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To: Participants of the Ostrom Workshop

From: Ajay K. Mehrotra

Date: March 22, 2015

Re: Workshop Paper and Presentation

Thanks in advance for the opportunity to present, and get feedback on, the attached co-authored paper (with Steven Bank). This paper is an early draft of a chapter to be included in a manuscript for an edited volume on "The Corporation and American Democracy" (eds. Naomi Lamoreaux and Bill Novak). In my brief presentation time, I'll elaborate on the larger project of which this paper is a part.

One of the overarching themes of the edited volume is to explore the historical role of business corporations in the development of American democracy. As you'll see, our paper attempts to contribute to that theme by investigating the relationship between corporate taxation and American democracy in the first half of the twentieth century. Steve and I would welcome comments and suggestions that can help us underscore the democratic aspects in the development of corporate tax laws and policies. Thanks.

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Corporate Taxation and the Regulation of Early Twentieth-Century American Business

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Abstract:

In the early twentieth century, the taxation of modern business corporations became increasingly important to the development of American democracy. During that time, governments at all levels began to view business corporations not only as sources of badly needed public revenue, but also as potentially dangerous wielders of concentrated economic power. To combat the growing dominance of corporations, many fiscal reformers sought to use corporate taxation as a mode of regulatory governance. This paper explores the motives and intentions of fiscal reformers during critical junctures in the development of early twentieth-century U.S. corporate taxation. It seeks to explain how changing historical conditions shaped corporate tax law and policy. More specifically, this paper investigates why activists at certain times turned to taxation as a mode of corporate control, and why at other times they used tax policy to promote corporate growth. By focusing on the pivotal ideas and actions of key political economists, social commentators, and lawmakers, this paper attempts to answer the question: why did reformers see taxation as a viable form of public control over corporate power?

We argue that the corporate tax emerged and developed as a result of competing factions and changing social, political, and economic conditions. During the height of corporate consolidations, some reformers believed taxation could be used to control, or even reverse, the growth of corporate size and power. In the wake of corporate scandals, the government's collection and possible publicity of corporate information was seen as one specific way to regulate and discipline large-scale industrial corporations. By contrast, others saw the corporate tax as a means to encourage and foster the kind of behavior that would generate much needed economic activity and growth, especially during periods of financial crisis and economic recovery. Still others, mediating between these two extremes, sought to use the corporate tax in a supervisory capacity, while ensuring that it did not "kill the goose that lays the golden eggs." Thus, the corporate tax that developed throughout the first half of the twentieth century reflected changing visions of corporate regulation – visions that fluctuated among demands for penalty, subsidy, and neutrality.

Introduction

Throughout American history there has been a striking ambivalence toward the taxation of business corporations. On the one hand, there has been a long-standing anti-monopoly tradition that has attempted to use tax laws and policies to restrain the growth and power of business corporations. Yet, on the other hand, during particular historical moments, economic experts and government officials have also designed tax laws and policies to encourage the development of business corporations as effective engines of economic growth and prosperity. This tension between a desire to protect democratic values against the rising power of corporate capitalism and efforts to reap the material benefits of big business has come to define the early twentieth-century history of U.S. corporate tax law and policy.

Business corporations, to be sure, have long been a part of American law, economy, and society. But during the first half of the twentieth century the tension between using national tax policy to either control corporate power or facilitate its growth became increasingly pronounced. This period witnessed the accelerating rise of large-scale industrial business corporations that threatened to undermine democratic values. The tremendous size and power of the new industrial titans presaged the emergence of a new corporate plutocracy – one that could limit the ability of individual citizens to participate fully in a democratic polity. A world dominated by large business corporations left little room, or so it was believed, for participatory democracy. As a countermeasure, some lawmakers during this formative period attempted to use corporate taxation as a means of social control and restraint. Yet, the legal response was not always consistent or coherent. Some policymakers viewed the corporate tax, and particularly its collection and possible publicity of tax information, as one way to limit corporate growth, while others believed that the administrative aspects of the levy could be used to harness and manage the power of large-scale corporations. A complex set of mixed motives, in other words, shaped the early history of corporate tax laws and policies.

In this paper, we seek to disentangle the aims and intentions of fiscal reformers during critical junctures in the development of early twentieth-century U.S. corporate taxation. Our central aim is to explain how changing historical conditions have shaped corporate tax laws and policies over time. More specifically, this paper investigates why activists at certain times turned to taxation as a mode of corporate control, and why at other times they used tax policy to promote corporate growth. By focusing on the pivotal ideas and actions of key political economists, social commentators, and lawmakers, this paper attempts to explain how and why reformers saw taxation as a viable form of public control over corporate power.

We argue that the corporate tax emerged and developed as a result of competing factions and changing social, political, and economic conditions. During the height of corporate consolidations, some reformers believed taxation could be used to control, or even reverse, the growth of corporate size and power. In the wake of corporate scandals, the government's collection and possible publicity of corporate information was seen as one specific way to regulate and discipline large-scale industrial corporations. By contrast, others saw the corporate tax as a means to encourage and foster the kind of behavior that would generate much needed economic activity and growth, especially during periods of financial crisis and economic recovery. Still others, mediating between these two extremes, sought to use the corporate tax in a supervisory capacity, while ensuring that it did not "kill the goose that lays the golden eggs."[1] Thus, the corporate tax that developed throughout the first half of the twentieth century reflected changing visions of corporate regulation – visions that fluctuated among demands for penalty, subsidy, and neutrality.

This paper begins in Part I with the 1909 corporate excise tax, a federal levy on the privilege of conducting business in the corporate form. Although there were earlier precedents for national corporate taxes, particularly during the Civil War and the Spanish-American War, the 1909 law became the foundation for the modern income tax. From the start, the tax was driven by a complex combination of rationales that went beyond the wartime need for revenue. The origins of the 1909 tax, in this sense, were rooted in the differing logics that would come to define twentieth-century U.S. corporate tax law and policy. The act that created the 1909 corporate tax also contained the

[1] W. Elliot Brownlee, "Social Investigation and Political Learning in the Financing of World War I," in Michael J. Lacey & Mary O. Furner, eds., *The State and Social Investigation in Britain and the United States* 330 (New York: Cambridge University Press, 1993) (quoting letter from automobile manufacturer Cleveland Dodge to U.S. Treasury Secretary William G. McAdoo, dated April 16, 1917).

constitutional resolution that would ultimately lead to the Sixteenth Amendment, empowering Congress to levy an income tax without apportionment. This initial concession to populist social groups and progressive lawmakers originally had little chance of being adopted, but it helped ensure the cooperation of those who were generally opposed to increasing the federal government's taxing powers. The beginning of U.S. corporate taxation was, thus, a result of a political compromise that attempted to strike a delicate balance between competing interests.

After exploring the varying motivations for the 1909 corporate tax and the post-Sixteenth Amendment development of corporate income taxation, this paper turns, in Part II, to the World War One tax regime. While the first corporate income tax was relatively moderate, by the time the United States entered the First World War in 1917, it had established a tax base that would soon become the source of a robust corporate income tax and innovative business taxes such as the excess profits tax. Like the levies before them, those enacted as part of the Great War represented the tension in American law and political economy over the desire to promote corporate capitalism without undermining traditional liberal democratic values.

Part III examines the 1920s to illustrate how changing political currents and a moderate post-World War I recession led to the early retrenchment of certain parts of the wartime fiscal regime. Although business secured the repeal of the excess profits tax and a broadening of favorable tax treatment for mergers and acquisitions, many advocates saw these as hollow victories. Congress' adoption of Treasury Secretary Andrew Mellon's plan for the pullback of the income tax in lieu of competing proposals to replace it with a national sales tax solidified the place of the corporate income tax in the revenue scheme. This set the stage for the New Deal, which is discussed in Part IV.

When Franklin D. Roosevelt became president, the tone and substance of corporate tax laws and policies changed dramatically. The business-friendly policies of the 1920s came to an end. And the perception that corporate growth and concentration of economic power contributed to the Crash and ensuing Great Depression led to the embrace of corporate taxation as a device for managing and controlling corporate power. Social democratic concerns about participatory democracy seemed to trump the affinity for using business corporations to revive the economy. Rather than representing a permanent shift in the use of the corporate tax, though, New Deal policies were a reflection of the pendulum swing that typified much of corporate taxation over the early twentieth century.

Ultimately, changing historical conditions profoundly affected the early development of U.S. corporate tax law and policy. During periods of growing anxiety about corporate power and abuse, the corporate tax has been used to impose a penalty or to provide oversight, while during periods of concern about stimulating the economy, the corporate tax has been used to subsidize and incentivize corporate growth and productivity. Throughout, however, reformers have viewed the corporate tax as a means of influencing business, rather than just as a method of collecting revenue. Even when moderate reformers and lawmakers have called for the tax system to remain ostensibly neutral in the affairs of big business, the corporate tax has had a significant impact in shaping corporate decision-making.

I. The 1909 Levy and the Early Development of Corporate Taxation

Even before lawmakers began considering a corporate tax in 1909, there were several broader forces and seminal events that brought tax reform and corporate regulation to the forefront of national policymaking. First among these was the accelerating growth of corporate capitalism. Indeed, between 1895 and 1904, during what scholars have dubbed "the great merger movement," U.S. manufacturing firms consolidated at a remarkable, breakneck pace due to a confluence of historical factors. During that brief period, nearly two thousand companies combined with former rivals to create some of the nation's largest industrial corporations – many of which continue to exist today.[2] Unlike previous periods of corporate growth, the turn-of-the-century merger movement hastened the institutional convergence of industrial manufacturing and finance capital. Consequently, the ownership of large business corporations gradually became

[2] Naomi R. Lamoreaux, *The Great Merger Movement in American Business, 1895–1904* (New York: Cambridge University Press, 1895); Robert L. Nelson, *Merger Movements in American Industry, 1895–1956* (Princeton: Princeton University Press, 1959); Alfred D. Chandler, Jr. *The Visible Hand: The Managerial Revolution in American Business* (Cambridge, Mass.: Harvard University Press, 1977); David Bunting, *The Rise of Large American Corporations, 1889–1919* (New York: Garland Publishing, Inc., 1987).

more dispersed among the American elite, and a spirit of financial speculation and an ideology of "shareholder democracy" began to take shape.[3]

As these large-scale industrial corporations came to dominate the American economic and political landscape, tax reformers and lawmakers took notice. Taxation, along with the rise of public utility law, became an alternative means toward restraining and managing the growth of these new corporations.[4] As other more comprehensive forms of corporate control, such as the national incorporation movement, began to wane, taxation came to the fore.[5] The growing concentration of corporations in the Northeast industrial sector provided populist tax reformers, particularly those from the agrarian South and West, with an easy target. They pointed to the wealthy shareholders and managers of the new, large-scale industrial firms as the type of individual taxpayers who had the ability and obligation to bear a growing share of the costs of underwriting a modern state. For other progressive reformers, the colossal corporations themselves were seen as sources of tax revenue and as citizens in their own right – citizens that had a social duty under the principles of fiscal citizenship to contribute to the commonwealth. For more pragmatic state-builders, the development of a "corporate-administered" phase of American capitalism provided new "tax handles" with which to assess and collect personal and business incomes.[6] As income and economic power became concentrated in large, integrated business corporations, it became easier for government authorities to

[3] William G. Roy, *Socializing Capital: The Rise of the Large Industrial Corporation in America* (Princeton: Princeton University Press,1997); Vincent P. Carosso, *Investment Banking in America: A History* (Cambridge, Mass.: Harvard University Press, 1970); Lawrence E. Mitchell, *The Speculation Economy: How Finance Triumphed over Industry* (San Francisco: Berrett-Koehler, 2007); Julia C. Ott, *When Wall Street Met Main Street: The Quest for an Investors' Democracy* (Cambridge, Mass.: Harvard University Press, 2011).

