INTRODUCTION

The corporation has long been considered a misfit in American taxation. Even before the existence of an income tax, the corporation posed difficulties for nineteenth-century lawmakers seeking to preserve traditional sources of revenue such as the property tax. Writing in 1890, economist Edwin Seligman lamented "Governments are everywhere confronted by the question of how to reach the taxable capacity of the holders of these securities, or of the associations themselves. Whom shall we tax and how shall we tax them in order to attain a substantial justice? Perhaps no question in the whole domain of financial science has been answered in a more unsatisfactory way."[1]

The introduction of a corporate income tax a century ago only exacerbated the problem. This was particularly true as both the income tax and the corporation grew in size and prominence. In 1951, economist Richard Goode observed "[t]he modern corporation fits awkwardly into a set of tax principles based on economic and political theories that are drawn largely from a simplified picture of a society in which production is organized by small-scale proprietorships and partnerships."[2]

Because of the awkward fit, the question of how best to tax the corporation has spawned numerous studies, reports, and conferences over the years. As early as 1909, the Bureau of Corporations began issuing a multiyear series of reports on the states' experiences with taxing corporations. The original report, which was released during the debates over a proposal to enact the first federal corporate income tax and distributed to every member of the Senate, grappled with the problem of dual taxpayers: "Obviously a tax on the corporation is really a tax upon its stockholders, for otherwise then as a matter of legal reasoning a corporation and its stockholders are one. Hence the

1. Edwin R. A. Seligman, *The Taxation of Corporations I*, 5 POL. SCI. Q. 269 (1890).

2. RICHARD GOODE, THE CORPORATION INCOME TAX 1 (1951).

00-Bank-Intro.indd ix 1/19/2010 6:12:39 PM
Electronic copy available at: http://ssrn.com/abstract=1592662

question whether both the corporation and the stockholders shall be taxed is an interesting problem as to double taxation."[3] The question was still not resolved by mid-century, as the published proceedings of a 1946 conference entitled "How Should Corporations Be Taxed?" revealed: "The people of this country appear to have reached substantial agreement that the individual income tax must constitute a major element in the national tax system; they have reached no such accord as regards the corporation income tax."[4] If a consensus had been reached about the continued existence of the corporate income tax by the late 1970s, it did not extend to the form of the tax. In a published report on a conference sponsored by the Brookings Institution that followed the release of the Treasury Department's *Blueprints for Basic Tax Reform*,[5] economist Charles McLure asked the proverbial question: "Must corporate income be taxed twice?"[6] Since then, there have been a number of similar conferences and studies of these questions, with little resolution.[7]

---

3. *Report of the Commissioner of Corporations on the System of Taxing Manufacturing, Mercantile, Transportation, and Transmission Corporations, in the states of Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island, and Vermont* (May 17, 1909).

4. James W. Martin, *Foreword*, *in* How Should Corporations Be Taxed?, at v (1947).

5. U.S. Department of Treasury, Blueprints for Basic Tax Reform (1977).

6. Charles E. McLure, Jr., Must Corporate Income Be Taxed Twice? (1979).

7. *See, e.g.*, U.S. Department of the Treasury, Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once (1992); American Law Institute, Federal Income Tax Project—Integration of Individual and Corporate Income Taxes—Reporter's Study of Corporate Tax Integration (1993); American Law Institute, Federal Income Tax Project—Reporter's Study of Taxation of Private Business Enterprises (1999); President's Advisory Panel on Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* (2005); U.S. Department of the Treasury, *Treasury Tax Conference on Business Taxation and Global Competitiveness: Background Paper* (July 30, 2007); Office of Tax Policy, U.S. Department of Treasury, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century* (Dec. 20, 2007); Congressional Research Service, *Corporate Tax Reform: Issues for Congress* (Oct. 31, 2007; updated July 24, 2008) (hereinafter *CRS Report*).

00-Bank-Intro.indd x 1/19/2010 6:12:39 PM
Electronic copy available at: http://ssrn.com/abstract=1592662

One of the difficulties posed by the existence of the corporation is identifying its appropriate location for tax purposes. It may be incorporated in one jurisdiction, headquartered in a second jurisdiction, and own assets and conduct business in multiple other jurisdictions. Historically, this was a domestic tax problem, primarily for state and local property taxes in the nineteenth century with the advent of industries such as railroads and telegraphs where businesses frequently crossed state lines. In more modern times, this has become an international tax problem with the emergence of the multinational corporation. In an age in which intangible property such as intellectual rights may have as much or more value as the assets of the firm, the ability to divide up the firm, and hence the taxable income, between multiple locations has grown ever greater. Although this book is not primarily concerned with the U.S. rules for taxing corporate profits earned internationally, the advent of the multinational corporation surely has placed competitive pressure on the structure of the purely domestic corporate tax system.

A more vexing problem than determining where to tax the corporation is determining at what level to tax corporate income. From a legal perspective, the corporation is a separate entity, distinct from the individuals who own its shares. It can exist beyond the lives of the individual investors. Under this perspective, the corporation can be taxed separately at the entity level, and the identity and tax status of the shareholders is irrelevant to determining the appropriate marginal rate to be applied to the corporation. From an economic perspective, however, the corporation is merely a collection of investors and employees in a common enterprise that interacts with customers and suppliers. Thus, taxing the corporation at the entity level is really a decision to impose a tax on one or more of these constituent groups, although which group ultimately bears the burden is still a matter of some controversy among economists. If the shareholders bear the burden, then it becomes important to consider the corporate rate in the context of the applicable individual income tax rates. A rate set lower than the average effective rate for a corporation's shareholders will result in undertaxation, whereas a rate set higher than the average effective rate will result in overtaxation.

