

PARITY LOST: THE PRICE OF A CORPORATE TAX IN A PROGRESSIVE TAX WORLD

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ABSTRACT

The United States has always taxed income at progressive rates, so that an individual's tax burden would increase with his ability to pay. Whenever the United States has had an income tax, it has also imposed an entity level tax on the profits of certain businesses, but not others. Both the structure of the progressive tax rates and the design of the entity level tax on business profits have evolved over time, resulting in a wide range of incentives and outcomes. This Article recounts the early history of the income tax in the United States, focusing on how an entity level tax on business profits operated within the context of a system that taxed individuals at progressive rates. It highlights how the combination of rules created disparities in the taxation of business profits, setting the stage for individuals to exploit those disparities in an effort to minimize their tax bills. Although Congress adopted measures to reduce the disparities and curb tax avoidance, such measures proved increasingly less effective as the income tax took on a more progressive design, resulting in distorted outcomes that seemed to get worse over time. In light of this experience, the Article questions whether the system ever achieved any form of parity in the taxation of business profits, potentially undermining its very ability to operate in a progressive way.

INTRODUCTION

Scholars typically apply three criteria to evaluate a tax: fairness, efficiency and simplicity.¹ Of these three, fairness may be considered the most fundamental quality that a tax should possess because it reflects the universal desire for equity and equal treatment.² Indeed, the public has consistently displayed an expectation that equity should play a role in setting tax policy, even if it is not the dominant role.³

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¹ MICHAEL A LIVINGSTON, *TAXATION: LAW, PLANNING, AND POLICY*, at xxxiv (2003).

² C. Eugene Steuerle, *And Equal (Tax) Justice for All?*, in *TAX JUSTICE: THE ONGOING DEBATE* 253, 254-57 (Joseph J. Thorndike & Dennis J. Ventry Jr. eds., 2002).

³ *Id.* at 255-57.

When scholars ask whether a tax is fair or equitable, they generally focus on the distribution of the tax burden. There are several theories that can justify a particular allocation of the tax burden. However, the income tax in the United States has always been intended to allocate the burden based on an individual's ability to pay.⁴ This essentially embraces a theory of fairness referred to as the equal sacrifice theory.⁵ That doctrine acknowledges that money has declining marginal utility, so that a rich person will value an additional dollar less than a poor person will.⁶ Accordingly, a rich person would need to pay tax at a higher rate in order to equal the sacrifice made by a poor person subject to a lower tax rate.⁷ This is the understanding that supports a tax that imposes progressively higher rates on higher levels of income.⁸

However, a progressive system of rates will not necessarily cause the tax burden to be allocated in a way that reflects an individual's ability to pay. For example, any effort to allocate a greater share of the tax burden to higher income individuals will be frustrated if individuals who occupy the same income level do not pay the same amount in tax.⁹ In other words, the system will not treat individuals at different income levels differently if it fails in the first instance to treat individuals at the same income levels the same.

There are a number of factors that might prevent individuals from paying the same tax even though they fall within the same income range. For example, consider a rule that exempts a certain item of income from tax, perhaps because of a governmental policy to favor the activities that generate that kind of income. Now imagine two individuals who have identical amounts of income, but the first derives all of his income from the exempt source while the second derives all of his income from taxable sources. In the absence of the rule, both individuals would pay the same amount of tax. However, the existence of the rule causes the first individual to pay no tax while the second one remains subject to tax. The disparate outcomes produced by the absence of a uniform rule may call into question how fair the tax system really is, because both individuals appear to have the same ability to pay the tax.

⁴ The first federal income tax, enacted in 1861, was designed with this goal in mind. W. Elliot Brownlee, *Social Philosophy and Tax Regimes in the United States, 1763 to the Present*, in *TAXATION, ECONOMIC PROSPERITY, AND DISTRIBUTIVE JUSTICE* 1, 10 (Ellen Frankel Paul et al. eds., 2006). A progressive income tax was expected to compensate for high tariffs and excise taxes on a wide range of consumer goods. *Id.*

⁵ See EDWIN R. A. SELIGMAN, *PROGRESSIVE TAXATION IN THEORY AND PRACTICE* 214 (2d ed. 1908). Alternatively, the burden could be allocated in line with the benefits one receives from the government. STEPHEN F. WESTON, *PRINCIPLES OF JUSTICE IN TAXATION* 247 (1903).

⁶ SELIGMAN, *supra* note 5, at 214. See LIAM MURPHY & THOMAS NAGEL, *THE MYTH OF OWNERSHIP: TAXES AND JUSTICE* 24 (2002).

⁷ SELIGMAN, *supra* note 5, at 214-15.

⁸ This assumes ability to pay is measured by income. One could also measure income on some other basis, such as wealth. Steuerle, *supra* note 2, at 270. Alternatively, one could theoretically tax individuals based on their ability to earn. MURPHY & NAGEL, *supra* note 6, at 22-23.

⁹ This observation essentially reflects the view expressed in the economics literature that vertical equity cannot be achieved unless horizontal equity is first achieved. MURPHY & NAGEL, *supra* note 6, at 13 (citing RICHARD A. MUSGRAVE, *THE THEORY OF PUBLIC FINANCE* 160 (1959)).

The United States has never had a uniform way of taxing business profits. In fact, every tax on income has included at least two different approaches for taxing the profits of a business. Today, the two principal approaches are reflected in the way the tax law treats partnerships and corporations. In the case of a partnership, the firm itself is not subject to tax on its business profits. Instead, the partners are required to pay tax on their share of the firm's profits, whether they receive any or not.¹⁰ This is often referred to as a flow through model of taxation. In the case of a corporation, the firm and its owners constitute separate and distinct taxpaying units, with the firm subject to tax on any profits it makes, and the owners separately subject to tax on any profits they actually receive.¹¹ Because both the firm and its owners are subject to tax on corporate profits, the corporate model is often described as a double tax on those profits.

Even though the tax law has always included more than one way for taxing firm profits, lawmakers did not always intend for the methods to produce inconsistent outcomes. In fact, as this article will show, Congress seemed committed to preserving parity in the taxation of business profits at least until the 1930s. However, some of its efforts were more successful than others.

The various approaches to taxing business profits during the nineteenth century did not create significant disparities.¹² However, the disparities became more pronounced and more widespread in the twentieth century.¹³ The disparities grew more pronounced over time in part because of the way the two sets of rules for taxing business profits operated within the larger tax system. The nineteenth century income tax system had a relatively simple design and sometimes used a single tax rate to determine someone's tax liability. In addition, the tax on business profits operated as little more than a mechanism for collecting the tax owed by the business owners on their share of business profits. However, the income tax of the twentieth century has always featured a progressive rate structure, with higher rates of tax applying to higher levels of income. Indeed, when the country adopted the modern income tax as a permanent part of its fiscal affairs, one of the central objectives was to impose a tax based on an individual's ability to pay.¹⁴ At the same time, the system included a unique way for taxing the profits of a business when it was incorporated. Corporate profits were not taxed in full if the firm did not distribute them to its shareholders. By contrast, any distributed corporate profits and any profits of an unincorporated business, such as a partnership or sole proprietorship, were taxed in full in all cases.

The partial tax relief available to undistributed corporate profits was based on the view that the firm would later invest these amounts in the business.¹⁵

¹⁰ See I.R.C. § 701 (2006). Unless otherwise indicated, all references to the "I.R.C." are references to the Internal Revenue Code of 1986 as amended (Title 26 of the United States Code).

¹¹ See I.R.C. § 11(a) (imposing a tax on the income of any corporation) and I.R.C. § 61(a)(7) (requiring any recipient of a dividend to include the item in "gross income", exposing it to tax).

¹² See *infra* text accompanying notes 16-79.

¹³ See *infra* Tables 1 through 3 and Charts 1 through 3 in the Appendix.

¹⁴ H.R. REP. NO. 63-5, at II (1913).

¹⁵ See, e.g., *infra* text accompanying notes 156 and 174.

However, the disparity in the taxation of business profits set the stage for the formation and use of corporations that withheld profits from shareholders solely to avoid tax that would otherwise be assessed. This Article recounts the evolution of the income tax in the United States, with particular attention to the taxation of business profits. It focuses on how the growing disparities in the taxation of business profits created increasingly irresistible incentives for tax avoidance. It also summarizes the efforts undertaken to curb such activity. The historical account covers the period starting from the Civil War to the mid 1930s and is divided into two parts. The first part covers the tax acts of the nineteenth century when the systems for taxing incomes had a very modest progressive design. The second half covers the modern income tax that has evolved to the one we have today. The Article concludes with an analysis that calls into question whether the failure to curb tax avoidance undermined the efforts to tax income in a progressive way.

THE NINETEENTH CENTURY INCOME TAX ACTS

The United States has a long tradition of using taxation to restrict privilege, a tradition that derives from republican values that competed with notions of individual liberty since at least the days of the founding fathers.¹⁶ Until the Civil War, the idea that privilege should be restricted was largely reflected in state tax laws that were purposely designed to achieve a measure of social justice.¹⁷ Thus, flat taxes were imposed on real and personal property on the theory that people with high incomes spent a larger share of their incomes on land and property than low income individuals did.¹⁸

Republican values did not immediately influence the structure of taxes at the federal level because the Constitution required any direct federal tax to be uniform.¹⁹ As a result, the federal government was financed solely with tariffs and excise taxes until the Civil War.²⁰ However, the Union government had to find an alternative to taxes on consumption because simply raising them to support an army was politically impossible.²¹ The solution was to adopt the country's first tax on income.²² It would be the first of four temporary measures to tax incomes.²³ In each instance, the tax was structured to operate in a progressive manner, with a low tax rate applying to low levels of income and higher rates applying to higher levels of income.²⁴ At the same time, lawmakers observed two different procedures for taxing business profits. The first procedure was to require each owner of the firm to pay tax on his share of

¹⁶ Dennis J. Ventry, Jr., *Equity versus Efficiency and the U.S. Tax System in Historical Perspective*, in *TAX JUSTICE*, *supra* note 2, at 25, 28.

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ U.S. CONST. art. I, § 8, cl. 1.

²⁰ Ventry, *supra* note 16, at 29.

²¹ *Id.*

²² Act of Aug. 5, 1861, ch. 45, § 49, 12 Stat. 292, 309 (repealed 1862).

²³ *Id.* See also Act of Aug. 27, 1894, ch. 349, 28 Stat. 509; Act of June 30, 1864, ch. 173, 13 Stat. 223; Act of July 1, 1862, ch. 119, §§ 89-93, 12 Stat. 432.

²⁴ See, e.g., *infra* notes 30-33, 50, 92-93 and accompanying text.

the profits of the enterprise.²⁵ The second approach was to require the firm, not its owners, to pay the tax on its profits.²⁶ The government made a conscious attempt to coordinate the tax paid by the firm with the larger progressive tax on individuals so as to minimize any disparities in the way business profits were taxed and to avoid any possibility that any dollar of profits would be taxed twice.²⁷ These efforts were rarely a perfect solution, but they were largely successful at eliminating the most substantial disparities.

1861

The very first income tax was adopted in 1861.²⁸ It was a 3% levy on income in excess of \$800.²⁹ However, because the Treasury made no effort to assess or collect any tax under this law, the 1861 Act was virtually meaningless.³⁰ Thus, as a practical matter, all income was taxed at a zero rate.

1862

Congress enacted an income tax in 1862 in order to finance the Civil War.³¹ Under the 1862 Act, all individuals were exempt on the first \$600 of income.³² An individual whose income did not exceed \$10,000 was taxed at 3% on his entire income in excess of the \$600 exemption.³³ An individual whose income exceeded \$10,000 was taxed at 5% on his entire income in excess of the \$600 exemption.³⁴ Thus, when the country first implemented a progressive rate structure, it did so by requiring higher income individuals to pay higher rates on their entire income. This procedure stands in contrast to the progressive marginal rate structure that would characterize all future tax acts.³⁵ Under those later acts, a different rate would apply to different portions of an individual's income.³⁶

The system adopted in 1862 was designed so that the profits of any business would be subject to tax when paid out to its owners.³⁷ Moreover, in most

²⁵ This was the approach generally observed for firms other than financial institutions and companies in the transportation sector. *See, e.g.*, text accompanying note 38.

²⁶ Certain financial institutions and companies in the transportation sector were treated this way. *See, e.g.*, text accompanying notes 39-42.

²⁷ *See* text accompanying note 43.

²⁸ Act of Aug. 5, 1861, § 49, 12 Stat. at 309.