[4] On the rise of public utility law, see Novak in this volume.

[5] On the early efforts for national incorporation, see Crane in this volume.

[6] The term "tax handles" is generally associated with the work of early developmental economists. See, e.g., Richard Musgrave, *Fiscal Systems* (New Have: Yale University Press, 1969), 125; Harley H. Hinrichs, "Determinants of Government Revenue Shares among Less-Developed Countries," *Economic Journal* 75 (September 1965), 546–56. Political and economic historians have, of course, also recognized the importance of changing economic organization to the development of tax regimes. W. Elliot Brownlee, *Federal Taxation in America: A Short History* (New York: Cambridge University Press, 2003); Martin Daunton, *Trusting Leviathan: The Politics of Taxation in Britain, 1799–1914* (Cambridge: Cambridge University Press, 2001), 14–15.

identify and access sources of tax revenue. Thus, corporate and individual income became more visible and "legible" for taxing authorities.[7]

It was not only large-scale industrial firms that caught the attention of government regulators and taxing authorities. The increasing size and power of banks and insurance companies also heightened concerns that concentrated economic power could undermine democratic ideals. A series of scandals in the insurance industry, exposed by muckraking journalists and a special 1905 commission appointed by the New York Legislature, illustrated just how far certain executives were willing to go to evade existing investment regulations and to corrupt the political process. Evidence of direct payoffs of government officials and other nefarious dealings convinced many ordinary Americans that large financial interests were distorting the democratic process. For many contemporaries, these companies were afflicted with what Louis Brandeis referred to as, "the curse of bigness." With their unbridled concentration of wealth and power, they were "the greatest economic menace of today."[8]

In addition to the growing public concern over corporations, the resurgence of the protective tariff and the increasing attention to economic inequality also made corporate tax reform a pressing issue. As tariff revenue increased steadily during the first decades of the twentieth century, protectionism was once again associated with an increasing cost of living. Although the annual rate of inflation in the early 1900s was rather moderate (averaging about 2 percent annually), the perception among many ordinary Americans was that the widening scale and scope of import duties was raising the prices of the "necessaries of life," and unduly protecting domestic monopolies.[9] Because the tariff

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[7] James C. Scott, *Seeing Like a State: How Certain Schemes to Improve the Human Condition Have Failed* (New Haven: Yale University Press, 1998).

[8] Louis D. Brandeis, "The Curse of Bigness," *Harper's Weekly*, Jan. 10, 1914; Louis D. Brandeis, *Business – A Profession* (Boston: Small, Maynard & Co., 1914), 118. Morton Keller, *The Life Insurance Enterprise, 1885-1910: A Study in the Limits of Corporate Power* (Cambridge, MA: Harvard University Press, 1963), 12-14. Michael McGerr, *A Fierce Discontent: The Rise and Fall of the Progressive Movement in America, 1870-1920* (New York: Free Press, 2003), 169-174.

[9] "The Increased Cost of Living," *American Economist* (August 22, 1902), 95; Mark Aldrich, "Tariffs and Trusts, Profiteers and Middlemen: Popular Explanations for the High Cost of Living, 1897–1920," *History of Political Economy* 45:4 (2013), 693-746; Hugh Rockoff, "Banking and Finance, 1789–1914," in *The Cambridge Economic History of the United States, Vol. II The Long Nineteenth Century*, ed. Stanley L. Engerman and Robert G. Gallman (New York: Cambridge University Press, 2000), 665; Milton Friedman and Anna Jacobson Schwartz, *A Monetary History of the United States, 1867–1960* (Princeton: Princeton University Press, 1971), 152–74.

affected the price of many every day consumption items, including food and clothing, these levies imposed a greater financial burden on the poor than the rich, taking more from those who had less. The regressive incidence of customs duties also fueled concerns that the growing power of business corporations and the existing tax regime were exacerbating disparities in economic wealth and power. These distributional concerns would only multiply as corporations became more powerful and as the tariff continued to be seen as a shield protecting American monopoly power.[10]

If broader structural forces provided the critical background for the origins of the 1909 corporate tax, the triggering event came with the panic of 1907 and the ensuing economic recession. The panic began with the San Francisco earthquake of 1906, which devastated the city and its inhabitants, while setting in motion a series of events that dramatically undermined confidence in Northeastern financial institutions. As a result, hundreds of small banks throughout the country failed. Commodity prices plummeted. Imports declined precipitously. And unemployment skyrocketed. Like earlier recessions, the downturn that followed the panic compelled reformers and lawmakers to reconsider the role of the state in the economy.[11]

In the wake of the panic and subsequent recession, tax reform soon became a pressing issue. With tariff revenues declining due to the downturn, and greater attention focused on growing inequalities, lawmakers began to consider a new income tax that would make up revenue shortfalls and address the distributional impact of the existing tariff regime. Although the movement for a national income tax had been growing throughout the late nineteenth-century, it was initially defeated in 1895 by the U.S. Supreme Court, which struck down the 1894 income tax as a violation of the direct tax clause.[12] Since that time the Court had approved other types of national levies, namely an estate tax and a corporate excise tax used to finance the Spanish-American War, which

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[10] Douglas Irwin, "Tariff Incidence in the American Gilded Age," *Journal of Economic History* 67:3 ((2007), 582-607; Ajay K. Mehrotra, *Making the Modern American Fiscal State: Law, Politics, and the Making of the Modern American Fiscal State* (New York: Cambridge University Press, 2013), Ch. 5.

[11] O. M. W. Sprague, "The American Crisis of 1907," *Economic Journal* 18:71 (1908), 353–72; Robert F. Bruner and Sean D. Carr, *The Panic of 1907: Lessons Learned from the Perfect Storm* (New York: John Wiley and Sons, 2009).

[12] *Pollock v. Farmers' Loan & Trust Co.*, 158 U.S. 601 (1895).

ultimately encouraged some lawmakers to consider a new income tax that might pass constitutional muster.[13]

Even though the concept of taxing individual income was not new, the idea and process of taxing corporations remained a vexing issue throughout the late nineteenth and early twentieth centuries. Economic experts, social commentators, and lawmakers all debated the differing methods of taxing corporate wealth. "Governments are everywhere confronted by the question of how to reach the taxable capacity of the holders of [corporate] securities or of the associations themselves," explained Edwin R.A. Seligman, one of the leading tax experts of the time. "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."[14]

An equally puzzling concern for economic experts and lawmakers was who ultimately bore the burden of a corporate tax. For decades, scholars had been arguing that the incidence of a corporate levy was contingent on numerous factors and assumptions. Most agreed that differing market conditions and contexts meant that a tax on business corporations could be shifted among several different groups, including shareholders or workers or creditors or even consumers.[15] Still, despite the claims that the incidence of a corporate tax was ambiguous, lawmakers contended that shareholders would be the ultimate payers of the tax in the form of lowered dividends or diminished share prices.[16] Based on this reasoning, some lawmakers believed that corporations could be used as collection and remittance devices to get at the wealth held by the owners of large business corporations. From this perspective, corporations were simply an aggregation of individual wills – artificial legal entities created to pursue individual economic interests. And thus the corporate levy was merely a way to exploit the corporate form to get at the true targets of the tax: the wealthy individual shareholders of business corporations.

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[13] *Knowlton v. Moore*, 178 U.S. 41 (1900); *Spreckles Sugar Refining Co. v. McClain,* 192 U.S. 397 (1904).

[14] Edwin R. A. Seligman, "The Taxation of Corporations I," *Political Science Quarterly* 5:2 (June 1890).

[15] Edwin R. A. Seligman, *The Shifting and Incidence of Taxation*, 2nd ed. (New York: MacMillian, 1899 [1892].

[16] Steven A. Bank, *From Sword to Shield: The Transformation of the Corporate Income Tax, 1861 to Present* (New York: Oxford University Press, 2010).

In the spring of 1909, Senators Joseph W. Bailey (D-TX) and Albert Cummins (R-IA) proposed a new comprehensive income tax that included a levy on corporate income – a levy that was premised on the notion of using the corporate tax to target shareholder wealth. The Bailey-Cummins bill called for a 3 percent tax on all individual and corporate income above a $5,000 exemption level. To relieve low-income taxpayers from the corporate levy, the bill permitted shareholders who had income below the $5,000 threshold to apply for a refund of their portion of corporate taxes paid by the business.[17] For Cummins, the main objective of the bill was to tax corporate owners. "The corporation is simply the instrumentality for the enrichment of its stockholders," he informed fellow lawmakers, "and if the instrumentality results in conferring upon its stockholders an income above the minimum fixed by the amendment, then it should be taxed; but if that income is below the minimum, there is no more reason for imposing a tax upon it than there would be if it were derived as a salary or as profit in a real estate transaction or as the profits of a farm."[18] From this perspective, the corporate levy was not intended to be a tax on corporations *qua* corporations. Rather, the goal was to use corporations as seemingly neutral, administrative machines – as remittance vehicles to collect income from wealthy shareholders.[19]

Although the Bailey-Cummins bill was ultimately tabled, it was not long before the movement for a renewed income tax gained momentum. In a June 1909 message to Congress, President William Howard Taft helped propel the income tax campaign by proposing a corporate excise tax along with a constitutional amendment permitting an income tax without apportionment. On the campaign trail, Taft had claimed that an income tax might be constitutional, but once he became president he recognized that a direct challenge to the Court could tarnish the integrity of an institution that he revered and would later in his career join.[20] In his congressional message, Taft provided a variety of justifications for a new revenue bill. Citing to a "rapidly increasing deficit," the president called for tariff revision and the adoption of "new kinds of taxation" to help "secure an adequate income" for the growing federal government. This part of his

[17] 44 *Congressional Record* 3137 (1909).
[18] 44 *Congressional Record* 1424 (statement of Sen. Cummins).
[19] Bank, *From Sword to Shield*, [xx].
[20] Buenker *Income Tax and the Progressive Era*.

message suggested that Taft was concerned with using the new levy mainly as a source of revenue.[21]

Yet, even in this context, Taft appeared to believe that both shareholders and corporations – as separate legal entities – could be sources of tax revenue. The tax, Taft explained, imposed "a burden at the source of income at a time when the corporation is well able to pay and when collection is easy."[22] As scholars have noted, Taft's words implied two different meanings. On the one hand, the focus on sources of income and collection ease suggested that Taft believed the levy could be an effective indirect means to tax shareholder wealth.[23] At the same time, the president's reference to the corporation's "ability to pay" suggests that he also may have believed that the corporation ought to be treated as a separate legal entity, as a natural person, with its own taxpaying duties and obligations.[24]

Other parts of Taft's message were more explicit about the use of taxation as a means of corporate supervision and control. At the outset, Taft explained that the levy "is an excise tax upon the privilege of doing business as an artificial entity," and hence "not a direct tax on property." He did this, no doubt, to ensure that the excise tax would not be challenged as a violation of the Constitution's direct tax clause. Taft maintained that "another merit of this tax is the federal supervision which must be exercised to make the law effective over the annual accounts and business transactions of all corporations." He was referring to how an effective corporate tax could collect and make public vital information about the operations of large-scale business entities. Taft acknowledged that the corporate form "has been of the utmost utility in the business world," but he also reminded Congress that "substantially all of the abuses and all of the evils which have aroused the public to the necessity of reform were made possible by the use of this very faculty."[25]

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[21] S. DOC. NO. 61-98, at 1.

[22] *Id.* at 3.

[23] Bank, *From Sword to Shield*.

