part because of political economy concerns over the tax system's inability to preserve the efficacy of its labor-capital income centrifuge, but also because it was thought desirable to split income, not along the lines of labor and capital income, but instead along the lines of normal (marginal) returns to capital, on the one hand, and everything else (rents and labor income), on the other.<sup>26</sup>

¶21 On its face, a dual income tax would appear to be inconsistent with traditional “ability to pay” measures of how the burdens of taxation should be distributed. If implemented appropriately, however, the dual income tax's economic efficiency gains can be captured without doing violence to distributional goals—or, more accurately, to distributional results achieved under our current system. For example, the equity argument in defense of the status quo rests on the flawed premise that the comprehensive income tax today operates to tax the capital income of the wealthy at the IRC's highest marginal statutory rates. As a result of clientele effects, that is not necessarily the case. Wealthy taxpayers generally invest in ways that maximize their after tax returns, and in doing so reduce the tax burden imposed on their capital income to very low levels.<sup>27</sup> The

<sup>24</sup> See Frederik Zimmer, *Direct Taxes in Norway—A Bird's Eye View*, 56 BULL. INT'L FISCAL DOCUMENTATION 352, 352–53 (2002).

<sup>25</sup> Cf. Joseph Bankman & Thomas Griffith, *Is the Debate Between an Income Tax and a Consumption Tax Really a Debate About Risk? Does It Matter?*, 47 TAX L. REV. 377, 406 (1992) (arguing that “taxation of [economic rents] is much less troublesome than taxation of” normal returns).

<sup>26</sup> See *infra* Part III.C.

<sup>27</sup> Tax-exempt municipal bonds are one example in which the highest marginal rate taxpayers, far from suffering an implicit tax that reflects their economic income, enjoy much greater after-tax returns than simple theory might suggest (because lower-bracket taxpayers are the marginal investors in such instruments). See CONG. BUDGET OFFICE & STAFF OF JOINT COMM. ON TAXATION, SUBSIDIZING INFRASTRUCTURE INVESTMENT WITH TAX-PREFERRED BONDS 34 (2009), available at <http://www.cbo.gov/ftpdocs/106xx/doc10667/10-26-TaxPreferredBonds.pdf>; STAFF OF JOINT COMM. ON TAXATION, PUB. NO. JCX-14-06, PRESENT LAW AND BACKGROUND RELATING TO STATE AND LOCAL GOVERNMENT BONDS 6 (2006) (determining that the implied tax rate of a marginal holder of tax-exempt bonds between 1986 and 2005 varied between 17 and 27%). Similarly, wealthy taxpayers derive the bulk of long-term capital gains, taxed at a flat rate of 15%. Martin A. Sullivan, *Is the Income Tax Really*



net result is that the current system for taxing capital income has none of the redistributive virtues sometimes imagined for it. Sullivan, for example, has calculated that the U.S. personal income tax today is actually regressive at the highest income levels (above roughly \$2 million per year in adjusted gross income). He ascribes the phenomenon entirely to the 15% tax rate on dividend income and net capital gain.<sup>28</sup> Moreover, the largest single capital income tax, the corporate income tax, is already a proportional (flat) tax in practice. Finally, there are important arguments that the “vertical” equity analysis is flawed because it misapprehends capital as something ultimately distinct from labor, rather than as a simple store of past labor. There is good reason to be optimistic, therefore, that migrating to a constant burden capital income tax (in particular, one in which the capital gains tax is repurposed along the lines suggested elsewhere in this series) is unlikely to lead to more regressive taxation of capital income.

¶22 The last reason to pursue vigorously the application of dual income taxation in the United States is that a dual income tax makes a virtue of necessity. A dual income tax is an effective strategic response to the problems that otherwise would plague the U.S. tax system if, as appears likely, the United States materially lowers its corporate income tax rate and allows the maximum individual income tax bracket to rise. In the absence of some strategic response, this rate differential would lead to a phenomenon not seen for at least a generation: the rise of the taxable (“C”) corporation as a tax shelter. If this factual premise is accepted, the issue then becomes not whether to wish a dual income tax for the United States, but rather, whether to wish a well-implemented one.

¶23 A dual income tax addresses both legs of this tax rate gap problem. First, it eliminates any tax preference for investing personal investment assets through a C corporation (what might be called “capital stuffing”). Second, it also eliminates any tax preference on the part of an owner-manager of a closely-held C corporation to under-compensate his own labor contributions to his firm’s net income in order to earn a higher after-tax rate of return on the assets retained in corporate solution (“labor stuffing”). The dual income tax addresses these phenomena without the efficiency burden of alternative strategies, such as raising dividend taxes and capital gains taxes on sales of corporate stock.<sup>29</sup>

### C. Scope of this Article

¶24 This Article introduces the dual income tax to a larger U.S. audience through a detailed examination of the best-engineered examples to date, those implemented by the Nordic countries (Norway in particular). The experiences of the Nordic countries are useful predictors of the stress points that U.S. policymakers would need to resolve were they to implement dual income tax principles in the United States.

¶25 Part II identifies some of the key conceptual issues raised by a dual income tax that are not present in a comprehensive income tax (at least of the ideal variety). Those issues relate to the special problems of implementing an explicitly schedular tax system. As already noted, the most important is the development of a reliable mechanism to separate the income of an owner-manager of a business into its labor and capital components. Part

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*Progressive?*, TAX NOTES TODAY, Dec. 10, 2009, at 237–44.

<sup>28</sup> Sullivan, *supra* note 27, at 237–44.

<sup>29</sup> Cf. Daniel Halperin, *Mitigating the Potential Inequity of Reducing Corporate Rates* (Tax Pol’y Ctr. Working Paper, 2009), available at <http://www.taxpolicycenter.org/publications/url.cfm?ID=411931>.

III recounts the Nordic experience in detail, with a particular emphasis on how these jurisdictions addressed the unique problems posed by dual income taxes. Finally, Part IV summarizes the key lessons from the Nordic experience for U.S. policymakers.

¶26 A future article in this series will extend the analysis more directly to current U.S. tax policy debates. That article will consider the efficiency and equity arguments for adopting a dual income tax in the United States, as well as the usefulness of a dual income tax in addressing the capital stuffing and labor stuffing problems briefly referenced above. In doing so, the article will demonstrate that the critical implementation issue required for a successful dual income tax—a mechanism for separating an owner-manager’s net business income into its labor and capital components—is an issue for the U.S. tax system today, and one poorly handled by existing tools.

## II. UNIQUE ASPECTS OF A DUAL INCOME TAX

### *A. Central Role of the Labor-Capital Income Centrifuge*

¶27 The dual income tax is unique in the sense that, even in an ideal form, it requires a mechanism to distinguish labor from capital income when the two are mixed together as net business income. A principal reason to study the Nordic experience with dual income taxes, therefore, is to test whether a robust mechanism for separating labor from capital income in fact can be developed.

¶28 Every business enterprise can be understood as the joint application of labor and capital inputs in proportions unique to each case. In the case of a widely-held public corporation, the suppliers of labor and capital can be expected to define for themselves the relative contributions of each through the process of setting wages; the post-compensation remainder by definition must be capital income.<sup>30</sup> In the case of a closely-held business, by contrast, there is no reliable non-tax commercial or financial imperative to segregate the labor contributions of the business’s owner from the returns on the capital she has deployed in the business. To implement an ideal dual income tax, however, one must perform just such an exercise, since each factor is taxed under a different schedule.

¶29 Like the economist on a desert island armed with an actual tin of food and a notional can opener, an ideal dual income tax system therefore must assume a device to distinguish labor from capital income in the hands of the owner-manager. At the risk of mixing mechanical metaphors, this Article conceives of this device as a “labor-capital income centrifuge.” Through its operation, solutions of business income are separated into their labor and capital components.

¶30 The ideal comprehensive income tax does not require a labor-capital income centrifuge because, by definition, labor and capital factors are taxed under a single schedule. Surprisingly, the ideal consumption tax also does not require a mechanism for distinguishing labor from capital income, even though the whole purpose of a consumption tax (at least of the postpaid variety) is to exempt normal returns to capital from tax.<sup>31</sup> An ideal expenditure tax, for example, can accomplish this result simply by

<sup>30</sup> See *supra* note 5.

<sup>31</sup> David Weisbach, *The (Non)taxation of Risk*, 58 TAX L. REV. 1 (2004); Shaviro, *supra* note 21, at 98–103.

providing a deduction for all capital investment. Under certain assumptions that are reasonable in the context of ideal systems, the resulting tax base is one that excludes normal returns to capital.<sup>32</sup> This result in turn applies to the closely-held business as much as it does to the publicly-owned firm. When applied to an expenditure tax, the problem of separating capital from labor income thus resolves itself, because the mechanism to do so is simply to subtract from the tax base capital *inputs*—not the income derived from those inputs. As a result, the tax base is not measured by segregating the portion of business output (income) that is attributable to labor inputs from the portion attributable to capital inputs.

¶31 In sum, for different reasons, neither an ideal income tax nor an ideal consumption tax of the postpaid variety requires one to assume the existence of a special labor-capital income centrifuge, but an ideal dual income tax does. In the study of ideal systems, this observation would end the matter. In the world of actual policy, however, one cannot assume that a reliable labor-capital income centrifuge can be constructed. In light of the important role played in the U.S. economy by privately-held business firms, the design of the labor-capital income centrifuge becomes the central question in considering whether a dual income tax is feasible for the United States.

¶32 One answer to this design challenge might be to rely on existing American tax technologies that address the same question. The IRC has adopted rules in a number of circumstances to tease apart labor from capital income. In doing so, the IRC typically phrases the exercise as distinguishing “earned” from “unearned” income. As the next article in this series will demonstrate, however, the solutions that the IRC has adopted have proved to be dispiritingly badly engineered. In general, our current methodologies for distinguishing labor from capital income in those areas where the issue is squarely presented under the IRC rely on fact-specific, case-by-case “reasonable compensation” disputes. In turn, the concept of “reasonable compensation” almost always is invoked as a ceiling, but not a floor, on an owner-manager’s labor income. Moreover, there are important instances (e.g., the recent “carried interest” debates) where existing methodologies arguably have no application at all.

¶33 A practical labor-capital income centrifuge thus could be useful to U.S. tax administration without regard to whether the United States should move toward a dual income tax. Such a mechanism could usefully be employed to address labor-capital income distinctions that current law requires be drawn, or to prevent the corporate tax system in the future (when a gap between corporate and individual tax rates has emerged) from being used as a tax shelter for the labor income of owner-managers of closely-held firms. At the same time, this tax technology is central to the dual income tax enterprise,<sup>33</sup> and policymakers cannot be expected to consider the merits of a dual income tax unless they have confidence that a successful labor-capital tax centrifuge can be constructed.

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A “wage” (prepaid) consumption tax arguably is different, in that as applied to the owner-manager of a closely-held firm, the determination of returns on capital that are excluded from the tax base is essentially identical to the issue confronted in a dual income tax. To this author, this observation is another reason (beyond the fundamental distinction that wage taxes exempt true economic rents as well as normal returns from tax) an expenditure tax is the superior way of conceptualizing an ideal consumption tax.

<sup>32</sup> See Weisbach, *supra* note 31, at 21–23; Shaviro, *supra* note 21, at 96, 101.

<sup>33</sup> See, e.g., Genser & Reutter, *supra* note 7, at 452.

Indeed, the principal academic objection to the dual income tax enterprise has been that the dual income tax is doomed to fail precisely because an effective labor-capital income centrifuge allegedly cannot be constructed.<sup>34</sup>

¶34 The Nordic designs for a labor-capital income centrifuge relied on relatively straightforward mechanical rules to assign a portion of an owner-manager's business income as capital income, and the remainder as labor income. In a nutshell, those rules operate by providing an arbitrary (but generous) statutory rate of return on an owner-manager's business assets. The owner-manager's net business income is treated as low-taxed capital income to the extent of the product of that rate of return and her investment in business assets, and as labor income to the extent of any excess.<sup>35</sup>

¶35 As originally conceived, the Nordic dual income taxes applied these "income-splitting" rules to the current net business income of a closely-held enterprise controlled by one or more owner-mangers. The rules were not thought necessary in the case of widely-held firms because, in those cases, employees and owners could be expected to negotiate between themselves for a market-rate return to labor. As a result, one major theme in the implementation of dual income taxes has been where to draw the line between firms subject to the income-splitting regime (that is, the application of the labor-capital income centrifuge) and firms to which the rules were not applied.

¶36 The Nordic countries applied their income-splitting rules to current operating income, not to gains from the sale of a business.<sup>36</sup> As pointed out earlier, this is consistent with current U.S. practice, in which gain from the sale of self-developed assets generally is characterized as capital gain, not income from past labor efforts.

¶37 The Nordic implementations of a labor-capital income centrifuge have not been universally successful, for a variety of reasons described below, but they are interesting in their own right. In particular, they are very different from those employed by the United States when this country last imposed significantly higher marginal tax rates on individuals than on corporate income (circa 1981).<sup>37</sup> Unlike U.S. practice, the Nordic solutions rely on simple mechanical rules rather than difficult "facts and circumstances" litigation to police the boundary between labor and capital income.<sup>38</sup> As a result, what the Nordic solutions lack in perfection they compensate for in (relative) simplicity and universal application. At the same time, the United States arguably is heading down the path of requiring these sorts of imperfect solutions, or alternative imperfect solutions, to address the future hypothesized earlier in this Article, in which corporate tax rates will be materially lower than individual rates. Whether the Nordic dual income tax outcome dominates that obtained under the current half-hearted U.S. attempt to tax capital income requires a closer examination of how the Nordic countries have implemented dual income taxes in practice. Part III of this Article therefore turns to that task. It concludes that

<sup>34</sup> Nordic scholars, apparently the victims of an unexamined collective foot fetish, invariably describe the "Achilles heel" of the system as its attempt to divide labor from capital income in the case of an owner-manager. See *infra* Part III.C.

<sup>35</sup> See *infra* Part III.B.4.

<sup>36</sup> The new post-2004 Norwegian system described appears to reverse this result. See *infra* Part III.D.

<sup>37</sup> See *Personal Exemptions and Individual Income Tax Rates, 1913–2002*, IRS STAT. INFO. BULL. (I.R.S., Wash., D.C.), Spring 2002, at 216; *Corporation Income Tax Brackets and Rates, 1909–2002*, IRS STAT. INFO. BULL. (I.R.S., Wash., D.C.), Spring 2002, at 284.

<sup>38</sup> The U.S. approach is described in the next article in this series.

Norway, for example, abandoned the dual income tax too quickly; its construction of its labor-capital income centrifuge was flawed, but could have been made more robust.