²⁹ *Id.*

³⁰ This was primarily because the legislation was largely viewed as a provisional measure that was expected to be considerably revised at the next session of Congress. HAROLD Q. LANGENDERFER, *THE FEDERAL INCOME TAX 1861-1872*, at 236-37 (1954); EDWIN R. A. SELIGMAN, *THE INCOME TAX: A STUDY OF THE HISTORY, THEORY, AND PRACTICE OF INCOME TAXATION AT HOME AND ABROAD* 435 (1911).

³¹ JOHN F. WITTE, *THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX* 68 (1985).

³² Act of July 1, 1862, ch. 119, § 90, 12 Stat. 432, 473.

³³ *Id.*

³⁴ *Id.*

³⁵ *See, e.g.*, Act of June 30, 1864, ch. 173, 13 Stat. 223.

³⁶ *See, e.g., Id.* § 116, 13 Stat. at 281, *amended by* Act of Mar. 3, 1865, ch. 78, 13 Stat. 469.

³⁷ This stands in contrast to a rule that applies a tax to all the profits derived by a business, whether paid out to the owners or not. That model was expressly adopted in the Revenue

cases, the firm's owners, not the firm itself, were responsible for actually paying the tax.³⁸ However, the recipient did not have to pay tax on any dividends from certain companies that were required to withhold a tax on dividends paid to shareholders.³⁹ Specifically, certain financial institutions, including banks, trust companies, savings institutions, and insurance companies had to pay a 3% tax on any profits paid out as dividends.⁴⁰ This tax had to be deducted from the dividends actually paid out.⁴¹ In a similar fashion, all railroad companies had to pay a 3% tax on any profits paid out as dividends, withholding the tax from the dividend.⁴² The tax withheld from these payments was designed to be a substitute for the tax that the recipient would have had to pay. Lawmakers intentionally structured the tax to operate in this way so as to avoid a double tax.⁴³

However, there was one disparity that arose out of the interaction of the progressive tax on individuals and the flat tax that was withheld on dividends paid by taxable businesses. The income from a taxable business would be overtaxed to a person whose total income was less than \$600. In such a situation, the 3% tax paid by the business on the owner's share of the profits would exceed the zero percent tax that would have applied had the dividend been paid by a business not subject to the entity level tax. Meanwhile, the income from the business would be undertaxed to a person whose total income was over \$10,000. In such a situation, the 3% tax paid by the business on the owner's share of the profits would be less than the 5% tax that would have applied had the individual been required to pay the tax on that income.

The possibility that profits of the business could be overtaxed was not without controversy.⁴⁴ However, as a practical matter, that possibility probably did not represent a major problem. An individual whose income fell below the \$600 exemption likely received little to no dividends. This scenario is supported by the fact that the tax on dividends accounted for a very small share of total income tax revenues.⁴⁵

Act of 1864, which is discussed in the 1864-1872 section of this Article. *See infra* pp. 136-139. The Revenue Act of 1862 does not expressly limit the tax to profits that are paid out. Instead, it is a result of the way the Act defined an individual's taxable income. It included all "profits," "dividends" and income "from any other source whatever." Act of July 1, 1862, § 90, 12 Stat. at 473. It would be inconsistent with the statutory scheme to conclude that certain undistributed profits should be taxed. Moreover, it may be that this issue has little practical significance. At the time the law was in effect, it was the general practice for a business to distribute all of its earnings to its owners. Steven A. Bank, *A Capital Lock-In Theory of the Corporate Income Tax*, 94 GEO. L.J. 889, 915 (2006) (citing WILLIAM Z. RIPLEY, *RAILROADS: FINANCE AND ORGANIZATION* 244 (1915)).

³⁸ Act of July 1, 1862, § 90, 12 Stat. at 473.

³⁹ *Id.* § 91, 12 Stat. at 473-74.

⁴⁰ *Id.* §§ 81-82, 12 Stat. at 469-71.

⁴¹ *Id.*

⁴² *Id.* Railroads had to deduct and withhold a similar 3% tax on interest paid to bondholders. *Id.*

⁴³ Steven A. Bank, *Entity Theory as Myth in the Origins of the Corporate Income Tax*, 43 WM. & MARY L. REV. 447, 453-54 (2001).

⁴⁴ LANGENDERFER, *supra* note 30, at 507-09.

⁴⁵ ROBERT STANLEY, *DIMENSIONS OF LAW IN THE SERVICE OF ORDER: ORIGINS OF THE FEDERAL INCOME TAX, 1861-1913*, at 279 n.74 (1993).

By contrast, the possibility that profits of a business could be undertaxed was viewed with enough concern that the Commissioner of Internal Revenue issued a regulation to address the inequity.⁴⁶ Under that rule, a 2% tax would be owed on dividends and interest received by individuals whose income exceeded \$10,000.⁴⁷ That tax, combined with the 3% tax paid by the business, would equal the 5% tax that would have applied if the statute required the individual to be taxed on his share of the profits of the business.

Thus, the income tax system and the entity level tax on certain businesses were coordinated in a way to eliminate major disparities in the amount of tax assessed on an individual's share of the profits of a business. However, these efforts did not eliminate all of the disparities. While there is reason to believe that these disparities did not have much practical significance at the time, they foreshadow the kinds of issues that would be faced in the future as both the tax system and the national economy underwent changes.

1864 – 1872

By 1864, the country needed more money and restructured the income tax to alleviate its financial condition.⁴⁸ The new measure enacted by Congress differed from the 1862 Act in three important ways.⁴⁹ First, the tax rates themselves were increased. Second, the schedule of tax rates applied in bracketed fashion so that each rate applied only to income that fell within a certain range, not to an individual's entire income. Third, the profits of a business were expressly taxed to the owners, not to the business.

Under the 1864 Act, an individual was exempt on his first \$600 of income, a 5% tax applied to income over \$600 and up to \$5,000, while a 10% tax applied to all income over \$10,000.⁵⁰ One early tax scholar noted that the progressive design of the 1864 Act was the subject of some discussion, implying that it was not without controversy:

Secretary [of the Treasury] Fessenden, in his report for 1864, defended the progressive income tax in the following words: "The adoption of a scale augmenting the rate of taxation upon incomes as they rise in amount, although unequal in one sense, cannot be considered oppressive or unjust, inasmuch as the ability to pay increases in much more than arithmetical proportion as the amount of income exceeds the limit of reasonable necessity."⁵¹

⁴⁶ GEORGE S. BOUTWELL, *A MANUAL OF THE DIRECT AND EXCISE TAX SYSTEM OF THE UNITED STATES* 197 (1863).

⁴⁷ *Id.*

⁴⁸ Joseph A. Hill, *The Civil War Income Tax*, 8 Q.J. ECON. 416, 423 (1894).

⁴⁹ *Compare* Act of June 30, 1864, ch. 173, 13 Stat. 223, *with* Act of July 1, 1862, ch. 119, 12 Stat. 432.

⁵⁰ Act of Mar. 3, 1865, ch. 78, 13 Stat. 469 (amending Act of June 30, 1864, § 116, 13 Stat. at 281). Prior to the amendment, an individual was exempt on his first \$600 of income, a 5% tax applied on income over \$600 and up to \$5,000, a 7.5% tax applied on income over \$5,000 and up to \$10,000, and a 10% tax applied on income over \$10,000. Act of June 30, 1864, § 116, 13 Stat. at 281. Congress made the change in order to reduce a shortfall in expected revenues. STANLEY, *supra* note 45, at 35.

⁵¹ SELIGMAN, *supra* note 5, at 102 (quoting REPORT OF THE SECRETARY OF THE TREASURY 15 (1864)).

The profits of a business were expressly taxed to the individual owners, regardless of whether the business was incorporated and regardless of whether the profits were paid out to the owners.⁵² Thus, as in the Act of 1862, the Act of 1864 contained a uniform rule for taxing the profits of a business. The two Acts differed, however, in that the former limited the tax to profits paid out to owners, while the latter applied the tax to profits that were paid out as well as profits that were retained by the business.

Superficially, the 1864 Act eliminated any possibility that an individual's share of business profits would either be overtaxed or undertaxed, as was the case under the 1862 Act. However, a number of other provisions had the effect of perpetuating the same problem as existed under the prior law.

Under the 1864 Act, a business that operated in certain industries had to pay a flat tax on its annual profits.⁵³ Certain financial institutions had to pay a 5% tax on all dividends paid to shareholders and on any undistributed surplus.⁵⁴ A separate provision required certain transportation companies to pay a 5% tax on all dividends paid to shareholders and any undistributed surplus.⁵⁵ In each case, the tax on the dividends had to be withheld from the payments made to the shareholders, just as they had under the 1862 Act.

The design of the tax raised the possibility that the profits from these taxable businesses could be double taxed in two different ways. First, a double tax on the same dollar profits would arise if a dividend was paid out of previously taxed undistributed profits from a prior year. This problem was addressed by relieving the company from the obligation to withhold tax on any such dividend.⁵⁶ Double taxation would also arise if the recipient of a dividend would have to pay tax on that item of income. This problem was addressed in the same way as it was in the 1862 Act. Thus, any dividends received from such taxable businesses did not have to be taken into account by the recipient.⁵⁷ Of course, this solution was an imperfect one for the same reasons as the 1862 Act, in that it did not completely eliminate the disparities in the taxation of business

⁵² Act of June 30, 1864, § 117, 13 Stat. at 282 (“[T]he gains and profits of all companies, whether incorporated or partnership . . . shall be included in estimating the annual gains, profits, or income of any person entitled to the same, whether divided or otherwise.”). Under the interpretation of the Commissioner of Internal Revenue, the amounts taxed to an individual included the undivided profits of a corporation. See DIGEST OF DECISIONS AND REGULATIONS MADE BY THE COMMISSIONER OF INTERNAL REVENUE, 1864-1898, at 16, 36, 37, 39, 40 (1906). In dictum, the Supreme Court concurred with this interpretation in *Collector v. Hubbard*. *Collector v. Hubbard*, 79 U.S. (12 Wall.) 1 (1870). Taxing partnerships and corporations in the same way under a uniform rule seems to be consistent with the prevailing view about the nature of a partnership and a corporation. At the time, both business forms were considered to be an aggregate of its owners. See Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L.J. 53, 58 (1990).

⁵³ Act of June 30, 1864, §§ 120, 122, 13 Stat. at 283-85.

⁵⁴ *Id.* § 120, 13 Stat. at 283-84. A business was subject to this provision if it was a “bank, trust company, savings institution, and of any fire, marine, life, [or] inland insurance company” *Id.*

⁵⁵ *Id.* § 122, 13 Stat. at 284-85. The same withholding tax applied to any interest paid to bondholders. *Id.* A business was subject to this provision if it was a railroad, canal, turnpike, canal navigation or slackwater company. *Id.*

⁵⁶ *Id.* § 121, 13 Stat. at 284.

⁵⁷ *Id.* § 117, 13 Stat. at 281.

profits. Admittedly, it was effective in preventing such business profits from being double taxed in those situations in which the shareholder's income fell between \$600 and \$5,000, the range that was subject to a tax of 5%, the same rate that applied to the business. However, it did not alleviate the problem of overtaxed or undertaxed profits that would occur when the shareholder's income fell outside of that range. Because the 5% tax on the business was more than the zero rate of tax on income up to \$600, an individual in that income bracket would be overtaxed on their share of the profits from such a business. Meanwhile, because the 5% tax on the business was lower than the 10% tax on individual income over \$5,000, an individual in that income tax bracket would be undertaxed on their share of the profits from such a business.⁵⁸

The problem of overtaxed and undertaxed business profits was corrected under amendments incorporated into the 1864 Act before it went into effect.⁵⁹ Under the amended version, an individual would have to include in income any interest and dividends on which the payor had withheld tax.⁶⁰ However, the tax withheld on any payment was counted towards the recipient's tax liability.⁶¹ This tax credit mechanism stands in contrast to the provisions of the original Act, which simply excluded these items of tax paid income from the recipient's gross income.⁶² Under the revised design, the potential for an item to be undertaxed was eliminated because if the recipient had income in excess of \$10,000, placing him in the 10% tax bracket, a tax of 5% would still be owed on any dividend on which the payor withheld 5%.

In 1867, Congress amended the 1864 Act so as to restructure the income tax in other notable ways.⁶³ Starting in 1867, the two-tiered graduated rates were replaced with a flat 5% tax on all income in excess of a \$1,000 exemption amount.⁶⁴ The change reduced the amount of progressivity built into the tax system, but it did not eliminate it entirely because for all practical purposes, there were two tax brackets: a zero percent bracket and a five percent bracket. Even this structure would cause an individual's tax burden to gradually increase with his ability to pay because the effective tax rate would rise with the person's income level.