[24] Marjorie Kornhauser, "Corporate Regulation and the Origin of the Corporate Income Tax," *Indiana Law Journal* 66 (Winter 1990); Reuven S. Avi-Yonah, "Corporations, Society, and the State: A Defense of the Corporate Tax," *Virginia Law Review* 90 (2004). For more on the importance of "ability to pay" logic in the origins and development of the income tax, see generally, Mehrotra, *Making the Modern American Fiscal State*.

[25] S. DOC. NO. 61-98, at 3.

With the American economy and society still reeling from a financial panic linked to abuses in the banking industry and an earlier series of insurance company scandals,[26] Taft's address bolstered the progressive view of taxation as a device to curb the abuses of corporate capitalism. Indeed, the president spelled out how the tax in a "perfectly legitimate and effective" way could help the government, stockholders, and the general public gain "knowledge of the real business transactions and the gains and profits of every corporation in the country." By making the inner dealings of big businesses more transparent, the corporate tax, Taft insisted, would be a "long step toward that supervisory control of corporations which may prevent a further abuse of power."[27] Taft's many references to the public disclosure aspects of the law demonstrated that he believed the tax could be much more than merely a means of collecting and remitting taxes from wealthy shareholders.[28]

In its final form, the Tariff Act of 1909 contained a tax on the legal privilege of doing business in corporate form. In particular, the law required "every corporation, joint stock company or association, organized for profit and having a capital stock represented by shares" to pay a "special excise tax with respect to the carrying on of doing business."[29] The tax was set at an annual flat rate of one percent on net income above $5,000, and even applied to all foreign corporations engaged in business in the United States.[30] The law also contained the controversial public disclosure feature that Taft had recommended. This provision directed that all corporate tax returns "shall be filed in the office of the Commissioner of Internal Revenue and shall constitute public records and be open to inspection as such."[31] For some progressive lawmakers such as Albert Cummins this provision did not go far enough in encouraging corporate transparency. For others, like Senator Elihu Root (R-NY), the publicity provision was "exceedingly drastic and injurious." To a certain extent, then, the law reflected a political compromise between competing factions. Neither side seemed particularly pleased, but both could point to

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[26] McGerr, *A Fierce Discontent*; Keller, *The Life Insurance Enterprise*.

[27] S. DOC. NO. 61-98, at 3.

[28] Kornhauser, "Corporate Regulation and the Origin of the Corporate Income Tax."

[29] Tariff Act of 1909, ch. 6, § 38, 36 Stat. 11, 112-13.

[30] The law excluded "amounts received by [corporations] as dividends upon stock of other corporations." *Id.*

[31] Tariff Act of 1909, Ch. 6, § 38(6), 36 Stat. 11, 116.

relative achievements. The low rates placated conservative opponents of taxation and the publicity requirement, for the most part, satisfied many progressives. Eventually, however, business criticism of the publicity provision led lawmakers to limit its scope and reach. And within two years, public access to corporate returns was officially eliminated.[32]

While the publicity provision of the 1909 law was an innovative, albeit short-lived, feature of corporate taxation, the idea of taxing business corporations was hardly new. Indeed, throughout the nineteenth century, states and localities regularly taxed property held by corporations. Several subnational jurisdictions also included corporate shares as taxable personal property. Over time, however, as financial assets such as stocks and bonds became more prevalent and dispersed, it became more difficult for states and municipalities to enforce the property tax on such intangible, personal property. As a result, fiscal reformers turned to the national government and other levies to tax the wealth held in financial assets.[33]

Well before 1909, the federal government also attempted to tax business corporations to finance wars. During the Civil War and the Spanish-American War, national lawmakers experimented with several temporary corporate levies. Yet none of these early measures seemed specifically designed to capture the taxpaying ability of corporations *qua* corporations. The Civil War income tax, for example, applied to business profits, but mainly as an indirect means to tax individual shareholders. The 1898 excise tax on sugar and oil producing industries, by contrast, was a tax on the privilege of doing business and hence was a model for the 1909 law.[34]

Yet, even the 1898 excise tax was enacted for conflicting reasons. On the one hand, the statute's legislative history and its general application to all sugar and oil refinery businesses, not just corporations, suggest that lawmakers were not singling out

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[32] 44 Cong. Rec. 4038 (1909); Philip C. Jessup, *Elihu Root* (1938), 230; Kornhauser, "Corporate Regulation and the Origin of the Corporate Income Tax;" Avi-Yonah, "Corporations, Society, and the State: A Defense of the Corporate Tax."

[33] R. Rudy Higgens-Evenson, *The Price of Progress: Public Services, Taxation, and the American Corporate State, 1877-1929* (2002); Glenn W. Fisher, *The Worst Tax? A History of the Property Tax in America* (1996); Clifton K. Yearley, *Money Machines: The Breakdown and Reform of Governmental and Party Finance* (1970).

[34] Steven A. Bank, Kirk J. Stark, and Joseph J. Thorndike, *War and Taxes* (Washington, D.C.: Urban Institute, 2008): 51; Bank, *From Sword to Shield*, at 58-62.

corporations as regulatory targets, but rather that they were using the excise levy as a proxy to tax the owners of sugar and oil companies, and hence generate the revenue necessary to prosecute a war.[35] On the other hand, if the ultimate targets of the tax were specifically Standard Oil and American Sugar, two of the largest and most powerful industrial corporations in America at the time,[36] then perhaps the 1898 excise tax was a forerunner of the legislative attempt to control the increasing wealth and power of corporate capital. Furthermore, since the 1898 law did not contain disclosure requirements, lawmakers seemed less interested in transparency as a form of public supervision, and more focused on using the levy to curb the growing profits of specific business corporations.[37]

Unlike the earlier corporate taxes, which were temporary measures in response to wartime emergencies, the 1909 levy paved the way for a more permanent corporate tax. In fact, after the Sixteenth Amendment was ratified in 1913 and a comprehensive income tax enacted in that same year, the corporate excise tax was replaced with a direct tax on corporate incomes. This new corporate income tax acted as a complement to the individual income tax. The new law provided a "normal" tax of one percent on all individual and corporate income above certain exemption levels. It also enacted a graduated set of "surtaxes" on individual income that ranged from 1 to 6 percent on income above $20,000. Because shareholders were exempt from paying the normal tax rate on dividends, the normal rate on their corporate income was merely applied at the corporate rather than the individual level. With this system in place, only truly wealthy shareholders paid a graduated surtax on corporate dividends.[38]

The adoption of progressive rates, however, complicated the taxation of corporate income. With higher individual surtax rates, there was an incentive for corporations to retain earnings rather than distribute them as dividends to individual shareholders. The corporate form, in other words, could be used to avoid graduated individual income taxes. To combat this, lawmakers enacted a highly subjective penalty provision, known as an

[35] Bank, *From Sword to Shield*, at 58-59.

[36] In 1897, Standard Oil was the largest industrial corporation in the country, with over $256 million in total assets, and American Sugar was the third largest with $116 million in total assets. Bunting, *Rise of Large American Corporations*, 149.

[37] Kornhauser, "Corporate Regulation;" Avi-Yonah, "Corporations, Society."

[38] Section II(A), subdivision (2), Underwood Tariff Act of October 3, 1913, 38 Stat. 166.

undistributed profits tax. According to this feature, shareholders of a corporation that retained earnings for the purpose of avoiding the shareholder-level surtax on dividends would be subject to surtaxes on their pro rata share of the earnings as if they had been distributed. In effect, this provision provided partnership-like, pass-through tax treatment for those corporations that were deemed to be tax avoidance vehicles. Because this provision provided a disincentive for corporate managers to aggregate profits at the corporate level, the penalty also limited the economic power of large-scale corporations. Thus the 1913 Act, with its progressive rate structure, was arguably the beginning of the modern American corporate tax.[39]

With the enactment of the 1913 income tax, Congress began to acknowledge the differences between corporations and their owners. In many ways, it is no surprise that during this time the corporation was targeted as a separate legal entity, with its own tax paying capacity. Since the turn of the century, American legal theorists had been incorporating the ideas of continental scholars to argue that corporations had separate legal identities.[40] Building on the work of German jurists, American legal scholars like Ernst Freund had been advancing for many years the juridical conception of the corporation as a real or natural, not merely artificial, entity. This argument, in many ways, flowed naturally from American constitutional law. As early as 1886, the U.S. Supreme Court in the famous *Santa Clara* case had ruled that corporations were legal persons with property rights that could not be denied without equal protection.[41] If corporations were entitled to the property rights of legal personhood, tax reformers argued, they surely also had the attendant responsibilities and obligations that came with legal personhood – including the duty to pay taxes.

American policymakers not only absorbed the ideas of legal theorists, they went further in showing how corporations embodied the ideal of taxing a legal person according to their earning capacity or ability to pay. In 1909 the U.S. Bureau of

[39] Ibid. [cite to specific sections].

[40] See, for example, Ernst Freund, *The Legal Nature of the Corporation* (Chicago: University of Chicago Press, 1897). On the influence of continental legal theories for American law, see generally Morton Horwitz, *Transformation II*, 179–80; Ron Harris, "The Transplantation of the Legal Discourse on Corporate Personality Theories: From German Codification to British Political Pluralism and American Big Business," *Washington & Lee Law Review* 63 (2006), 1421–78.

[41] *Santa Clara v. Southern Pacific Railroad*, 118 U.S. 394 (1886). On the specific meanings of *Santa Clara* for corporate rights, see Bloch and Lamoreaux in this volume.

Corporations explained how corporations provided "a place where the theoretically perfect test – ability to earn – can be applied in practice as a means of ascertaining the proper amount of taxes to be paid." Business corporations were uniquely situated to measure future earning power. "The market value of the stock depends not wholly upon past earnings, but also, and chiefly upon supposed ability to earn in the future," wrote the Bureau. Consequently, corporations faced a tax burden "which is theoretically correct," and which "may well be taken into account when one discusses whether it is to the public interest to encourage the formation of corporations."[42]

Just as government officials were discussing why corporations were ideal entities for taxation, economic experts and social commentators were also linking the growing inequality created by modern industrialism to the rise of large-scale corporations. "The greatest force in the last three decades making for income concentration has been the successful organization of monster corporations," wrote statistician and political economist Willford I. King in 1915. "The promoters and manipulators of these concerns have received, as their share of the spoils, permanent income claims, in the shape of securities, large enough to make Croeus appear like a pauper."[43] The goal for King and many other progressive reformers was to use the corporate tax to attack these concentrations of wealth.

From its origins in the 1909 excise tax to its development as part of a more comprehensive income tax, the corporate tax was marked by dueling, perhaps even contradictory, rationales. For those who feared that "monster corporations" were separate legal persons that could threaten American democracy, certain elements of the new corporate tax were seen as a means toward limiting the growing size and influence of these economic and legal entities. Meanwhile, for those who viewed the corporation as simply an aggregation of individuals, the corporate tax was merely an effective administrative device, a tool for collecting and remitting taxes on wealthy shareholders. Although they disagreed on why a corporate tax was necessary, both sides seemed to agree that the time had come for some form of levy on large business organizations.

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[42] U.S. Department of Commerce & Labor, Bureau of the Corporations, *Taxation of Corporations: New England I* (1909), 3

[43] Willford I. King, *The Wealth and Income of the People of the United States* (New York: Macmillan Co., 1915), 231–2, 80, 218–19.

Thus, the multiple goals of corporate tax policy were not necessarily mutually exclusive or antithetical to each other. Just as bootleggers and Baptists could come together to support Prohibition, anti-corporate regulators and administrative revenue reformers could agree, at least in principle, on the need for a corporate tax, even if their motivations differed.