### *B. Other Consequences of Schedular Taxation*

¶38 One issue laid at the feet of schedular income tax systems in general is that income of a type that is inadvertently unspecified escapes taxation altogether; the more general formulation of the concern is that taxpayers can devote substantial and wasteful energy to re-characterizing income subject to a high-tax schedule into lower-taxed income.<sup>39</sup> As applied to dual income taxes, at least, this problem is greatly overstated for two reasons. First, as Part III develops, a dual income tax can be implemented (as Norway did) as a general tax imposed on all income from whatever source derived, combined with a labor surtax. By doing so, there is no risk of some unspecified species of income escaping tax altogether. Second, a dual income tax has only two schedules; as a result, the mischaracterization issue in practice comes back simply to the question of whether an efficacious labor-capital income centrifuge can be deployed. That issue in turn is more explicitly and consistently presented on the face of the dual income tax statute than are—to take one important counterexample—the distinctions in current U.S. law between capital gains, on the one hand, and other forms of capital or labor income, on the other.<sup>40</sup>

¶39 The last issue presented by all schedular systems is whether to permit any form of netting across the different schedules. In the dual income tax context, the principal netting issue is whether a net negative return on capital can be applied to reduce net labor income, and if so, at what rate. In addition, however, the Norwegian labor-capital income centrifuge actually could produce hypothetical negative returns to labor. Although this result was an artifact of the particular mechanical rules for separating returns from capital and from labor, which operated by specifying a return to capital and then deeming the remainder a return to labor,<sup>41</sup> it must be resolved in some fashion. And finally, there are a number of cases of implicit netting of labor against capital income. For example, if the dual income tax is implemented as a general tax on all income combined with a labor income surtax, then net negative capital income implicitly offsets labor income in the general income tax base. A well-implemented dual income tax should develop consistent rules of application for all these examples.

## III. NORDIC DUAL INCOME TAXES

### *A. Overview*

¶40 Beginning with Denmark in 1987,<sup>42</sup> the four Nordic countries (Denmark, Finland, Norway, and Sweden) have experimented with variations on the theme of a dual income tax. Denmark abandoned the dual income tax ideal early on,<sup>43</sup> and the other three

<sup>39</sup> Cf. KLEIN ET AL., *supra* note 7, at 15.

<sup>40</sup> Cf. *Comm'r v. P.G. Lake, Inc.*, 356 U.S. 260 (1958); *Comm'r v. Ferrer*, 304 F.2d 125 (2d Cir. 1962). For example, by eliminating any distinction between capital gains (other than those derived from sales of “C” corporation stock) and other forms of capital income, the issues presented in a case like *P.G. Lake* simply resolve themselves.

<sup>41</sup> See *infra* Part III.B.4.

<sup>42</sup> Sorensen, *Global Income Tax*, *supra* note 6, at 60–61.

<sup>43</sup> *Id.*

countries have frequently revised their systems in light of their experiences.<sup>44</sup> It, therefore, is not possible to describe a unified dual income tax as currently implemented. Nonetheless, the Norwegian system as in effect from 1992–2003 arguably was the closest to the ideal as any of the various implementations.<sup>45</sup> Moreover, the reasons for its revision (introduced in 2004 and fully effective January 2006) shed light on the limitations of the dual income tax strategy for taxing capital income.<sup>46</sup> Accordingly, the discussion in this Article takes the Norwegian dual income tax circa 2002 as a model of a “best practices” implementation of the ideal.<sup>47</sup>

¶41 The Nordic dual income taxes resemble the U.S. tax system in some critical respects. For example, the Nordic systems tax residents on their worldwide income, treat corporations as taxable persons, treat partnerships and proprietorships as fiscal transparencies, and permit an interest deduction.<sup>48</sup> The dual income taxes differ in that they adopt a very comprehensive definition of capital income, tax that income on a separate proportional rate schedule, and then adopt unique rules (the labor-capital income centrifuge) for separating capital from labor income in those cases where markets cannot be relied on to do the job.

### B. Dual Income Taxes in Practice

#### 1. Specification of the Real Income Base

¶42 As the prior discussion suggested, a successful tax on capital income ordinarily requires a comprehensive real income tax base. In connection with its adoption of a dual income tax in 1992, Norway, for example, substantially broadened its tax base by revising its depreciation rules to more closely track economic depreciation, and eliminated many business tax expenditures.<sup>49</sup> More strikingly, Norway included in the capital income tax base an imputed rental value of owner-occupied homes. Even these countries are not immune to political pressures, however, and the values employed for calculating imputed rent were said to be very low, and the taxes wildly unpopular.<sup>50</sup> For that reason, Norway’s tax on the imputed rental value of owner-occupied housing was

<sup>44</sup> See *infra* Part III.D.

<sup>45</sup> See, e.g., Leif Muten, *Dual Income Taxation: Swedish Experience*, in TOWARDS A DUAL INCOME TAX?: SCANDINAVIAN AND AUSTRIAN EXPERIENCES 19 (1996) (“The leading nation in the field is Norway.”).

In addition to the articles cited in notes 6 and 7, *supra*, there is a large body of articles on the Norwegian system from 1992–2005, particularly as the result of the International Fiscal Association holding its annual conference in Norway in 2002. See, e.g., Zimmer, *supra* note 24; Hakon Lochen, *The Taxation of Income from Capital versus the Taxation of Earned Income in Norway*, 56 BULL. FOR INT’L TAXATION 359 (2002); Ole Gjems-Onstad, *Computing Capital Gains on Shares: A Ten-Year Old—and Successful(?)—Experiment*, 56 BULL. FOR INT’L TAXATION 364 (2002) [hereinafter Gjems-Onstad, *Computing Capital Gains*]; Sven Rune Greni, *Tax Issues regarding the Relationship between Joint-Stock Companies in Norway and their Shareholders*, 56 BULL. FOR INT’L TAXATION 437 (2002); Kvamme, *supra* note 12.

<sup>46</sup> See Sorensen, *Nordic Dual Income Tax*, *supra* note 7; Ole Gjems-Onstad, *Norway’s Tax Reform 2004–2006*, 59 BULL. FOR INT’L TAXATION 141 (2005) [hereinafter Gjems-Onstad, *Norway’s Tax Reform*].

<sup>47</sup> The next several subsections sometimes refer to this system in the present tense (when lumped together with other Nordic dual income taxes), but it should be remembered that in fact the Norwegian system was substantially revised in 2004. See *generally infra* Part III.D.

<sup>48</sup> Zimmer, *supra* note 24, at 353.

<sup>49</sup> Nossen, *Taxing Capital Income*, *supra* note 7, at 191; Zimmer, *supra* note 24, at 355. The shipping industry, however, was successful in negotiating a special tax regime for its operations. Lochen, *supra* note 45, at 360.

<sup>50</sup> Zimmer, *supra* note 24, at 353; Lochen, *supra* note 45, at 360.

repealed with effect from 2005.<sup>51</sup> Still, some acknowledgment of the principle is remarkable, in light of the complete unwillingness of most U.S. policymakers even to comprehend the concept.<sup>52</sup>

¶43 The United States also broadened its tax base in 1986, but over time that base has become substantially narrowed through tax expenditures.<sup>53</sup> It is extraordinary from a U.S. perspective that Norway and the other Nordic countries apparently have been able to preserve their capital income tax base, notwithstanding all the inevitable special pleadings for exceptional treatment.<sup>54</sup> It is tempting (if un-provable) not simply to attribute this phenomenon to superior Nordic budgetary scruples, but to a consensus desire to preserve the low proportional tax on capital income, which requires the broad base to raise adequate revenue and to avoid distributional concerns.

## 2. Taxation of Capital Income

¶44 The Nordic dual income taxes impose a proportional (flat) tax on capital income. In every case, the capital income tax rate is materially lower than the top rate on labor income. For this purpose, capital income includes the net income of business enterprises (whether conducted through corporate or pass-through entities), interest, dividends, capital gains, actual rental income and deemed rental income from owner-occupied housing.<sup>55</sup>

¶45 The Nordic countries specify their labor and capital baskets slightly differently. In some cases, the two are kept apart as separate baskets, with special rules (discussed below in Part III.B.5) to address when a loss in one basket can be applied against income in the other. By contrast, in the Norwegian system in effect from 1992–2004, net capital income and net labor income were taxed together at a single proportional rate (the “general” tax), and gross labor income above certain thresholds in turn was subject to specified progressive surtaxes (the “personal” tax).<sup>56</sup>

¶46 The individual capital income rate (putting to one side the special cases of dividends and capital gains on corporate stock) generally is set at the same rate as the corporate income tax rate (although Sweden maintains a small difference between the two).<sup>57</sup> In turn, the personal capital income/corporate rate typically is set equal to the lowest rung on the labor tax progressive rate schedule.<sup>58</sup>

<sup>51</sup> See INT’L MONETARY FUND, IMF COUNTRY REP. NO. 05/196, NORWAY: 2005 ARTICLE IV CONSULTATION –STAFF REPORT 20 (2005), available at <http://imf.org/external/pubs/ft/scr/2005/cr05196.pdf>.

<sup>52</sup> See Jerome Kurtz, *The Interest Deduction Under Our Hybrid Tax System: Muddling Toward Accommodation*, 50 TAX L. REV. 153, 188–93 (1995).

<sup>53</sup> Edward Kleinbard, *How Tax Expenditures Distort Our Budget and Our Political Processes*, 123 TAX NOTES 925 (2009).

<sup>54</sup> The explanation may rest on difference of political economy and culture; can one imagine the Internal Revenue Service, for example, following the lead of the Norwegian Tax Administration and titling the opening paragraph of its annual report “A Society Where Everyone is Willing to Pay His Dues”? See NORWEGIAN TAX ADMIN., ANNUAL REPORT FOR 2006, at 2 (2006); cf. Lochen, *supra* note 45, at 361.

<sup>55</sup> Sorensen, *Nordic Tax System*, *supra* note 7, at 2–3.

<sup>56</sup> Kvamme, *supra* note 12, at 448; Zimmer, *supra* note 24, at 353.

<sup>57</sup> Cnossen, *Reform and Coordination*, *supra* note 7, at 146. Part III.B.4, *infra*, describes the special rules for separating labor from capital income in the case of net business income earned by a closely-held business.

<sup>58</sup> Sweden again deviates slightly from this. See Cnossen, *Reform and Coordination*, *supra* note 7, at 146.

¶47 For example, in the Norwegian system in effect from 1992–2003, corporate net profits were taxed at a flat rate of 28%, as was all individual net income from labor and capital (other than dividends and some capital gains on corporate stock, which were exempt), because that was the rate imposed under the general tax. In turn this also was the bottom bracket in the gross labor income surtax (the personal tax) progressive rate schedule, which climbed to as high as 47.5%.<sup>59</sup>

¶48 From a U.S. perspective, the lowest tax bracket in the Norwegian progressive schedule for taxing labor income (28% circa 2003) appears very high, but of course Norway, like the United States, has exemptions and allowances. Moreover, the identity of rate between capital income taxes and the first bracket of labor income taxes has the serendipitous advantage of making the distinction between labor and capital income unimportant for the smallest proprietorships and partnerships.

¶49 In Norway, at least, interest expense incurred by businesses and individuals alike is fully deductible, regardless of whether the interest expense was incurred in connection with a trade or business or whether the expense was incurred to purchase or carry a tax-favored asset.<sup>60</sup> Under the pre-2004 dual income tax, however, the deduction was available only in calculating a taxpayer's "general" tax liability, which can be phrased alternatively as observing that interest deductions were deductible only at the capital income rate. For the same reason, in the case of a wage earner, the "personal" tax functioned as a surtax on gross labor income.

¶50 For example, imagine that in 2002 a Norwegian taxpayer earned \$200<sup>61</sup> in salary income, had \$50 of interest income from personal investments, \$75 in capital losses, and paid \$100 in home mortgage interest expense (net of any inclusion for the deemed rental value of his home). The Norwegian taxpayer's general basket net income would be \$200 + \$50 – \$75 – \$100, or \$75, which amount would be subject to tax at 28%. His labor income subject to the "personal income" surtax, however, would be \$200; this amount would be subject to tax at the graduated surtax rates imposed on gross labor income.

¶51 Thus, a taxpayer's gross labor income subject to surtax was not limited to his net income. It does not follow from this observation, however, that the taxpayer obtained no benefit from his interest deduction because, in the absence of that interest expense, his general tax liability would be 28% of \$175, and his personal income surtax would remain based on his gross wages of \$200.

¶52 On the other hand, in the case of an owner-manager under pre-2004 law, the owner-manager's labor income from his business never exceeded 100% of his net business

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<sup>59</sup> *Id.*

<sup>60</sup> Ole Gjems-Onstad et al., *Norway*, in EUROPE: CORP. TAXATION § 2.7.5 (Int'l Bureau of Fiscal Documentation, 2009); Marianne Iversen, *Norway*, in 4 GUIDES TO EUROPEAN TAXATION: TAXATION OF INDIVIDUALS IN EUROPE § 4.5 (Int'l Bureau of Fiscal Documentation, 2006).

This result at first blush appears extraordinary to an American reader, but is consistent with the very broad definition of capital income adopted (as including, for example, a deemed return on owner-occupied housing and on all business assets), and has the singular merit of making irrelevant the question of whether indebtedness is incurred to support a sole proprietorship or personal consumption. If, by contrast, interest deductibility is limited only to business indebtedness, then tax administrators must police the boundaries between personal and business indebtedness in circumstances where money is at least approximately fungible.

<sup>61</sup> For the convenience of American readers, I ignore the Norwegian krone and use the U.S. dollar in all examples.



income. For this reason, it can be said that the non-interest business expenses of entrepreneurs were deductible against higher-taxed labor income.<sup>62</sup>

¶153 None of the Nordic countries imposes a domestic or cross-border “final” withholding tax on interest paid by a Nordic business.<sup>63</sup> As a result, interest paid to a domestic tax-exempt investor or an international investor erodes the local (source) tax base. This result is viewed as unavoidable in light of the Nordic countries’ standing as small capital-importing countries.<sup>64</sup>

### 3. Taxation of Dividends and Capital Gain on Corporate Stock

¶154 If the purpose of a dual income tax is to impose a single proportional tax on capital income, then it must follow that the personal tax on dividend income should be integrated with the corporate income tax, so that distributed corporate income bears the same tax burden as does capital income earned entirely outside the corporate setting. The Nordic countries largely accept this guiding principle in theory, but have deviated from it in practice for all the usual reasons (e.g., revenue constraints, political pressures, concern that a simple dividend imputation system created shareholder pressures to over-distribute corporate earnings, or concern that the corporate tax base itself was imperfect). Nonetheless, Norway and Finland in 2003 employed a full dividend imputation system; Sweden, by contrast, did not.<sup>65</sup>

¶155 Almost uniquely, Norway also attempted to apply an imputation system to capital gains realized on the sale of corporate stock. This was known as the “RISK” system.<sup>66</sup> The idea was simply to allocate retained corporate profits to shareholders for the purpose of giving each shareholder a step-up or down in their stock basis.<sup>67</sup> For this purpose, dividends reduced a shareholder’s stock basis (since the earnings supporting those dividends had increased basis), and dividends in excess of earnings constituted a net negative adjustment. Because a RISK adjustment could be negative as well as positive, the system was mandatory.<sup>68</sup>

¶156 U.S. readers familiar with the difficulties of accounting for partner basis adjustments to reflect the operations of publicly-traded partnerships will not be surprised to learn that the RISK system was both complex and imprecise in practice. For example, as a simplification matter the adjustment was made only once a year (unless dividend policies changed mid-year). Moreover, the rules as originally constructed applied only to top-tier companies and not to earnings pushed up from subsidiaries. Similarly, special basis push-up rules had to be developed for corporate-level capital gains on portfolio investments. Finally, there were substantial complexities in combining the RISK system with foreign corporate earnings that either were exempt from Norwegian tax (under some

<sup>62</sup> Interest expense was effectively allocated directly against capital income. See discussion *infra* Part III.B.4.