The other notable amendment changed the way the tax on individuals was coordinated with the entity level tax imposed on certain businesses. The existing law required an individual to take the dividends into account but per-

⁵⁸ The possibility of overtaxed and undertaxed income did not exist under the bill that was originally introduced by the House Ways and Means Committee. That piece of legislation imposed a flat 5% tax on all income, including business profits. SELIGMAN, *supra* note 30, at 440. The problem only arose after the bill was modified during Congressional debates to include a graduated rate structure. *Id.* at 441.

⁵⁹ Act of Mar. 3, 1865, ch. 78, 13 Stat. 469 (amending Act of June 30, 1864, ch. 173, 13 Stat. 223).

⁶⁰ *Id.*, 13 Stat. at 479.

⁶¹ *Id.*

⁶² Act of June 30, 1864, § 117, 13 Stat. at 281.

⁶³ Act of Mar. 2, 1867, ch. 169, § 13, 14 Stat. 471, 477-80 (amending Act of June 30, 1864, ch. 173, 13 Stat. 223).

⁶⁴ *Id.*, 14 Stat. at 477-78.

mitted the tax liability to be reduced by the tax withheld by the business.⁶⁵ Starting in 1867, any dividends received from a taxable business would not be taken into account when computing an individual's tax liability.⁶⁶ At a superficial level, this change did not create any disparities because the 5% flat tax withheld from the payment was identical to the 5% flat tax imposed on the individual. However, because an individual was exempt on the first \$1,000 of income, there was at least the potential for a dividend to be overtaxed to the extent it was paid to someone whose income did not exceed \$1,000. Congress reduced the tax rate to 2.5% in 1870.⁶⁷ The tax remained in effect and applied to amounts earned through 1871.⁶⁸ It was never renewed and was simply allowed to expire following multiple attempts by wealthy individual to repeal it outright on the grounds that it was a temporary measure intended to meet the demands of the war and nothing more.⁶⁹

1894

Congress reinstated an income tax in 1894 in the aftermath of the economic dislocations produced by the Panic of 1893 and amid the growing sense that the existing system of tariffs was an inequitable way to finance the government.⁷⁰ The measure was later invalidated by the Supreme Court and never took effect.⁷¹ However, its provisions are instructive, in that they follow the model set by prior Acts. Some features were similar to those contained in the 1864 Act.⁷² Thus, there was a flat tax that applied to an individual's income in excess of an exempt amount. In this case the tax was 2% and the exemption was \$4,000.⁷³ The 1894 Act imposed the tax on an individual's "profits, and income . . . of every business, trade, or profession . . ."⁷⁴ This language does not expressly state whether the tax was intended to reach an individual's entire share of business profits, whether paid out to the owner or not. However, concluding that it does would be reasonable. First, the conclusion would be consistent with the practice and policy initiated in the 1862 Act. Second, it would be consistent with the method of taxing business profits under the 1894 Act's rules that applied to certain taxable entities.

The 1894 Act revived the old entity level tax and extended its scope so that it applied to all "corporations, companies, or associations doing business for profit . . ."⁷⁵ Each such taxable entity had to pay a 2% tax on its "net

⁶⁵ See *supra* notes 60-61 and accompanying text.

⁶⁶ Act of Mar. 2, 1867, § 13, 14 Stat. at 478.

⁶⁷ Act of July 14, 1870, ch. 255, § 6, 16 Stat. 256, 257.

⁶⁸ *Id.* However, the tax was last collected in 1872 on amounts earned in 1871. See Act of March 2, 1867, ch. 169, § 13, 14 Stat. 478.

⁶⁹ Ventry, *supra* note 16, at 29; Seligman, *supra* note 30 at 466-68.

⁷⁰ WITTE, *supra* note 31, at 70.

⁷¹ See *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429, 586 (1895).

⁷² Act of June 30, 1864, ch. 173, 13 Stat. 223, amended by Act of Mar. 3, 1865, ch. 78, 13 Stat. 469, further amended by Act of Mar. 2, 1867, ch. 169, § 13, 14 Stat. 417, 477-80.

⁷³ Act of Aug. 27, 1894, ch. 349, § 27, 28 Stat. 509, 553, invalidated by *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429 (1895).

⁷⁴ *Id.*

⁷⁵ *Id.* § 32, 28 Stat. at 556.

profits,” whether paid out as a dividend or not.⁷⁶ As under the amended Act of 1864, all of a corporation’s profits were to be taxed.⁷⁷ However, unlike the earlier Act, this one did not operate through the use of a withholding mechanism on dividends. Thus, amounts paid to shareholders represented the after-tax profits of the corporation, not the pre-tax profits of the corporation reduced to reflect the recipient’s tax on that income. Nevertheless, as a result of the coordination of the corporate tax and the individual tax, the tax paid by the corporation on its profits took the place of the tax that would otherwise be paid by the shareholder on any dividend. This change is apparent from the fact that their recipients did not take corporate dividends into account, eliminating the possibility that such income would incur a double tax.⁷⁸ Of course, this mechanism for preventing a double tax did not prevent the possibility that an individual with less than \$4,000 in income would be overtaxed on any corporate dividend he received. The number of cases that fell into this category remains unknown. On the one hand, the \$4,000 exemption was expected to leave no more than one-tenth of the population subject to the income tax.⁷⁹ A tax-paid corporate dividend could have been received by a substantial number of individuals with incomes below the \$4,000 threshold.

SUMMARY OF THE NINETEENTH CENTURY TAX ACTS – PARITY PRESERVED

There are four themes that run through the income tax acts of the late nineteenth century. First, each one contained a very modest progressive design, in that some portion of income was exempt from tax even though a flat rate might have been imposed on all income in excess of the exemption. Second, there was a concerted attempt to tax business profits in a uniform way. In 1862, the uniform rule was to impose a tax on all profits paid out to the owners of a business. In 1864 and 1894, the uniform rule was to impose a tax on all profits derived by the business, whether paid out or not. Third, the government made concerted efforts to prevent business profits from being undertaxed. In the 1862 Act, this was accomplished by an administrative practice to impose a 2% make-up tax on all dividends received by an individual in the 5% tax bracket to supplement the 3% tax that was withheld. In 1864, this was accomplished by giving the recipient of a dividend a credit for any tax withheld by the company. Fourth, in no instance was there an effort made to mitigate against the risk of an overtaxed dividend, a possible reflection of the fact that any such cases would be rare.

⁷⁶ *Id.* The Act provided that:

The net profits or income of all corporations, companies, or associations shall include the amounts paid to shareholders, or carried to the account of any fund, or used for construction, enlargement of plant, or any other expenditure or investment paid from the net annual profits made or acquired by said corporations, companies, or associations.

Id.

⁷⁷ Act of June 30, 1864, ch. 173, §§ 120, 122, 13 Stat. 223, 283-85.

⁷⁸ Act of Aug. 27, 1894, § 28, 28 Stat. at 554.

⁷⁹ STANLEY, *supra* note 45 at 133 tbl.3-7.

THE EARLY TWENTIETH CENTURY

The income tax laws that were enacted in the years following the adoption of the Sixteenth Amendment continued the tradition of being structured in a progressive way. They also continued the tradition of treating certain businesses—specifically corporations—as separate taxpaying units. However, the income taxes of the twentieth century are distinctive in that the rate tables are much more progressive, a feature that will exacerbate the potential for corporate profits to be either overtaxed or undertaxed. Aware of these disparities and the opportunities they created for taxpayers to avoid tax, lawmakers adopted measures directed at restoring at least a measure of parity. However, the early measures proved ineffective, leading to a series of adjustments designed to repair the shortcomings in the law. However, these efforts to curb taxpayer attempts to avoid tax proved to be largely futile, casting doubt on whether all taxpayers in the same income level were actually paying the same amount of tax.

1913

In the wake of the Sixteenth Amendment, Congress adopted an income tax on individuals and corporations.⁸⁰ One of the overriding objectives of the Revenue Act of 1913 was to devise a system that allowed the tax burden to vary with an individual's ability to pay.⁸¹ This objective was largely motivated by the fact that the existing system of tariffs and excise taxes allocated the tax burden in an inequitable way, with poorer persons having to surrender a greater share of their income to the government than wealthy persons would.⁸²

The tax system adopted in 1913 was slightly more complex than the ones that preceded it, primarily because it actually consisted of two separate taxes on individuals.⁸³ The first was the normal tax and the second was the surtax.⁸⁴ The 1913 Act also contained an entity level tax on corporations and similar business forms.⁸⁵ However, that tax did not interact with the normal tax in the same way that it interacted with the surtax, creating disparities that lawmakers struggled to address.⁸⁶

The normal tax was a 1% tax on an individual's net income in excess of an exempt amount.⁸⁷ The exempt amount depended on a person's marital status. An unmarried individual was allowed to exclude the first \$3,000 from the nor-

⁸⁰ Revenue Act of 1913, ch. 16, 38 Stat. 114.

⁸¹ H.R. REP. NO. 63-5, at 37 (1913).

⁸² *Id.*

⁸³ Revenue Act of 1913 § II(A)(2), 38 Stat. at 166.

⁸⁴ *Id.*

⁸⁵ The corporate tax applied to “[e]very corporation, joint-stock company or association, and every insurance company, organized in the United States, no matter how created or organized, not including partnerships” *Id.* § II(G)(a), 38 Stat. at 172.

⁸⁶ It is not entirely clear why Congress adopted the system that it did. The corporate income tax replaced a virtually identical tax adopted in 1909. The normal tax seems to have been viewed as an extension of that tax to individuals. *See* 50 CONG. REC. 1302 (1913) (remarks of Rep. Anderson). Lawmakers may have viewed the surtax as the vehicle for achieving its progressive objectives.

⁸⁷ Revenue Act of 1913 § II(A)(1), 38 Stat. at 166.

mal tax, while married couples were collectively allowed to exclude the first \$4,000.⁸⁸ An individual's net income would include his share of the profits of any partnership, whether those profits were distributed or not.⁸⁹ However, net income did not include any corporate dividends.⁹⁰ Instead, all dividends and any undistributed corporate profits were subject to an identical 1% tax at the entity level under the corporate tax provisions.⁹¹ Thus as in prior tax laws, the entity level tax paid by certain businesses was the functional substitute for the tax that would have been paid by the recipient of any dividend. However, because the normal tax only kicked in when an individual's income exceeded the exempt amount, an individual whose income fell below that threshold would have been overtaxed on his share of any corporate profits.

The disparities produced by the normal tax paled in comparison to the disparities produced by the surtax. Under the surtax, an individual whose income exceeded \$20,000 was subject to tax under a schedule of six rates ranging from 1% to 6%.⁹² The rates applied in a graduated way with the 1% tax applying to net income above \$20,000 and up to \$50,000, while the 6% rate applied to amounts in excess \$500,000.⁹³ The members of Congress broadly agreed on this overall structure of the surtax.⁹⁴ However, lawmakers seemed to struggle before settling on an approach for applying the surtax (or any second level of tax) to business profits.

The application of the surtax to business profits was not expressly addressed in the original bill reported out of the House Ways and Means Committee and later passed by the full House.⁹⁵ The Senate Finance Committee addressed the issue directly by amending the bill to include a provision that required an individual to pay surtax on his share of the profits of any business, whether incorporated or not, as long as he would be "legally entitled to enforce the distribution or division of the same."⁹⁶ The drafters inserted this language out of an apparent concern that both partnerships and corporations would start reducing the amount of profits they distributed to their owners in an attempt to prevent those profits from being subject to the surtax.⁹⁷

⁸⁸ *Id.* § II(C), 38 Stat. at 168.

⁸⁹ *Id.* § II(D), 38 Stat. at 169.

⁹⁰ *Id.* § II(B), 38 Stat. at 167.

⁹¹ *Id.* § II(G)(a), 38 Stat. at 172.

⁹² *Id.* § II(A)(2), 38 Stat. at 166.

⁹³ *Id.*

⁹⁴ The Senate Finance Committee did not recommend any changes to this aspect of the tax as proposed by the House Ways and Means Committee and adopted by the full House of Representatives. Compare S. REP. NO. 63-80 (1913), with H.R. REP. NO. 63-5 (1913).

⁹⁵ See H.R. REP. NO. 63-5 (1913). See also J. S. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS: 1938-1861, at 983-84 (1938).

⁹⁶ SEIDMAN, *supra* note 95, at 983.