II. World War One and the Rise of a Robust Corporate Tax Regime

If the 1913 income tax initiated the development of modern corporate taxation, the World War I tax regime, with its dramatically higher tax rates and innovative business levies, clearly accelerated the process. Yet like its earlier versions, the wartime corporate taxes were riddled by a variety of complex justifications. As the costs of conducting a global war increased, the need for new and sustained revenues pushed Congress to enact steeply progressive income tax rates. At the same time, the robust demand for wartime goods and materiel provided an opportunity for some industrial corporations to benefit enormously from the war effort. To prevent excessive war profiteering, lawmakers enacted several novel profits taxes. Although these levies were intended to act as constraints on "unreasonable" corporate profits, they frequently had unanticipated consequences. In fact, by the end of the war the steeply progressive rates and the new profits taxes led some experts to wonder whether the new tax regime was unnecessarily hindering the development of corporate capital.

Even before the U.S. officially entered the war in April 1917, the need for war preparedness led lawmakers to transform the federal tax system. The Revenue Act of 1916, in fact, initiated a series of wartime tax measures that significantly shifted the national tax system away from its traditional reliance on indirect and regressive consumption taxes to the modern system of direct and progressive taxation. The 1916 law contained higher individual and corporate rates, a modest federal estate tax, and a net receipts tax on munitions makers. The revenue acts that followed also ushered in a revolution in administrative capacity, as the power and personnel of the U.S. Treasury Department increased dramatically. By focusing the new national tax powers on the wealthiest Americans, and rejecting a broad-based mass income or sales tax, the

Woodrow Wilson administration and its congressional allies set a clear tone: the World War One tax regime would be focused on "soaking the rich."[44]

There was, to be sure, some resistance to the new "soak-the-rich" wartime tax regime. Most business interests, however, limited their opposition to private correspondence with policymakers. Many were profiting enormously from the war, and they feared that any public protests would be interpreted as anti-patriotic. Still, politically conservative interests preferred to finance the war with a mix of consumption taxes and bonds rather than steeply progressive income or munitions levies. Populist lawmakers, by contrast, initially used the threat of highly progressive taxation to try to blunt the war effort. On the eve of the war, Claude Kitchin (D-N.C.), the House majority leader and powerful chair of the House Ways and Means Committee, did not hide his sectional bias. When wealthy New York citizens, he wrote, "are thoroughly convinced that the income tax will have to pay for the increase in the army and navy, they will not be one-half so frightened over the future invasion of Germany and preparedness will not be so popular with them as it now is."[45] Only later did populists like Kitchin see the war as an opportunity use tax policy as type of anti-monopoly tool.

One of the Wilson administration's greatest achievements during the war was its ability to build a fragile political coalition of populist Democrats and progressive Republicans in support of the new, robust tax regime. Led by Treasury Secretary William G. McAdoo, who was also Wilson's son-in-law, the administration together with its congressional allies was able to dramatically raise individual tax rates and lower exemption levels. Although the WWI revenue laws did not usher in a mass-based tax, they did increase the scope and scale of taxes on America's wealthiest citizens. During the war, the top marginal individual income tax rate soared to 77 percent, and in fiscal year 1919 nearly 17 percent of the labor force filed individual income tax returns. As a result, the effective tax rate of the nation's wealthiest 1 percent of households climbed from roughly 3 percent in 1916 to 15 percent within two years. Although the corporate income tax rate also increased, it did not do so at the same pace and hence the spread

[44] W. Elliot Brownlee, "Wilson and Financing the Modern State: The Revenue Act of 1916," *Proceedings of the American Philosophical Society*, 129:2 (1985), 173-210; Brownlee, *Federal Taxation in America*, 59-72; Mehrotra, *Making the Modern American Fiscal State*, Ch. 7.

[45] Arthur Link, *Wilson: Campaigns for Progressivism and Peace*, 62.

between individual and corporate rates widened significantly, providing further incentives for wealthy shareholders to use corporations as tax avoidance vehicles.[46]

Originally, there was some thought to subjecting corporate income to the high marginal rates applied to individuals. During its deliberations over the revenue Act of 1917, the Senate Finance Committee considered treating corporations like partnerships, where income earned by the entity was taxed to the owners individually at their marginal rates regardless of whether the income was actually distributed.[47] This idea, and another proposal to extend the 1913 Act's undistributed profits tax to cover all retained earnings, not just those unreasonably retained to avoid the shareholder-level taxes, was rejected, however, in large part because corporations insisted that it would harm their ability to accumulate the funds necessary to meet the needs of the wartime economy.[48] Corporations claimed that retained earnings were particularly important in a period when businesses were limited in their ability to raise money from the capital markets because of the large flotation of government bonds to finance the war.[49] Corporate managers contended that they needed to lock-in capital, so that they could "meet the great demands now laid upon the industries of the country . . . both normal and due to the war at home and abroad."[50] In effect, the separate corporate income tax was justified at this time as a way to shield corporate income from the high wartime rates on individuals.

To make sure those retained earnings were still adequately taxed at the corporate level, Congress enacted one of the most complex and controversial provisions of the war: the excess profits tax. Whereas the 1916 munitions tax levied a flat 12.5 percent tax on the profits of all armament producers, the newly created excess-profits tax applied to

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[46] *Historical Statistics of the United States*, Series Ea 758-772. Effective tax rates refer to the ratio of taxpayers total tax liability to total income. For those few taxpayers who had annual incomes that exceeded $1 million the effective tax rate skyrocketed from 10 percent to over 70 percent between 1916 and 1918. W. Elliot Brownlee, "Historical Perspectives on U.S. Tax Policy toward the Rich," in *Does Atlas Shrug? The Economic Consequences of Taxing the Rich*, ed. Joel B. Slemrod (New York: Russell Sage Foundation, 2000), 45.

[47] 55 Cong. Rec. 5966 (1917) (statement of Sen. Furnifold Simmons, D-N.C.)

[48] Id. (Simmons, speaking about the undistributed profits tax proposal, reported that "[t]he corporate interests of the country without exception so far as I know protested and presented convincing facts to support their protest, that to require them at the present time either to distribute their surplus or to pay a tax of 15 per cent upon it if retained, would be several times the price of money in the open market; that it would under present conditions impose a serious handicap upon corporately conducted business.").

[49] Id.

[50] Id.; Steven A. Bank, "A Capital Lock-In Theory of the Corporate Income Tax," *Georgetown Law Journal* 94 (2006): 922-923.

profits "over a reasonable return on invested capital." Moreover, the law affected all businesses, not just those in the munitions industry. The initial goal was to use this new levy to attack the large, industrial corporations that were benefiting enormously from the war effort.[51]

A tax on excess profits reflected the belief that the broader public, operating through the powers of the state, had a legitimate stake in collecting excess private gains generated by war profiteering. Although other nations were already using excess profits taxes as a funding source for the war, the unprecedented turn to this levy by the United States signaled the Wilson administration's desire to alter the concept and meaning of business profits – at least during the war. The term "excess" profits, itself, implied that there was some reasonable level of earnings that a business was entitled to, but that any surplus amount above that level was "unreasonable" or "abnormal." Such wartime surpluses were deemed to be windfall gains that exceeded a legitimate amount of financial profit. At a time when ordinary Americans were sacrificing life and limb, the enactment of an excess profits tax expressed a growing social indignation with war profiteering and a demand for shared sacrifice that was at the heart of the Wilson administration's sense of fiscal citizenship.[52]

Indeed, social concerns over excessive and unscrupulous war profiteering drove the demands for an excess-profits tax. As early as 1917, calls for the "conscription of wealth" to match the conscription of men began to fill the editorial pages of the country's leading publications.[53] Soon after the United States entered the war, the popular journal *The Outlook* documented "the extraordinary increase in profits" among the leading industrial firms. Comparing the profits of over one hundred companies from 1914 to 1916, the editors calculated that the aggregate profits of these corporations "exceed the

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[51] Eight percent was established as the "reasonable rate of return," and all profits above that level were taxed at graduated rates ranging from 8 percent to a maximum of 60 percent on corporate profits that were in excess of 32 percent of invested capital. *Revenue Act of 1917*, 40 Stat. 300 (1917). For an elementary and useful example of how excess profits were calculated, see Rockoff, *America's Economic Way of War*, 116.

[52] "The Excess Profits Tax – Discussion," *American Economic Review* 10:1 (March 1920), 19–32; W. Elliot Brownlee, "Economists and the Formation of the Modern Tax System in the United States: The World War I Crisis," in *The State and Economic Knowledge: The American and British Experiences*, ed. Mary O. Furner and Barry Supple (Cambridge: Cambridge University Press, 1990), 401–34, 409–11; Mehrotra, *Making the Modern American Fiscal State*.

[53] "Conscripting Capital," *Los Angeles Times* (June 4, 1917), II4; "Where the Burden Shall Fall," *Puck* (April 21, 1917), A7; "The Conscription of Wealth," *The Independent* (April 28, 1917), 193.

profits of the year in which the war began by over a billion dollars." From this statistical evidence, *The Outlook* joined other leading popular periodicals in supporting an excess-profits tax to make "the war-brides pay up."[54]

From the start, though, many economic and legal experts questioned the efficiency, administrability, and even constitutionality of a tax on all "excess" profits beyond a "normal level." The main point of contention was the use of "invested capital" as a baseline from which excess profits could be determined. The term "invested capital" was used elsewhere at this time, including in determining regulatory rates for public utility companies, but it was a notoriously difficult concept to apply in practice.[55] Economist Edwin Seligman summarized the hostility toward the use of "invested capital" in determining excess profits when he wrote that "what constitutes capital is so elusive as to be virtually impossible of precise calculation."[56]

Members of the business and legal communities echoed Seligman's concerns. *The Commercial and Financial Chronicle* – that bastion of orthodox business thinking – attacked the "Excessive Taxation of 'Excess' Profits" as "governmental confiscation of wealth."[57] Though most business leaders were cautious about publicly complaining about the excess profits tax, privately they seethed. Jacob Schiff, a senior partner in the investment banking firm of Kuhn, Loeb & Co., complained directly to Treasury Secretary McAdoo in 1917 that the high wartime rates would "curb the push and ambition which is at the bottom of all material progress and development." Similarly, the automobile manufacturer Cleveland Dodge wrote to McAdoo privately warning that the excess profits tax schemes "would kill the goose which lays the golden egg."[58]

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[54] "Helping the War Pay for Itself" *The Outlook* (July 27, 1917), 319–20; "To Tax 'Excess Profits,'" *Literary Digest* (January 27, 1917), 176; "The Excess Profits Tax" *New Republic* (September 15, 1917), 174–5; Brandes, *Warhogs*, 135–7. Hugh Rockoff has estimated that the profits taxes accounted for roughly 40 percent of total wartime taxes, making it the leading source of tax revenue. Rockoff, *America's Economic Way of War*, 117–18.

[55] C.L. King, *The Regulation of Municipal Utilities* (New York, 1912); William G. Raymond, *What is Fair? A Study of Some Problems of Public Utility Regulation* (New York, 1918).

[56] Edwin R. A. Seligman, "The Excess-Profits Tax," *The Nation* (March 28, 1918), 365–6

[57] "Excessive Taxation of 'Excess' Profits," *Commercial and Financial Chronicle* (September 1, 1917); "The Mysteries of the 8% Excess Profits Tax," *Commercial and Financial Chronicle* (April 28, 1917); "Assails the Profits Tax; Counsel of Bankers' Association Warns against Hasty Legislation," *New York Times* (December 6, 1918).

[58] W. Elliot Brownlee, "Social Investigation and Political Learning in the Financing of World War I," in *The State and Social Investigation in Britain and the United States* 330 (Michael J. Lacey & Mary O.