<sup>63</sup> Cnossen, *Reform and Coordination*, *supra* note 7, at 146–47.

<sup>64</sup> See *id.* at 147–50.

<sup>65</sup> Cnossen, *Reform and Coordination*, *supra* note 7, at 146; Zimmer, *supra* note 24, at 353.

<sup>66</sup> The term is unrelated to the English-language word “risk,” but instead is a Norwegian acronym: “Regulering av aksjers Inngangsverdi med Skattlagt Kapital.” Gjems-Onstad, *Computing Capital Gains*, *supra* note 45, at 364.

<sup>67</sup> See *id.* at 365.

<sup>68</sup> *Id.*

treaties) or eligible for foreign tax credits (under others).<sup>69</sup> As a result, despite the good intentions underlying the RISK system and its theoretical appeal, it was abandoned in the Norwegian tax reforms of 2004–2006.<sup>70</sup>

#### 4. The Labor-Capital Income Centrifuge in Practical Application

¶157 From the outset, the Nordic dual income taxes have recognized the necessity of separating an owner-manager’s net business income into its labor and capital income components through some comprehensive and reliable mechanism.<sup>71</sup> To perform this “income-splitting,” the Nordic countries rely on mechanical rules to separate the labor income of owner-managers from their capital income; these rules apply regardless of the purpose or source of business income. These mechanical rules are admittedly imperfect in the sense that there is no administrable model that can identify the value of an owner-manager’s labor inputs, but the theory has been that the approach adopted is good enough for its purposes and has the great virtue of simplicity.<sup>72</sup>

¶158 The Nordic income-splitting rules are applied only in those cases where markets cannot be expected to perform the job. Thus, income-splitting rules are thought not to be necessary for large public corporations, because there is sufficient discontinuity between shareholders and employees that employees will demand compensation for their labor inputs in the form of wages, rather than through an increase in the value of whatever portion of the equity of the firm they might own.<sup>73</sup> As a result, income-splitting is a concept relevant only for proprietorships and certain closely-held firms. Setting and policing the dividing line between those firms that are subject to income-splitting regime and those that are not is one of the most difficult aspects of administering a dual income tax.

¶159 Very generally, the Nordic countries have followed one of two related approaches. Under the more ambitious “source” or “allocation” model (followed by Norway before 2004), the business income of proprietorships, partnerships, and closely-held corporations was split as it was earned into labor and capital components, by imputing a statutory return to invested capital and deeming the remainder to be a return to labor inputs (up to a ceiling, as described below), regardless of the form of the business enterprise. Under the “fence” model, by contrast, retained corporate profits are taxed at corporate (e.g., capital income) rates until withdrawn from corporate solution, at which point a similar formulary splitting of labor from capital income takes place.<sup>74</sup> Because the source model is the analytically more interesting of the two, and because Norway pursued this approach with an unusual zeal for getting the rules right, this Article follows Sijbren Cnossen and others by focusing principally on the Norwegian approach.<sup>75</sup>

<sup>69</sup> *Id.* at 366–69.

<sup>70</sup> Gjems-Onstad, *Norway’s Tax Reform*, *supra* note 46, at 141.

<sup>71</sup> Michael Riis Jacobsen, *Norwegian Economic National Report*, in *YEARBOOK FOR NORDIC TAX RESEARCH* 2008, at 143, 149–53 (Robert Pålsson ed., 2008).

<sup>72</sup> *Id.*

<sup>73</sup> See Sorensen, *Dual Income Taxation*, *supra* note 7, at 557.

<sup>74</sup> See Cnossen, *Taxing Capital Income*, *supra* note 7, at 201–04.

<sup>75</sup> The pre-2004 Norwegian approach to separating labor from capital income is described in detail in Sorensen, *Nordic Tax System*, *supra* note 7; Cnossen, *Taxing Capital Income*, *supra* note 7; Zimmer, *supra* note 24; and Lochen, *supra* note 45.

¶60 The basic pre-2004 Norwegian income-splitting methodology is most easily described by beginning with a proprietorship. The net income of a proprietor was deemed to be attributable to both capital and labor inputs; that net income was divided into capital and labor components by imputing a return to the capital invested in the business, and deeming the remainder to be labor income.

¶61 The calculations required several steps. First, the taxpayer calculated his gross deemed capital income derived from his proprietorship by multiplying a statutory deemed return on capital (Norwegian five-year government securities plus six percentage points, by way of example, in the early years of the dual income tax) by his aggregate tax basis in his assets, including purchased intangibles.<sup>76</sup> By relying on tax basis as the multiplicand, the Norwegian system contained a partial corrective to over-generous depreciation deductions, because an artificially large reduction in basis would reduce amounts allocable to capital income, and therefore would mean that a greater percentage of net income would ultimately be characterized as labor income.<sup>77</sup>

¶62 From this amount, the taxpayer subtracted his interest expense incurred in his business. In this fashion, interest expense was allocated directly against capital income. This net deemed return on capital (a deemed gross return on assets less actual interest expense) was taxed as capital income.<sup>78</sup> (As explained below, what this meant in practice was simply that this amount was excluded from the proprietor's calculation of his liability for the gross labor income surtax.) Then, and subject to the myriad special rules set out immediately below, the taxpayer's actual pretax business income, less the net amount allocated to capital income, was treated as labor income.

*Example 1.* Imagine that a Norwegian herring fisherman in a pre-2004 year held \$1000 in assets in his business (i.e., the adjusted basis in his fishing boat), and that the statutory deemed return on capital was 9%. The proprietorship generated \$240 in income after all expenses but before interest expense, and incurred \$80 in interest expense. In this case, the proprietorship's net capital income would be \$1000 x 9%, or \$90 of gross deemed capital income, minus \$80 of actual interest expense, or \$10. The taxpayer's labor component would be \$240 of pre-interest expense operating income minus \$90 (gross deemed capital income), or \$150.

¶63 The taxpayer's \$160 of net business income in this example (\$240 of net business income before interest expense, minus \$80 interest expense) thus was divided into \$10 in capital income and \$150 in personal services income. The *entire* \$160 in net business income (the \$10 of net capital income plus the \$150 in labor income), would go into the taxpayer's general income basket to be taxed at a flat rate of 28%, along with any other wages or investment income, because that basket included all of a taxpayer's income. The elaborate income splitting exercise outlined here was relevant *only* for purposes of calculating the taxpayer's liability for the labor surtax: for that purpose, the \$150 of

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<sup>76</sup> See Cnossen, *Taxing Capital Income*, *supra* note 7, at 202–03; Lochen, *supra* note 45, at 362 (for a description of the capital rate of return allowance as an annual rate set by the legislature and the point that self-generated intangibles are excluded).

<sup>77</sup> This point is more systematically exploited in Cnossen's business enterprise income tax proposal. See Cnossen, *Taxing Capital Income*, *supra* note 7, at 182.

<sup>78</sup> See *id.* at 205.

deemed labor income from his proprietorship would be included in the personal income (labor surtax) basket, as would any other wage or labor income of the taxpayer.

¶164 To summarize, the income-splitting rules were just that: they split an owner-manager's net business income into two components solely for purposes of calculating the owner-manager's liability for the personal income (gross labor income) surtax. The calculation of statutory gross deemed capital income in effect was a *net income allocation* device, not a separate and incremental deduction.<sup>79</sup> The sum of the two components equaled the owner-manager's net business income (including the deduction of business interest), and that sum was subject to the general (proportional) net income tax. The next subsection considers the possibility of negative capital income and positive labor income, or vice versa.

¶165 In practice, a proprietor's income-splitting calculations were materially more complex than the summary to this point suggests, because the proprietor's residual profits after the capital income component was removed (\$150 in the above example) were *not* invariably treated as labor income. Of the remaining business profits (e.g., the formulary capital income component), another deduction was permitted of 20% of the proprietorship's employment costs;<sup>80</sup> this appears to have been a purely political "small business" accommodation. In this regard, Norway's social security system employs an accounting convention known as "G." G has a krone value that adjusts from year to year; in 2002 that value was about \$7000.<sup>81</sup> If the income of the proprietor was reduced by virtue of the arbitrary deduction of 20% of wages to a figure below 6 G, then the deduction was clawed back until the proprietor's income equaled 6 G.<sup>82</sup>

¶166 Finally, the proprietor's residual business profits, after the separation of the capital income component and after the special deduction (if any) for wages, were taxed to the sole proprietor as labor income—but only to a point.<sup>83</sup> Labor income rates applied only to residual business profits up to 16 G. From 17 G to 75 G, residual business profits were taxed again as capital income (apparently under the theory that such profits must represent some form of economic rents<sup>84</sup>), unless the proprietor was a lawyer, accountant, doctor, consultant or the like, in which case labor income rates applied to all residual business profits. Amounts above 75 G and up to 134 G again were taxed as labor income; business profits beyond 134 G apparently reverted once again to capital income.

¶167 One important question in the implementation of a dual income tax is the choice of the statutory deemed rates of return on invested capital.<sup>85</sup> As implied in the preceding

<sup>79</sup> Thus, for example, the statutory deemed rate of return was not strictly comparable to "allowance for corporate equity" deductions, or the author's proposed "cost of capital allowance." Michael Keen & John King, *The Croatian Profit Tax: An ACE in Practice*, 23 FISCAL STUDIES 401 (2002); Kleinbard, *Rehabilitating Income Tax*, *supra* note 17.

<sup>80</sup> See Lochen, *supra* note 45, at 362.

<sup>81</sup> *Id.* at 363.

<sup>82</sup> *Id.*

<sup>83</sup> See *id.*

<sup>84</sup> See *id.* for a more jaundiced interpretation, reflecting the universal implications of political factors in a policy setting.

<sup>85</sup> Sorensen has demonstrated that in an ideal dual income tax, where there are no limitations on the utilization of losses, the correct statutory deemed rate of return is the normal rate of return. Peter B. Sorensen, *Neutral Taxation of Shareholder Income*, 12 INT'L TAX & PUB. FIN. 777, 784–90 (2005) [hereinafter Sorensen, *Neutral Taxation*]. But no tax system offers current rebates of operating losses, and political economy concerns can always be expected to specify a rate that can be presented as comparable to the actual borrowing costs of small businesses. See Sorensen, *Nordic Dual Income Tax*, *supra* note 7, at

paragraphs, Norway opted for a relatively high deemed rate of return, on the theory that the rate should reflect the actual cost of capital to smaller firms (the ones subject to the income splitting regime). The actual figure chosen by Norway (Norwegian Treasury bonds plus six percentage points at the outset of the dual income tax, for example) of course is arbitrary, but at least in theory could have corresponded to estimates of the average cost of capital to small firms.<sup>86</sup>

¶68 An issue much discussed in the Nordic dual income tax literature is whether a business' return to capital should be determined by applying a rate of return to the business' gross assets and then subtracting interest expense from that gross capital income figure (as in the Norwegian model), or instead netting liabilities against the basis of assets and applying the deemed rate of return to the net assets of the enterprise (the Finnish and Swedish approach).<sup>87</sup> Peter Birch Sorensen has demonstrated that neither is ideal whenever the deemed rate of return differs from actual interest costs.<sup>88</sup>

¶69 For example, if the deemed return is greater than a business' interest costs, the gross asset method permits a business to ratchet up the share of its net business income that is treated as capital income by borrowing and investing the proceeds in secure assets; the increased deemed return to capital on the new assets exceeds the interest expense actually incurred to finance those assets. The net asset approach prevents this arbitrage, but in a system where all interest expense is deductible (as in Norway), the net income method encourages owner-managers to disguise personal debt as business debt in order effectively to deduct that interest against labor income rather than capital income (by reducing total net pre-allocation business income).<sup>89</sup>

¶70 There does not appear to be good evidence of the extent to which personal debt in fact migrated into purported business debt in the Nordic countries in order to arbitrage the net asset approach. To this outsider, however, this concern appears susceptible to straightforward audit enforcement, while the issue of designing a tax system that might encourage overleveraging to obtain arbitrage gains raises the specter of large implied social externalities (especially in light of the 2007–2009 global financial crisis). For these reasons, the net asset method seems clearly preferable.

¶71 The Norwegian taxation of partnerships followed the same basic pattern as that described above for proprietorships, except, of course, that the income was allocated

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571–72.

<sup>86</sup> See Tobias Lindhe, Jan Södersten & Ann Öberg, *Economic Effects of Taxing Different Organizational Forms Under the Nordic Dual Income Tax*, 11 INT'L TAX & PUB. FIN. 469 (2004) (analyzing the effect income splitting systems have on small firms' cost of capital).

It is easy to imagine more sophisticated rate of return schedules that rely on the same basic mechanism, but that reflect the declining cost of capital generally faced by firms as they grow from micro-enterprises to somewhat larger undertakings. For example, one can imagine a rate of return of Treasuries plus 6% (to choose an arbitrary example) on the first \$X of capital, a rate of Treasuries plus 4% on the next \$Y of capital, and a rate of Treasuries plus 3% on all remaining capital. A later article in this series continues with this line of reasoning in the context of sketching a possible American implementation of a dual income tax.

<sup>87</sup> See Cnossen, *Taxing Capital Income*, *supra* note 7, at 206–07; Sorensen, *Nordic Dual Income Tax*, *supra* note 7, at 568–71; Sorensen, *Nordic Tax System*, *supra* note 7, at 12–16.

<sup>88</sup> See Sorensen, *Nordic Dual Income Tax*, *supra* note 7, at 568–71; Sorensen, *Nordic Tax System*, *supra* note 7, at 12–16.

<sup>89</sup> Sorensen describes other arbitrage problems with the net asset method, but to an American reader it would appear that these other issues could be resolved by averaging the values of assets and liabilities within a year, as is done under I.R.C. § 956 for investments in U.S. property. Sorensen, *Nordic Dual Income Tax*, *supra* note 7, at 570–71.

among the partners in the partnership. Importantly, only “active” partners were allocated labor income; for a passive investor partner (e.g., the classic limited partner, in a U.S. sense), all of her income was capital income.<sup>90</sup>

¶72 Finally, the same income-splitting principles applied to the income of a corporation with one or more “active” shareholders, if those shareholders (along with certain family members) owned two-thirds or more of the corporation.<sup>91</sup> In that case, an active shareholder’s share of both the corporation’s capital income and its labor income (determined under the principles described above) became a personal tax liability of the active shareholder. To prevent double taxation the active shareholder also received a tax credit for the corporate income taxes paid.<sup>92</sup> Moreover, an active shareholder apparently could demand indemnification from the corporation for the resulting personal tax liability, so as to force the corporation to distribute to her enough cash to cover her tax bill.<sup>93</sup>

¶73 For these purposes, Norway applied only the most rudimentary attribution rules to treat an owner-manager as the owner of shares actually owned by others. For example, stock owned by minor children was treated as owned by a parent in order to bring the parent into the income-splitting regime, but stock owned by adult children was not so treated.<sup>94</sup>

### 5. Losses and Cross-Schedule Netting

¶74 Every schedular system, including the Nordic dual income taxes, must address the issue of netting losses and expenses derived from one activity against gains and income from another, both within one basket (as also is true of comprehensive income taxes) and more particularly across baskets. In general, the Nordic implementations of dual income taxes permit the unlimited netting of one type of capital income against another, and further permit the netting of a net loss in the capital income basket against income in the labor basket, but only at the capital income rate.<sup>95</sup> This result is undercut to some extent by the operation of the labor-capital income centrifuge described earlier, which in

<sup>90</sup> See Lochen, *supra* note 45, at 362–63. For this purpose, “active” partners generally were those who devoted more than 300 hours per year to the enterprise’s business. *Id.* at 362.