⁹⁷ Senator Williams offered this explanation in response to a question raised by Senator Root on the floor of the Senate:

That language, "if divided or distributed," is somewhat awkward, and for that very reason we want it to go back to the committee; but the object of the amendment was this: Here is a partnership, for example; the partners might make a very large amount of money, but they can effect an agreement whereby, instead of setting aside to each partner his income for that year, they allow it to go into the business, each partner to draw against the firm and make a showing of having no income at all from the partnership. Then, it was thought that for the purpose of

The idea of taxing an individual on a portion of firm profits not actually received by him was not new. The 1864 Act set a precedent for that.⁹⁸ However, now lawmakers began to question whether the law could validly permit the undistributed profits of a corporation to be considered the income of any shareholder.⁹⁹ For that reason, the provision was sent back to the Committee for further consideration.¹⁰⁰

The Committee modified the provision by requiring firm owners to pay surtax on their share of the undistributed earnings of a business in those cases where the undistributed amounts were beyond the reasonable needs of the business.¹⁰¹ Before deciding to limit the rule in this way, the Committee received the input of the Southern Railway Company, which cautioned against a rule that would put firms in the position of having to defend a decision to reinvest profits in the business.¹⁰² The Committee continued to draw no distinction between corporations and other businesses. Thus, the modified version applied to both incorporated and unincorporated firms.¹⁰³

Additional language was added to the original version to help clarify that the surtax would only reach those instances in which an intention to avoid tax motivated the decision not to distribute or divide profits. Specifically, owners would be taxed on their share of undistributed profits only when the companies

obtaining revenue a corporation might now and then pass up a portion of its profits to surplus or otherwise refrain from distributing them.

50 CONG. REC. 3774 (1913) (statement of Sen. Williams).

⁹⁸ See *supra* note 52 and accompanying text.

⁹⁹ This seems to be clear from the following exchange between Senators Root and Williams on the floor of the Senate:

Mr. ROOT. Mr. President, before the amendment goes back to the committee, I desire to ask that the committee consider the question whether it is possible that the gains and profits referred to in this provision can be regarded as the income of the individual stockholder when they are not divided or distributed. As I understand, this clause would have the effect of imposing an income tax on the aliquot share of each stockholder of a corporation in that part of the profits of the corporation for the year which might have been distributed but were not distributed.

Mr. WILLIAMS. Not precisely that; but such part of the income of the partnership or corporation as a partnership or shareholder would have the legal right to force the distribution of.

. . . .

Mr. ROOT. But taking it altogether, particularly considering the concluding words, I think it does aim to tax as income of the stockholder the profits of the corporation which are not divided. . . .

I understand the law to be—I think it is the law in all of our States—that no stockholder has a right to demand a dividend from the profits of a corporation against the judgment of the directors or trustees of the corporation.

50 CONG. REC. 3774 (1913) (statements of Sens. Root and Williams). There was little concern about the longstanding practice of taxing partners on their share of partnership profits. This likely reflects the fact that by the time the Revenue Act of 1913 was under consideration, a partnership had generally come to be viewed as an extension of its owners, not as a separate entity. See UNIF. P'SHIP ACT 1914, U.L.A. §§ 15, 25, 29.

¹⁰⁰ However, Senator Borah openly noted that if the committee decided not to apply the surtax to undistributed corporate profits, Congress would have to contend with reducing the risk that large estates would incorporate in order to escape the surtax. 50 CONG. REC. 3775 (1913) (statement of Sen. Borah).

¹⁰¹ SEIDMAN, *supra* note 95, at 984.

¹⁰² See 50 CONG. REC. 4379 (1913).

¹⁰³ SEIDMAN, *supra* note 95, at 983.

(whether incorporated or not) were “formed or fraudulently availed of for the purpose of preventing the imposition of such [surtax] through the medium of permitting such gains and profits to accumulate”¹⁰⁴ Senator Williams explained the objective of the language this way:

It applies only to such profits and the heaping up of such surplus as shall justify the Secretary of the Treasury in concluding that it is done for the purpose of evading the tax. Its main purpose is to prevent the formation of holding companies.¹⁰⁵

The Senate Finance Committee’s adoption of a uniform rule for taxing the undistributed profits of partnerships and corporations seems odd. After all, elsewhere in the legislation, the Committee specified that the partners of a partnership (but not the shareholders of a corporation) would have to pay tax on their share of firm profits, whether distributed or not.¹⁰⁶

By the time the bill was reconciled in the Conference Committee, the taxation of business profits under the surtax provisions underwent yet another change so as to eliminate the law from having two inconsistent rules for taxing the undistributed partnership profits. Under the compromise, the surtax would apply in two different ways, depending on whether the profits were derived from an incorporated business or not.¹⁰⁷ In the case of an unincorporated business, each owner would have to pay the surtax on his share of the profits of the business.¹⁰⁸ This rule essentially replicated the approach taken for purposes of the normal tax. However, if the business was a corporation, the conferees took a two pronged approach. First, each shareholder was required to pay surtax on any corporate profits actually distributed to him as a dividend.¹⁰⁹ Second, the shareholders would also have to pay surtax on their share of any profits that were not distributed if the corporation’s failure to do so was motivated by a desire to prevent the surtax from coming into play.¹¹⁰

Known as the accumulated earnings penalty tax, this latter provision was distinctive in part because it was not self executing. Instead, the government had to detect cases of unlawful conduct and assess the tax. When it did, the

¹⁰⁴ *Id.* at 984.

¹⁰⁵ 50 CONG. REC. 4330, 4380 (1913) (statement of Sen. Williams).

¹⁰⁶ 50 CONG. REC. 3827, 3855 (1913) (“*Provided further*, That any persons carrying on business in partnership shall be liable for income tax only in their individual capacity, and the share of the profits of a partnership to which any taxable partner would be entitled if the same were divided, whether divided or otherwise, shall be returned for taxation and the tax paid, under the provisions of this section”).

¹⁰⁷ SEIDMAN, *supra* note 95, at 983-84.

¹⁰⁸ Revenue Act of 1913, ch. 16, § II(D), 38 Stat. 114, 169 (“*Provided further*, That any persons carrying on business in partnership shall be liable for income tax only in their individual capacity, and the share of the profits of a partnership to which any taxable partner would be entitled if the same were divided, whether divided or otherwise, shall be returned for taxation and the tax paid, under the provisions of this section”).

¹⁰⁹ *But cf. id.* § II(B), 38 Stat. at 167 (allowing an individual to exclude dividends from taxable income for purposes of the normal tax only).

¹¹⁰ *Id.* § II(A)(2), 38 Stat. at 166 (“For the purpose of [the surtax] the taxable income of any individual shall embrace the share to which he would be entitled of the gains and profits, if divided or distributed, whether divided or distributed or not, of all corporations, joint-stock companies, or associations however created or organized, formed or fraudulently availed of for the purpose of preventing the imposition of such tax through the medium of permitting such gains and profits to accumulate instead of being divided or distributed”).

government would have to establish that the failure to distribute profits was motivated by the desire to avoid tax. The 1913 Act identified two factors that could independently be relied upon as prima facie evidence of a fraudulent purpose to escape the surtax. First, if the corporation was a mere holding company, that would constitute such prima facie evidence.¹¹¹ However, the 1913 Act did not define what a holding company was. Second, the fact that the corporation permitted its gains and profits to accumulate beyond the reasonable needs of the business would also constitute such prima facie evidence.¹¹² However, the mere fact that the gains and profits were permitted to accumulate and become surplus was not to be construed as evidence of a purpose to escape the surtax unless the Secretary of the Treasury certified that such accumulation was “unreasonable for the purposes of the business.”¹¹³ Thus, only certain instances of undistributed surplus would be the target of the tax on the theory that there were certain legitimate accumulations of surplus that could be distinguished from illegitimate accumulations. However, Congress left it to the Secretary of the Treasury to actually draw the distinctions and to make the judgment call.

In any year the tax applied, the result was that the firm was taxed similar to a partnership for purposes of the surtax, with the shareholders having to pay tax both on amounts they actually received and their share of any undistributed profits for the year. However, it would be incorrect to say that the firm and its shareholders were treated in a way that was identical to a partnership and its partners. A partner was not taxed on amounts actually received by the partnership. Rather, a partner was taxed solely on the partner’s share of profits derived by the partnership in a given year, while any actual distributions were tax free to the partner. By contrast, under the rules of the accumulated earnings tax, a shareholder remained subject to tax on any profits actually received from the corporation as a dividend. If in a later year, such a dividend consisted of amounts that were previously taxed to the shareholder under the accumulated earnings tax, that dividend would remain subject to tax. There was no provision exempting such a dividend from the surtax.¹¹⁴

¹¹¹ *Id.* § II(A)(2), 38 Stat. at 167.

¹¹² *Id.*

¹¹³ *Id.*

¹¹⁴ To that extent, the tax seems to operate as a penalty. However, writing at a more contemporaneous time, one scholar concluded that the provision was “not, strictly speaking, a penalty statute.” Lucius A. Buck & Francis Shackelford, *Retention of Earnings by Corporations Under the Income Tax Laws*, 36 VA. L. REV. 141, 153 (1950). However, he reached this conclusion without considering whether shareholders would be taxed on dividends consisting of profits that were previously taxed to them under the accumulated earnings rules in prior years. The one penal quality he did identify was the fact that the surtax would apply to amounts “the corporation could have accumulated to meet its reasonable needs.” *Id.* By that measure, however, it would seem that the approach for taxing partnerships also had a penal quality, since—under those rules—partners were not relieved of surtax on their share of partnership profits retained by the firm to meet its reasonable needs.

As a matter of Congressional intent, however, the legislative history for the Revenue Act of 1913 contains no evidence that lawmakers consciously intended a double tax to apply. Congress affirmatively rejected such an idea five years later when it revised the accumulated earnings tax. Those amended rules expressly exempt from the surtax future distributions of amounts that were previously taxed to shareholders. There is no evidence that the change

As a practical matter, however, it seems unlikely that this was an issue that ever arose. First, the accumulated earnings tax was assessed in extremely rare situations.¹¹⁵ Second, in the event that it was assessed, it seems even more unlikely that a corporation would have ever made a distribution of previously taxed earnings in later years. In order for it to have done so, it would have had to pay dividends that exceeded its earnings for the current year. That would seem to be a remote possibility for a corporation that attempts to minimize the profits it pays out in any given year. In any event, by the time the 1913 Act came into effect, it was already a well-established practice for corporations to legitimately retain some portion of its annual earnings.¹¹⁶

In the end, the system for taxing business profits did not operate in a uniform way. While all partnership profits were subject to as much as 7% in tax, corporate profits would be subject to tax at that rate only when they were distributed to shareholders. Corporate profits that were retained by the firm were only subject to the 1% corporate tax. These disparate rules for taxing firm profits seem to be premised on the idea that certain undistributed corporate earnings were entitled to partial tax relief that other forms of business profits did not deserve.

It is far from clear that all members of Congress shared this view. However, even if they did, the tax writers had reason to be concerned that taxpayers would employ tactics that would cause “undeserving” business profits to qualify for tax relief intended solely for corporate earnings that were retained to meet the reasonable needs of the business. After all, the system had a built-in incentive for individuals to utilize corporations to conduct a business and for such firms to retain as much profits as possible, not to pay them out to shareholders. This incentive was especially strong when the interests of the firm and its owners were sufficiently aligned, such as when the firm was wholly owned by one individual. The accumulated earnings tax was the one tool adopted for curbing such abusive practices. It would soon be apparent whether it would have the desired effect.

1917

Congress revisited its approach to the taxation of business profits only four years after it adopted the country’s permanent income tax.¹¹⁷ In 1917, Congress enacted the War Revenue Act, which actually consisted of two sets of income taxes.¹¹⁸ Certain provisions amended the existing normal tax, surtax

was motivated by a desire to ease the burden of the tax. To the contrary, as this Article attempts to show, Congress consistently tried to strengthen it.

¹¹⁵ See 55 CONG. REC. 6162, 6172 (1917) (remarks of Sen. Simmons) (noting that the government prosecuted only two cases under the statute in the four years it was in effect).

¹¹⁶ Bank, *supra* note 37, at 918.

¹¹⁷ In the intervening years, Congress enacted the Revenue Act of 1916. Revenue Act of 1916, ch. 463, 39 Stat. 756. Its operative rules were similar to those of the Act it replaced. However, the tax rates were adjusted. Both the normal tax rate and the corporate tax rate were increased from 1% to 2%. *Id.* § 1(a), 39 Stat. at 756; *Id.* § 10, 39 Stat. at 765. In addition, the schedule of surtax rates was expanded to cover thirteen tax brackets ranging from 1% to 13%. *Id.* § 1(b), 39 Stat. at 756-57.