As many experts predicted, the excess-profits tax did not always operate as intended. The Treasury Department economist, Thomas S. Adams, conducted a study of the excess profits tax in the summer of 1918 that documented how the levy was having perverse implications. The existing law, with its use of "invested capital" as the baseline for determining "excess profits," was adversely affecting small businesses more than the large corporations it was designed to attack. Larger corporations, Adams concluded, were able to manipulate the law to reduce their tax liability. By increasing their invested capital, either by issuing more equity or by increasing their investments in intangible assets or through other accounting maneuvers, they could inflate the base from which their rates of return and profits were calculated, thereby placing their net profits in a lower tax bracket. By contrast, smaller enterprises, especially those that relied less on heavy industry, did not have high levels of capital to begin with, nor did they have the slack or flexibility to adjust their capital levels or annual investments. Thus, they were hardest hit by the excess profits tax.[59]

Despite the uncertain effects of the excess profits tax, there were some lawmakers and experts who believed a revised profits levy could be used as a permanent measure to combat monopoly power. Congressman Claude Kitchin remained an advocate for maintaining the excess profits tax in its original form, in spite of its defects, mainly because he hoped it would become a permanent part of the postwar fiscal order – not as a source of significant revenue, but rather as a cudgel that could be used to tame powerful corporate interests. Nearly all tax experts were critical of the administrative burdens of the levy, but a few were optimistic that it could seize "some of the promised advantages of socialized industry without incurring the risks and disadvantages of socialism."[60] Eventually, however, the Treasury Department was able to convince lawmakers that a hybrid excess profits and war profits tax ought to be used to fund the remaining war effort. By hinging the calculation of "war profits" to a pre-war level of acceptable

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Furner, eds., 1993); Ronald F. King, *Money, Time & Politics: Investment Tax Subsidies and American Democracy* 104 (1993).

[59] "Memorandum on the Differences between a War Profits and an Excess Profits Tax," July 27, 1918, NARA Excess Profits Tax Folder; Leffingwell to Adams, July 27, 1918, Reel 10, RCLP; Brownlee, "Economists and the Modern Tax System," 415–17. George O. May, "Methods of English War Profits Tax," *New York Times* (September 4, 1917).

[60] Robert Murray Haig (assisted by George E. Holmes), *The Taxation of Excess Profits in Great Britain* (Princeton, N.J.: American Economic Association, 1920), 174-5.

profits, the new hybrid levy was reframed as a temporary measure, one that could be – and was – easily dismantled after the war. Indeed, when the war officially ended in the spring of 1919, the excess profits tax was one of the first targets of the fiscal conservatives who swept into office.

Although excess profits taxation was quickly eliminated, the overall thrust of the new income tax regime did not wither away after the conflict. The ultimate success of the income and profits tax regime demonstrated the federal government's ability to underwrite a global war with a strong tax system. This success convinced reformers, lawmakers, and tax administrators that a direct and progressive tax system – especially one with a strong corporate income and profits tax component – could be used both to collect badly needed revenue and to discipline corporate war profiteering.

III. The Mellon Plan and a Pro-business Shift in Tax Policy

The aftershocks of World War I continued to reverberate at the outset of the 1920s. The dislocation occasioned by the war's end and a sharp drop in prices ushered in a recession between 1920 and 1922.[61] Furthermore, the heavy wartime taxes remained after armistice as the country strained to cover the war bill. The top combined individual normal and surtax rate, which had been seven percent in 1913, had more than doubled to fifteen percent in 1916 and rose to a whopping 77 percent at war's end, with commentators calling it "the greatest burden that had ever been laid upon the American people.[62]

In the post-war recessionary environment, a new vision of corporate taxation was beginning to emerge. The voices of those who had sought to use corporate tax policy to discipline big business during the war were drowned out by those seeking to use corporate tax reform as a means to subsidize or facilitate business activity and economic growth. In his 1920 Annual Report, Treasury Secretary David Houston's prescriptions for tax reform reflected this gradual shift in attitude: "While it is vitally important that saving and reinvestment effected through the medium of the corporation should not be

[61] Charles R. Geisst, *Wall Street: A History* 155 (New York: Oxford Univ. Press, 1997).

[62] Roy G. Blakey & Gladys C. Blakey, *The Federal Income Tax* (New York: Longman, Green and Co., 1940), 153.

dealt with more leniently than similar savings made by the partnership or individual, it is equally important that the methods of taxation employed should in all cases penalize saving and investment as little as possible."[63] Even at this early stage, government officials were aware that it was exceedingly difficult for corporate tax policy to remain completely neutral.

By 1921, a consensus was forming about the need for business tax relief, which extended beyond corporate taxation to the high progressive rates on partners, sole proprietors, and individual investors. In his inaugural address that year, President Warren G. Harding remarked that the "business world reflects the disturbance of war's reaction."[64] Other lawmakers agreed that steeply progressive taxes were undermining the postwar recovery. A U.S. House Ways and Means Committee Report observed that "the exacting of the present excessive sums of taxes from the country contributes in no small degree to the depressing influences under which business and industry in general are staggering as an aftermath of the World War . . . The reduction of the tax burden is essential to business recovery."[65]

One particular target of business tax reformers was the excess profits tax. As they had during the war, critics of the levy noted its contradictory implications. The National Association of Manufacturers contended that the public equated "excess" with "illegal" profits, and the levy incentivized corporations to undertake inefficient projects on deductible expenses, thereby artificially depressing investor returns.[66] Not only was the tax viewed as problematic in concept, it was also considered complex in operation, requiring significant audits, frequent appeals, and lengthy processes before liability could be established. Indeed, the uncertainty the tax generated was itself considered a threat to business. Treasury economist T.S. Adams wrote that "[t]housands of business concerns, particularly corporations, must some day be confronted with large additional tax bills for

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[63] David F. Houston, *Annual Report of the Secretary of the Treasury* (1920): 34.

[64] Inaugural Address of Warren G. Harding, March 4, 1921, at 7, available at http://www.yale.edu/lawweb/avalon/presiden/inaug/harding.htm.

[65] H.R. Rep. No. 67-350, at 1 (1921), reprinted in 1939-1 C.B. (pt. 2) at 168.

[66] James Emery, "The Excess Profits Tax – An Unsound Fiscal Policy," in *Proceedings of the National Industrial Conference* (National Industrial Conference Board, 1920), Special Report No. 9, p. 3.

the war period. These 'heavy but indefinite future obligations' . . . hang like a suspended avalanche over American business."[67]

There was some sentiment in favor of simply replacing the excess profits tax with an undistributed profits tax to get at earnings retained within the corporation, but the economic downturn helped quash this idea. Partly, this was because the issue of retained earnings was less important when corporate earnings were already down. Senator Reed Smoot (R – UT) noted "[d]uring war times . . . there may have been some reason for taxing undistributed earnings, but just as surely as we stand here to-day there is not much danger of undistributed earnings for the year 1921, and, I think, for a number of years to come."[68] With little fear that corporations were being used as tax avoidance vehicles, lawmakers began to see retained earnings in a more positive light.

More importantly, many observers believed that it was important to shield corporations and corporate savings from the high individual rates enacted during the war. Whereas retained earnings had been viewed as a tax avoidance maneuver prior to the war, they came to be seen as an important engine for economic recovery through corporate reinvestment. T.S. Adams, who had advocated for undistributed profits taxation in 1918, changed his tune by 1923:

> The proposal [to tax undistributed profits] has been rejected because Congress and the people will not face the prospect of applying fifty per cent surtaxes to the great volume of savings effected every year by the corporations of this country. . . We want corporations to save, to reinvest, to plow back their profits into the business. We admit that it would be undesirable to apply the high surtaxes to the savings made by corporations. Saving, reinvesting is beneficent; it is a renewal of the lifeblood of business; and that part of the business income of the country [that is retained] cannot stand surtaxes rising to fifty per cent."[69]

Secretary of State Charles Evan Hughes sounded a similar theme in a May 1924 speech before the National Institute of Social Sciences: "[w]e must have a surplus and it must be used to develop enterprise. How fatuous to dry up this essential source of prosperity by

[67] Blakey & Blakey, *Federal Income Tax*, at 194.
[68] Cong. Rec. vol. 61, p. 6861 (statement of Sen. Smoot).
[69] Thomas Adams, "Evolution v. Revolution in Federal Tax Reform," *Proceedings of the National Tax Association* 16 (1924): 308-09.

plans of taxation which discourage enterprise and yet are stridently proclaimed as being in the interest of the people!"[70]

The pro-business shift in corporate taxation also was evident in the move to further liberalize the tax treatment of mergers, consolidations, and other corporate reorganizations. In 1918, Congress adopted a provision to permit the nonrecognition, or tax deferral, of gains and losses on exchanges of stock or securities in such transactions, but it was considered too vague and restrictive to permit much activity. This had proven problematic as businesses made the transition from wartime to peacetime production. Because of the high progressive rates imposed on individuals during the war, stockholders simply would not risk engaging in transactions that might lead to taxable income. The slow-down in merger activity during the recession from 1920-1922 was blamed at least in part on the defects of the 1918 law.[71] T.S. Adams testified before the Senate Finance Committee that "where any heavy tax is involved the reorganization is held up. They do not do it. All kinds of business readjustments have been stopped. . . . the principal defect of the present law is in blocking desirable business readjustments."[72] In the 1921 Act, Congress expanded and clarified the reorganization provision to remove it as an obstacle. As the Senate Finance Committee report on the Act emphasized, the amendments "will, by removing a source of grave uncertainty . . . permit business to go forward with the readjustments required by existing conditions."[73]

Supporters of the 1921 Act tried to pump it up as a pro-business measure. "The present Federal tax law is distinctly more favorable to business than any since the war," declared New York City tax lawyer and former Treasury official Arthur Ballantine in the winter of 1922. "An individual or partnership may incorporate the business without tax liability by reason of the transfer to the corporation. The exchanges of securities in the course of corporate reorganizations may be effected without tax liability."[74]

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[70] "Hughes here pleads for swift justice," *New York Times*, May 16, 1924, p. 3.

[71] For more on the declining pace of merger activity at this time, see J. Keith Butters, John Lintner, Willam L. Cary, *Effects of Taxation on Corporate Mergers* (1951), p. 294; John M. Blair, *Economic Concentration: Structure, Behavior and Public Policy* (1972), p. 264.

[72] *Hearings on H.R. 8245 Before the Senate Comm. On Fin.*, 67th Cong. 29 (1921) ("1921 Senate Hearings").

[73] Id. at 12.

[74] "Praises Present Tax Law," *N.Y. Times*, Dec. 17, 1922.

Notwithstanding the positive reviews of the 1921 Act, many pro-business Republicans were dissatisfied. Postmaster William H. Hays, the former chairman of the National Republican Party, wrote a letter to newly appointed Treasury Secretary Andrew W. Mellon urging him to move more quickly to scale back the wartime tax regime, complaining that the 1921 Act did not go far enough in aiding business and investors.[75] These critics viewed the repeal of the excess profits tax as a start, but the amendments to the income tax only served to lessen the negative impact of a tax that had outlived its usefulness with the passing of the exigencies of war.

The problem was that the business community itself could not agree on a suitable alternative to the excess profits tax and the income tax. Treasury Secretary David Houston warned that returning to pre-war levels of revenue was not an option, at least in the short-term, because of the large amount of floating debt remaining from the war, including the $7 billion in Victory bonds and other obligations that would be coming due in the next three years.[76] Moreover, although a reduction in the size of government was urged and cost reductions were pursued in many cases, the growth in administrative expenses seemed unlikely to be reversed entirely.[77] A national sales tax was the most promising alternative source of revenue, but business split on whether to support it. Many business trade groups supported a sales tax, ranging from the Business Men's National Tax Committee to the New York Board of Trade.[78] Other organizations, though, such as the National Industrial Conference Board, the National Association of Credit Men, the National Association of Retail Grocers, and the Committee of Manufacturers and Merchants of Chicago all opposed the various sales tax proposals.