Further complicating the matter is that the separate legal status of the corporation means that the directors, rather than the shareholders, control the use of corporate profits. Imposing a tax on the

00-Bank-Intro.indd xi 1/19/2010 6:12:39 PM
Electronic copy available at: http://ssrn.com/abstract=1592662

shareholders for their allocable share of the corporate profits creates a liquidity problem if the directors choose not to distribute those profits. By contrast, waiting to impose the tax on the shareholders until the profits are distributed permits the corporate directors to defer taxation on those profits indefinitely. Taxing the corporation reaches the profits and avoids deferral, but at a rate that is disconnected from and in addition to the rate that would apply to individuals. This potentially creates a horizontal equity problem where shareholders have heterogeneous tax profiles, as is likely under a graduated marginal rate income tax.

The so-called "classical" system of corporate taxation in the United States, which treats corporations as separate legal entities for tax purposes, is how America has historically resolved these various questions. Unlike other business enterprises such as partnerships and limited liability companies, corporations are taxed separately on their income. Shareholders are taxed a second time on this income, but only upon its distribution in the form of a dividend. This has resulted in the double taxation of corporate income distributed to shareholders. By contrast, corporate income distributed as interest to bondholders avoids double taxation because interest is deductible as an expense. While normally this separate entity treatment results in the corporation recognizing gain on transactions between itself and its shareholders or third parties, Congress defers recognition of gain realized in certain events, such as certain mergers or contributions of appreciated property in exchange for stock, so long as the shareholders in the aggregate do not cash out their investments to any substantial degree.

Observers have long criticized this system on the grounds that it distorts a number of individual business decisions.[8] One such decision is the choice to incorporate a business rather than operate it as a general or limited partnership, a limited liability company, or a sole proprietorship. Recent estimates suggest that investments in incorporated businesses face an effective tax rate of around 30 percent whereas noncorporate businesses only pay an effective rate of

8. *See, e.g.*, Gary Clyde Hufbauer & Paul L. E. Grieco, Reforming the U.S. Corporate Tax 1 (2005) (noting that the tax is "riddled with distortions and inequities").

20 percent,[9] with the double taxation of corporate income accounting for much of the difference.[10] Although there are a variety of nontax reasons a business might prefer to operate in corporate form, such as the combination of limited liability, freely transferable shares, and the noninterference of investors in management decisions, this extra tax burden may tip the balance in the other direction. Furthermore, this additional tax burden may make it more difficult for corporations to attract investors. Alternative investments, such as owner-occupied housing, for example, with an effective tax rate of only 4 percent, are potentially much more attractive after-tax.[11]

A second decision that is distorted by the current corporate tax system is the decision between retaining earnings and distributing them as a dividend. The shareholder-level tax on corporate income is only levied when the income is distributed as a dividend. Retained earnings, therefore, avoid the double tax as long as they remain in the corporate shell. That distinction potentially helps align shareholder and manager interests toward earnings retention. This does not mean that shareholders have no exit strategies for their investments or that those exit strategies are free of tax. Where a market for corporate stock exists, the shareholder can recoup the nondistributed earnings through a sale of the stock to third parties. Alternatively, the shareholder can sell the stock back to the corporation in a redemption transaction. In both cases, the transaction is typically taxable, albeit with lesser consequences. Even though the money received in either transaction theoretically represents, to some extent, the earnings of the corporation, and indeed the transfer of earnings from the corporation to the shareholder in a redemption can appear quite similar to a dividend transaction, it is only subject to capital gains tax at the shareholder level to the extent of the gain. In other words, the shareholders are allowed tax-free recovery of basis. By contrast to the sale or redemption, the entire dividend is subject to tax, historically at the much higher rates applicable to ordinary income. The 2003 enactment of a 15 percent rate on dividends to match the capital gains rate

9. *CRS Report, supra* note 7, at 30, table 9.

10. U.S. Department of the Treasury, *Treasury Conference on Business Taxation and Global Competitiveness: Background Paper* 25 (July 23, 2007).

11. *CRS Report, supra* note 7, at 30, table 9.

mitigates the rate differential problem, but still applies to the entire amount distributed rather than just the gain.[12]

This general bias in favor of retentions is exacerbated by certain non-corporate tax provisions. For instance, the domestic production deduction, which was enacted in 2004 to replace provisions prohibited as export subsidies by the World Trade Organization, effectively permits the exclusion of a percentage of a firm's net income from "qualified production activities."[13] This allows a roughly 3 percent reduction in tax rate for certain activities falling under this definition, including manufacturing and construction. In the case of corporations, this means that even though the top corporate and individual rates are both currently 35 percent, the actual corporate rate is still lower. Shareholders in firms qualifying for the deduction therefore have a further incentive to allow the corporation to reinvest the profits in the qualifying activities rather than distributing them in a dividend where they would not only be subject to an individual-level tax, but the earnings on such profits would be subject to a higher rate than at the corporate level. Similar incentives exist in firms with large amounts of assets that qualify for various accelerated depreciation provisions and other targeted tax breaks.

A third decision that is potentially distorted by the design of the corporate income tax is the choice between raising money with debt or equity. Because dividend payments are subject to two layers of tax, whereas interest payments are only subject to one because of the deduction available at the corporate level, the tax burden on debt is much less than the tax burden on equity. Indeed, although the Treasury estimates that equity is taxed at an effective rate that is approximately 40 percent, debt has a negative tax burden of minus 2 percent.[14] The Congressional Budget Office found a similar spread between the effective tax rates on debt and equity on slightly different numbers.[15] This disparity encourages overreliance on debt, which subjects corporations to an excessive risk of bankruptcy and other

12. I.R.C. § 1(h)(11).

13. I.R.C. § 199.

14. *CRS Report*, *supra* note 7, at 30, table 9.