¹¹⁸ War Revenue Act, ch. 63, 40 Stat. 300 (1917).

and corporate tax statutes. Other provisions constituted an entirely new tax on income, referred to as the War Income Tax.¹¹⁹ Congress seemed as focused as ever on the elimination of disparities in the way the law applied to business profits. Some of the provisions were intended to minimize such disparities.¹²⁰ However, other rules seemed to make matters worse. The War Income Tax fell into the latter category.

The War Income Tax consisted of a normal tax on individuals, a surtax on individuals, and a corporate tax. The normal tax was a flat 2% tax on net income in excess of an exempt amount.¹²¹ Meanwhile, the corporate tax was set at 4%, marking the first time the corporate tax rate was not equal to the normal tax rate for individuals and creating a new source of disparity in the taxation of business profits.¹²² As under prior tax acts, corporate dividends were exempt from the normal tax, while partnership profits were taxed to the partners.¹²³

The surtax component of the War Income Tax was structured as a set of seventeen graduated rates ranging from 1% to 50%.¹²⁴ The surtax applied to an individual's share of any partnership profits, whether distributed or not.¹²⁵ However, if the profits were generated by a corporate business, the shareholder had to pay surtax only on the amounts he received as a dividend.¹²⁶ The net effect of the War Income Tax was to perpetuate and magnify the disparities that were already produced by the existing taxes on income. Partnership profits were subject to a combined tax of as much as 67%. However, the combined tax on corporate profits was as much as 69% if distributed and 6% if not distributed. This combination of rules only increased the incentive for individuals to form corporations and to refrain from paying out the firm's earnings.

Congress made one noteworthy change to the existing corporate tax provisions, hoping it would reduce some of the differences between the taxation of corporate profits and other income, including partnership profits derived by individuals. It supplemented the existing 2% corporate tax with an additional tax on undistributed corporate profits.¹²⁷ Under the new provision, a corporation had to pay a 10% tax on its after tax net income that remained undistributed six months after the end of the tax year.¹²⁸ However, certain amounts of

¹¹⁹ The legislation also contained a title imposing a war excess profits tax on every corporation, partnership and individual. *Id.* §§ 200-214, 40 Stat. at 302-08. These provisions replaced the war excess profits tax that was passed earlier in the year, on March 3, 1917. *Id.* § 214, 40 Stat. at 308.

¹²⁰ *See, e.g., infra* notes 127-33 and accompanying text.

¹²¹ War Revenue Act § 1, 40 Stat. at 300. For purposes of the War Income Tax, the personal exemption was set at \$1,000 for single individuals, and \$2,000 for married couples and heads of families. *Id.* § 3, 40 Stat. at 301.

¹²² *Id.* § 4, 40 Stat. at 302.

¹²³ *Id.* § 3, 40 Stat. at 301. *See also* Revenue Act of 1916, ch. 463, § 5(b), 39 Stat. 756, 759-60 and § 8(e), 39 Stat. at 762.

¹²⁴ The surtax came into play when net income exceeded \$5,000. The top rate applied when net income exceeded \$1 million. War Revenue Act, § 2, 40 Stat. at 301.

¹²⁵ *Id.* § 3, 40 Stat. at 300-01. *See also* Revenue Act of 1916 § 8(e), 39 Stat. at 762.

¹²⁶ War Revenue Act, § 3, 40 Stat. at 300-01. *See also* Revenue Act of 1916 § 5(b), 39 Stat. at 759-60.

¹²⁷ War Revenue Act § 1206(2), 40 Stat. at 333-34.

¹²⁸ *Id.*

undistributed earnings were exempt from this new tax. First, the tax was not imposed on amounts that were “actually invested and employed in the business.”¹²⁹ Second, the tax was not imposed on amounts that were “retained for employment in the reasonable requirements of the business.”¹³⁰ Third, the tax was not imposed on amounts invested in obligations of the United States government.¹³¹ However, if the Secretary of the Treasury determined that any amount retained for employment in the business was not so employed or was not reasonably required in the business, then the corporation had to pay a 15% tax on such amounts.¹³² This measure was viewed as an attempt to balance the need to minimize disparities in the taxation of business profits without penalizing a corporation for investing in its future.¹³³

Like the accumulated earnings tax,¹³⁴ the tax on undistributed corporate profits focused on the lack of parity in the taxation of undistributed corporate profits and the taxation of profits from an unincorporated business. However, the two measures differed in some noteworthy ways. First, the undistributed earnings tax was designed to be self-assessed in the first instance, so that it would be triggered in the absence of action by the Secretary of the Treasury. By contrast, the accumulated earnings tax could be assessed only after the Secretary of the Treasury had determined that the corporation had been formed or availed of for the proscribed purpose. The second major difference was that the undistributed earnings tax was a tax on the corporation, while the accumulated earnings tax was a tax on the shareholders.

The tax on undistributed corporate profits was the subject of considerable debate. The provision was added to the bill by the Senate Finance Committee. Its members were motivated by a desire to restore a measure of parity between the taxation of corporate profits and other income.¹³⁵ At the same time, the

¹²⁹ *Id.*

¹³⁰ *Id.*

¹³¹ *Id.*

¹³² *Id.*

¹³³ Summarizing the compromise reached by the Conference Committee, Senator Simmons commented:

Of course, dividends declared by corporations have been subject to the surtax of the individual stockholder receiving them, but neither the existing law nor the House bill require corporations to distribute their earnings or impose any surtax or penalty upon such part of their earnings as remain undistributed. As a result the corporations of the country have accumulated large undivided surpluses which have escaped the income surtax as long as they remained undistributed. It is evident that in these circumstances the greater the individual surtax the greater the inducement to corporations to refrain from distributing their surpluses.

Your committee thought it expedient to devise some method of coercing distribution of these earnings when not retained for the necessary requirements of the business. With this end in view the Senate adopted an amendment proposed by the Finance Committee imposing a tax of 10 per cent upon the undistributed surplus of a corporation but exempted from this tax such retained surplus as the Secretary of the Treasury should ascertain and find was reasonably required in the business and actually employed in it.

55 CONG. REC. 7605, 7615 (1917) (statement of Sen. Simmons).

¹³⁴ Revenue Act of 1916, ch. 463, § 3, 39 Stat. 756, 758. The accumulated earnings tax remained in effect.

¹³⁵ According to the Senate Report:

Under both the House bill and existing law the normal tax of the corporation and the normal tax of the individual is the same. In these conditions the earnings of the corporation escape surtax

Committee tried to be sensitive to evolving business practices. The Committee Report noted that larger and larger portions of corporate profits were not being distributed, mostly because business began to view profits as way to finance future investment and because other options for financing corporate growth had become less attractive.¹³⁶ Because this new practice necessarily prevented such undistributed sums from being subject to the surtax, the Committee reasoned that the only way to address the situation was to impose a tax on at least a portion of undistributed corporate profits.¹³⁷

The Senate Finance Committee considered a number of alternatives before settling on the measure that ultimately became law. First, the Committee thought it could completely eliminate disparities by applying to corporations the rule that applied to partnerships, which would make a shareholder responsible for the surtax on his share of corporate profits whether paid out or not.¹³⁸ This option was rejected because of the fear that there might be a constitutional objection to taxing a shareholder on amounts that he did not actually receive.¹³⁹ In addition, the Committee was concerned about the possibility that a minority shareholder would be required to pay tax on income that he could not force the corporation to pay to him.¹⁴⁰

Having ruled out a shareholder level tax on undistributed corporate profits, the Committee considered ways to impose the tax on the corporation itself. The initial idea was to impose a flat tax of 15% on 80% of undistributed corporate earnings.¹⁴¹ That idea was met with protests from corporate interests, who convinced the Committee that it would impose a serious handicap on business conducted in corporate form because managers would be faced with the difficult choice of either distributing surplus or paying a tax that would have been several times what it would cost to borrow the money in the open market.¹⁴² The Committee was persuaded that the practice of retaining corporate surplus

until distributed among its shareholders. This situation seemed to your committee to bring about an inequality between the corporation and the individual which should be remedied as far as practicable.

S. REP. NO. 65-103, at 21 (1917).

¹³⁶ *Id.* at 21-22.

¹³⁷ *Id.*

In view of the fact that it has heretofore been the custom of corporations, for well recognized and sound economic reasons to retain in the business a greater or less proportion of their annual earnings, and in view of the further fact that the present situation calls for unusual outlays for purposes of expansion, development, etc., to meet the demands and requirements of the situation, and the increased difficulty in borrowing money on satisfactory terms and conditions caused by the large demand of the Government upon the investing public to float its securities issued to raise revenue for the war, your committee believes that the situation would be best met by imposing the surtaxes above mentioned upon such portions of the retained surplus as is not retained for employment in the business

Id.

¹³⁸ 55 CONG. REC. 5947, 5966-67 (1917) (remarks of Senator Simmons).

¹³⁹ *Id.*

¹⁴⁰ *Id.* Accord 55 CONG. REC. 6310, 6335 (1917); 55 CONG. REC. 6162, 6173 (1917).

¹⁴¹ 55 CONG. REC. 5947, 5966-67 (1917). Accord 55 CONG. REC. 6162, 6174 (1917).

¹⁴² 55 CONG. REC. 5947, 5966-67 (1917) (remarks of Senator Simmons).

was a longstanding and sound practice that should not be treated as an attempt to avoid tax on the income.¹⁴³

Although the Committee felt that corporations should not be penalized for reinvesting profits in the business, it nevertheless believed that something had to be done to establish greater parity between the taxation of partnership profits and the taxation of corporate profits.¹⁴⁴ The compromise was the provision that became law: a 10% tax on those undistributed profits that did not fall into one of the exempt categories, supplemented by a provision to impose a 15% tax on those profits that were found to be in excess of the reasonable requirements of the business.¹⁴⁵

Not everyone had high expectations that the law would achieve the Committee's goal. Senator Andrieus A. Jones expressed concern about whether it was possible for the Secretary to perform the job required of him under the legislation:

Mr. President, under that provision the duty is imposed upon the Secretary of the Treasury to ascertain the reasonable business requirements of every corporation in the United States. It is estimated that next year there will be 400,000 of them, and he is to find out not only what they are doing but whether they ought to do it or not; to ascertain the reasonable requirements of every line of business under the sun, a task absolutely impossible of execution, not only as to the varied classes of business of the country but by reason of the enormous task of doing it. . . .

It is impossible from another point of view. What are the reasonable business requirements of the corporation? What is the business in which its capital may be employed or for which it may be reserved to be employed? How are you going to ascertain what is the business of the corporation?¹⁴⁶

The Committee's recommendation encountered a number of counterproposals when it was debated on the Senate floor. One of the more forceful cases for a different approach was made by Senator Jones, who sat on the Finance Committee but questioned the wisdom of the tax on undistributed profits. He stressed that corporate profits were undertaxed compared to profits derived from unincorporated businesses, inspiring one of his colleagues to note how this bias against the latter would only encourage such businesses to take on a corporate form.¹⁴⁷ At the same time, Senator Jones acknowledged that a corporation should not be taxed on profits that were retained for reinvestment.¹⁴⁸ However, he noted that unincorporated businesses were no less entitled to such an exemption.¹⁴⁹ To rectify the situation, he offered an unsuccessful amendment that would have applied a 10% tax on the retained profits of any corporation in excess of \$5,000.¹⁵⁰ This would have eliminated the vague standard that established an exemption for any amounts that were "reasonably" required by a business.

¹⁴³ *Id.*

¹⁴⁴ *Id.*

¹⁴⁵ War Revenue Act, ch. 63, § 1206(2), 40 Stat. 300, 334 (1917).

¹⁴⁶ 55 CONG. REC. 6162, 6173 (1917) (remarks of Sen. Jones).

¹⁴⁷ 55 CONG. REC. 6310, 6329 (1917) (colloquy between Sens. King and McCumber).

¹⁴⁸ 55 CONG. REC. 6162, 6175 (1917) (remarks of Sen. Jones).

¹⁴⁹ *Id.* at 6171, 6173, 6175.