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[75] Mellon to Hays, November 17, 1921, Record Group 56, General Records of the Department of Treasury, Correspondence of the Office of the Secretary of the Treasury, Central Files of the Office of the Secretary of the Treasury, 1917-32, Box 187, Folder "Tax – Exchanges of Property, 1921-1932," National Archives and Record Administration, College Park, Md.

[76] David F. Houston, "The Treasury's Plan for Federal Taxes," *Review of Reviews* 63 (1921): 53. See also "To Cut Tax by More Borrowing," *The Literary Digest*, April 9, 1921, at 11; "For the Payment of the Debt," *The New Republic*, May 11, 1921, at 310; Mehrotra, *Making the Modern American Fiscal State*, at 348.

[77] Edward B. Rosa, "Expenditures and Revenues of the Federal Government," *Annals of the American Academy of Political and Sociel Science* 95 (1921): 1-2; Robert Bruce Watson, "The Trend of Federal, State, and Local revenues in the United States," *Annals of the American Academy of Political and Sociel Science* 95 (1921): 132-33.

[78] See K. M. Williamson, "The Literature on the Sales Tax," *Quarterly Journal of Economics* 35 (Aug. 1921), pp. 618-33; Randolph E. Paul, *Taxation in the United States* (1954), p. 128; Roy G. Blakey & Gladys C. Blakey, *The Federal Income Tax* (1940), p. 190.

Their concern was that the tax would effectively act as a gross receipts tax and if business could not easily shift the cost to consumers, it could be particularly damaging to businesses with higher costs and lower margins. [79]

The resulting compromise – the Mellon Plan – was both a rejection of a complete retreat from the pre-war era and a continuation of the more business friendly tax policies enacted in 1921. Under the Mellon Plan, a steep reduction of the top combined personal income tax rates from 77 percent at the end of the war to 25 percent by 1927 was coupled with a modest increase in the corporate rate from 10 percent to 13.5 percent over the same period. This was more pro-business than it might at first appear. The corporate rate increases were viewed as a substitute for the revenues from the excess profits tax in 1921 and the capital stock tax in 1924,[80] both of which most businesses viewed to be more odious than the corporate income tax. Moreover, the drop in the top individual rates was considered necessary to spur business investment. In his 1924 book written to garner popular support for the plan, Mellon wrote,

> The high rates inevitably put pressure upon the taxpayer to withdraw his capital from productive business and invest it in tax-exempt securities or to find other lawful methods of avoiding the realization of taxable income. The result is that the sources of taxation are drying up; wealth is failing to carry its share of the tax burden; and capital is being diverted into channels which yield neither revenue to the Government nor profit to the people.[81]

Mellon particularly highlighted the example of the railroad industry, noting that "[it] is estimated that the railroads will require a billion dollars a year of new capital in order satisfactorily to provide the facilities and equipment requisite to handle the traffic presented and to reduce the cost of transportation. . . . If the railroads are to be furnished with capital, much of it must come from the sale of stock and to permit any sale surtaxes must be reduced as to attract the large investor to that type of security."[82]

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[79] 1921 Senate Hearings, supra note XX, at 360; Mehrotra, *Making the Modern American Fiscal State*, 379.

[80] Blakey & Blakey, *Federal Income Tax*, at 221, 241.

[81] Andrew W. Mellon, *Taxation: The People's Business* (New York: The Macmillan Company, 1924): 13.

[82] Id. at 104, 105-06.

Throughout the 1920s, Progressives and their allies continued to beat the drum for using tax as a tool to try to control corporations, but any victories were small and short-lived. For example, they repeatedly attempted to revive the publicity requirement originally enacted in 1909 for corporate tax returns, but they now sought to apply it to all returns. After a public inspection requirement was defeated in 1921, Congress finally adopted a provision in 1924 requiring public inspection of both the names of corporate and individual taxpayers and the amount of taxes they paid. During deliberations over this requirement, then-Secretary of Commerce Herbert Hoover had warned that public disclosure would particularly harm businesses, arguing that "it may be well recalled that publicity of tax returns which was required during the period of 1867 to 1872 contributed to the industrial and financial chaos of the time."[83] By 1926, the anti-publicity movement got the upper hand and the amount of tax paid was no longer made public.[84]

Similarly, as part of the deliberations over the Revenue Act of 1928, Congress considered a graduated corporate income tax that would for the first time tax the "bigness" that Louis Brandeis had decried more than a decade earlier.[85] Business immediately assailed the proposal. The *Wall Street Journal* called it "a direct challenge to the 'Big Business' savoring of the old trust busting days," complaining that it would "penalize the stockholders of the large corporations, such as the railroads" and that it was "essentially an excess profits tax" without the use of the more equitable invested capital standard.[86] Although the House approved the proposal, it was later rejected in the Senate in favor of a one percentage point reduction of the single corporate rate and an increase in the exemption from $2,000 to $3,000 for corporations with incomes of $25,000 or less.[87] For at least a little while longer, business concerns still trumped in the tax arena.

[83] "Tax Bill Conferees Clash Over Changes," N.Y. Times, May 17, 1924, at 1 (

[84] Blakey & Blakey, *Federal Income Tax*, at 272.

[85] Louis Brandeis, "A Curse of Bigness," *Harper's Weekly*, Jan. 10, 1914, at 18; See Steven A. Bank, "Taxing Bigness," *Tax Law Review* (forthcoming 2014). In a similar vein, Brandeis was also an advocate of anti-chain store legislation. See, generally, Richard Schragger, "The Anti-Chain Store Movement, Localist Ideology, and the Remnants of the Progressive Constitution, 1920-1940." *Iowa Law Review* 90 (2005): 1011.

[86] "Senate to Decide Fate of Tax Bill," *Wall St. J.*, Dec. 21, 1927, at 18.

[87] *See* "Senate Tax Cut Near $300,000,000," *N.Y. Times*, May 23, 1928, at 6; Roy G. Blakey, "The Revenue Act of 1928," *Am. Econ. Rev*. 18 (1928): 429, 435.

IV. The 1930s and the New Deal on Corporate Taxation

The stock market crash in 1929 and the onset of the Great Depression forced a re-examination of all sorts of governmental policies, including in the corporate sphere. This time, however, the prescription for the economic situation was decidedly less business friendly than it had been in the early 1920s during the much milder post-WWI recession. Whereas corporations were seen as part of the solution in 1921, and therefore to be protected from or encouraged by taxation, after the Crash corporations were seen as part of the problem and tax reform was viewed as part of the solution.

One of the most significant changes in the intervening decade was the continued rise of large corporations and the dominance of large corporate groups and their owners in the economy. As policymakers began to investigate the causes of the economic downturn, the growth of big business was identified as a contributing factor. Supreme Court Justice Louis Brandeis effectively captured the prevailing sentiment in this new era, writing that "coincident with the growth of these giant corporations, there has occurred a marked concentration of individual wealth, and . . . the resulting disparity in incomes is a major cause of the existing depression. Such is the Frankenstein monster which states have created by their corporation laws."[88] In addition to the race to the bottom in state corporate laws that Brandeis referenced, there was a growing concern that the pro-business tax policies of the 1920s had contributed to the dangerous concentration of corporate power.

As Franklin Roosevelt took office, he and his allies in Congress sought not merely to reverse the pro-business tax policies of the 1920s, but to use the corporate tax as one of the tools to achieve his vision for the federal oversight of corporations. Indeed, the effort to use the corporate tax to influence corporate behavior was not just a political or reactionary movement driven by the economic events in 1929. Rather, it was one of the main pillars of New Deal policy, fueled by academic research and the powerful personalities in Roosevelt's so-called "Brain Trust" of close advisors.

The New Deal's anti-business posture began on the campaign trail. In a May 1932 memorandum, Raymond Moley and other Brain Trusters outlined a national

[88] *Louis K. Liggett Co. v. Lee*, 288 U.S. 517, 566-67 (1933) (Brandeis, J., *dissenting*).

program for recovery.[89] One of the key prongs was to address the problem of corporate "hoarding," or retaining earnings to pay for expansion or to hold as a private "war chest" rather than distributing them as dividends. Adolf Berle, a Columbia law professor who was responsible for this section of the memo, wrote that "this attempt of corporations to provide for a rainy day was really the thing which itself brought on the rainy day. The expansion doubly upset the balance of production and consumption."[90] Berle had just completed his work with economist Gardiner Means on their seminal book, *The Modern Corporation and Private Property*, before being recruited to help develop Roosevelt's economic platform.[91] Based on the insights gleaned from that research and fellow Columbia professor Rex Tugwell's research on the misallocation of capital resources in the corporate economy,[92] Berle advised that "we should carefully consider a modification of taxes on corporate income, aimed at discouraging undue accumulation of corporate reserves, and stimulating distribution of such reserves to the millions of small investors who are their rightful owners."[93] This proposal for "a tax on undistributed surplus income of corporations" was intended to serve as a check against corporate managers who had "lost sight" of the small investors and acted like corporate profits were "private funds."[94]

Soon thereafter in 1932, the U.S. Committee on Banking and Currency authorized an inquiry to investigate the causes of the stock market crash.[95] The subsequent hearings, known as the Pecora Hearings after Ferdinand Pecora, the aggressive lead counsel for the Committee,[96] contained substantial revelations of corporate abuses, including rampant tax avoidance through largely legal maneuvers. The Pecora Hearings only fanned the flames

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[89] Memorandum of May 19, 1932 of Raymond Moley and others for Franklin Delano Roosevelt, outlining a National Program for Recovery, available in Box 282, Folder 3, of the Hoover Institution Archives, Stanford University ("Memorandum of May 19, 1932").

[90] Id. at 2.

[91] Adolf A. Berle & Gardiner C. Means, *The Modern Corporation and Private Property* (New York: Commerce Clearing House, Inc., 1932). See Daniel R. Fusfeld, *The Economic Thought of Franklin D. Roosevelt and the Origins of the New Deal* (1954): 207-08, 213.

[92] Rexford G. Tugwell, *The Industrial Discipline and the Governmental Arts* (1933): 203-05.

[93] Memorandum of May 19, 1932, 3.

[94] Id. at 4.

[95] Stock Exchange Practices: Hearing Before the Senate Committee on Banking and Currency on S. Res. 84, 73d Cong. 2319-25 (1933).

[96] Mark J. Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* (1994): 110-111; "The Man Who Will Question Morgan," *N.Y. Times*, May 21, 1933, sec. 8, at 2.

for those seeking to use corporate tax reform as a means of controlling corporate growth and expansion.[97] In 1933, the House authorized a study of the internal revenue system to investigate some of the sensational revelations from Pecora's investigation. The resulting House Subcommittee Report targeted a variety of corporate tax provisions. It specifically named the expansion of the tax-free corporate reorganization provisions in 1921 and 1924 as one of the culprits for business failure, proposing to repeal non-recognition (tax-deferral) treatment altogether for such transactions. "[T]he present provisions," the report observed, "have encouraged the injection into business structure of an unsavory stimulus, such as the organization of large holding companies and the overcapitalization of business."[98]

The Report, which was introduced by Senator William Borah as an amendment to a Senate Bill, also recommended eliminating the ability of a group of affiliated corporations to file a consolidated return, which was characterized as an attempt "to strike at the holding company system."[99] As described in Daniel Crane's chapter in this volume, Borah would go on in 1937 to co-sponsor the Borah-O'Mahoney Bill requiring federal licensing and oversight of corporations by the Federal Trade Commission. Borah's participation in both reforms – the elimination of consolidated returns and the call for federal licensing – suggested that reformers viewed tax and antitrust law as two means of accomplishing the same ends in the quest to manage and supervise corporations from the federal stage rather than relying upon state corporate law.