15. Congressional Budget Office, *Taxing Capital Income: Effective Rates and Approaches to Reform* (Oct. 2005).

00-Bank-Intro.indd xiv 1/19/2010 6:12:39 PM

financial difficulties. Moreover, overleveraging reduces a firm's flexibility to adapt to changing economic circumstances.

Some have countered these criticisms by suggesting that the corporate income tax supplements the progressivity of the individual income tax system by targeting wealthy shareholders.[16] This argument, however, is difficult to sustain. It depends on the incidence of the corporate income tax. Because the corporation is just a legal fiction, an actual human being must ultimately bear the burden of the tax. If the corporate income tax is borne by its owners in the form of lower dividends, and those owners are generally upper-bracket taxpayers, then the tax serves as an indirect surtax on those wealthy shareholders. If, conversely, the tax is shifted to the firm's employees in the form of lower wages, to its customers in the form of higher prices, or to its vendors in the form of reduced payments for goods, then the tax is more likely to be regressive. The traditional understanding, set forth in Arnold Harberger's seminal work on the subject, is that the tax falls on the capital of the corporation, at least in the short run.[17] The notion is that in a closed economy, prices and wages are already set to maximize profits and thus the tax cannot be shifted to either of these places without hurting bottom-line profits. This result relies on several questionable assumptions,[18] but perhaps the most criticized is the assumption of a closed economy, or an economy in which investment stops at the national borders.[19] This has led Harberger himself to conclude that, in the long run,

---

16. See Jeffrey L. Kwall, *The Uncertain Case Against the Double Taxation of Corporate Income*, 68 N.C. L. Rev. 613 (1990).

17. Arnold C. Harberger, *The Incidence of the Corporation Income Tax*, 70 J. Pol. Econ. 215 (1962).

18. *See* William A. Klein, *The Incidence of the Corporation Income Tax: A Lawyer's View of a Problem in Economics*, Wis. L. Rev. 576, 581–87 (1965).

19. John Mutti & Harry Grubert, *Corporate and Personal Taxation of Capital Income in an Open Economy* 1 (U.S. Department of Treasury Office of Tax Analysis, Paper No. 55, 1984); Laurence Kotlikoff & Lawrence Summers, *Tax Incidence, in* 2 Handbook of Public Economics (Alan Auerbach & Martin Feldstein eds., 1987). There are, however, questions as to the true "openness" of the global economy. *See* Joel Slemrod, *Effect of Taxation with International Capital Mobility, in* Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax 115, 117 (Henry J. Aaron et al. eds., 1988).

the burden is borne by labor rather than capital.[20] Some disagree, suggesting that capital still bears the burden in an open economy,[21] but the question is far from settled.[22]

Others have suggested that the corporate tax is useful as a device for regulating the corporation. From the very earliest history of the corporate income tax, people have praised its ability to serve as a tool to regulate the corporation. Proponents of a corporate income tax in 1894 predicted that one of its benefits would be the "salutary" influence it would have on corporations by establishing a means of federal oversight.[23] Some have argued that this was one of the motivating factors when a corporate excise tax was adopted in 1909.[24] At the time, President Taft noted that one of the merits of the tax was "the federal supervision which must be exercised in order to make the law effective over the annual accounts and business transactions of all corporations."[25] During the New Deal, President Roosevelt and Congress tried to implement that ideal, embarking on an ambitious campaign to change corporate behavior through reform of the corporate tax.

The recent spate of corporate scandals and government bailouts has led to a revival of the regulatory justification for the corporate

20. Arnold C. Harberger, *The ABCs of Corporation Tax Incidence: Insights into the Open-Economy Case, in* Tax Policy and Economic Growth 51–52 (American Council for Capital Formation, 1995); Arnold C. Harberger, *The Incidence of the Corporation Income Tax Revisited*, 61 Nat'l Tax J. 303 (2008).

21. Jane G. Gravelle & Kent Smetters, *Who Bears the Burden of the Corporate Tax in an Open Economy?* (NBER Working Paper Series No. 8280, May 2001).

22. *See* Joel Slemrod, *Professional Opinions about Tax Policy*, 48 Nat'l Tax J. 121 (1995) (reporting that, in a survey of 100 members of the National Tax Association, more than half thought the incidence of the corporate tax fell on labor or consumers); Stephen J. Entin, *Tax Incidence, Tax Burden, and Tax Shifting: Who Really Pays the Tax?* Tax Notes, Dec. 13, 2004, at 1549, 1567–69.

23. William L. Wilson, *The Income Tax on Corporations*, 158 N. Am. Rev. 1, 7 (1894).

24. Reuven S. Avi-Yonah, *Corporations, Society and the State: A Defense of the Corporate Tax*, 90 Va. L. Rev. 1193, 1218 (2004); Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, Ind. 66 L. J. 53, 99 (1990).

25. 44 Cong. Rec. 3344 (1909) (message from President Taft).

00-Bank-Intro.indd xvi 1/19/2010 6:12:39 PM

income tax.[26] According to the argument, the regulation is justified not by virtue of the benefits created by the state, which are no longer unique or significant, but by the power managers exercise over the substantial accumulation of wealth held by corporations.[27] In another variant on this regulatory argument, the corporate tax is considered beneficial on corporate governance grounds because it reduces the agency costs inherent in the face of diverse shareholder tax profiles.[28] The notion is that in the absence of the application of an entity-level tax set at rates unrelated to those of its shareholders, the managers, who often are themselves shareholders, will be inclined to act in a manner most consistent with their own tax circumstances or with the circumstances of the group most willing to support them.