¹⁵⁰ *Id.*

The Senate also entertained the idea of allowing all businesses, whether incorporated or not, to retain a certain amount of earnings tax free.¹⁵¹ The idea was to permit both incorporated and unincorporated businesses to exclude from tax amounts that were not in excess of the reasonable needs of the business. However, that idea was thought to put tax collections in jeopardy.¹⁵² One Senator, Gilbert M. Hitchcock, suggested that the idea would be improved if the exemption only applied to 5% of the profits of a business.¹⁵³

Chairman Furnifold M. Simmons of the Senate Finance Committee defended the proposal on several grounds. First justifying it as a form of rough justice, he contended that the tax collected under the proposal would roughly equal the tax that would be collected if profits in excess of reasonable business needs were distributed and subject to surtax at the shareholder level.¹⁵⁴ Second, he explained that the Committee viewed the measure as one that would encourage more corporate distributions.¹⁵⁵ Another Committee member, Senator Porter McCumber, explained that members made a conscious tradeoff when they voted for the measure: they were prepared to permit a portion of corporate profits to go untaxed currently so that the business could invest its surplus in ways that would produce larger taxable corporate profits in future years.¹⁵⁶

Whatever motivated Congress to design the measure as it did, the resolution was neither easy to reach nor without its critics. Perhaps that problem explains why Congress would find itself revisiting the issue and resolving it differently only one year later.

1918

In the Revenue Act of 1918, Congress adjusted the income tax system in ways to make it even more progressive.¹⁵⁷ In that context, Congress had to consider yet again the ever growing disparities in the way business profits were taxed and the options for reducing that disparity. As it did in 1917, Congress enacted some provisions that restored a measure of parity by counteracting the effects produced by other parts of the existing law.¹⁵⁸ Other provisions underwent adjustments intended to enhance their efficacy.¹⁵⁹ The fact that Congress made further adjustments only three years later would suggest that the results were not entirely satisfactory.¹⁶⁰

Congress continued its tradition of tinkering with the tax rates on individuals and corporations. This time, however, it did not just adjust the surtax. It also restructured the normal tax by replacing the single flat rate with a graduated tax consisting of two brackets. Under the normal tax for calendar year

¹⁵¹ 55 CONG. REC. 6310, 6330-31, 6336 (1917) (remarks of Sen. McCumber).

¹⁵² *Id.* at 6332 (remarks of Sen. Simmons) (speculating that it would result in 50% fewer tax collections).

¹⁵³ *Id.* at 6336 (remarks of Sen. Hitchcock).

¹⁵⁴ *Id.* (remarks of Sen. Simmons).

¹⁵⁵ *Id.* at 6335.

¹⁵⁶ *Id.* at 6334 (remarks of Sen. McCumber).

¹⁵⁷ Revenue Act of 1918, ch. 18, 40 Stat. 1057.

¹⁵⁸ See *infra* notes 192-93 and accompanying text.

¹⁵⁹ See *infra* notes 200-03 and accompanying text.

¹⁶⁰ Revenue Act of 1921, ch. 136, § 230, 42 Stat. 227, 252.

1918, the first \$4,000 of net income above an exempt amount was taxed at 6%, while any remaining net income was taxed at 12%.¹⁶¹ As under existing law, the normal tax applied to an individual's share of partnership profits.¹⁶² However, corporate dividends were exempt from this tax.¹⁶³ To make up for this exemption, the corporation had to pay a 12% tax on its net income.¹⁶⁴

The adoption of a two-tiered normal tax alongside a flat corporate tax perpetuated and magnified the disparities between the taxation of corporate profits and the taxation of other business profits. Now, in the few cases where a married shareholder's income did not exceed the relatively modest \$2,000 exemption, there would be a 12% tax on income that would otherwise be tax free. In addition, if the shareholder's income fell between \$2,000 and \$6,000, the corporate tax would be double the tax the shareholder would pay on his share of profits from an unincorporated business. Under existing law, by contrast, corporate dividends were overtaxed in those few cases in which a married couple's income did not exceed a \$4,000 exemption amount.¹⁶⁵

After 1918, the normal tax rates were scheduled to be adjusted in a way that would magnify the disparities even further. Starting in 1919, the first \$4,000 of net income above an exempt amount was taxed at 4%, while all other net income was taxed at 8%.¹⁶⁶ By contrast a flat tax of 10% applied to corporate profits, higher than both rates established for the normal tax.¹⁶⁷ As a result, corporate dividends were overtaxed in all cases, with the difference being no less than two percentage points.

The corporate tax on undistributed earnings was repealed.¹⁶⁸ Meanwhile, the individual surtax was restructured to consist of fifty-four brackets ranging from 1% to 65%.¹⁶⁹

The structure of the corporate tax was the result of a compromise. Under the bill, reported out of the Ways and Means Committee and passed by the House, a corporation was subject to a two-tiered tax.¹⁷⁰ A 12% tax applied to that portion of the corporation's net income that was either: distributed to shareholders as dividends; paid out to satisfy certain debts of the corporation; or paid out to buy Liberty Bonds.¹⁷¹ Meanwhile, an 18% tax applied to the rest

¹⁶¹ Revenue Act of 1918 § 210(a), 40 Stat. at 1062. When computing net income for purposes of the normal tax only, a single person was allowed to exclude \$1,000, while a married couple or head of a family could exclude \$2,000. *Id.* § 216(c), 40 Stat. at 1069. In addition, any taxpayer was entitled to reduce his net income by an additional \$200 for each dependent he could claim. *Id.* § 216(d), 40 Stat. at 1069.

¹⁶² *Id.* § 218(a), 40 Stat. at 1070.

¹⁶³ *Id.* § 216(a), 40 Stat. at 1069.

¹⁶⁴ *Id.* § 230(a)(1), 40 Stat. at 1076. A corporation was allowed to reduce its net income by \$2,000 for purposes of computing its income tax liability. *Id.* § 236(c), 40 Stat. at 1080.

¹⁶⁵ The existing exemption for an unmarried individual was \$3,000. Revenue Act of 1916, ch. 463, § 7(a), 39 Stat. 756, 761, *amended by* War Revenue Act, ch. 63, § 1203(1), 40 Stat. 300, 331 (1917).

¹⁶⁶ Revenue Act of 1918, ch. 18, § 210(b), 40 Stat. 1057, 1062.

¹⁶⁷ *Id.* § 230(a)(1), 40 Stat. at 1076.

¹⁶⁸ *Id.* § 230(a), 40 Stat. at 1075.

¹⁶⁹ *Id.* § 211(a), 40 Stat. at 1062-64.

¹⁷⁰ H.R. REP. NO. 65-767, at 12 (1918), *reprinted in* 1939-1 C.B. 86, 94.

¹⁷¹ *Id.* at 4, *reprinted in* 1939-1 C.B. at 94.

of the corporation's net income.¹⁷² This compares to a two-tiered normal tax that imposed a 4% levy on the first \$4,000 of an individual's income and 12% on the rest.¹⁷³

The House adopted this plan, but the Senate Finance Committee rejected it, believing that the plan failed to acknowledge that a corporation should not be taxed at a higher rate on amounts spent on investments that would lead to increased production in future years.¹⁷⁴ Indeed this approach was the exact reverse of the one taken under the undistributed profits tax, which did not impose tax on amounts reinvested in the business. However, the Committee openly acknowledged that it would be difficult to design a system that would relieve from tax all "legitimate uses of earnings." Such legitimate uses included, in particular, amounts that a corporation invested in the business.¹⁷⁵ Because it was impossible to implement such a system, the Committee decided to restore the flat 12% tax (8% after 1918) on corporations, but to limit the war-excess profits to corporations.¹⁷⁶ Thus, the Senate Finance Committee viewed the flat rate as the best of all options and appeared to view the war-excess profits tax on corporations as a substitute for a tax on undistributed earnings.¹⁷⁷

The two competing measures were reconciled in the Conference Committee. Under that compromise, the House reluctantly agreed to restore the flat tax on the condition that it would be set at 10% after 1918, not the 8% that was part of the bill passed by the Senate.¹⁷⁸ The House Conferees also believed that the pressure to raise revenue had been considerably reduced between the time the measure was voted out of committee and the time it was in the hands of the Conference Committee. When the Ways and Means Committee was drafting the bill, World War I was still ongoing, and the 18% tax was part of an overall effort to generate all the revenue that the government could reasonably justify.¹⁷⁹ The Conferees were particularly mindful of the fact that the high surtax rates on individual incomes would increase the incentive for corporations to accumulate profits and to not pay them out to shareholders as dividends.¹⁸⁰ By the time the Conferees met to reconcile the competing revenue bills, the war was over and the government was not under the same pressure to raise money. However, even if the government's need for money had declined, one would still have to question whether the bill contained adequate safeguards or incentives to prevent the unreasonable accumulation of corporate profits.

Congress changed the surtax by adding more brackets and increasing the tax rate for the highest bracket. Under the 1918 Act, there were fifty-four sur-

¹⁷² *Id.*

¹⁷³ *Id.*, reprinted in 1939-1 C.B. at 88.

¹⁷⁴ S. REP. NO. 65-617, at 4-5 (1918), reprinted in 1939-1 C.B. 117, 120. Senator Penrose described the arrangement in the House bill as one that would penalize corporations that practiced "conservative methods of business administration which have characterized the most wisely handled corporations." 57 CONG. REC. 549 (1918).

¹⁷⁵ S. REP. NO. 65-617, at 4-5, reprinted in 1939-1 C.B. at 120.

¹⁷⁶ *Id.*

¹⁷⁷ 57 CONG. REC. 3010 (1919) (exchange between Reps. Stafford and Kitchin).

¹⁷⁸ *Id.* at 3003-05 (remarks of Rep. Kitchin); *id.* at 3132 (remarks of Sen. Simmons).

¹⁷⁹ *Id.* at 3005 (remarks of Rep. Kitchin).

¹⁸⁰ *Id.*

tax brackets (up from thirteen) with rates ranging from 1% to 65%.¹⁸¹ As in all past revenue acts, the surtax applied to an individual's share of partnership profits, whether distributed or not, but it only applied to an individual's share of corporate profits actually distributed.¹⁸² The 1917 War Revenue Act addressed this disparity by taxing a corporation on a portion of its undistributed profits in addition to imposing a tax on illegitimately accumulated corporate earnings.¹⁸³ One year later, Congress discarded the tax on undistributed corporate profits and again relied solely on the accumulated earnings tax with substantial modifications.¹⁸⁴

Under the revised version of the accumulated earnings tax, any corporation that fraudulently accumulated earnings was subject to the rules that apply to personal service corporations, while the corporate income tax did not apply.¹⁸⁵ The personal service corporation rules required the shareholders to be taxed on their share of firm profits as if they were members of a partnership.¹⁸⁶ The result was that each shareholder would have to pay the normal tax and the surtax on their share of firm profits, whether he received any or not.¹⁸⁷

To make up for the absence of a tax on undistributed profits, Congress restricted the war-excess profits tax to corporations.¹⁸⁸ This restriction represented a change from existing law, which imposed the war-profits tax on corporations, partnerships and individuals alike.¹⁸⁹

Limiting the application of the war-profits tax to corporations did not eliminate the tax advantage that at least some corporate businesses enjoyed over their partnership counterparts. In fact, it may have made matters worse, creating a greater incentive for partnerships to convert to corporate form. This seems to be the conclusion drawn by the drafters when they met in conference to reconcile the measures passed by the House and Senate.

The Revenue Act of 1918 was not passed until February 24, 1919, yet its provisions were applicable starting in 1918.¹⁹⁰ This meant that if a partnership decided that it would be better off operating as a corporation under the new

¹⁸¹ The 1% surtax applied on net income above \$5,000 and up to \$8,000, while the 65 percent surtax applied to net income in excess of \$1 million. Revenue Act of 1918, ch. 18, § 211(a), 40 Stat. 1057, 1062–64. Individuals were no longer subject to the war profits tax enacted as part of the 1917 War Revenue Act.

¹⁸² *Id.* § 213(a), 40 Stat. at 1065; *id.* § 218(a), 40 Stat. at 1070.

¹⁸³ War Revenue Act, ch. 63, § 1206(2), 40 Stat. 300, 334 (1917).

¹⁸⁴ Revenue Act of 1918 § 230(a), 40 Stat. at 1075.

¹⁸⁵ *Id.* § 220, 40 Stat. at 1072.

¹⁸⁶ *Id.* § 218(e), 40 Stat. at 1070.

¹⁸⁷ The application of section 220 appeared to be quite cumbersome. The Treasury declared in an early pronouncement that “[w]hether a corporation is taxable under section 220 can not be determined in advance; it must be determined at a later date in the light of what it has actually done with the profits retained.” T.B.M. 2, 1 C.B. 181 (1919). The implication is that the corporation and its shareholders would report income and pay tax as if the provision did not apply. If the government determined that the provision did apply, then adjustments would have to be made at both the firm level and the shareholder level to conform to reverse the original treatment and to conform with partnership treatment.

¹⁸⁸ S. REP. NO. 65-617, at 4-5 (1918), *reprinted in* 1939-1 C.B. 117, 124. *See also* Revenue Act of 1918 § 300, 40 Stat. at 1088.