Lochen gives the example of a firm with three partners, two of whom are active, and states that the two active partners would receive 100% of the firm’s labor income (50% each). Presumably this allocation would be capped at the total amounts actually received by the active partners, but Lochen is unclear on this point. For example, if the partnership has \$20 of capital income and \$80 of labor income, and profits are shared equally, the two active partners would have \$33 in economic income but \$40 in allocated labor income for tax purposes (if there was no economic income cap). Zimmer describes a rule under which “active” partners could demand that the partnership pay their tax liabilities on their allocated labor income, but it is not clear from his description how this rule worked in practice. Zimmer, *supra* note 24, at 353.

<sup>91</sup> See Zimmer, *supra* note 24, at 353; Sorensen, *Global Income Tax*, *supra* note 6, at 75.

<sup>92</sup> See Sorensen, *Nordic Tax System*, *supra* note 7, at 18–19.

<sup>93</sup> See Zimmer, *supra* note 24, at 353. Cash received by an owner-manager from her corporation to pay her tax bill was not itself treated as a taxable event, so the net effect was that the tax was measured by the personal characteristics of the owner-manager, but indirectly paid by the corporation. See Lochen, *supra* note 45, at 362.

<sup>94</sup> Annette Alstadsaeter, *The Achilles Heel of the Dual Income Tax: The Norwegian Case*, 20 FIN. ECON. PAPERS 5, 7, 16 (2007).

<sup>95</sup> See Cnossen, *Reform and Coordination*, *supra* note 7, at 146.

Norway at least worked to permit the deduction of non-interest business expenses against labor income otherwise subject to the progressive “personal” income tax.<sup>96</sup>

¶75 The Nordic countries achieve these results through slightly different mechanisms. As previously described, in the pre-2004 Norwegian system, capital income and labor income were taxed together at a single proportional rate in one basket (the “general” tax), in which losses or expenses of any type were applied against positive gains or income of another, and gross labor income above certain thresholds in turn was subject to specified progressive surcharges.<sup>97</sup> Finland and Sweden, by contrast, tax capital income and labor income entirely separately. Those countries give a labor income tax credit for any capital income net loss, but do so at the effective capital income tax rate.<sup>98</sup>

¶76 In the Norwegian system, all interest expense is deductible, and there is no distinction between “capital losses” (in the American sense) and “ordinary income.” As applied to Norway’s pre-2004 system, these rules meant that credit card interest expense and losses from the sale of personal investments could be netted against labor income within the general (proportional rate) basket.<sup>99</sup> The progressive labor surtaxes, by contrast, were taxes on gross labor income, and a taxpayer’s interest expense or investment losses were irrelevant for that purpose.<sup>100</sup> A net loss in the general basket (which, again, did not reduce an individual’s “personal” tax liability) could be carried forward for ten years, even when that loss was attributable entirely to what might be thought of as personal expenses, such as interest expense on debt incurred to fund consumption.<sup>101</sup> The resulting tax loss carryover of course could be applied against future net income in the general basket, but not against future income in the personal basket.

¶77 Norway did not (and does not) have any anti-abuse rules to limit the “cherry-picking” (or “loss harvesting”) of an individual taxpayer’s unrealized investment losses.<sup>102</sup> Nonetheless, the Norwegian tax authorities do not appear to view this as problematic.<sup>103</sup> Certainly, the impetus to engage in loss harvesting is substantially vitiated in the Norwegian system, when compared to that of the United States, because (i) all capital income is taxed at a low rate (which reduces the value of the implicit tax asset), (ii) the tax rate is proportional rather than progressive (so that, for example, there is no need for self-help income averaging, and no advantage to claiming short-term rather than long-term capital losses), and (iii) there is no “end game” of deferring unrealized gains to obtain a tax-free step-up at death. It is interesting, and a point in favor of dual income tax systems, that Norway has found that, so mitigated, the cherry-picking problem is reduced in practical importance to the status of an affordable nuisance.

¶78 As previously suggested, the pre-2004 Norwegian system’s stark dividing line between its general basket (with complete netting of gains, losses, income, and expense

<sup>96</sup> *Id.*

<sup>97</sup> *Id.*

<sup>98</sup> *Id.*

<sup>99</sup> See Lochen, *supra* note 45, at 360.

<sup>100</sup> See Kvamme, *supra* note 12, at 448.

<sup>101</sup> See Zimmer, *supra* note 24, at 355.

<sup>102</sup> “Cherry-picking” refers to the common problem of taxpayers recognizing investment losses promptly, while deferring their unrealized investment gains. It is an artifact of the realization doctrine. By recognizing losses immediately, taxpayers can then earn a return on their tax savings. Conversely, if a taxpayer does not monetize an unrealized loss, the value of that implicit tax asset does not earn any return.

<sup>103</sup> Personal communication with Michael Riis Jacobsen, Norwegian Ministry of Finance (Feb. 1, 2010).

from any financial or business asset, or from any liability) and its personal basket (which was a gross labor income concept) was blurred in the case of owner-managers within the income-splitting regime—that is, taxpayers on whom the labor-capital income centrifuge operated. A prior subpart has explained the mechanical process for dividing an owner-manager’s net business income into its labor and capital components.<sup>104</sup> Because that process began by calculating a return to capital, and then treated the remainder of the taxpayer’s net business income as labor income, one can fairly say that business expenses (other than interest expense, which, as explained earlier, was deducted “off the top” against tentative gross capital income) ultimately were deductible at the taxpayer’s personal income marginal bracket. Interest expense, however, always was deductible only within the general income basket.

*Example 2.* Consider the herring fisherman last discussed in *Example 1*. If instead of earning \$240 in net business income before interest expense, the fisherman incurred an additional \$100 in expenses (or alternatively suffered an equivalent reduction in gross income due to a poor fishing season), his deemed net capital income (\$10) would be unaffected because that figure is calculated by reference to a deemed statutory return on assets and the taxpayer’s actual interest expenses, not a fraction of income. But the fisherman’s net business income, of course, would decline from \$160 to \$60, and the fisherman’s personal (gross labor) income, therefore, would decline from \$150 to \$50. (Technically, the calculation would be \$140 of net pre-interest business income minus \$90 gross deemed capital income.) The \$100 in additional business expenses thus would reduce both general basket income (because the business, in fact, was less profitable) and also income subject to the gross labor income surtax.

¶179 An owner-manager who had a bad year in business might end the year with a net operating loss. That loss was deductible against other income items in the taxpayer’s general basket.<sup>105</sup> Since the division of operating results into capital and labor components was meaningless for general income purposes, and since all interest expense was (and remains) deductible in determining liability for general income tax, the prospect of generating negative capital income and positive labor income (for example, through shifting personal debt into the proprietorship, thereby saddling the proprietorship with excessive interest expense) had no general basket consequences. Moreover, an owner-manager’s labor income subject to the personal income surtax was determined without regard to financing costs.<sup>106</sup>

¶180 In a dual income tax along the lines adopted by Norway prior to 2004, the operation of the labor-capital income centrifuge (the income-splitting rules) could lead to the bizarre concept of negative labor income.

<sup>104</sup> See *supra* Part III.B.4.

<sup>105</sup> See Zimmer, *supra* note 24, at 353.

<sup>106</sup> An anti-abuse rule did exist to prevent taxpayers from arbitraging the gross income method by borrowing to finance financial investments that had a lower return than the statutory deemed return to capital, thereby skewing the relative proportions of capital and labor income in the firm’s net income. Cf. Sorensen, *Nordic Dual Income Tax*, *supra* note 7, at 580.



*Example 3.* The poor harried herring fisherman continues to own \$1000 in business assets, and the statutory deemed return to capital remains 9%. The fisherman has \$80 in pre-interest expense net business income and \$80 in interest expense. Under these facts, the fisherman has zero net income, comprising \$10 in capital income (\$90 deemed gross return on capital minus \$80 actual interest expense) and -\$10 in labor income (\$80 pre-interest expense net income minus \$90 deemed gross return on capital). The herring fisherman includes zero net income from his proprietorship in his general income basket.

¶81 Incurring negative labor income thus had no independent general income tax consequence, and further did not reduce other positive labor income (e.g., wages) subject to the progressive personal income surtax. Negative labor income could, however, be carried forward to reduce a taxpayer's labor income from that same business activity (herring fishing, in this example) subject to the progressive personal income surtax in future years.<sup>107</sup> Negative labor income thus reduced a taxpayer's future liability for progressive personal income surtaxes from the same line of business, but had no other significance.

### C. *The Norwegian Experience 1992–2003*

¶82 In reviewing the problems that Norway confronted in the implementation of its dual income tax prior to the 2004 reforms, it is important to remember that the system in general was thought to have worked well, and to have led to material efficiency gains when compared to Norway's pre-1992 capital income tax environment (which in many ways resembled the current state of U.S. capital income taxation).<sup>108</sup> Nonetheless, almost from the beginning of the Norwegian dual income tax experience, evidence mounted that the Norwegian implementation of the labor-capital income centrifuge was flawed.

¶83 Early on, for example, Peter Birch Sorensen described the income-splitting principle that was applied to closely-held corporations as the "Achilles heel" of the pre-2004 system, because "active" shareholders could dilute their ownership below the two-thirds threshold that triggered the income-splitting rules in the corporate context.<sup>109</sup> Moreover, Sorensen argued that there was empirical evidence that many Norwegian owner-managers did just that.<sup>110</sup>

¶84 Following in Sorensen's footsteps, Annette Alstadsæter titled her paper, *The Achilles Heel of the Dual Income Tax*, after the same general topic.<sup>111</sup> She also found evidence that Norwegian entrepreneurs migrated to "widely-held" corporate structures, in

<sup>107</sup> Alstadsæter, *supra* note 94, at 7.

<sup>108</sup> See Jacobsen, *supra* note 71, at 143 ("[T]he experience with the dual income tax, at least in Norway, is that it was a huge success and that it improved the redistributive properties of the tax system as well as the allocation of real capital.").

<sup>109</sup> Sorensen, *Global Income Tax*, *supra* note 6, at 73; Sorensen, *Capital Income Tax*, *supra* note 7, at 214.

<sup>110</sup> Sorensen, *Nordic Dual Income Tax*, *supra* note 7, at 575; Sorensen, *Nordic Tax System*, *supra* note 7, at 19.

<sup>111</sup> Alstadsæter, *supra* note 94, at 5.

which more than one-third of the firm was owned by passive investors; as she points out, however, those passive investors could be adult relatives of the owner-manager.<sup>112</sup>

¶85 In addition to the avoidance of the income-splitting model, Alstadsæter found evidence that taxpayers engaged in what this Article calls “capital stuffing,” in which taxpayers aimed not to reduce the tax burden on capital income as such (since that burden was constant regardless of whether an investment was held directly or through a corporation), but rather to change the fraction of a firm’s business income that was treated as capital rather than labor income. This could happen, for example, when the deemed return to capital provided by the statutory rate of return formula exceeded the rates of return actually earned by individuals on their core investments.<sup>113</sup>

¶86 Finally, Michael Riis Jacobsen, a Senior Advisor to the Royal Ministry of Finance, presented extensive evidence of the decline of the applicability of the income-splitting model across a number of different Norwegian industries in the period of 1995–2000. He also found that the imputed labor income of the preponderance of owner-managers of those firms subject to income-splitting tended to be negative.<sup>114</sup> From this he concluded that “the portion of companies . . . taxed according to the split model to a larger extent was the companies that gained from it. . . . [T]he model was easy to escape for companies that did not gain[] from it, [and] . . . the rules for the actual income splitting [model were] very favourable.”<sup>115</sup>

¶87 To address these perceived fatal flaws, and in particular the avoidance of the income-splitting model, Norway, in 2004, enacted an entirely new regime for the taxation of capital income that fully took effect in 2006.<sup>116</sup> That new system is described below.<sup>117</sup>

¶88 There appear to have been three principal weaknesses in Norway’s pre-2004 implementation of its dual income tax. The first and most important was that it was easy to avoid the statutory definition of a closely-held business enterprise subject to the income-splitting regime. The second was that the “gross income” method of applying the labor-capital income centrifuge was susceptible to abuse, through borrowing to finance income-producing assets that yielded very little net income, but that had a positive impact on the allocation of an owner-manager’s net business income away from the labor income basket. The third was that the statutory deemed return on capital was excessively generous; this generosity was evident not simply in the statutory rate, but also in the special deductions for compensation and the like, described earlier.<sup>118</sup> And of course, owner-managers of firms that avoided the application of the income-splitting rules (by being characterized as widely-held) effectively could treat all their net business income as returns on capital, simply by not paying any of it to themselves as salary.

¶89 This description of the infirmities in the pre-2004 system implicitly emphasizes the central problem of the ease with which the definition of a closely-held business could be avoided, for example by giving interests in the firm to adult children. By contrast, the arbitrage opportunities created by Norway’s use of the “gross income” method for

<sup>112</sup> *Id.* at 16.

<sup>113</sup> *Id.* at 8–16; *see also supra* note 106.

<sup>114</sup> Jacobsen, *supra* note 71, at 150–51.

<sup>115</sup> *Id.* at 150.

<sup>116</sup> Sorensen, *Capital Income Tax*, *supra* note 7, at 214–16.

<sup>117</sup> *See infra* Part III.D.

<sup>118</sup> *See supra* note 80 and accompanying text.

income-splitting are best seen as persuasive evidence in favor of the “net income” method, whose results cannot be gamed by borrowing to create new balance sheet assets that yield little or nothing over their financing costs. And the excessive generosity of the deemed return on capital inside the income-splitting regime lost its urgency when the regime, as a whole, was so easily avoided.

¶90 Finally, the fact that so many taxpayers who remained in the income-splitting system incurred negative labor income appears to be an artifact of the other technical infirmities. First, the fisc was the victim of adverse selection: owner-managers who benefitted greatly from excluding themselves from income-splitting could do so by divesting just one-third of the enterprise to adult children and other “independent” actors, so the only taxpayers left in the system were those who benefitted from it.<sup>119</sup> Second, the financial asset arbitrage described earlier<sup>120</sup> and the generous statutory deemed return on capital both operated to skew the allocation of net business income away from the labor income basket.

¶91 Additionally, it is easy to imagine that the income-splitting method required aggressive facts-and-circumstances auditing of two taxpayer temptations: first, to record personal assets as business assets; and second, to claim personal consumption or investment costs (other than interest expense) as business expenses. Each would have had the effect of reducing an owner-manager’s labor income (by increasing the deemed return to capital in the first case, and by reducing net income in the second). Neither temptation, however, is unique to the dual income tax. Indeed, both problems are prevalent in U.S. taxation of small businesses today. To expect any tax regime to obviate the need for this sort of factual investigation by the taxing authority is to ask too much.