There are several problems with justifying the corporate tax because of its ability to regulate corporate managers. First, while there have been modern attempts to use the corporate tax for explicitly regulatory purposes, they have largely been unsuccessful, such as the attempt to encourage performance-based executive compensation by restricting the deductibility of non-performance-based compensation.[29] Second, the regulatory rationale suffers from the same defects as the shareholder rationale with respect to incidence. If corporate managers effectively shift the incidence of the corporate tax elsewhere or avoid the tax altogether through planning or entering into corporate tax shelter schemes, then the corporate tax may do little to reduce the amount of wealth under corporate control.

The latter concern about corporate tax avoidance provides more fuel for those who contend that the current system for taxing business enterprises is "broken."[30] The reality is that the corporate income

---

26. Avi-Yonah, *supra* note 24, at 1218.

27. *Id.*

28. Hideki Kanda & Saul Levmore, *Taxes, Agency Costs, and the Price of Incorporation*, 77 Va. L. Rev. 211, 227–33 (1991); Joseph A. Snoe, *The Entity Tax and Corporate Integration: An Agency Cost Analysis and a Call for a Deferred Distributions Tax*, 48 U. Miami L. Rev. 1, 22–28 (1993)

29. Steven A. Bank, *Devaluing Reform: The Derivatives Market and Executive Compensation*, 7 DePaul Bus. L.J. 301, 302 (1995) (describing Section 162(m)).

30. *See, e.g.*, Daniel N. Shaviro, *Principles for Comprehensive Income Tax Reform*, Testimony before the United States Senate Committee on Finance, Apr. 15, 2008; Jason Furman, *Corporate Taxes, in Need of Reform*,

00-Bank-Intro.indd xvii 1/19/2010 6:12:39 PM

tax as a part of the federal revenue system has been on the decline for at least the last half century. Taxes on corporate income and profits, which accounted for approximately one-third of federal revenues and 5.6 percent of gross domestic product after World War II, were only 7 percent of federal revenues and 1.2 percent of gross domestic product (GDP) at the end of 2003.[31] Whereas an increase in corporate profits between 2003 and 2006 led to the largest three-year increase in corporate tax receipts in the last fifty years, the percentage of federal revenues remained between 10 and 15 percent.[32] Some of this decline is attributable to aggressive use of domestic and off-shore tax planning devices, but the increase in popularity of pass-through entities such as partnerships, limited liability companies, and corporations electing to be taxed similarly under Subchapter S of the Internal Revenue Code may have been the most significant factor.[33] Moreover, a recent report of the General Accounting Office found that close to 60 percent of all corporations paid no tax at all between 1998 and 2005.[34]

Notwithstanding its decline in relative importance, the corporate tax remains a meaningful source of revenue. Although a few may suggest that we should let it disappear through self-help measures, most advocate one of a variety of reform proposals that have circulated over the years. These fall into one of three categories. The first and most radical type of reform proposal has been to replace the corporate income tax with some alternative source of revenue. As far back as 1921, there were serious proposals to repeal the corporate

---

WASHINGTONPOST.COM, Oct. 27, 2007, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2007/10/26/AR2007102601860.html (last visited November 19, 2009); Henry J. Paulson, *Our Broken Corporate Tax Code*, WALL ST. J., July 19, 2007, at A15.

31. Jane G. Gravelle, *The Corporate Tax: Where Has It Been and Where Is It Going?*, 57 NAT'L TAX J. 903 (2004).

32. *2008 Economic Report of the President*, table B-80, *available at* http://www.gpoaccess.gov/eop/ (last visited November 19, 2009); Martin A. Sullivan, *Despite Rapid Growth, Corporate Tax Receipts Fall Short*, TAX NOTES, July 17, 2006, at 216.

33. U.S. Department of the Treasury, *Treasury Conference on Business Taxation and Global Competitiveness: Background Paper* 13–14 (July 23, 2007).

34. General Accounting Office, *Comparison of the Reported Tax Liabilities of Foreign- and US-Controlled Corporations,* 1998–2005 (July 2008).

00-Bank-Intro.indd xviii 1/19/2010 6:12:39 PM

income tax and replace it with a general sales tax, although this was part of a general proposal to repeal the income tax. A narrower modern version of this is the business activities tax (BAT). This proposal, which was recently examined by Treasury,[35] would substitute a form of consumption tax for the corporate income tax. Under the BAT, firms would be taxed on their gross receipts and be allowed a deduction for their purchases of goods and services from other businesses. Because dividends and interest would neither be taxable nor deductible, the tax would not affect the capital structure of the firm or the dividend decision, although special rules would likely be required to prevent the use of the corporations as a tax shelter for accumulated earnings. Moreover, because it would apply to all businesses, rather than just corporations, there would be no effect on the incorporation decision. It would effectively be an expansion of the approach already available with immediate expensing under the accelerated depreciation system.

A more modest type of reform proposal that has been forwarded in many different incarnations over the years is one that seeks to broaden the corporate base and reduce the rate. One version of this approach, similar to that employed in the Tax Reform Act of 1986, advocates the repeal of targeted tax breaks such as accelerated depreciation provisions, investment tax credits, and other special interest driven provisions in favor of across-the-board reductions in the corporate tax rate. Other potential targets in a base broadening reform include repealing the manufacturers' deduction discussed earlier or adopting methods to combat corporate tax shelters, such as codifying the judicial economic substance doctrine or requiring book and tax conformity in the calculation of income. Although most of these provisions are available to all businesses, they are primarily used by corporations, costing the government billions of dollars annually. For example, the manufacturing deduction is expected to cost $258 billion over the next ten years, $210 billion attributable to corporations.[36] Similarly, all but $1 billion of the $132 billion ten-year cost to the government from the research and experimentation (R&E)

35. Office of Tax Policy, U.S. Department of Treasury, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century* (Dec. 20, 2007).