¹⁸⁹ War Revenue Act, ch. 63, § 201, 40 Stat. 300, 303 (1917).

¹⁹⁰ *See, e.g.*, Revenue Act of 1918 § 210(a), 40 Stat. at 1057.

law, it would have missed out on a full year of tax savings even if it underwent a conversion immediately after the 1918 Act was signed into law. Congress addressed the situation by permitting any partnership or sole proprietorship that incorporated before July 1919 to be treated as a corporation retroactively to January 1, 1918.¹⁹¹ In one respect, this provision stands as a concession that the government's attempts to level the playing field had fallen short. On the other hand, one might view the provision as an invitation to engage in a form of self-help.

The tax laws did not favor all corporate enterprises, paradoxically leading Congress to enact a provision that treated certain disfavored businesses as partnerships for tax purposes. The provision addressed so-called personal service corporations, which referred to any corporation whose income was derived primarily from the activities of the principal owners who were also actively and regularly engaged in the business in which capital was not a material income producing factor.¹⁹² These businesses were at risk of being taxed out of existence if they were subject to both the corporate tax and to the war-excess profits tax.¹⁹³

Lawmakers were slow to identify a suitable way to address the predicament of personal service corporations. Under the bill reported out of the House Ways and Means Committee, a maximum excess profits tax of 20% would have applied to the earnings of any corporation whose activities were to be ascribed to its stockholders and not to the invested capital.¹⁹⁴ Meanwhile, the Senate bill imposed an 8% flat tax on the net income of such corporations.¹⁹⁵ The Conferees eventually resolved the situation by treating a personal service corporation like a partnership.¹⁹⁶ Thus, the business was not subject to the 12% (falling to 10% after 1918) corporate tax.¹⁹⁷ Instead, the shareholders were taxed on both any amounts they actually received from the corporation and their share of any undistributed profits derived by the corporation during

¹⁹¹ *Id.* § 330, 40 Stat. at 1094; 57 CONG. REC. 3269 (1919) (remarks of Sen. Smoot). This election was only available to a business in which capital was a material income producing factor. Revenue Act of 1918 § 330, 40 Stat. at 1094.

¹⁹² Revenue Act of 1918 § 200, 40 Stat. at 1059. However, the term did not refer to any corporation where at least 50% of the gross income was derived from trading as a principal. *Id.*

¹⁹³ 57 CONG. REC. 3135-36 (1919) (remarks of Sen. Simmons). *See also* 57 CONG. REC. 501 (1918) (remarks of Sen. Smoot). This is so because a corporation's war-excess profits tax liability was tied to the amount of its invested capital. Revenue Act of 1918, § 301(a)-(b), 40 Stat. at 1088. A personal service corporation is unlikely to have any invested capital. A company with no invested capital would pay the lower of two amounts. The first was a 65% tax on its net income in excess of \$3,000 in 1918. The second was a 30% tax on net income between \$3,000 and up to \$20,000 and an 80% tax on its net income over \$20,000. *Id.* § 302, 40 Stat. at 1089. In either case, the tax would be in addition to the corporate tax of 12%. This arrangement compares to the graduated surtax rates imposed on individual incomes, which ranged from 1% to 65% under the Act. Moreover, the combination of corporate level taxes would be supplemented by the individual surtax on any amounts distributed by the corporation to its shareholders.

¹⁹⁴ 57 CONG. REC. 3008 (1919) (remarks of Rep. Kitchin).

¹⁹⁵ *Id.* at 3136 (remarks of Sen. Simmons).

¹⁹⁶ Revenue Act of 1918 § 218(e), 40 Stat. at 1070.

¹⁹⁷ *Id.* § 218(e), 40 Stat. at 1070; *id.* § 230(a), 40 Stat. at 1075-76.

the year.¹⁹⁸ The measure was lauded for establishing parity in the taxation of personal service corporations, partnerships and sole proprietors.¹⁹⁹

The accumulated earnings tax provisions reappeared in the 1918 Act as they had in all past revenue acts (other than the War Revenue Act of 1917). Its provisions continued to apply to shareholders of corporations that improperly accumulated earnings in order to prevent the income from being subject to the shareholder level surtax. However, the rules were modified slightly. Under the 1918 Act, such corporations were subject to the same rules as a personal service corporation.²⁰⁰ Thus, any dividends actually received would be subject to both the normal tax and the surtax at the shareholder level.²⁰¹ The corporation itself was not subject to the corporate tax, as had been the case under prior law.²⁰² Instead, starting in 1918, a corporation appeared to have nothing to lose by unlawfully accumulating its profits. If it was detected, the government would have made adjustments consistent with treating the business as a partnership, which is what it should have done in the first place. However, that analysis overlooks the fact that the corporation would still have to pay the war-profits tax.²⁰³

The accumulated earnings tax rules were modified in one additional way. Under prior versions of the rule, the tax would not kick in unless there was evidence that the corporation was “fraudulently” availed of to avoid the surtax on individuals. The 1918 Act eliminated the requirement of proving fraud when earnings of a corporation were allowed to accumulate for the purpose of preventing the imposition of the surtax upon the stockholders. Congress believed that the provision had proved to be of little value when such proof was a required element.²⁰⁴

1921

Congress waited just two years before revisiting the nation’s income tax laws. The changes it made increased existing disparities between the taxation of corporate profits and the taxation of profits from other businesses, increasing yet again the incentive to engage in forms of tax avoidance. Because the changes effectively gave corporations that retained profits a greater tax advantage than they had before, the law increased the pressure on the rules directed at penalizing abuses of the corporate form.

¹⁹⁸ *Id.* § 218(e), 40 Stat. at 1070.

¹⁹⁹ 57 CONG. REC. 3136 (1919) (remarks of Sen. Simmons).

²⁰⁰ Revenue Act of 1918 § 220, 40 Stat. at 1072.

²⁰¹ Under normal circumstances, the dividend would have been exempt from the normal tax. However, under the personal service corporation rules, the dividend loses its status as such, preventing the payment from qualifying as an exempt receipt for purposes of the normal tax. *See id.* § 218(e), 40 Stat. at 1070.

²⁰² *Id.* § 220, 40 Stat. at 1072.

²⁰³ *Id.* § 200, 40 Stat. at 1059; H.R. REP. NO. 65-1037, at 52-53 (1919).

²⁰⁴ S. REP. NO. 65-617, at 5 (1918). When describing the need to eliminate the element of fraud, Senator Simmons described the class of cases that were the target of the provision: “There is no doubt but that there are a number of so called close corporations, corporations with only a small number of stockholders, that have been organized primarily for the purpose of availing themselves of the privilege of retention to escape surtaxes upon their earnings.” 57 CONG. REC. 253 (1918).

Congress increased the corporate tax rate and eliminated the war-profits tax on corporations.²⁰⁵ Under the Revenue Act of 1921, a corporation had to pay a 12.5% tax on its entire net income, up from 10% under the existing law.²⁰⁶ At the same time, the war-profits tax was scheduled to expire after 1921.²⁰⁷ This was significant because the war-profits tax was initially viewed as a stand-in for a tax on undistributed corporate profits.²⁰⁸ Now, there was neither a tax on undistributed profits, nor a substitute for one. Perhaps the increase in the corporate tax was meant to fill the gap. The absence of a war-excess profits tax also meant that existing tax law no longer needed to treat a personal service corporation as a partnership. Understandably, the personal service corporation rules expired along with the war-profits tax after 1921.²⁰⁹

Meanwhile, the legislation did not materially change the tax on individuals. It retained the two-tiered rate structure that was then part of the normal tax, with the first \$4,000 of an individual's net income above an exempt amount being taxed at 4%, and all other net income taxed at 8%.²¹⁰ Individuals also remained liable for the surtax under a schedule of fifty-four rates ranging from 1% to 65% for 1921.²¹¹ Starting in 1922, the schedule contained forty-eight rates ranging from 1% to 50%.²¹² Any partner in a partnership remained liable for both the normal tax and the surtax on his share of partnership profits, whether he received them as a distribution or not.²¹³ Corporate profits distributed as a dividend remained exempt from the normal tax but subject to the surtax.²¹⁴

The provisions of the 1921 Act remained in effect until 1924.²¹⁵ However, an individual's tax liability for 1923 was retroactively reduced by 25%.²¹⁶ The reduction could either be refunded to the taxpayer or used by him as a credit against future tax liability.²¹⁷

²⁰⁵ Revenue Act of 1921, ch. 136, § 230, 42 Stat. 227, 252.

²⁰⁶ *Id.* A corporation was generally allowed to reduce its net income by \$2,000 when computing its income tax liability. *Id.* § 236(b), 42 Stat. at 257.

²⁰⁷ Jesse I. Miller, *High Lights of the Federal Revenue Act of 1921*, 95 CENT. L.J. 106, 108 (1922).

²⁰⁸ S. REP. NO. 65-617, at 4-5, reprinted in 1939-1 C.B. 117, 124. See also Revenue Act of 1918 § 300, 40 Stat. at 1088.

²⁰⁹ Miller, *supra* note 207, at 108.

²¹⁰ Revenue Act of 1921 § 210, 42 Stat. at 233. However, the 1921 Act did change the exemptions that were available to individuals. When computing net income for purposes of the normal tax only, a single person was allowed to exclude \$1,000, while a married couple or head of a family could exclude \$2,500 (up from \$2,000). *Id.* § 216(c), 42 Stat. at 243. However, the exclusion was capped at \$2,000 for any married couple or head of a family whose net income exceeded \$5,000. *Id.* In addition, any taxpayer was entitled to reduce his net income by an additional \$400 (up from \$200) for each dependent he could claim. *Id.* § 216(d), 42 Stat. at 243.

²¹¹ A 1% tax applied to net income over \$5,000 and up to \$6,000, while the 65% tax applied to net income over \$1 million. *Id.* § 211(a)(1), 42 Stat. at 233-35.

²¹² A 1% tax applied to net income over \$6,000 and up to \$10,000, while a 50% tax applied to net income over \$200,000. *Id.* § 211(a)(2), 42 Stat. at 235-37.

²¹³ *Id.* § 218(a), 42 Stat. at 245.

²¹⁴ *Id.* § 216(a), 42 Stat. at 242.

²¹⁵ Revenue Act of 1924, ch. 234, § 1104, 43 Stat. 253, 353.

²¹⁶ *Id.* § 1200(a), 43 Stat. at 353.

²¹⁷ *Id.*

The combination of provisions in the 1921 Act made it even less attractive for a corporation to distribute its profits to its shareholders. Any dollar of profits would have already been subject to a 12.5% tax paid by the corporation. In addition, any after-tax profits distributed to a shareholder would have been subject to a surtax of as much as 50%.²¹⁸ Meanwhile, any dollar that the corporation did not distribute would have been subject to the 12.5% corporate tax and no other tax.²¹⁹ Not only did a corporation have a greater incentive to retain as much profits as it could, when it did so, it operated at a far greater advantage over any partnership. Any dollar of partnership profits would have been subject to a normal tax up to 8% and a surtax up to 65% for 1921 (reduced to 50% starting in 1922), a combined tax that far exceeded the 12.5% corporate tax on undistributed corporate profits.

The incentives built into the 1921 Act resulted in a need to fortify the penalties for abusive practices. Congress revised the accumulated earnings penalty tax in a way that would increase the price to a corporation that failed to distribute enough of its profits. Under the 1921 Act, a corporation had to pay a 25% penalty tax on its net income in addition to the 12.5% corporate tax that had already been paid.²²⁰ Moreover, the surtax of up to 50% would have applied to any after tax profits that were later distributed to shareholders.²²¹ Under prior law, the shareholders were required to pay the penalty by treating the undistributed profits as if they were distributed.²²² The change in procedure was adopted in order to comply with the Supreme Court's decision in *Eisner v. Macomber*,²²³ which cast doubt on the constitutionality of taxing stockholders on the undistributed profits of a corporation.²²⁴

The 1921 Act gave the Commissioner the power to waive the accumulated earnings penalty if the shareholders agreed to be taxed on their share of firm profits as if the firm were a partnership.²²⁵ This election was only available when the corporation had been found to have unlawfully accumulated profits.²²⁶ In the event such permission was granted, the corporation would not be liable for any income tax, war profits, or excess profits tax for the year.²²⁷ A corporation could not eliminate its exposure to the accumulated earnings penalty by electing to treat the corporation as a partnership for income tax purposes.²²⁸ Senator Andrieus A. Jones of New Mexico suggested that the option of taxing corporate profits under the partnership rules should be available to all

²¹⁸ Revenue Act of 1921 § 211(a)(2), 42 Stat. at 235-37.