¶92 In sum, the most dramatic infirmity in the pre-2004 Norwegian dual income tax was the problem of active shareholders diluting their ownership below the two-thirds mark. A staff member of a tax-writing committee of the U.S. Congress would require only a few seconds to propose that the problem lay not with the system, but with the threshold. For example, under U.S. precepts, a “controlled foreign corporation” is one as to which there exist one or more “United States shareholders” that directly, indirectly, or constructively own more than 50% of the voting power or value of the corporation’s stock; a “United States shareholder,” in turn, is a U.S. person that owns (again, directly, indirectly, or constructively) 10% or more of the voting power or value of the corporation’s stock.<sup>121</sup> The definition of a “personal holding company” is similar.<sup>122</sup>

¶93 At least in theory one could combine a test modeled on this precedent, along with a requirement that the relevant 10% shareholders satisfy a second requirement of a specified minimum level of personal activity for the corporation. If Norwegian law had been amended along these lines, one wonders how many Norwegian corporate owner-managers would have been able to escape a net this broadly cast and finely woven.

¶94 Sorensen has argued that any new standard would still draw an essentially arbitrary line,<sup>123</sup> but that is true of so many aspects of tax (or indeed any other) law, that by itself it seems a disquieting reason for abandoning the entire dual income tax enterprise. While it

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<sup>119</sup> Jacobsen, *supra* note 71, at 150–51.

<sup>120</sup> See *supra* notes 105–106 and accompanying text.

<sup>121</sup> I.R.C. §§ 957(a), 958(a)–(b), 951(b) (2006).

<sup>122</sup> See I.R.C. §§ 542(a)(2), 544 (2006).

<sup>123</sup> Sorensen, *Dual Income Taxation*, *supra* note 7, at 571.

is true that, as described below,<sup>124</sup> the replacement system has important theoretical advantages (by taxing economic rents more heavily than normal returns), it also is true that the replacement system has theoretical problems (through the reintroduction of asymmetric returns to risk and differences in tax result between debt and equity financing), as well as practical issues that may yet prove problematic. Therefore, the existence of an arbitrary line between closely-held and publicly-held firms by itself does not seem to explain the Norwegian decision to abandon its investment in the original dual income tax system.

¶195 The answer appears to lie in issues of political economy rather than economic theory. According to Michael Riis Jacobsen, “[t]he problem in the former [1992–2004] tax system was not the split model or the idea of income splitting itself. The problem was that politicians could not resist the temptation of using the split model to obtain all sorts of non-efficient political goals.”<sup>125</sup>

¶196 From this vantage point, the gaps in the Norwegian attribution rules for determining when a small business was subject to the income-splitting model becomes explicable not as a lapse in technical oversight, but rather as a political decision to favor owners of small entrepreneurial businesses. This suggests a useful insight for any American implementation of a dual income tax: the system should be designed to withstand the political impulse to extend the benefits of capital income rates disproportionately to small business owners, who are as much a favored class in the United States as they are in Norway.<sup>126</sup>

#### D. *The Norwegian 2004–2006 Revisions*

##### 1. Collision of Administrative Frustration and Economic Theory

¶197 As noted above, ostensibly because of dissatisfaction with the application of income-splitting to closely-held corporations, Norway recently overhauled its dual income tax structure; the new rules generally became fully effective as of January 1, 2006.<sup>127</sup> The new regime repealed the RISK system and dividend imputation credit systems, but more generally abandoned the idea of a single flat (proportional) rate of tax on all capital income.

¶198 Norse mythology would have described the new Norwegian system for taxing capital income as having had two parents. The first parent knew only the workaday world of tax administration: it was moved by the concern that the labor-capital income centrifuge was not working as intended, because the definition of a closely-held business was so easily avoided. The second parent, however, came from the land of economic

<sup>124</sup> See *infra* Part III.D.

<sup>125</sup> Jacobsen, *supra* note 71, at 153; see also Frederik Zimmer, *A Critical Assessment of the Nordic Dual Income Tax Model*, in YEARBOOK FOR NORDIC TAX RESEARCH 2008, at 217, 222 n.1 (Robert Pålsson ed., 2008) (explaining that the substantial increase in income inequality in Norway from 1993 to 2004 was “wholly due to capital income”). The same point can be made, however, for the United States. Sullivan, *supra* note 27.

<sup>126</sup> One can imagine framework policies that could retard some of these impulses. For example, current “Pay As You Go” revenue constraints could be revised to provide, first, that a dual income tax must be self-financing within the world of capital income, and, second, that any change in law cannot produce a net increase in capital income and a net decrease in labor income.

<sup>127</sup> See generally Sorensen, *Nordic Dual Income Tax*, *supra* note 7; Sorensen, *Nordic Tax System*, *supra* note 7; Gjems-Onstad, *Norway’s Tax Reform*, *supra* note 46.

theory, and saw in the troubles of her partner an opportunity to rethink the fundamental basis on which capital income was taxed. The result was a creative and ingenious offspring, but one with its own complexities and its own potential weaknesses.

¶99 To understand the economic theory that motivated the reform, it is important to observe that capital income can be usefully subdivided into three baskets: (i) normal returns (the dull plodding time value of money returns one gets by buying government bonds), (ii) risky returns, and (iii) economic rents—the supersized returns to capital that are earned by virtue of a unique asset or market position (for example, a patented pharmaceutical).<sup>128</sup> One way of understanding classic dual income taxes is that they tax all three components of capital income (particularly normal returns and economic rents) at the same rate.

¶100 But the economic argument for a low (or no) tax on normal returns is more attenuated when applied to economic rents, precisely because they are unique and valuable. Economic rents can bear a relatively high rate of tax so long as the after-tax returns from those economic rents remains superior to those from the next best alternative, which by hypothesis is the normal return.<sup>129</sup> (By definition, rational agents will already have seized all economic rent opportunities to which they are exposed, so the next best use of money must be a fungible marginal investment, which yields the normal return.) And it is the taxation of normal returns that privileges current consumption over future consumption, because the normal return (the basic rate of return to savings) is the rate that preserves a present value equivalence between the two.<sup>130</sup>

¶101 The new Norwegian system relies on this thinking to put economic rents (and net risky returns above a certain threshold) into an individual’s progressive “personal” surtax basket, regardless of whether the owner of the investment that gives rise to this income is “active” or “passive.” As a result, some capital income derived from a proprietorship now is taxed at rates as high as the maximum rate on labor income. (As described below, an analogous result applies to corporate earnings, through the introduction of a double tax on dividends where one had not previously applied.) At the same time, the 2004–2006 amendments retain some dual income tax principles, by exempting normal returns earned by owner-managers from the incremental progressive tax; as a result, these normal returns on capital are taxed only under the flat 28% general tax.

## 2. Overview of the New System

¶102 At the risk of greatly oversimplifying matters, the differences between the two Norwegian systems can be understood as a reversal of presumptions. Under the pre-2004 dual income tax, all net income from whatever source derived was taxed at a single low proportional tax rate, and, in addition, gross labor income was subject to a progressive surtax. Under the new system, all net income from whatever source derived is taxed at progressive rates, except that concessionary proportional rates apply to some relatively narrowly-defined categories of capital income: in particular, retained profits of a business

<sup>128</sup> For a more complete discussion of this division of capital income into its constituent parts, see Kleinbard, *Designing Income*, *supra* note 17, at 168–71, and Kleinbard, *Rehabilitating Income Tax*, *supra* note 17, at 8–9.

<sup>129</sup> *Cf.* Bankman & Griffith, *supra* note 25, at 406 (arguing that “taxation of [economic rents] is much less troublesome than taxation of” normal returns).

<sup>130</sup> See Shaviro, *supra* note 21, at 101.

entity, and, at the personal level, interest income and a normal (risk free) return on equity. The consequence of this reversal of presumptions is that capital income is now taxed differentially. Normal returns are taxed at relatively low proportional rates. (In contrast, a comprehensive income tax would burden normal returns at the same rate as labor income, and a consumption tax would not burden normal returns at all.) Returns to risk and economic rents are taxed at rates comparable to labor income rates.

¶103 The new system thus is still a dual income tax, but the split between its flat rate and progressive rate now is a split down the middle of capital income returns. The new system retains the same rate of return mechanism as the former labor-capital income centrifuge, but repurposes the mechanism into a device for distinguishing normal returns to capital from other returns. While the new system thus eliminates the former system's heavy reliance on income-splitting mechanisms (and avoidance), it also introduces a new asymmetry between the taxation of debt and equity financing. It also arguably introduces a bias against risk-taking, through the legislature's decision to define normal returns as a risk free rate, without providing full loss offsets. The next few pages develop these themes.

¶104 The reversal of presumptions described here is not immediately apparent on the face of the new tax law, which, in many respects, looks superficially like its predecessor. Like its predecessor, the current Norwegian system imposes two levels of tax on individuals. The first is a 28% "general income" tax, which features a flat rate (subject to a personal exemption) and deductions for business expenses; all income is subject to this flat rate net income tax. The second level individual tax is a progressive surtax on gross labor income above certain thresholds (NOK 441,000 in 2009), called the "personal income" tax, with rates ranging up to 12% for 2009 (23%, including the individual's 11% social security contribution on self-employment income).<sup>131</sup> The personal income tax sits on top of the general income tax, so that the maximum marginal tax rate imposed in 2009 on an individual's income from self-employment is 51% (28% general income tax, plus 12% personal income surtax, plus 11% social security contribution).<sup>132</sup>

¶105 Looking a bit deeper, however, the new system raises the tax burden on returns to risk and on rents to rates comparable to labor rates (i) for a sole proprietor, by effectively defining those items as part of "personal income" and (ii) for an entity owner, by deliberately double taxing those capital returns under the general income tax. A double tax at 28% (i.e.,  $1 - (0.72 \times 0.72)$ ) works out to a tax rate of just over 48%, which is only a little lower than the maximum marginal rate on self-employment labor income. (For that reason, there is only a modest incentive to engage in "labor stuffing.") At the same time, normal returns are run through the general income tax wringer only once, for a total tax burden of 28%. The precise mechanisms employed to accomplish this consistent double taxation of some but not all capital income is complex, and is described below.

### 3. Operation of the New System

¶106 Under the new approach, a proprietor today still calculates her tax liability in respect of a sole proprietorship in roughly the same manner as she would before the

<sup>131</sup> NORWEGIAN MINISTRY OF FIN., PUB. NO. R-0619, BUDGET 2009, at 13 (2009), *available at* [http://www.statsbudsjett.dep.no/upload/Statsbudsjett\\_2009/dokumenter/pdf/budget\\_2009.pdf](http://www.statsbudsjett.dep.no/upload/Statsbudsjett_2009/dokumenter/pdf/budget_2009.pdf).

<sup>132</sup> *Id.*; Iversen, *supra* note 60, §§ 1.1, 7.

statute was amended. More specifically, a proprietor first calculates her liability for “general” income tax (the flat 28% tax on *all* net income, including capital income) by applying standard income tax methodologies, including deductions for normal business expenses.<sup>133</sup> Then, to calculate her liability for the “personal income” surtax (the progressive tax on gross labor income), the sole proprietor removes her capital income from her net general income. The remainder is subject to the labor (“personal”) income surtax.<sup>134</sup> Importantly, however, capital income in this sense is now defined to exclude economic rents (and net risky returns above certain thresholds).

¶107 Losses from the operation of a sole proprietorship may be deducted against personal capital income, and any net loss carried forward indefinitely.<sup>135</sup> Loss carryovers do not compound.<sup>136</sup>

¶108 To separate out her capital income under the new system, the proprietor first backs out of her “general” income tax base any explicit financial asset income or loss items (e.g., dividend income, interest income, capital gains or capital losses); by definition, these items are subject only to the “general” tax and not the labor surtax.<sup>137</sup> For example, interest income earned by an individual is taxed only as “general” income, and, therefore, is taxed at a flat rate of 28%.<sup>138</sup>

¶109 In addition to backing out returns on financial investment assets, the taxpayer calculates a statutory deemed return on capital employed in her proprietorship, but now that deemed rate of return is set at a short-term, pre-tax, risk-free rate of return, equivalent to the return on three-month Norwegian government bonds, multiplied by the proprietor’s tax basis in her business assets.<sup>139</sup> This risk-free return on the taxpayer’s equity in her business is then deducted from the proprietor’s tax base for “personal” surtax purposes only, and therefore effectively is subject only to the “general” 28% flat tax.<sup>140</sup> The new deduction is variously referred to as the “rate-of-return allowance,”<sup>141</sup> the “allowance for proprietor’s equity,”<sup>142</sup> or the “shielding deduction.”<sup>143</sup> The idiosyncratic additional deduction for a portion of wages paid to employees of the business also remains available (although its value is now set at 15% of wages, so long as taxable income is not reduced below 6 G).<sup>144</sup>

¶110 The treatment of an individual’s liabilities (and interest expense) depends on the context of the borrowing. If an individual borrows money to make personal investments, then the interest expense is deductible in determining the flat rate, “general” tax base (as

<sup>133</sup> See Iversen, *supra* note 60, §§ 1.1, 10.1.

<sup>134</sup> *Id.* § 10.1.

<sup>135</sup> See *id.* § 3.

<sup>136</sup> See *id.*

<sup>137</sup> See *id.*

<sup>138</sup> See Gjems-Onstad, *Norway’s Tax Reform*, *supra* note 46, at 142–43.

<sup>139</sup> Iversen, *supra* note 60, § 10.1.

<sup>140</sup> *Id.*; see also Gjems-Onstad, *Norway’s Tax Reform*, *supra* note 46 (describing Norway’s revised system of corporate taxation).

<sup>141</sup> See, e.g., Sorensen, *Nordic Tax System*, *supra* note 7, at 20.

<sup>142</sup> See, e.g., Bert Brys & Christopher Heady, *Fundamental Reform of Corporate Income Tax in OECD Countries* 15 n.2 (2007) (unpublished paper, on file with OECD, Center for Tax Policy and Administration), available at [https://editorialexpress.com/cgi-bin/conference/download.cgi?db\\_name=IIPF63&paper\\_id=87](https://editorialexpress.com/cgi-bin/conference/download.cgi?db_name=IIPF63&paper_id=87).

<sup>143</sup> See, e.g., Iversen, *supra* note 60, § 10.1.

<sup>144</sup> *Id.*

is wholly personal interest expense).<sup>145</sup> The interest expense is added back, however, in calculating the individual's liability for personal surtax, because the surtax is a gross tax on labor income.<sup>146</sup>

¶111 In the case of a proprietor conducting an active trade or business, the Norwegian tax treatment is a bit more complex. Essentially, the goal is to treat the proprietor's net trade or business income as subject to the flat 28% general tax, and then to treat the proprietor as liable, in addition, for the labor surtax on all net business income available to the proprietor in his personal capacity, beyond the "rate of return allowance." (As will be seen, this places the proprietor in a position analogous to that of a shareholder in a corporation.) To accomplish this result, interest expense incurred in connection with a proprietorship (other than interest on trade payables) is fully deductible, and is not added back for surtax purposes.<sup>147</sup> At the same time, however, the proprietor's aggregate basis in her trade or business assets, which is the base against which the rate of return allowance is calculated, is determined by subtracting from that aggregate basis the proprietorship's borrowings from banks and other financial institutions, as well as tradable debt of the proprietor, up to an aggregate limit of the value of the proprietor's assets.