36. *Id.* at 48, table 3.1.

00-Bank-Intro.indd xix 1/19/2010 6:12:39 PM

credit is expected to come from corporations.[37] This base-broadening approach has the benefit of offering revenue neutrality, while reducing distortions between different industries or assets and allowing the United States to be more competitive at least on statutory rates.

Critics of a base-broadening approach suggest that the reduction in targeted tax benefits such as accelerated depreciation could negate any economic advantages associated with the lower rates. The Treasury's Office of Tax Policy suggests that much of the incentive for new investments could be lost if the three largest tax benefits—accelerated depreciation, manufacturing production deduction, and the R&E credit—were repealed.[38] Even a rate reduction alone, however, could reduce some of the disparities between debt and equity and between different asset classes simply by reducing the value of the differential treatment.[39] Some also contend that this approach has the ability to actually increase federal revenues from the corporate income tax, citing the inverse relationship between a country's statutory tax rate and the percentage of corporate tax revenues as a share of the country's GDP.[40]

A third type of reform that occupies a middle ground is the integration of the corporate and individual income taxes. Integration, which typically involves partially or fully eliminating the second layer of tax on either the corporate or shareholder side, would generally resolve many of the distortions currently caused by the corporate income tax system. The bias in favor of debt would likely be eliminated if dividends weren't subject to a second layer of tax, whereas the bias in favor of retained earnings would at least be reduced unless individual income tax rates were set significantly higher than corporate income tax rates. In the latter situation, there would still be an incentive for the corporation to retain and reinvest the earnings so any income would be subject to tax at the lower corporate rate. Similarly, the preference for noncorporate enterprises would be reduced as long as the differential between the income and corporate

37. *Id.*

38. *Id.* at 48.

39. Alex Brill, *Corporate Tax Rates: Receipts and Distortions*, TAX NOTES, Dec. 22, 2008, at 1421, 1424.

40. *Id.* at 1423.

tax rates was not raised to equal the current differential between the double tax and the individual rate.

Over the years, a variety of integration methods have been proposed. The most extreme, and the one that would actually eliminate the distortions caused by the corporate income tax, would make the corporate income tax a pass-through system. This would effectively be the same as repealing the corporate income tax. It could be replaced by expanding subchapter S to cover all corporations, which would be a parallel form of pass-through system, or by subjecting corporate income to subchapter K, which is the pass-through system in place for partnerships and limited liability companies. Few, however, suggest that such a widely applicable pass-through approach would be feasible. Although it was suggested in 1917 soon after the income tax was enacted, the difficulty in administering such a tax for the modern widely held corporation with its complicated capital structures has always dictated against such an approach. As an alternative, some have suggested subjecting only smaller corporations to the pass-through treatment and taxing the owners of publicly traded corporate stock on a mark-to-market basis.[41] This would force shareholders to recognize income on the increase in value of their shares each year (and permit them to recognize loss on the decrease in value in a down year). Because of the potential for such a tax to distort the decision to retain or hold a share of stock, this alternative has gained no traction.

A second method of integrating the corporate and individual income taxes is to provide a deduction for dividends. This would make dividend payments on par with interest payments, negating the distortion in favor of debt over equity. One difficulty with this approach, and why it has not been adopted in countries with integrated systems, is that it makes it more complicated to collect tax from tax-exempt shareholders or foreign shareholders. In the modern corporation, both types of tax indifferent shareholders hold

---

41. *See, e.g.*, Joseph M. Dodge, *A Combined Mark-To-Market and Pass-Through Corporation-Shareholder Integration Proposal*, 50 TAX L. REV. 265 (1995); Michael S. Knoll, *An Accretion Corporate Income Tax*, 49 STANFORD L. REV. 1 (1996); Victor Thuronyi, *The Taxation of Corporate Income—A Proposal for Reform*, 2 AM. J. TAX POL'Y 109 (1983); David Slawson, *Taxing as Ordinary Income the Appreciation of Publicly Held Stock*, 76 YALE L.J. 623 (1967).

major stakes. Thus, it would convert a double tax system into a no tax system.

A third method that addresses some of the deficiencies of the dividend deduction method is a shareholder credit system. The corporation pays a tax on its income and shareholders receive a credit equal to the amount of tax that it would have paid in the absence of the credit on the income distributed as a dividend. This ensures that one layer of tax is collected at the corporate level while shareholders pay tax at their own marginal rates and receive a credit in the amount of the corporate tax. If the credit is set at the amount of tax paid at the corporate level, regardless of the amount that would have been due from the shareholder at his or her applicable marginal rate, then it becomes a shareholder imputation system. Under an imputation system, the corporate tax operates as a withholding system for the individual income tax. If fully implemented, then the shareholder credit is refundable to the extent that bit exceeds the shareholder-level tax that would otherwise be due. The logic is that if the shareholder would owe no tax if the income had been earned directly, it should not owe any tax just because the income has been earned through a corporation that has a higher marginal tax rate.

A fourth method, and the only one to be used in the United States to any extent, is a dividend exclusion system. This approach was first used in 1954, when a $50 exemption was enacted that later rose to $100 before being repealed in 1986. In a variant on this approach, dividend income was subject to the preferential capital gains rate rather than the ordinary income rate under legislation enacted in 2003. From a horizontal equity perspective, a system of fully or partially excluding dividends is less preferable that the shareholder credit method. Shareholders with lower marginal rates than the corporate rate bear a greater burden than shareholders with rates that exceed the corporate rate. Moreover, tax-exempt shareholders or those who would otherwise owe no tax end up being taxed once when they would have not been taxed at all if they had earned the income directly. Nevertheless, this system is the easiest to administer and the most politically feasible, especially when the exemption is only partial relief.