In the Revenue Act of 1934, the recommendations to reform the reorganization provisions and abolish consolidated returns were scaled back, but nevertheless they were adopted in a way that suggested a momentum shift in corporate taxation. Rather than proposing to repeal the reorganization provisions, which Treasury Secretary Henry Morgenthau pointed out would actually cost revenue because it would permit

[97] One outgrowth of the Pecora Hearings was the adoption of a proposal for publicizing tax returns by requiring disclosure of the pink slip containing basic summary information that each taxpayer had to submit with his return. Unlike in 1909, this publicity was required for both corporations and individuals and was focused more on the revelations of widespread tax avoidance among wealthy individuals than it was on corporate regulation. See Marjorie E. Kornhauser, "Shaping Public Opinion and the Law: How a "Common Man" Campaign Ended a Rich Man's Law," *Law and Contemporary Problems* 73 (2010): 123.

[98] Subcommittee of the House Committee on Ways and Means, 73d Cong., 2d Sess., Preliminary Report on Prevention of Tax Avoidance (Comm. Print 1933): 39.

[99] "Tax Bill Changes Offered by Borah," *N.Y. Times*, March 2, 1934, at 38 (referring to Senator William Borah's introduction of the Subcommittee recommendation in a Senate bill).

stockholders to claim their post-Crash losses,[100] the eligibility for reorganization treatment was “restricted . . . [t]o conform more closely to the general requirements of corporation law.”[101] The U.S. Chamber of Commerce tried to invoke 1920s-style arguments, warning that the new provision “will discourage mergers which, in the view of recent economic conditions should be made in the interests of good business policies,”[102] but this argument failed to dislodge the proposal the way it might have a decade earlier. Some amendments were made, but contemporary commentators still complained that the provision as enacted “sharply modified” the availability of the tax-free reorganization.[103] Presumably, though, this was intended to make mergers and acquisitions, and the resulting concentration of wealth and power, more costly and therefore more difficult.

The foundation for the proposal to repeal the consolidated return was laid even before Roosevelt assumed office and the subcommittee issued its report. It was based on the growing concern about holding companies, which first appeared at the turn-of-the-century as states relaxed their restrictions on corporations holding stock in other corporations, and in particular about the use of pyramidal structures that enabled investors at the top of the pyramid to leverage a relatively small investment in one corporation into control over a vast empire.[104] The consolidated return appeared to “penalize[] David and assist Goliath.”[105] The fear was that consolidated returns had enabled these corporate groups to drive out competition through predatory pricing while at the same time avoiding taxation on monopoly profits, all by using the losses from one

[100] Statement of the Acting Secretary of the Treasury Regarding the Preliminary Report of a Subcommittee of the House Committee on Ways and Means Relative to Methods of Preventing the Avoidance and Evasion of the Internal Revenue Laws Together with Suggestions for the Simplification and Improvement Thereof, 73d Cong. (1933): 10.

[101] H.R. Rep. No. 73-704, at 14 (1934), reprinted in 1939-1 C.B. (pt. 2), at 564.

[102] Hearings on H.R. 7835 Before the Senate Committee on Finance, 73d Cong. (1934): 50 (brief of F.H. Clausen, Chairman of the Special Committee on Federal Taxation, U.S. Chamber of Commerce). (“1934 House Hearings”)

[103] Roswell Magill, “Effect of Taxation on Corporate Policies,” *U.S. Law Review* 72 (1938): 637, 639, n. 9.

[104] See Berle & Means, supra note xx; James C. Bonbright and Gardiner C. Means, *The Holding Company: Its Public Significance and its Regulation* (New York: McGraw-Hill Book Co., 1932); Steven A. Bank and Brian R. Cheffins, “The Corporate Pyramid Fable,” *Business History Review* 84 (Autumn 2010): 435.

[105] 75 Cong. Rec. 7125 (1932) (statement of Representative Charles Cannon, D-Mo).

subsidiary to offset the gains from another. As Missouri Democrat Charles Cannon explained,

> An electric company or telephone branch or transportation company pays little attention to the cost of installing new services. A railroad company can run a bus line at a loss, a streetcar company can operate a line of taxicabs, or a power company can preempt a new community at a loss. Through the benevolent provisions of this law they charge these losses against their profits elsewhere and reduce their taxes while destroying competition and monopolizing the market.[106]

Congress rejected Cannon's proposal to repeal the consolidated return in the Revenue Act of 1932, but it did subject corporate groups to a penalty tax that rose to as much as one percent for the privilege of filing a consolidated return.[107] House Speaker John Nance Garner described how the adoption of a penalty tax rather than full repeal served as a compromise between those seeking to use taxation to battle corporate abuse and those worried that the tax reform would kill the golden goose: "[i]f it is advantageous to them to file such returns they will pay the penalty. If there is no advantage in consolidated and affiliated returns, they will submit separate returns."[108]

As a result of the Subcommittee Report in 1933, corporate tax reformers reintroduced the proposal to repeal the consolidated return. In the Revenue Act of 1934, they were ultimately successful in securing repeal, but not without railroads obtaining an exemption after Ben Dey, general counsel of the Southern Pacific Railroad, testified that "it is impossible to put the railroads under this proposal without committing a terrific public crime. They simply cannot stand it."[109] Railroads still had to pay the penalty tax in existence prior to 1934, but the ability to continue filing consolidated returns robbed the repeal of much of its influence over railways.[110]

By 1935, the New Deal's movement away from a pro-business approach was largely complete. In his tax message to Congress in June of 1935, Roosevelt openly

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[106] Id.

[107] Blakey & Blakey, *Federal Income Tax,* 345.

[108] 75 Cong. Rec. 7127 (1932).

[109] 1934 House Hearings, supra note xx, at 486. The railroads argued that the 1920 Transportation Act limited their ability to consolidate their lines in a single corporation. Id. at 503-04 (statement of Jacob Aronson of the New York Central Lines).

[110] James C. Bonbright and Gardiner C. Means, *The Holding Company: Its Public Significance and its Regulation* (1932): 227-28.

embraced regulatory taxation as a means to limit corporate abuses. He justified measures such as a graduated corporate tax rate and an intercorporate dividends tax much in the way President Taft had justified a corporate tax in 1909 – as the price for the privileges afforded to the corporate form by the government – but the focus was more on the abuses of those privileges than on the price for them. Roosevelt proclaimed that "we should seek through taxation the simplification of our corporate structures through the elimination of unnecessary holding companies in all lines of business."[111] In effect, Roosevelt's goal was to tax out of existence what were perceived to be abusive holding company structures – or at least to tax them at a rate high enough to make them justify their necessity in securing higher returns.

These measures against "bigness," which were both adopted in the Revenue Act of 1935, hardly imposed the kind of rates or penalties one would need to truly reshape the corporate landscape by force.[112] Roosevelt's original proposal for graduated corporate rates suggested replacing a flat rate of 13.75 percent with a scheme rising from 10.75 percent to 16.75 percent.[113] The final Act imposed a 12.5 percent rate on income below $2,000 up to a 15 percent rate on income above $40,000.[114] Neither was likely to make bigness unprofitable. Similarly, the intercorporate dividends tax was actually just a reduction of the 100 percent exemption for dividends received by a corporate shareholder to a 90 percent exemption, amounting to an effective tax of 1.5 percent on intercorporate dividends.[115]

Even progressive sources were dubious about the impact of these provisions. The *New Republic* claimed that "it will scarcely break up the big industrial units, nor will it restore enough competition to make any visible difference."[116] This has led modern observers to deride the 1935 Act and indeed the entire New Deal corporate tax program as a "symbolic showpiece . . . full of sound and fury," but signifying "almost nothing."[117]

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[111] Franklin D. Roosevelt, "Message to Congress on Tax Revision," *American Presidency Project* (June 19, 1935), http://www.presidency.ucsb.edu/ws/?pid=15088.

[112] See Steven A. Bank, "Taxing Bigness," *Tax Law Review* 66 (2013): 379.

[113] Roosevelt, Message to Congress.

[114] Revenue Act of 1935, 49 Stat. 1014, 1015 §102 (1935).

[115] Mark Leff, *The Limits of Symbolic Reform: The New Deal and Taxation, 1933-1939* (1984), 143.

[116] "A Conservative Tax Program," *New Republic* 83 (1935): 208.

[117] Leff, *Limits of Symbolic Reform,* 2.

Historian Paul Conkin observed that the provisions enacted in 1935 "neither soaked the rich, penalized bigness, nor significantly helped balance the budget."[118]

Such pronouncements, however, ignore the extent to which the New Deal corporate tax program was largely about establishing the principle of differentiation between large and small corporations, so that corporations could be taxed based upon size.[119] For New Deal opponents, this distinction was called "the camel's head inside the tent."[120] Indeed, the intensity of business reaction reflected this concern. Edward G. Seubert, the President of Standard Oil Company of Indiana, wrote in a letter to stockholders "[t]he danger in present proposals is not so much in their immediate effect as in adoption of the principle of discriminating against a corporation merely because it is big and successful."[121] A representative of the Armstrong Cork company testified that the reduction in the top rates in the House bill did not give much comfort: "Experience teaches that once the opening wedge is driven, the field covered by a new tax tends to expand steadily."[122] Moreover, when viewed in the context of the Public Utility Holding Company Act also enacted in 1935, which ordered the break-up of pyramidal holding company structures among public utility companies, business concern about the regulatory aims of New Deal corporate tax measures was well justified.[123] New Deal corporate tax policy seemed focused on attacking large-scale business corporations.

In his second term, Roosevelt's corporate tax policy only served to confirm business fears about his expanding ambitions to control the size and growth of corporate wealth. In 1936, Roosevelt proposed perhaps the most disturbing of all corporate tax reforms from the perspective of business – an undistributed profits tax. Although his advisers had urged such a policy as a tool against corporate surplus as far back as the 1932 Berle memorandum, Roosevelt had resisted because of the fear that business

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118 Paul K. Conkin, *The New Deal* (2d ed. 1975): 63.

119 Bank, Taxing Bigness, (noting that between 1932 and 1935, all corporations were subject to the same flat rate tax, which prevented raising corporate rates without harming small business).

120 Harley L. Lutz, "The Federal Revenue Act of 1935," *American Economic Review* 26 (1936): 161, 167.

121 Howard Wood, "Standard Oil Chief Assails New Tax Plan," *Chicago Daily Tribune*, August 6, 1935, at 23.

122 1935 Senate Hearings at 120 (statement of H.W. Prentis, Armstrong Cork Co.).

123 Steven A. Bank, "When We Taxed the Pyramids," *Florida State University Law Review* 41 (2013): 39.

opposition would derail his other New Deal policies.[124] His electoral landslide in 1936, coupled with a budgetary crisis, prompted him to move forward. In a supplemental budget message delivered on March 3, Roosevelt proposed replacing the corporate tax and the exemption of dividends from the individual tax with a penalty tax on excessive retained earnings.