¶112 As a result, the rate of return allowance can be said to exclude from the personal surtax a risk-free return on the taxpayer's equity invested in her proprietorship, if one accepts as a rough surrogate for a direct measure of equity the proprietor's business assets minus bank/tradable debt of the proprietorship. The proprietor's total tax deduction for the cost of capital deployed in her trade or business is the sum of that statutory allowance and her actual interest expense. The proprietor's rate of return allowance therefore is analogous to the corporate tax "allowance for corporate equity" (ACE) concept first proposed in 1991, although the ACE was conceived as a device to exempt normal returns from tax entirely.<sup>148</sup>

¶113 Importantly, Norwegian law does not have any "thin capitalization" limitations on the deductibility of interest expense (outside of the special petroleum tax regime).<sup>149</sup>

<sup>145</sup> See *id.* § 4.5.

<sup>146</sup> See *id.* § 1.1; see also *id.* § 7 (demonstrating the calculations of the general tax and personal surtax).

<sup>147</sup> *Id.* § 10.1.

<sup>148</sup> Michael Devereux & Harold Freeman, *A General Neutral Profits Tax*, 12 FISCAL STUD. 1 (1991); see also Keen & King, *supra* note 79, at 402–07.

One alternative would be to grant a uniform statutory rate of return allowance for all capital deployed in a business, in lieu of an interest deduction. This alternative direction was explored in the author's Business Enterprise Income Tax (BEIT), where the statutory allowance is called the Cost of Capital Allowance (COCA). Kleinbard, *Designing Income*, *supra* note 17, at 178–96.

Like the new Norwegian system, the BEIT operates to separate normal returns, on the one hand, from risky returns and rents, on the other, but to subject all three to an income tax. See *id.* at 178–91. The BEIT's tax rates can be set to accomplish the results to which the Norwegian system also points: a low tax on normal returns and a high tax on risky returns and rents. (As proposed, the BEIT did not do so, because the author in retrospect took as an unstated axiom that government bond interest income and the like would be subject to the progressive income tax; if one relaxes that assumption and follows the Nordic lead, by extending a low capital income tax rate to claims against entities (like governments) not within the BEIT system itself, then one easily could tweak the BEIT proposal to replicate the current Norwegian insights into how to define the dividing line between types of capital income.)

A principal advantage of the COCA approach is that it eliminates any continuing tax incentive to prefer issuing debt to equity, when the taxpayer's actual interest expense exceeds his statutory allowance. *Id.* at 191–93.

<sup>149</sup> See Gjems-Onstad et al., *supra* note 60, §§ 2.7.5, 13.3; KPMG, NORWEGIAN TAX FACTS NORWAY 2009:



Norway also does not impose any “fungibility of interest expense” standard on proprietors, under which, for example, interest expense would be deemed to support both personal investment income and business income in proportion to the relative incomes from each, or the relative tax basis of the investments in each.<sup>150</sup> As described in the next section, this flexibility might lead to the overleveraging of successful proprietorships, to fund either personal investments or personal consumption, because the interest expense attributable to the proprietorship’s activities reduces the proprietor’s liability for personal surtax. In the case of a highly profitable proprietorship, that advantage outweighs the reduction in the rate of return allowance that follows from business borrowings.

¶114 If one visualizes a proprietor’s net income from financial investments as held in his personal investment capacity, rather than as part of his trade or business, then, when the dust settles, a proprietor is taxed at labor rates on the entirety of his proprietorship’s *net* earnings (after interest expense) in excess of his allowance for proprietor equity. Income equal to the allowance for proprietor equity and personal investment income are taxed under the flat “general” income tax only. An owner-manager’s net business income thus is split under a different model than that employed under the former dual income tax, because now rents (and net risky returns) are taxed as if they were labor income.

¶115 The 2004 amendments also fundamentally changed the aggregate tax burdens imposed on partnerships and corporations, on the one hand, and their owners, on the other. In addition, partnership taxation now effectively follows the corporate model.<sup>151</sup> For simplicity, the next few paragraphs refer only to corporations.

¶116 Under the new system, the taxation of a corporation as an entity remains largely unchanged. The corporate rate (28%) also remains the “general” individual tax rate.<sup>152</sup> In general, however, the aggregate tax burden imposed on a business enterprise and its owners now is much higher than it was under the pre-2004 dual income tax.

¶117 As will be recalled, under the prior tax regime the dividend imputation and RISK systems were designed to eliminate, as far as possible, double taxation of corporate profits when realized by shareholders, whether through distributions or sales of stock.<sup>153</sup> In the ideal case, the result was a constant tax burden on distributed net business profits of 28%, the same tax rate imposed on interest income or other capital income earned directly by an individual.

¶118 The new regime repealed the dividend imputation and RISK rules. In their place, individual shareholders generally now pay tax on dividends they receive and capital gains they realize on corporate stock at the flat 28% capital income tax rate. This means that *undistributed* corporate earnings are subject to a flat 28% corporate tax rate, but *distributed* corporate earnings (or undistributed earnings effectively monetized through secondary market sales of stock) bear a tax of roughly 48% [ $0.28 + ((1 - 0.28) \times 0.28)$ ],

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A SURVEY OF THE NORWEGIAN TAX SYSTEM 18 (2009), *available at* [http://www.kpmg.no/arch\\_img/9484126.pdf](http://www.kpmg.no/arch_img/9484126.pdf). One case has suggested that there is a quasi-common law notion that some debt of a highly overleveraged firm might be re-characterized as equity. See Gjems-Onstad et al., *supra* note 60, § 13.3.

<sup>150</sup> For comparison, see the U.S. rules for allocating domestic interest expense between the United States and foreign sources for purposes of applying the foreign tax credit limitation of I.R.C. § 904 (2006). I.R.C. § 864(e) (2006); Treas. Reg. §§ 1.861-8–1.861-12 (2009).

<sup>151</sup> See Gjems-Onstad et al., *supra* note 60, § 2.1.3 (describing the taxation of partnership income).

<sup>152</sup> See *id.* § 2.12.1; Iversen, *supra* note 60, § 1.1.

<sup>153</sup> See *supra* Part III.B.3.

which is close to the rate imposed on net proprietorship earnings.<sup>154</sup> (Inter-corporate dividends and corporate capital gains from stock are wholly tax-exempt, so that there is no cascading of corporate tax liabilities as income moves through multiple levels of corporate ownership.<sup>155</sup>) At the same time, interest income and other capital income earned directly by an individual remain subject only to the flat 28% “general” tax.<sup>156</sup>

¶119 Norway thus has now reverted to a “classical” corporate tax model, in which dividends and capital gains earned by Norwegian individual shareholders are taxed twice. Moreover, the aggregate tax burden on distributed corporate earnings (or net proprietorship profits) substantially exceeds the tax burden on interest income or other capital income earned directly by an individual.<sup>157</sup>

¶120 To understand the new Norwegian approach to classical (i.e., non-integrated) corporate tax models, assume that the ultimate distribution/capital gains tax is unavoidable. The traditional approach to constructing a classical corporate tax system, would leave shareholders facing a significant tax incentive to leave corporate earnings in corporate solution (and not to sell their stock), so that earnings could accumulate as long as possible in the lower-taxed environment.<sup>158</sup> In the marginal case, a business enterprise, confounded by any better idea of what to do with its surplus earnings, might be envisioned to invest them in risk-free government securities.

¶121 The new Norwegian system’s implementation of a classical corporate tax model addresses the incentive otherwise present for corporations to retain surplus earnings, and for shareholders to defer stock sales, by using the rate of return (or “shielding”) allowance described above in the context of a proprietorship to offer Norwegian individual shareholders a neutral investment environment with respect to the timing of stock distributions or sales. As explained in more detail immediately below, this is accomplished by providing individual shareholders a new rate of return allowance equal to a risk-free return on their stock investments.

¶122 As a result, a Norwegian shareholder logically should be indifferent between his corporation making an investment of surplus earnings in risk-free government bonds or the corporation distributing those earnings to the shareholder who makes the same investment. So long as the corporate toll charge (the tax on distributions or capital gains) is constant and unavoidable, the two scenarios have the same present value. This is what Nordic tax scholars mean when they describe the new tax system as “neutral”<sup>159</sup>: it is not neutral, however, if the question is whether its burdens are the same as those that would apply under a consumption tax.<sup>160</sup>

<sup>154</sup> Sorensen, *Nordic Dual Income Tax*, *supra* note 7, at 584.

<sup>155</sup> Gjems-Onstad et al., *supra* note 60, §§ 7.1.3, 7.1.6.2.

<sup>156</sup> Iversen, *supra* note 60, §§ 1.1, 2.3.1.

<sup>157</sup> The same of course can be said of the United States today, although the gap in the two tax burdens is not as large in the United States as it is in Norway.

<sup>158</sup> The next article in this series discusses this issue in detail, but very briefly, earnings that compound in a 28% annual tax rate environment, but that are subject to a 28% toll charge on ultimate withdrawal, bear a lower effective tax burden than earnings subject to a 48.16% annual tax charge—and the advantage in turn compounds with the passage of time.

<sup>159</sup> See Sorensen, *Dual Income Taxation*, *supra* note 7, at 571–74; Sorensen, *Nordic Dual Income Tax*, *supra* note 7, at 575–79; Peter B. Sorensen, *Neutral Taxation of Shareholder Income*, 12 INT’L TAX & PUB. FIN. 777 (2005) [hereinafter Sorensen, *Neutral Taxation*].

<sup>160</sup> Consumption taxes often are described as neutral, in the sense that future consumption is not burdened more heavily than is current consumption (because the normal return—the riskless return to waiting—is not subject to tax at all). See *supra* note 130 and accompanying text.

¶123 Mechanically, the new individual shareholder-level rate of return or “shielding” exemption is accomplished by giving individual shareholders what can be visualized as a supplemental tax basis in their stock, determined each year by multiplying their beginning tax basis (cost plus the opening balance in the supplemental account) by the same risk-free rate of return described above in respect of proprietorships, except that the return is calculated on an after-tax basis. (Because the amounts of income being shielded from double tax are normal returns on after-tax income (that is, after corporate tax), the allowance cannot be a pre-tax return on the capital invested to earn pre-corporate tax income.) The account balance compounds each year. When a dividend is received, that dividend is treated as tax-exempt to the extent of the balance in this supplemental account. Similarly, when stock is sold, the basis in the supplemental account is treated as additional basis that reduces the holder’s gain.<sup>161</sup> To make the concept more vivid, this Article refers to these rules as the “basis bump” mechanism.

¶124 The basis bump is calculated only once a year; as a result, an individual who sells before the end of a year loses any shelter for the normal return attributable to that part-year investment.<sup>162</sup> If the marginal buyer in the marketplace is also a taxpaying individual investor, then presumably shares sold before year-end would command a premium to reflect the “excess” basis bump awarded to the buyer. But, given the fact that Norway and the other Nordic countries are small economies with substantial inbound foreign investments (and further given the existence of domestic tax-exempt investors),<sup>163</sup> it is not clear whether this assumption is warranted.

¶125 Inter-corporate dividends and corporate capital gains from stock are wholly tax-exempt, so that there is no cascading of corporate tax liabilities as income moves through multiple levels of corporate ownership.<sup>164</sup>

¶126 As Sorensen has described, the new Norwegian approach could have been simplified, while still achieving the same general idea of taxing pure time value of money (risk-free) returns only at capital income rates, if the basis bump mechanism had not been adopted, and instead corporations were given the benefit of exempting risk-free returns at the enterprise level.<sup>165</sup> (The one level of tax on normal returns then would be absorbed at the investor level.) The difficulty with the alternative approach was principally one of tax revenues: by giving the exemption at the shareholder level, income ultimately distributed to tax-exempt investors bears the entity-level (capital income) tax alone, but if the exemption had been at the entity level, then all investors would benefit.<sup>166</sup>

¶127 Because corporate income is taxed at a 28% rate, and taxable dividend income or gain from the sale of stock (or, for that matter, partnership distributions or gain from the

<sup>161</sup> Sorensen, *Nordic Dual Income Tax*, *supra* note 7, at 575–77; Iversen, *supra* note 60, § 2.3.2.

<sup>162</sup> Sorensen, *Nordic Dual Income Tax*, *supra* note 7, at 581; Jacobsen, *supra* note 71, at 157–58.

<sup>163</sup> The rate of return allowance applies to nonresident individual shareholders within the European Economic Area, but not to those outside it. Gjems-Onstad et al., *supra* note 60, § 7.1.2. Thus, a basis bump would not benefit many foreign investors.

<sup>164</sup> *Id.* §§ 7.1.3, 7.1.6.2.

<sup>165</sup> Sorensen, *Nordic Dual Income Tax*, *supra* note 7, at 585–86.

<sup>166</sup> *Id.*; Sorensen, *Neutral Taxation*, *supra* note 159, at 793. By the same token, one could go further and suggest that corporations be taxed at the 48% aggregate rate, and that distributions and shareholder capital gains be tax-free. Then the problem would be the mirror image of that described in the text: tax-exempt investors, including shareholders resident in other countries in the European Economic Area (as to whom there are no dividend or capital gain withholding taxes) would indirectly bear a Norwegian corporate income tax that was not competitive by world standards.

sale of a partnership interest)—that is, gain not sheltered by the “basis bump” mechanism—also is taxed at 28%, the aggregate tax burden on business income earned through an entity (corporate rate plus shareholder rate) now is just over 48% in the case of returns beyond a normal return. This is roughly comparable to the maximum tax rate on labor income of 40% (technically, 28% general tax plus 12% labor tax surcharge), plus social security contributions; for a sole proprietor, those contributions bring the aggregate tax burden on labor income to 51% for 2009.<sup>167</sup> This, in essence, is the stated rationale for the new Norwegian system: by bringing the tax burden on capital income that exceeds a normal return into line with the taxation of labor income, Norway hoped to avoid the problems it faced under prior law in policing the labor-capital income divide in the case of closely-held firms.<sup>168</sup>

¶128 Like many countries, Norway imposes limitations on the use of capital losses. In particular, a basis bump cannot give rise to a tax-cognizable loss.<sup>169</sup> Moreover, capital loss carryovers are not increased by an interest factor to compensate for their current non-utilization.<sup>170</sup> This asymmetry in the treatment of gains and losses increases the effective tax burden on capital investment.

¶129 To summarize, the new Norwegian system bears some superficial resemblance to the earlier dual income tax, but the old capital income splitting mechanism has now been repurposed. In the dual income tax, the labor-capital tax centrifuge operated to segregate an arbitrary blended return to capital from labor income. Now, under the new Norwegian implementation of a classical corporate tax system, a superficially similar capital income splitting mechanism is applied to segregate *risk-free* returns from other forms of capital income, and then to exempt those risk-free returns from the incremental labor surtax. The result is now a complex multi-level schedular income tax system:

1. Corporate/partnership income that is retained by the enterprise, interest income or royalties received by individuals, and other miscellaneous items of investment income of individuals all are taxed at a flat 28% rate.
2. Distributed corporate/partnership profits are also taxed at an aggregate flat tax burden of 28%, but only to the extent that those distributions do not exceed a normal return on an individual shareholder’s investment.<sup>171</sup>

<sup>167</sup> NORWEGIAN MINISTRY OF FIN., *supra* note 131, at 13, 55, 69.

<sup>168</sup> Sorensen, *Nordic Dual Income Tax*, *supra* note 7, at 575.

<sup>169</sup> An unused basis bump can be carried forward indefinitely but can be used only to offset future gain on the same stock. Iversen, *supra* note 60, § 2.4.4.

<sup>170</sup> *See generally id.* § 3 (discussing loss carryforwards).