***

This book does not aim to refute the criticisms of the corporate tax or to endorse any particular reform. Rather, it attempts to provide

historical context to help explain why the system evolved as it did. This includes examining the economic and political pressures, as well as the special interest lobbying, that helped determine the direction of the tax during critical junctures in the last century. The focus is on structural developments in the corporate tax itself, rather than changes to the income tax generally that affect corporations, such as the advent of accelerated depreciation or the availability of certain credits in the 1970s and 1980s, although such broader developments sometimes help explain the need or demand for structural change for the corporate tax. Less attention is also given to broadly applicable judicial developments that may have affected the enforcement of the corporate income tax, such as the use of the economic substance and business purpose components of the general substance over form doctrine to combat corporate tax shelters in the 1990s and early 2000s. Notably, General Utilities and its 1986 repeal, which ended integration for property dividends, is only discussed briefly in the Conclusion. The primary emphasis is on developments in the first half of the twentieth century that helped establish the corporate tax structure and the dilemmas posed by this structure, while the book ends with a brief look at the modern situation to demonstrate the continuing relevance of this history. By understanding the contingent and nuanced history of the corporate income tax we may learn to make sense of what otherwise currently seems like an incoherent and arbitrary tangle of laws and regulations and to identify what pressures could help to determine the future direction of business taxation.

Not everyone would agree that the corporate income tax developed in response to historical developments. Former Harvard Law School Dean Robert Clark famously concluded that corporate income tax is the product of "a few basic decisions" made when the tax was first enacted.[42] According to Clark, the corporate tax system effectively had "its major traits determined by a set of genes fixed in its infancy," rather than developing "in a passive, mechanistic way, its important parts constantly shaped and reshaped in response to the shifting

42. Robert Charles Clark, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 YALE L.J. 90, 92 (1977). Clark discussed seven fundamental choices in all, several of which have been reversed in the thirty years since he wrote his article. *Id.* at 97–130.

pressures of a changing environment."[43] From this perspective, the tax developed in reaction to endogenous pressures—its own internal logic borne of the decisions made at the outset—rather than a reaction to exogenous pressures that arose through the years from changing circumstances. Clark went so far as to suggest that the evolution of the corporate income tax could be described and explained "without reference to changing political or economic conditions."[44]

Clark's characterization of the corporate income tax is accurate and at the same time simplistic. It is accurate in the sense that the corporate tax system derives from a few fundamental principles. These principles help to dictate much of the remaining structure for the system and help to differentiate it from other methods of taxing corporate income. Although some later developments have blurred the lines implicit in some of these principles, such as the advent of new forms of corporate-like enterprises on the state level or the introduction of new financial instruments that are hybrids between debt and equity, the existence of such lines still drives the tax treatment under the system.

It is simplistic, however, in the sense that it suggests the system is a coherent product of a set of initial choices. The corporate income tax was neither created in one day nor did it develop along one inevitable path. The modern corporate income tax and its fundamental guiding principles have evolved over the last century in large part in response to the various difficulties in taxing corporate income. Sometimes this was the result of deliberate decisions in a time of heightened concern about one aspect of the problem of corporate taxation. Other times, however, it was an unintended consequence of a reaction to a particular set of circumstances. In both cases, path dependence and a desire for stability and predictability helps to explain the continued adherence to such modifications long after the circumstances that gave rise to them have passed.

***

The book's title—*From Sword to Shield*—serves as a metaphor for the transformation that took place in taxing corporate income in the early twentieth century, and much of the book is focused on the

43. *Id.* at 90.
44. *Id.* at 94.

quandary faced by lawmakers during the last century as a result of this transformation. As seen in the first several chapters of the book, corporations distributed most of their earnings annually during the nineteenth and early twentieth centuries, and taxation at the corporate level was seen as a method of facilitating the collection of an individual income tax in the Civil War-era and again toward the end of the century. This naturally permitted a level of integration between the corporate and shareholder-level taxes, with the corporate tax effectively serving as a sword against shareholder evasion. As corporate practice changed and retained earnings became more common, however, Congress was faced with a dilemma when the income tax became a more prominent revenue source in World War I. A pass-through approach applied to a corporation that possessed both the power and the will to retain its earnings was problematic. On the one hand, it could prejudice minority shareholders by forcing them to pay tax on earnings that they were powerless to cause to be distributed. On the other hand, it could induce corporations to distribute earnings at a time when the country needed them to invest such earnings in growing their businesses, particularly during a postwar recession. The dramatic increase in individual rates during the war had only served to make more salient this potential concern. At the same time, failing to subject shareholders to the individual income tax on corporate profits until those profits were distributed as a dividend risked deferring taxation indefinitely. The development of the separate corporate income tax prevented indefinite deferral by subjecting corporate income to current taxation, but shielded corporations from the higher marginal rates often applied at the individual level by subjecting corporations to a separate rate structure.

The corporate income tax's transformation from a sword against shareholders to primarily a shield for corporate earnings created a fundamental problem for lawmakers. This problem, which has received more attention among corporate scholars than tax scholars, is the difficulty Congress and the Treasury face in trying to balance the traditional corporate governance concerns about excessive external and internal expropriation.[45] The concern about excessive external

---

45. *See* Naomi R. Lamoreaux, *Scylla and Charybdis? Some Historical Reflections on the Two Basic Problems of Corporate Governance*, 83 Bus. Hist. Rev. 9 (2009).

expropriation is that the government will take too much from the corporation through taxation and thereby cripple its ability to serve as an engine of growth. This is sometimes expressed as a concern about killing the goose that lays the golden eggs, but it goes beyond the problem of high tax rates and naked expropriation. Levying high tax rates on any business may dissuade it from operating, but corporations are uniquely designed to accumulate retained earnings for large-scale investments that would otherwise be difficult to fund.[46] Interfering with the capital lock-in function associated with the board's control over dividends therefore could have a larger ripple effect on the economy.