Roosevelt and his supporters expected that business would oppose the penalty tax and the attempt to affect dividend policy,[125] but they may have underestimated the degree of opposition. Economist Alfred G. Buehler reported that "[t]he business world . . . was aghast at the proposal and shuddered at the consequences if it was adopted."[126] The *New York Times* argued that the penalty tax would substitute "the blanket judgment of Congress and the Treasury Department, based on a general theory" for the "individual judgment of business managers, based on their direct knowledge of the needs of their particular company."[127] One of the biggest concerns was that it would drive a wedge between corporate managers and stockholders. The U.S. Chamber of Commerce predicted that the tax "would engender such uncertainties concerning the sound course to pursue as to subject management to grave difficulties with shareholders and creditors."[128]

When Roosevelt managed to stave off efforts to quash his proposal, business leaders pushed to neutralize its distributive force. They favored retaining the tax on dividends so that the penalty for a distribution to shareholders would cancel out the penalty for retaining earnings.[129] The goal was to realign managers and shareholders on the question of dividend policy, at the price of effectively introducing double taxation of corporate income.[130] As enacted in the Revenue Act of 1936, the top rate of 27 percent on

[124] Brownlee, "Historical Perspective on U.S. Tax Policy Toward the Rich," 29, 51.

[125] John Morton Blum, *From the Morgenthau Diaries: Years of Crisis, 1928-1938* (1959): 308 (quoting Herman Oliphant, Treasury general counsel).

[126] Alfred G. Buehler, *The Undistributed Profits Tax* (1937), 29.

[127] "Punishing Prudence," *N.Y. Times*, March 13, 1936, at 22.

[128] Revenue Act, 1936: Hearings on H.R. 12395 Before the House Committee on Ways and Means, 74th Cong., 2d Sess. (1936): 739-40 (statement of Fred H. Clausen, chairman of the Committee on Federal Finance, Chamber of Commerce of the United States) (1936 House Hearings").

[129] They hoped to accomplish this by limiting the rate of the undistributed profits tax to the same normal rate applied to dividends, which would make shareholders indifferent between distribution and retention. Bank, *From Sword to Shield*, 176.

[130] Bank, *From Sword to Shield*, 164-83.

undistributed profits was identical to the lowest surtax rate for incomes in excess of $44,000.[131]

The demise of the undistributed profits tax, and indeed the New Deal's anti-big business stance in corporate taxation generally, began in the summer of 1937. That was when an early economic recovery from the Great Depression was quickly dashed. Much like in the early 1920s, when reformers cited the post-war recession as a justification for business friendly corporate tax policy, the swift economic slowdown created a window of opportunity for business groups.[132] Critics blamed the undistributed profits tax for a myriad of economic problems, ranging from rising unemployment and growing stock market volatility to strikes by capital and declining business confidence.[133] In 1939, Congressional leaders and Treasury and administration officials jointly negotiated a business tax aid program that (1) eliminated the undistributed profits tax, (2) liberalized the capital stock tax,[134] (3) eliminated the limit on capital loss deductions for corporations, and (4) permitted corporations to carryforward losses for two or three years.[135] By 1942, the ban on consolidated returns enacted in 1934 was also lifted.[136]

Once the United States entered World War II, renewed concerns over excessive war profiteering once again led to higher rates on individual and corporate income. But, unlike the previous global conflict, this time there was a decidedly business-friendly feel to Congress' approach to taxing corporations. For instance, excess profits taxation was a primary feature, but corporations were permitted to choose between a war profits

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[131] Revenue Act of 1936, §101, 49 Stat. 1014 (1936). Joseph J. Thorndike, *Their Fair Share: Taxing the Rich in the Age of FDR* (Washington, D.C.: Urban Institute Press, 2013), [xx].

[132] "Testimony before the Senate Special Committee to Investigate Unemployment Relief, January 4, 1938," in *Economic Balance and a Balanced Budget: Papers of Marriner S. Eccles* (Rudolph L. Weissman ed., 1940): 89, 91; Leff, supra note xx, at 209.

[133] Bank, *From Sword to Shield*, 184-85.

[134] The capital stock tax, first enacted in 1916 during World War I, was a tax on the value of a corporation's capital stock. Corporations had to declare their stock value and were assessed on that value. The tax was paired with an excess profits tax, which was imposed on profits that exceeded a percentage of the company's declared capital stock value. So, if a corporation sought to evade the capital stock tax by declaring a low valuation, it would potentially get hit with a higher excess profits tax. In 1938, the capital stock tax was set at $1 for each $1000 of fair value. Blakey & Blakey, supra note xx, at 453; Ellen R. McGrattan, "Capital Taxation During the U.S. Great Depression," NBER Working Paper No. 16588 (2010): 13.

[135] Bank, *From Sword to Shield*, 188-89; "Leaders to Push Business Tax Aid at Present Session," *Wall Street Journal*, May 16, 1939, at 1.

[136] Bank, "When We Taxed the Pyramids," supra note xx.

approach that set the base equal to the average of the previous three pre-war years and a high profits approach that set the base equal to a normal percentage return on invested capital.[137] This flexibility permitted companies with large prewar profits to keep making those profits during the war by choosing the average return base, while companies that had profited only modestly during the war could choose the invested capital base and thereby preserve the ability to increase their profits during the war. In one example, a company was reportedly not subject to any excess profits tax despite having war-related orders of $70 million and profits that were 3000 percent larger than its previous year's profits.[138]

Another example of the use of taxation to subsidize or incentivize corporations was in the context of depreciation allowances. Under the Second Revenue Act of 1940, Congress adopted a special provision that permitted accelerated depreciation deductions for buildings deemed necessary for national defense. The recovery period for such buildings was set at five years or the conclusion of the war, whichever came first.[139] In effect, the brief recovery period allowed corporations to write off their capital purchases faster, making these expenditures more cost effective. As former Treasury official Randolph Paul explained, this accelerated recovery period was necessary "to tempt private capital into war plants."[140]

Toward the end of World War II, it was clear that the shift away from a more punitive approach to corporate taxation, at least for the moment, was complete. J. Keith Butters and John Lintner of the Harvard Business School had published a number of influential and well-publicized studies in the spring of 1944 documenting the extent to which the post-war recovery could be harmed by the corporate tax burden.[141] This started a flurry of corporate tax reform proposals. During the summer, three high-profile corporate tax reform proposals designed to aid business in the transition to the post-war

[137] Bank et al., *War and Taxes*, supra note xx, at 88-89. There was a higher rate schedule applicable to the average earnings approach that operated like a penalty for choosing that option. Randolph E. Paul, *Taxation in the United States* (1954): 268.

[138] Paul, *Taxation in the United States*, at 271.

[139] Paul, *Taxation in the United States*, at 270.

[140] Id. at 295.

[141] J. Keith Butters and John Lintner, *Effect of Federal Taxes on Growing Enterprises, Study No. 1: The Lockheed Aircraft Corporation* (1944); J. Keith Butters and John Lintner, *Effect of Federal Taxes on Growing Enterprises, Study No. 2: Polaroid Corporation* (1944).

economy were released within weeks of each other.[142] Many groups soon followed with their own plans, leading to almost sixty proposals being in circulation at one point.[143] Although budgetary concerns deferred radical reform, a "five point program" which was "designed to improve the cash position of business" was signed into law in 1945.[144]

Conclusion

Throughout the first half of the twentieth century, U.S. corporate tax laws and policies were shaped by competing groups struggling to cope with changing historical conditions. From the start, the corporate tax was riddled by conflicting justifications and rationales. The 1909 excise tax, enacted as a political comprise brokered by President Taft, marked the modern beginnings of American corporate taxation. Adopted at the height of the Progressive Era, when reformers were concerned that a new wave of corporate consolidations might undermine the ideals of American democracy, the 1909 law became a dual-edged sword. It was wielded by both anti-monopoly reformers and moderate state-builders. The former believed the law could be used to restrain the growth and power of the new large-scale, industrial corporations. The law's short-lived public disclosure provisions, in particular, were touted as useful ways to curb corporate abuses. Greater transparency of corporate operations, activists contended, would make these new concentrations of economic power more accountable to democratic politics.

Other more moderate lawmakers and reformers viewed the corporate tax as a means toward effectively taxing wealthy shareholders. Even when the levy morphed from an excise to an income tax on net corporate income, proponents argued that it ought to be seen as an indirect levy on corporate owners, and hence as an efficient way to raise revenue. From this perspective, the corporate tax was not meant to diminish the capital held within corporations and controlled by business managers and executives. Rather, it was simply a way of using the corporate form as a type of collection and remittance device to tax the income flowing to affluent individual shareholders. Although the early

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142 Bank, *From Sword to Shield*, 191-201.

143 "Tax Report," *Wall Street Journal*, January 30, 1946, at 1.

144 C.P. Trussell, "Agree on Aid for Reconversion," *N.Y. Times*, May 11, 1945, at 34; "Tax Relief Bill is Sent to Truman," *N.Y. Times*, July 21, 1945, at 1.

rationales for the corporate tax were not identical, they reflected a growing social concern that increasing concentrations of wealth – whether it was held by corporate managers or individual owners – could undermine the precepts of modern American democracy.

The corporate tax's dual ability both to raise revenue and discipline big business became even more robust during World War I. The dramatic increase in individual and corporate tax rates and the adoption of novel business levies to combat war profiteering not only ushered in a new era of "soak-the-rich" taxation, they also helped advance the notion that wealthy individuals and corporations had a social responsibility to contribute to the war effort. Meanwhile, the need for corporate capital to keep up with the demands for wartime supplies and material provided a new rationale for business managers, who defeated calls for an undistributed profits tax by arguing that corporate tax policy could help lock-in necessary capital. Not all aspects of the wartime tax system operated as planned, however. The excess profits tax may have had some unintended consequences that led to its ultimate demise after the war. Yet, for the most part, the war experience strengthened the place of the corporate tax in the modern American fiscal order.

The end of the Great War brought with it a significant shift in corporate tax laws and policies. Although the modern fiscal state did not wither away after the conflict, the retrenchment of the 1920s created a more business-friendly environment. With Andrew Mellon at the helm of the Treasury Department throughout most of the decade, and with the economy struggling to make the transition from war to peace, business tax relief became a paramount concern. Consequently, the excess profits tax was repealed, tax rules on corporate mergers and acquisitions were relaxed, and top marginal rates were slashed, though they did not return to their pre-war levels. Business corporations were even encouraged to retain earnings and develop surpluses that could be used for further capital investments and economic growth. The material benefits generated by corporate capitalism were hailed as supporting rather than undermining American democracy.

This sanguine view of the relationship between big business and a democratic polity came to a crashing halt, however, with the arrival of the Great Depression. In fact, during the early New Deal, corporate tax policies were decidedly anti-big business. Corporate managers and owners were singled out as causes of the Depression and as sources of political corruption. Although the enacted tax laws and policies of the early

1930s did little to change the business landscape, President Roosevelt's rhetoric and proposals to use tax policy to discipline and control corporations created a conservative backlash. The quick end to the fragile economic recovery in 1937 only accelerated the backlash, leading to the repeal of the short-lived undistributed profits tax and other pro-business reforms.

When the United States entered World War II, corporate taxation continued to exhibit the mixed motives that had marked its early adoption and development. On the one hand, the dramatic increase in rates and the enactment of a modified excess-profits tax indicated that the federal government was well aware of how the risks of excessive wartime profiteering could undermine faith in the legitimacy of American democracy. On the other hand, the government was not above using tax policies to shape the wartime economy, to induce corporations to make particular kinds of tax-favored investments. Indeed, the war witnessed the increasing use of tax benefits like accelerated depreciation to shape corporate behavior and decision-making.

Well after the war, the fluctuating rationales and reasoning behind corporate tax policy persisted, moving in tandem with changing historical conditions. During some economic downturns, tax laws were designed to subsidize businesses; for example, in the use of accelerated depreciation to encourage capital investment and hence stimulate the economy. At other times, when corporate scandals were particularly salient, tax laws and policies were used to crack down on perceived corporate abuses and malfeasance. As in the past, more recent corporate tax proposals have been notable less for their success, than for their persistence in searching for alternative methods of controlling and nurturing the corporate enterprise. A striking ambivalence towards business corporations has been, and remains, a central part of American law and democracy.