<sup>171</sup> This result follows from the special annual basis bump equal to a normal return on an individual shareholder’s tax basis in her shares. That basis bump protects an individual shareholder from tax on distributions of normal returns, but does *not* reduce the aggregate tax burden on business profits below 28%. Normal returns thus are taxed, but are taxed only once, and at the enterprise level. For example, imagine that an individual investor puts \$1000 into a corporation and that corporation makes a pure marginal investment, on which the return is a normal pre-tax return. The corporation pays a 28% tax on that return. If the statutory rate of return allowance for basis bump purposes (the after-tax yield on three-month government securities) equates to an after-tax return on the corporation’s next best investment alternative (which may not strictly be true), then the corporation can distribute its after-tax profits to the investor without further tax at the investor level, but in no circumstance does the investor obtain a tax benefit that eliminates the corporation’s tax on its returns from its marginal investment.

3. Risk-free returns on an individual's net equity capital invested in his sole proprietorship are taxed at a flat rate of 28%. That rate is the result of the annual rate of return (shielding, or allowance for proprietor equity) deduction, which protects that return from the labor ("personal") income surtax.

4. Returns of any business *beyond* the risk-free return (which risk-free return is taxed at a flat 28% rate, either under the corporate income tax or the "general" individual income tax), when distributed to ultimate individual owners, are taxed at a rate close to the *maximum* rate imposed on labor income, regardless of whether the investor is "active" or "passive." Unlike sole proprietors, individual investors in partnerships or corporations do *not* get the benefit of lower progressive rate brackets on capital income beyond risk-free returns; instead, active individual owner-managers of separate legal entities (a concept that no longer has any technical meaning) are expected to exercise self-help, by receiving corporate or partnership income as salary, as required to fill up the lower labor income brackets.<sup>172</sup>

5. Labor income is taxed at progressive rates; the maximum tax imposed on self-employment income is quite close to the tax on supra-risk-free returns of a business enterprise.

¶130 The new Norwegian system thus is very different from its predecessor. Most important, investors in entities no longer use rate of return calculations to divide their labor income from capital income (indeed, the concept of active and passive investors no longer has tax meaning), and economic rents now are taxed at maximum rates in the neighborhood of 48–51%, rather than former law's 28%. Rate of return formulae applied to capital invested in a business still are relevant, but now are used to shield risk-free returns to capital from double tax. Oversimplifying, one can say that rents are now taxed roughly like labor income (assuming labor is at the maximum progressive rate).

### *E. Comparison of Old and New Norwegian Systems*

#### 1. Reallocating the Tax Burden on Risky Returns

¶131 The most commonly articulated impetus for the new Norwegian capital income tax system was the observation that the former dual income tax's labor-capital income centrifuge was not operating properly when applied to closely-held business entities.<sup>173</sup> The reason for the breakdown was clear—an excessively narrow and easily avoided definition of "closely-held"—but the response to the problem went far beyond a simple overhaul of the broken machinery.

¶132 The new capital income tax system is complex, but in essence can be understood as constituting a complete rethinking of the proper tax burden to impose on risky returns

<sup>172</sup> Sorensen, *Nordic Tax System*, *supra* note 7, at 25.

<sup>173</sup> *See supra* Part III.C.

(net of a risk-free return) and economic rents, and a repurposing of the role of the labor-capital tax centrifuge to a narrow time value of money neutralization device. By reverting to a classical corporate tax system, albeit one with a new twist (the basis bump mechanism), Norway has kept a corporate tax rate that is commensurate with that of its peer countries, which is important for a small open economy with substantial international investment in its capital markets. In particular, and as noted earlier, investors from other European Economic Area countries can invest in the Norwegian capital markets without suffering Norwegian withholding taxes.<sup>174</sup> As a result, the higher aggregate tax rate is imposed only on Norwegian individual shareholders.

¶133 In a related step, Norway has repurposed the former dual income tax's labor-capital income centrifuge into a device to measure the fraction of a taxpayer's total capital income that corresponds to a risk-free return on capital (which amount in turn is taxed at a concessionary rate). This feature, which is believed to be unique to Norway, is a direct response to the objection that other classical corporate tax models encourage corporations to retain surplus earnings, and shareholders to defer stock sales, in each case to reduce the effective tax burden on their capital income.

¶134 The new Norwegian system for taxing business income has raised the tax rate on rents from the low capital income rate to a burden comparable to the maximum rate on self-employment income. This alignment of rates obviously reduces the relevance of distinguishing labor from capital income, but even without regard to this asserted rationale, there are two economic arguments in favor of this result. First, as previously described, rents are not thought to be as responsive to tax rates as are normal returns, because, even after absorbing a tax increase, rents still offer returns not duplicable elsewhere.<sup>175</sup> As a result, a government can tax rents more heavily than normal returns without affecting behavior.

¶135 Second, as applied to the classic owner-manager scenario, many returns that appear as economic rents are more properly characterized as returns to labor. For example, if one looked at the financial statements of a hugely successful restaurant, one might see a remarkably high return on the physical capital invested in the business; what would be missing from the balance sheet, however, would be the years of under-compensated personal effort of the restaurateur to develop the goodwill and other intangible assets of the business, all of which effectively have a tax basis of zero. One way of looking at the new Norwegian tax system is that it takes claims for the existence of rampant rents in the economy with a grain of salt. By characterizing all of them as quasi-labor income, the new system may be over-inclusive, but arguably may be right more often than it is wrong.

¶136 When one contemplates exporting the new Norwegian system to other jurisdictions, in particular the United States, the system's economic virtue arguably becomes its key political economy vice. Consider again the example from early in this Article of the indefatigable entrepreneur who successfully develops a local food shop into a powerful brand. When the entrepreneur sells her business, the new Norwegian system would tax the entrepreneur at labor or quasi-labor rates on the gains attributable to those self-developed intangibles. Whatever the economic merits, this represents a dramatic rethinking of the scope of (preferential) capital income, in ways that one must recognize

<sup>174</sup> See *supra* note 63 and accompanying text; *accord* Gjems-Onstad et al., *supra* note 60, § 8.5.1.

<sup>175</sup> See *supra* note 25 and accompanying text.

as inconsistent with contemporary American tax dialogue. Norway's 2004 reform was politically feasible because the higher tax rates on rents and supra-normal returns to risk could be used to fund lower taxes on labor income, but in the United States, at least, that tradeoff seems unlikely given how low labor (ordinary) income tax rates are compared to world norms, and given the revenue constraints confronting the country.

¶137 The political economy problem would not be limited to sales of closely-held businesses. Investors might argue that imposing what might be characterized as a labor tax burden (the double tax) on equity returns earned by passive investors in public companies is unfairly burdensome, particularly when compared with worldwide norms of capital income tax. There is no labor-capital income confusion in the case of the passive investor, particularly an investor in a public company, and it seems odd to drag such an individual into the double tax system solely to avoid the difficulty of distinguishing labor from capital income in completely different contexts. As described below, the new system treats the debt of public companies differently from the debt of private firms, and it might be argued that the same should have been true for equity in public firms.

¶138 Even on its own terms of efficient revenue collection through higher burdens on rents, the new system's reversion to a relatively high rate of tax on rents and net supra-normal returns to risk will impose substantially higher disincentives to undertake risky investments generally, if losses are treated less favorably than gains for tax purposes. All tax systems in practice are asymmetrical with respect to gains and losses (for example, by not providing instant refunds to loss companies, or by failing to give relief to a business firm that fails and is dissolved). To the extent that they embody these sorts of asymmetries, tax systems discourage risk-taking;<sup>176</sup> the problem of course grows along with the tax burden in question.

¶139 The Norwegian system arguably sets a high-water mark among developed country income taxes in its near-symmetry in loss utilization, in particular through the absence of any "cherry-picking" limitations and full netting of all forms of capital losses against all forms of capital income, but even Norway is bounded by political realities. The system suffers from limitations on loss utilization at the firm level (for example, the absence of compounding of loss carryovers and the non-refundability of loss carryovers on liquidation of the firm) and at the shareholder level (in particular, the rule that the new basis bump mechanism can only reduce income, and not give rise to a loss). The system thus is susceptible to the criticism that, when combined with its high tax rates on very successful undertakings, it discourages risk-taking.

¶140 One second-best response to preserving rough neutrality in risk taking, notwithstanding a tax regime's residual loss limitations, is to compensate in a rough and ready way for their effects through a somewhat more generous rate of return allowance.<sup>177</sup>

<sup>176</sup> Weisbach, *supra* note 31, at 27–29.

<sup>177</sup> The designs of both the former and the current Norwegian systems are sensitive to the cost of capital allowance rates that are specified in ways that go beyond those rates' interaction with limitations on loss utilization. For example, the former dual income tax's labor-capital tax centrifuge relied on a single specified rate of return to capital to segregate the capital income component of mixed business income. If that rate were set lower than a representative blended return on business capital, then in those instances where the tax centrifuge was employed (closely held businesses), capital income would bear a higher tax rate than was intended; conversely, if the cost of capital rate exceeded a blended return on business capital, labor income would be taxed less than its nominal rate. Norwegian analysts generally described the specified formula as generous, see, e.g., Sorensen, *Neutral Taxation*, *supra* note 159, at 780, but that

¶141 In this regard, building on earlier work, Sorensen has shown that the new Norwegian corporate tax system requires simply an after-tax risk free rate of return as the interest rate in its deemed return on capital formula, but only if taxpayers have absolute certainty that they will receive the tax benefits of losses.<sup>178</sup> The current Norwegian system is more symmetrical than most, but, as noted, it is not perfect in this regard. Sorensen’s work can be read to imply that, when its preconditions cannot be satisfied for political reasons, one might rethink whether the risk-free rate is the right measure of normal returns in practice.

## 2. Tax Burdens on Debt vs. Equity Capital

¶142 The new Norwegian system has eliminated the former difficulty in policing the boundary between owner-managers subject to income-splitting and pure providers of capital, but in turn appears to have reintroduced a dramatic distinction in tax burdens between debt and equity finance that the dual income tax had avoided. In general, even in the hands of a fully taxable Norwegian individual investor, interest income is taxed only under the “general” income tax at a rate of 28%, and interest income from loans to business firms when held by tax-exempt and international investors is not taxed at all.<sup>179</sup> Equity returns, however, to the extent they exceed a risk-free return, are subject to full double tax, at a combined rate of roughly 48% in the hands of a domestic individual shareholder, and are never reduced below the 28% corporate tax rate. The dual income tax was vulnerable to the problem of debt finance provided by tax-exempt or international investors, but was neutral with respect to the tax burden on funds provided by a domestic individual investor.

¶143 In this regard, as pointed out in the previous section, Norway does not impose any general statutory “thin capitalization” rule to limit the tax deductibility of interest, and Norway further does not impose any fungibility of money or similar test on indebtedness incurred by a proprietor in connection with her trade or business.<sup>180</sup> Without some countervailing rule, owner-managers and individual passive investors alike could be expected to strip out corporate earnings to themselves through interest payments, thereby preserving a 28% tax rate on business income beyond a risk-free normal rate of return.<sup>181</sup>

¶144 Norway has responded to this concern by taxing interest income received by individuals from privately-owned corporations and partnerships as if that interest income were a taxable corporate dividend, to the extent that the interest received exceeds the

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apparent generosity in turn was dominated by the ease with which small businesses potentially subject to the labor-capital income allocation rules opted into an all-capital income environment (by broadening their shareholder base just enough to fail the rigidly-defined closely-held business test).

<sup>178</sup> Sorensen, *Dual Income Taxation*, *supra* note 7, at 574; Sorensen, *Neutral Taxation*, *supra* note 159, at 784–86; Stephen R. Bond & Michael P. Devereux, *Generalized R-Based and S-Based Taxes Under Uncertainty*, 87 J. PUB. ECON. 1291, 1296 (2001).

<sup>179</sup> As to international investors, see Gjems-Onstad et al., *supra* note 60, §§ 8.5.1.1, 8.5.1.2.

<sup>180</sup> See *supra* notes 149–150 and accompanying text.

<sup>181</sup> The statutory normal rate of return is an after-tax risk-free rate, while corporate obligors all pay some risk premium. Moreover, individuals could be expected to employ profit-participating loans and other near-equity instruments to extract as much income as possible in the form of interest payments. See also Sorensen, *Nordic Dual Income Tax*, *supra* note 7, at 581–82 (describing some means shareholders might use to take advantage of the asymmetrical tax treatment of debt and equity).



risk-free normal return on the loan.<sup>182</sup> The rule applies regardless of whether the creditor in fact is an equity owner in the company.

¶145 The difficult question is whether the new tax system induces overleveraging in other contexts. The underlying theoretical work on which the new system rests demonstrated the neutrality of a specified ideal corporate tax system in which interest income could be tax-exempt in the hands of marginal investors while corporate profits were taxed, but it critically assumed in doing so that creditors received only normal returns, and that all rents were captured by shareholders.<sup>183</sup> When it applies, the anti-abuse rule described above protects this assumption by, in effect, treating supra-normal returns of individual creditors as if those returns were dividends paid on equity.<sup>184</sup>

¶146 The anti-abuse rule was constructed narrowly, however, on the grounds that its principal objective was to protect against a new form of labor-capital income splitting (that is, an owner-manager receiving returns to labor in the form of supra-normal interest charges on loans to his firm).<sup>185</sup> This leaves open the prospect that creditors and equity holders in other contexts can employ debt financing that bears a supra-normal return in order to stream to creditors a portion of a firm's income that constitute rents, and that therefore should have borne double tax.

¶147 As one example, the anti-abuse rule does not impose any tax penalty on interest paid to entities (as opposed to natural persons).<sup>186</sup> As in the United States, tax-exempt institutions represent a substantial portion of Norway's capital markets investors. These include residents of European Economic Area countries, which are exempt from Norwegian withholding tax on dividends so long as the investor meets certain minimum economic activity tests in its residence.<sup>187</sup> Moreover, Norway does not impose withholding tax on interest paid to any other foreign investor.<sup>188</sup> These limitations imply that the new system theoretically might encourage classic leveraged buyout financing structures, in which a significant portion of firm equity is replaced with layers of capital that formally is junior debt, but which economically takes on many equity risks and characteristics.

¶148 The anti-abuse rule also does not apply at all to acquisitions of debt of public companies, presumably on the theory that whatever interest they pay in fact is fair compensation for the use of money.<sup>189</sup> As a result, there do not appear to be any tax impediments to the creative use of debt, including debt whose returns are contingent in some fashion on the success of the enterprise, to strip out earnings of publicly-held

<sup>182</sup> Iversen, *supra* note 60, § 2.3.1. Technically, the rule operates by taxing the same interest income twice. First the income is taxed at 28%; then 72% of the interest income, minus the rate of return allowance, is taxed again at 28%. KPMG, *supra* note 149, at 11.

<sup>183</sup> Bond & Devereux, *supra* note 177, at 1302–05; Stephen R. Bond & Michael P. Devereux, *On the Design of a Neutral Business Tax Under Uncertainty*, 58 J. PUB. ECON. 57 (1995). The neutral tax systems developed in these articles were also consumption rather than income taxes, in that risk-free returns were not taxed at all.

<sup>184</sup> Sorensen, *Neutral Taxation*, *supra* note 159, at 795 (drawing the connection between the theoretical works referenced in the immediately preceding footnote and the design of the Norwegian anti-abuse rule).