The corporate governance concern about excessive internal expropriation is that managers will take too much from the corporation or will divert its profits to nonproductive uses. If corporate managers are shielded from excessive taxation because of the concern about external expropriation, they may be equally shielded from shareholders or other corporate monitors. Thus, for example, the availability of a separate and lower rate structure and additional deductions and credits at the entity level may increase the amount of funds left in the corporation. The second and higher layer of tax at the shareholder-level may provide a disincentive for shareholders to demand higher dividends or to investigate further a board's decision to reinvest profits in the business. Furthermore, the divergent treatment of certain items for tax and accounting purposes may limit transparency and the use of corporate tax shelter transactions to shield even more of a corporation's earnings from taxation may exacerbate this lack of transparency.[47] All of this helps to facilitate internal expropriation by the managers themselves. Indeed, managers may be influenced to lobby in favor of large rate differentials, double taxation, and reduced transparency to enhance the conditions for internal expropriation.

One element that has exacerbated this dilemma over excessive internal and external expropriation has been the fluctuation in the

---

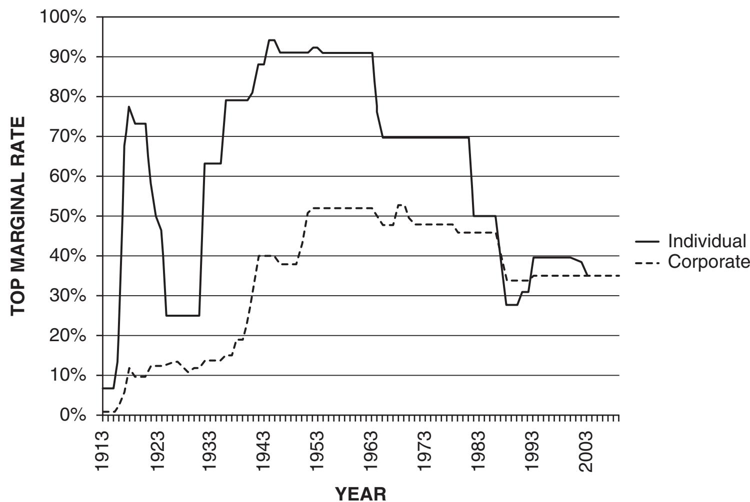
46. Lynn A. Stout, *On the Nature of Corporations*, U. Ill. L. Rev. 254 (2005); Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. Rev. 387, 390 (2003).

47. See Daniel N. Shaviro, Decoding the U.S. Corporate Tax 175 (2009); Mihir A. Desai and Dhammika Dharmapala, *Corporate Tax Avoidance and Firm Value*, 91 Rev. Econ. & Stat. 537 (2009).

individual and corporate tax rates over the last century. As illustrated in Figure 1, the top marginal rates for the two taxes diverged by as much as fifty percentage points at various times during this period, with the individual income tax soaring as high as 94 percent during World War II and remaining at 91 percent through the early 1960s. Although the top individual rate has typically exceeded the top corporate rate, the two rates inverted in 1986, which changed much of the conventional wisdom regarding the effects of the corporate tax on business behavior. More recently, the rates have converged, although corporate tax preferences such as the domestic production deduction for manufacturers have lowered the corporate effective rate below the individual rate for many firms. Much of this rate variability has been the result of exogenous factors such as wars, economic crises, and changes in political leadership.

The heterogeneity of corporate taxpayers has exacerbated the effect of this rate variability. This extends to differences in capital needs, age, and assets. For example, newer firms are more likely to experience heavy losses in the first few years, making the availability

FIGURE 1 TOP MARGINAL RATES, 1913–2009



Note: During the years in which there were both “normal” and “surtax” rates, the figure reflects the top combined rate.

of loss carryforward provisions critical. By contrast, traditional established firms are likely to have more retained earnings from previous years, making the tax rules governing distributions most important. Additionally, growth firms with heavy capital requirements are likely to prefer to retain earnings for future expansion, making rules governing the gain on sale of stock more critical as that is the most likely exit option for stockholders. This heterogeneity may help explain much of the differential responses of corporations to the various integration proposals forwarded over the years.[48]

As will be seen in the subsequent chapters of this book, the balancing of the concerns about excessive external and internal expropriation that resulted from the corporate income tax's transformation from a sword to a shield is at the center of the history of the modern corporate income tax. During the postwar period and throughout the 1920s, Congress was preoccupied with guarding against excessive external expropriation. The development of the tax-free reorganization provisions for corporate mergers and acquisitions reflects this concern. On the one hand, such transactions were realization events and, at a time when taxpayers were arguing that noncash consideration or capital gains were not taxable, Congress was wary of looking the other way. On the other hand, these transactions were considered necessary and beneficial to the postwar recovery and growth of the economy. Taxing them could stifle such transactions. Thus, Congress elected to reaffirm that mergers and acquisitions were realization events subject to taxation, but deferred recognition of any gains on transactions in which a sufficient continuity of ownership remained in the surviving enterprise.

By the 1930s, the attention shifted to concerns about excessive internal expropriation. As President Roosevelt and Congress searched for the causes of the Crash and ensuing Depression, they focused on regulating corporate governance. Tax became one of the most frequently called upon tools in the government toolbox. The tax-free reorganization provisions were narrowed, corporate holding

48. *See, e.g.*, Michael Doran, *Managers, Shareholders, and the Corporate Double Tax*, 95 Va. L. Rev. 517, 523 (2009); James Poterba, *Taxation and Corporate Payout Policy*, 94 Am. Econ. Rev. 171, 175 (2004); Alan J. Auerbach & Kevin A. Hassett, *On the Marginal Source of Investment Funds*, 87 J. Pub. Econ. 205, 228–29 (2002).