<sup>185</sup> *Id.*

<sup>186</sup> *See id.*

<sup>187</sup> Gjems-Onstad et al., *supra* note 60, §§ 8.5.1.1, 13.4.

<sup>188</sup> *Id.* § 8.5.1.2.

<sup>189</sup> *See* Sorensen, *Neutral Taxation*, *supra* note 159, at 795; Sorensen, *Nordic Dual Income Tax*, *supra* note 7, at 582.

Norwegian firms.<sup>190</sup> The idea here is that complex subordinated debt instruments can command returns that include an equity-type component, but the new Norwegian system will treat the entirety of the return as subject only to the capital income (“general”) tax. Pre-2008 U.S. corporate finance practice, in which increasingly sophisticated forms of tax-deductible instruments were created to strip out the income of taxpaying public corporations, counsels against the optimistic view that public companies would never clutter up their balance sheets in this manner.<sup>191</sup>

¶149 In short, if the ultimate goal of the new system is to impose a higher tax burden on rents and net supra-normal returns to risk, then one might question whether the current anti-abuse rules go nearly far enough in protecting the tax base against rent-bearing instruments denominated as debt for tax purposes.<sup>192</sup> Admittedly, there is little evidence (or at least concern) yet of such base erosion, but the U.S. experience would suggest that this reflects in part the inevitable time lag before American investment bankers storm Norway’s beaches.

### 3. Other Differences Between the Old and New Systems

¶150 As previously noted, the new system would appear to distort intra-year stock trading, because the basis bump for a year is awarded in its entirety to the holder on the last day of the year. As a result, the new system introduces a mini-“lock-in” problem, where taxpayers who wish to sell stock in November or December are induced to hold onto the stock until January to get the benefit of the annual basis bump.

¶151 The new system might appear to discriminate against proprietorships (because they are immediately taxed at labor income rates on earnings beyond the normal return), but paradoxically the system mildly discriminates in their favor. If one assumes that there is no loophole of any kind (including death) from the taxation of corporate/partnership earnings on distribution, then as a present value matter the proprietorship and corporation/partnership models are identical,<sup>193</sup> except that the proprietor obtains the benefit of lower-bracket tax rates on earned income. Owner-managers of entities can engage in self-help, by paying themselves higher salaries than they might have chosen to

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<sup>190</sup> As noted earlier, there are no limitations on the tax deductibility of interest paid by corporations. Moreover, Norway has no statutory thin capitalization rule (outside of the special petroleum tax regime). See *supra* notes 149–150 and accompanying text.

<sup>191</sup> See DEP’T OF THE TREASURY, REPORT TO THE CONGRESS ON EARNINGS STRIPPING, TRANSFER PRICING AND U.S. INCOME TAX TREATIES 7–31 (2007).

<sup>192</sup> In the case of small businesses, one might expect to see systematic overleveraging for a different reason: The new tax system can be expected to induce proprietors to characterize consumption or personal investment borrowings as in fact attributable to the taxpayer’s proprietorship, in order to eliminate to that extent the tax burden of the labor surtax. So long as the income thereby sheltered would have been subject to the “personal” income surtax, the taxpayer comes out ahead, even after taking into account the foregone rate of return allowance. (A similar strategy might apply to owners of business entities; by reducing entity income, total shareholder income subject to double tax is reduced, at the cost of a smaller basis bump.) The former system should not have been as susceptible to the same planning, because interest of any type only reduced general income.

This problem is a necessary cost of switching from the former “gross” method of applying income-splitting to what in effect is an instance of the “net” method. As noted earlier in the discussion of the two methods, this is a classic audit issue, although one compounded by the fungibility of money.

<sup>193</sup> This is a corollary to a point made earlier. See *supra* note 151 and accompanying text; see also Sorensen, *Nordic Dual Income Tax*, *supra* note 7, at 586.

pay before the reforms, to soak up the value of the lower labor income brackets. The proprietor gets to a similar place without the need for self-help.

¶152 Like any new tax system, the new Norwegian approach to taxing business income summarized above poses new administrative complexities. The new rules require shareholders to maintain “basis bump” records, which reflect not only a compounding of basis by the statutory normal return, but also adjustments to the basis bump account to reflect dividends received.<sup>194</sup> This administrative burden might be viewed as significant, particularly since it is visited on individual investors rather than companies.<sup>195</sup>

¶153 Another administrative issue may be the new system’s increased incentives for an owner-manager to disguise personal expenses as business expenses.<sup>196</sup> By doing so, the owner-manager avoids financing his personal consumption out of twice-taxed corporate profits. By raising the tax burden on successful small businesses, the new system raises the benefits from tax avoidance behavior of this sort.<sup>197</sup>

#### 4. Tradeoffs in Designs of the Old and New Systems

¶154 In sum, the new system draws support from economic theory by taxing rents more heavily than normal returns, and the new system also eliminates the ability of “active” owner-managers to opt into the former low-taxed capital income regime by bringing in enough passive investors to dilute themselves below a two-thirds ownership. The economic case for the new system is weakened in practice, however, by the asymmetric treatment of losses, without a commensurate rough and ready offset in the form of higher rates of return allowances. Together with the absolute level of increase in tax burdens imposed on successful passive investors, this factor may dampen the investment appetite of passive investors, compared to the old regime.

¶155 The most interesting tradeoff arising from the elimination of any requirement to police the boundaries of those small businesses subject to income-splitting is the reintroduction of a distinction between debt and equity financing. The new system would seem to encourage leveraged buyouts and the issuance by public companies of exotic forms of debt instruments to offer individual investors quasi-equity returns at preferential interest income tax rates. These induced responses have both revenue and efficiency costs.

¶156 It is not at all clear why the failure of the old definition of an active owner-manager should have been such a powerful driver of reform, at least until some effort had been made to revise the definition of active owner-managers in ways that are straightforward to imagine (at least for someone not constrained by Norwegian political or cultural norms). The new system appears to have administrative and compliance issues of its own, and it is not easy to see it as demonstrably superior in every dimension to the system it replaced.

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<sup>194</sup> Sorensen, *Nordic Dual Income Tax*, *supra* note 7, at 584–85.

<sup>195</sup> Peter Sorensen has pointed out to me that Norway is developing electronic systems to assist taxpayers in maintaining these records.

<sup>196</sup> A similar impulse with regard to interest expense is discussed in note 89 and accompanying text, *supra*.

<sup>197</sup> The same problem *should* have been important in the prior tax system, but an ironic silver lining to the cloud of widespread income-splitting avoidance would have been to reduce the significance of the issue (because any resulting expense shifting would in those cases produce only a general income tax savings).

¶157 When compared to its immediate predecessor, the new Norwegian system as currently implemented elevates the risk of the asymmetric treatment of losses. It also accepts higher overall burdens on capital income, possible dislocation in stock trading around year-end, a possible increased interest in shifting of expenses from the private sphere to small businesses, and the risk of overleveraging of C firms and the application of clientele effects to sort out debt and equity ownership among shareholders with different tax profiles. The new system accepts these problems in order to raise the tax rate on economic rents, to avoid the problems of an unsatisfactory prior implementation of an income tax splitting regime, and to avoid the risk of capital stuffing used to take advantage of arguably over-generous capital income rate of return allowances. Here is an instance where the theory of the second best<sup>198</sup> might caution that it is not easy to conclude that the new system necessarily dominates its predecessor. Time will give us a better sense of how the new system plays out in practice.

#### IV. CONCLUSION

¶158 The core insight of dual income tax systems is that unambiguous economic efficiency gains should be available through abandoning the fundamental premise of a comprehensive income tax, and instead embracing different tax rates for capital and for labor income.<sup>199</sup> Moreover, those economic efficiency gains should not necessarily come at a significant cost in terms of redistributive goals, both in light of modern theory (under which capital income taxation is generally a suboptimal redistributive device) and in light of the relatively low effective burden that capital income in the aggregate bears today (due to the many exceptions from the application of the comprehensive income tax's general rules and clientele effects). Finally, the United States arguably has little choice but to embrace a dual income tax, given the pressure to which it is subject to lower the statutory rate of the corporate income tax (the most important component of capital income taxation).

¶159 This Article has sketched the basic features of a dual income tax. It further has identified the key difference between any dual income tax and comprehensive income taxes or consumption taxes, which is that only the dual income tax of the classic variety requires a labor-capital income centrifuge to separate labor from capital income when both are combined as net business income. (The new Norwegian implementation of a dual income tax relies on the same mechanism, but does so to separate normal returns to capital from other returns to capital.)

¶160 The Nordic experiences with dual income taxes are vitally important, because they offer reasonably large-scale experiments in the implementation of a labor-capital income centrifuge, and hint at points of stress in a practical dual income tax that might not be evident solely through introspection. For that reason, this Article has considered at

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<sup>198</sup> The well-known “theory of the second best” suggests that when a tax creates economic inefficiencies (as almost all do), reforms that only partially correct those inefficiencies may compound rather than mitigate the deadweight loss associated with the tax. *See generally* R.G. Lipsey & Kevin Lancaster, *The General Theory of the Second Best*, 24 REV. ECON. STUD. 11 (1956–57); STAFF OF JOINT COMM. ON TAXATION, 110TH CONG., A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS 53–54 n.118 (Comm. Print 2008).

<sup>199</sup> *See, e.g.*, Sorensen, Nordic Tax System, *supra* note 7, at 6–8; Cnossen, *Taxing Capital Income*, *supra* note 7, at 186–91.

length how the Nordic countries implemented their dual income tax regimes, and what challenges those systems faced.

¶161 This Article has shown that none of the technical problems posed by any schedular system is an insurmountable obstacle to consideration of dual income tax principles in the United States. The original Norwegian experience in particular foundered on a narrow definition of those firms subject to the income-splitting regime. This Article has argued, however, that existing U.S. definitions could be pressed into service in this regard to reduce substantially the likelihood that the rules could be avoided by the introduction of a handful of passive investors into a firm's ownership structure.

¶162 The baroque complexity of the pre-2004 RISK system, the Norwegian fondness for alternating layers of labor and capital income, and other specifics should not obscure the basic themes of the classic dual income tax. Abstracted from the goriest of its details, the previous Norwegian system contemplated that "mixed" income would be allocated between capital and labor income based on attributing to capital income a generous return on the aggregate tax basis of a firm's business assets. Every business must keep track of the tax basis of its assets, for depreciation and gain/loss calculation purposes, and the return attributable to that aggregate basis in turn was a simple exercise in multiplication. Moreover, by relying on tax basis as the multiplicand, the Norwegian system contained a partial corrective to over-generous depreciation deductions, because the reduction in basis would mean that a greater percentage of net income would ultimately be characterized as higher-taxed labor income.<sup>200</sup> Finally, the division of a closely-held business' net profits into capital and labor income components did not require any special commercial or economic information or analysis of the business or its industry.

¶163 The end result might have been imperfect, and arguably yielded too generous an allocation to capital income (through the system's very generous deemed rate of return to capital), but to an outside reader the system was (or at least could have been) relatively simple and robust. Given the shoddy work that the United States has made in the past of separating labor from capital income, the classic Nordic-style implementation of a dual income tax can hardly be faulted as inexcusably imprecise. Moreover, it was universal and self-executing in its application, and did not rely on near-impossible determinations of purpose or abstruse characterizations of income into various types.

¶164 The new Norwegian implementation of a dual income tax can be viewed as a further refinement, in that it follows economic precepts to impose a higher tax burden on economic rents and risky returns to capital, and a lower burden on normal returns. The new Norwegian system thus has theoretical advantages over its predecessor, but also has its own administrative issues. In particular, it requires the investor-level "basis bump" mechanism described earlier (or a comparable firm-level adjustment) and appears to reintroduce a distinction between debt and equity financing that might lead to future abuse.

¶165 Once one takes administrative issues into account, it is difficult to project whether the new Norwegian system, once transplanted to the United States, would dominate the original Norwegian implementation of a dual income tax in every dimension, if the latter were amended to incorporate a much more robust definition of those enterprises subject to income splitting. In particular, the debt-equity distinction that has yet to be fully

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<sup>200</sup> This point is more systematically exploited in the author's business enterprise income tax proposal. See *supra* note 17.

exploited in Norway would seem to be a point of vulnerability for the new system, in light of the ingenuity of U.S. capital markets. Either, however, would seem to dominate current U.S. practice.

¶166 As a matter of political economy, the former system appears to be a more realistic one to contemplate importing into the United States, given that, unlike the new Norwegian approach, the former implementation of a dual income tax would not dramatically raise tax rates on gain attributable to the sale of self-developed intangibles, when compared with current U.S. norms. These intangibles, of course, arise in every successful small business, as well as in large corporations.

¶167 In considering the possible adoption of a dual income tax in the United States, one important simplifying rule that all the Nordic countries were able to adopt that would require adaptation was that the corporate income tax rate, the basic (lowest marginal) personal labor income rate, and the personal capital income tax rate could all be set at the same number. As a result, labor/capital income divisions were relevant only for taxpayers with income above this first bracket, thereby substantially reducing the administrative burdens of their labor-capital income centrifuges.

¶168 This is inconsistent with U.S. practice, where the lowest personal income tax bracket (10%) is much lower than can be anticipated as the current or reasonably foreseeable future corporate tax rate or the maximum rate on personal capital income. In practice, it seems unavoidable that the U.S. implementation of a dual income tax would need to follow general marginal tax brackets, subject to a ceiling (25%, for example) that is lower than the top bracket on labor income. The effect, however, should be similar to that achieved in the Nordic countries with respect to income splitting, at least outside the corporate tax context, in that the income-capital centrifuge would not need to be applied, except in cases where the marginal tax rate on an owner-manager's total taxable income exceeded the capital income rate.<sup>201</sup>

¶169 One important lesson for the United States from the Nordic experience is that a dual income tax needs to be implemented in a manner that makes it difficult for the political system to over-reward small business owners. The solution to this dilemma lies not in substantive rules, but rather in post-reform "framework legislation" that can set the terms under which legislation that reduces the tax burden on labor income can be considered by Congress.<sup>202</sup>

¶170 A future article in this series will extend this Article's analysis more completely to the United States. That article will focus in particular on the substantial economic distortions arising from "labor stuffing" and "capital stuffing" to which the United States will be subject within its comprehensive income tax system if (as many expect) corporate tax rates are reduced, individual income tax rates go up, and no effective labor-capital income centrifuge is enacted. The future article will show that a dual income tax can successfully respond to these behaviors. That is, addressing the behavioral distortions

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<sup>201</sup> To avoid introducing asymmetries between the individual and corporate tax systems, one would have to contemplate providing progressive rates on corporate income up to the same specified ceiling. Those lower progressive rates in turn could be subject to 'give-backs' out of higher incomes for both individuals and corporations (as is the case today for corporate income, by virtue of the flush language of I.R.C. § 11(b)). The end result would be a flat capital income tax on individual and corporate incomes above a specified income level.

<sup>202</sup> Cf. Edward D. Kleinbard, *Tax Expenditure Framework Legislation*, 63 NAT'L TAX J. 353 (2010) (forthcoming).

that otherwise would follow from reducing corporate income tax rates while raising individual rates requires more than just a mechanism to distinguish labor from capital income; the preferred solution also requires a consistent tax burden on capital income. The dual income tax is the most feasible way to design an income tax to accomplish these objectives.