00-Bank-Intro.indd xxviii 1/19/2010 6:12:40 PM

companies were targeted with unfavorable tax treatment, and retained earnings were subject to an undistributed profits tax. All of these measures reflected the growing concern that the liberal taxation of corporations had contributed to the crisis by allowing managers to operate in an unfettered manner. The belief was that the corporate tax was being used by corporate managers to shield them from active monitoring and restriction of their behavior.

This balancing act between concerns about the government and concerns about corporate managers has continued to influence corporate tax policy for much of the past century. After World War II, the focus was on making sure the corporate tax did not hinder business activity. Among other measures employed to respond to this concern, Congress permitted accelerated depreciation while adopting elective pass-through treatment for small business corporations. By contrast, more recently, Congress has vacillated between concern about corporate scandals and corporate tax shelters, on the one hand, and concerns about jobs and the competitiveness of American businesses on the other. Thus, Congress adopted a limit on the deductibility of nonperformance based executive compensation after reports about excessive compensation in the early 1990s and considered codifying the economic substance doctrine as a means of shutting down corporate tax shelters in light of the revelations in the Joint Committee on Taxation's Enron Report.[49] Even the adoption of dividend tax relief in 2003 was at least publicly justified as a way to enhance transparency by forcing corporations to focus on making and distributing real profits.[50] Amid the economic crisis in 2008, however, bipartisan attention was directed at reducing the statutory corporate rate and offering opportunities for firms to immediately deduct capital investments. In one particularly striking example of the push to ease

49. Bank, *supra* note 29, at 302; Staff of Joint Comm. on Tax'n, 108th Cong., Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations (2003), *available at* http://www.gpo.gov/congress/joint/jcs-3-03/vol1/index.html; Samuel C. Thompson, Jr. and Robert Allen Clary II, *Coming in From the 'Cold': The Case for ESD Codification*, 99 Tax Notes 1270 (May 26, 2003).

50. See Steven A. Bank, *Dividends and Tax Policy in the Long Run*, U. Ill. L. Rev. 533, 538–39 (2007).

corporate tax restrictions on business activity, rules originally adopted in 1986 to limit the abuse of loss carryforward provisions in corporate acquisitions were modified temporarily to facilitate the rescue of failing banks and other corporations.[51] Corporate tax policy is likely to continue to be shaped by the changing concerns over these issues for the foreseeable future.

***

This book is the culmination of more than a decade's work on the origins and evolution of the corporate income tax and many of its central features. Several of the chapters draw substantially upon this body of work, including articles published in the *Georgetown Law Journal*, the *Illinois Law Review*, the *North Carolina Law Review*, the *Tax Law Review*, the *Tulane Law Review*, the *Washington & Lee Law Review*, and the *William & Mary Law Review*. Through the passage of time and the accumulation of knowledge, I have been able to develop a more comprehensive and nuanced picture of this subject than I presented in my earlier papers. As a result, this book fills in much of the various gaps in the story from my previous works, including offering new examples and analysis and extending the story through the modern day, while tying it all together in a way that is both clarifying and new.

As with any project of this length, I owe a debt of gratitude to many individuals for help in conceiving it and bringing it to fruition. Over the years, my earlier work and earlier versions of several of the chapters in this book have benefited from the advice and suggestions of numerous individuals, including Reuven Avi-Yonah, Stephen Bainbridge, Joseph Bankman, Brian Cheffins, Beth Garrett, Bill Klein, Marjorie Kornhauser, Leandra Lederman, Ajay Mehrotra, Peter Oh, Kirk Stark, Lynn Stout, Joseph Thorndike, Dennis Ventry, Larry Zelenak, and Eric Zolt. The project was also enriched by discussions at faculty workshops held at Berkeley, Cambridge, Case, Florida State, George Washington, Harvard, Houston, Indiana, Michigan, Northwestern, NYU, Tel Aviv, UC Davis, UCLA, Vanderbilt, and Texas and at conferences and symposia such as the Stanford-Yale Junior Faculty Forum, the Duke Journal of Law and Contemporary

51. Notice 2008–83, 2008–42 I.R.B. 905; Karyn Bybee Friske & Darlene Pulliam, *Sec. 382 After the Bailout*, 40 THE TAX ADVISOR 372 (2009).

Problems' Symposium on Turning Points in the History of the Federal Income Tax, the UCLA and Cambridge Tax History Conferences, the Critical Tax Theory Conference, and the annual meetings of the American Society for Legal History, the Southeastern Association of American Law Schools, the Central States Law School Association, and the Association of American Law Schools. The editors at Oxford University Press and three anonymous reviewers also provided helpful comments on the manuscript.

As is true with most historically oriented books, some of the most significant contributions were made by those who assisted in the research of this project. Reference librarians at both UCLA and Florida State were patient and thorough in responding to my inquiries and always managed to obtain the hard-to-obtain sources. Archivists at the Hoover Institution Library and Archives at Stanford University and the Center for American History at the University of Texas offered their hospitality and help in locating crucial documents at a key point in the project's development. Finally, a number of student research assistants contributed significantly to the project, most notably Michael Barry, Paul Berk, Drew Capurro, Mirit Eyal-Cohen, Bruce Fraser, David Martin, Shane Noworatzky, Normarie Segurola, and Jacob Veltman.

00-Bank-Intro.indd xxxii 1/19/2010 6:12:40 PM