²¹⁹ *Id.* § 230, 42 Stat. at 252.

²²⁰ *Id.* § 220, 42 Stat. at 247.

²²¹ *Id.* § 211(a)(2), 42 Stat. at 235-37.

²²² Revenue Act of 1918, ch. 18, § 218(e), 40 Stat. 1057, 1070.

²²³ *Eisner v. Macomber*, 252 U.S. 189 (1920).

²²⁴ H.R. REP. NO. 67-350, at 12-13 (1921); S. REP. NO. 67-275, at 16 (1921). The *Eisner* court concluded that a shareholder could not be taxed on the value of a dividend paid in the form of stock in the dividend paying corporation. *Eisner*, 252 U.S. at 219.

²²⁵ Revenue Act of 1921 § 220, 42 Stat. at 247-48. This procedure would apply only if the shareholders unanimously agreed to it and if the Commissioner also consented. *Id.*

²²⁶ *Id.* § 220, 42 Stat. at 248.

²²⁷ *Id.* § 220, 42 Stat. at 247.

²²⁸ See I.T. 1289, I-1 C.B. 218 (1922). In that case the stockholders sought permission to be taxed as members of a partnership on the profits of the corporation whose retained profits were to be reinvested in the business. *Id.* That request was denied on the grounds that the

corporations, not just those that were determined to be organized for the purpose of avoiding the surtax.²²⁹ That suggestion was rejected.²³⁰

1924

The 1924 Act perpetuated the disparate taxation of business profits. Understanding that the rules created growing incentives for individuals to use corporations to avoid tax, Congress placed greater emphasis on the accumulated earnings tax as a device for discouraging undesirable practices. However, the provisions were clearly having very little impact, and some openly doubted whether fortifying penalties would help.

Congress did not change the corporate tax in 1924, keeping it as a 12.5% tax on corporate net income.²³¹ However, Congress restructured and lowered both the normal tax and the surtax on individuals from the levels established in 1921. Under the Revenue Act of 1924, the normal tax on individuals was restructured to consist of three tiers: a 2% tax applied to the first \$4,000 of net income above an exempt amount; a 4% tax applied to the next \$4,000 of net income; and a 6% tax applied to the remaining net income.²³² By contrast, the top rate under existing law was 8%. The surtax was also restructured to consist of forty brackets (down from forty-eight) with rates ranging from 1% to 40%.²³³ This compared to a 50% top rate under existing law. As in past revenue laws, if an individual was a partner in a partnership, that person had to include in net income his share of the profits of the partnership.²³⁴ Dividends were exempt from the normal tax on individuals, but not the surtax.²³⁵

By lowering the tax on individuals while making no changes to the corporate tax, Congress slightly reduced the comparative tax advantage enjoyed by corporations. However, the advantage was still considerable. Corporations still paid a high tax cost for distributing its profits to shareholders. Any dollar of profits would be subject to a 12.5% tax paid by the corporation. An additional tax of 40% would apply at the shareholder level. By contrast, any dollar

option was only available to a corporation that accumulated earnings in order to avoid the surtax. *Id.* at 219.

²²⁹ 61 CONG. REC. 7483 (1921) (statement of Sen. Jones).

²³⁰ 61 CONG. REC. 7483 (1921).

²³¹ Revenue Act of 1924, ch. 234, § 230, 43 Stat. 253, 282. In addition, as under prior law, the corporation was generally permitted to reduce its net income by \$2,000 for purposes of computing its income tax liability. *Id.* § 236, 43 Stat. at 285.

²³² *Id.* § 210(a), 43 Stat. at 264. A single person was permitted to reduce his net income by \$1,000 when computing his normal tax liability, while a married couple or the head of a family could reduce his net income by \$2,500 when computing his normal tax liability. *Id.* § 216(c), 43 Stat. at 272. In addition, any taxpayer was entitled to reduce his net income by an additional \$400 for each dependent he could claim. *Id.* § 216(d), 43 Stat. at 272. These adjustments were identical to those included in the 1918 Act, except that the exclusion available to high income couples or family heads was limited to \$2,000.

²³³ The 1% surtax applied to net income above \$10,000 and up to \$14,000, while the 40% top rate applied to net income over \$500,000. *Id.* § 211(a), 43 Stat. at 265-67. The 1924 Act also retroactively reduced income taxes on individuals for 1923 by 25%. *Id.* § 1200, 43 Stat. at 353.

²³⁴ *Id.* § 218(a), 43 Stat. at 275.

²³⁵ *Id.* § 216(a), 43 Stat. at 272.

that the corporation did not distribute would have been subject to the 12.5% corporate tax and no other tax. Not only were corporate distributions overtaxed compared to a corporation's undistributed profits, they were also overtaxed compared to the profits of a partnership, which would incur as much as a 6% normal tax and a 40% surtax. A tax on undistributed corporate profits would have reduced the advantage enjoyed by corporations. The Senate passed a version of the 1921 bill including such a measure.²³⁶ However, the provision was dropped from the bill reported by the Conference Committee.²³⁷

Both houses of Congress continued to rely on the accumulated earnings penalty tax to discourage the illegitimate use of corporations to evade taxes. The bill reported out of the House Committee on Ways and Means did not change the existing penalty tax rate. Thus, it provided for a 25% penalty tax on corporate net income.²³⁸ The House bill also retained the existing provision that relieved the corporation of the accumulated earnings penalty if the shareholders agreed to be taxed on the corporation's earnings as if they were partners in a partnership.²³⁹ The Senate Committee eliminated the option as a result of a decision to increase the penalty tax rate to 50%, which was considered to place a more effective check on the evasion of the individual surtax.²⁴⁰ The Senate amendment was ultimately adopted.²⁴¹

Lawmakers were acutely aware that the accumulated earnings tax did not have a very good track record of discouraging tax evasion.²⁴² The minority report of the Senate Finance Committee expressed its frustrations this way:

It is true a penalty against the organization of a corporation for the sole purpose of evading taxation is included in the present law and increased in the proposed bill. In actual result, however, such penalty provision has been and will be for all practical purposes a nullity. The penalty of the present law has only been applied in one or two cases. The Secretary testified before the committee that corporations were not being availed of so as to result in a decrease in taxation. Before another committee of the Senate a prominent attorney from the city of New York testified that such was generally being done. We believe that so long as the inducements exist in the law they will be availed of by interested taxpayers.²⁴³

²³⁶ Steven A. Bank, *Is Double Taxation a Scapegoat for Declining Dividends? Evidence from History*, 56 TAX L. REV. 463, 503 (2003).

²³⁷ *Id.* at 504.

²³⁸ H.R. REP. NO. 68-179, at 21-22 (1924). However, the House bill did include other amendments designed to eliminate opportunities for a corporation to fall outside the scope of the rule. Under existing law, a corporation that accumulated dividends from other corporations and interest on Liberty bonds would not run afoul of the prohibition against unreasonable accumulations of earnings. The proposed amendments eliminated that flexibility. *Id.* at 22. Those changes ultimately became law. See Revenue Act of 1924 § 220(d), 43 Stat. at 277.

²³⁹ See *supra* note 225 and accompanying text.

²⁴⁰ S. REP. NO. 67-275, at 26 (1921).

²⁴¹ Revenue Act of 1924 § 220(a), 43 Stat. at 277.

²⁴² During the floor debates on the 1924 Act, Senator George Norris of Nebraska observed that the use of corporations to evade surtax was a routine device for evading the surtax: "Everybody knows that it is quite common for men to escape taxation on incomes from Liberty bonds by organizing corporations really for the purpose of holding those Liberty bonds, and thus escaping the surtaxes they would have to pay if they owned them individually." 65 CONG. REC. 7359 (1924) (statement of Sen. Norris).

²⁴³ S. REP. NO. 68-398, pt. 2, at 9 (1924).

After a ten year run, the accumulated earnings tax had not proved to be equal to the challenge of curbing abuses of the corporate form. Corporations were widely used to shelter income from the surtaxes that would have otherwise applied. Congress may have had ample reason to justify giving partial tax relief to corporate profits that were retained for legitimate purposes. However, business profits were not being taxed in the way desired by the drafters of the law, primarily because it did not (and perhaps could not) distinguish legitimate from illegitimate accumulated earnings in any clear way. That undermined the effectiveness of the accumulated earnings tax in at least two ways. First, it necessarily meant that any earnings retained by a corporation, both legitimate and illegitimate, would enjoy partial tax relief, at least until the abusive practice was detected and prosecuted. However, the agencies responsible for enforcing the law could only go after the most egregious cases because they lacked the resources to go pursue all potential cases. Besides, the absence of a clear standard meant that it would have been risky for the agency to pursue borderline cases. As a result, the vast majority of abusive practices simply were not penalized. That meant that there were substantial numbers of cases where illegitimately accumulated earnings were undertaxed in practice.

1926

The 1924 Act was amended by the Revenue Act of 1926, which became effective on January 1, 1925.²⁴⁴ The principal effect of the law was to lower the rates for the normal tax and the surtax, while raising the corporate tax rate.

The 1926 Act retained the three-tiered structure of the normal tax, but reduced the tax rate for each of the tax brackets: a 1.5% tax (down from 2%) applied to the first \$4,000 of net income above an exemption amount; a 3% tax (down from 4%) applied to the next \$4,000 of net income; and a 5% tax (down from 6%) applied on the rest of an individual's net income.²⁴⁵ The surtax was restructured to consist of twenty brackets, down from forty under prior law.²⁴⁶ Moreover the rates were substantially reduced, ranging from 1% to 20%.²⁴⁷ These rates compared to 1% to 40% under prior law.

The corporate tax rate moved in the opposite direction, rising from 12.5% to 13% for 1925 and increasing further to 13.5% starting in 1926.²⁴⁸ Aside from these changes in the rates, the basic structure of the income tax system

²⁴⁴ Revenue Act of 1926, ch. 27, § 1200(a), 44 Stat. 9, 125.

²⁴⁵ *Id.* § 210(a), 44 Stat. at 21. The legislation also increased the personal exemptions that were available to individuals. A single person was permitted to reduce his net income by \$1,500 (up from \$1,000) when computing his liability for the normal tax. *Id.* § 216(c), 44 Stat. at 29. Meanwhile a married couple or head of a family could reduce his net income by \$3,500 (up from \$2,500) when computing his liability for the normal tax. *Id.* In addition, any taxpayer was entitled to reduce his net income by an additional \$400 for each dependent he could claim, the same as under prior law. *Id.* § 216(d), 44 Stat. at 29.

²⁴⁶ *Id.* § 211(a), 44 Stat. at 21-23; Revenue Act of 1924 § 211(a), 43 Stat. at 265-67.

²⁴⁷ The 1% surtax applied to net income over \$10,000 and up to \$14,000; the 20% surtax applied to net income over \$100,000. Revenue Act of 1926 § 211(a), 44 Stat. at 21-23.

²⁴⁸ *Id.* § 230(a)(1)-(2), 44 Stat. at 39. As under prior law, the corporation was allowed to reduce its net income by \$2,000 for purposes of computing its income tax liability. *Id.* § 236(b), 44 Stat. at 43.

remained the same. Thus, an individual had to pay normal tax and surtax on his share of any partnership profits.²⁴⁹ Meanwhile corporate dividends received by an individual were subject to the surtax but exempt from the normal tax.²⁵⁰

The incremental increase in the corporate tax rate, coupled with the substantial cut in the normal and surtaxes, reduced the tax advantage that undistributed corporate profits enjoyed over partnership profits (whether distributed or not) and distributed corporate profits.

Perhaps recognizing a reduced incentive to retain corporate profits for illegitimate purposes, Congress adjusted the accumulated earnings penalty tax. As in the past, the corporation remained liable for a 50% tax on its net income, in addition to the corporate tax.²⁵¹ However, Congress restored a modified version of the option that relieved a corporation of its obligation to pay the penalty. Under the revised provision, a corporation would not have to pay the penalty if all of the shareholders treated their shares of corporate profits as a dividend.²⁵² Subsequent distributions of amounts that were previously taxed to the shareholder under this rule were expressly exempt from the shareholder's normal tax and any surtax.²⁵³

As a result of this rule, the corporation's undistributed profits would be subject to the shareholder's normal tax and surtax. Meanwhile, the corporation's distributed profits would be subject to the corporate tax and the shareholder's surtax. By contrast, all partnership profits, whether distributed or not, were subject to the partner's normal tax and surtax. There was one other difference. Certain items of a partnership retained their quality and character in the hands of the partners.²⁵⁴ By contrast, the profits of a corporation were treated as a dividend.²⁵⁵ The combined effect of these changes likely had no material effect on the incentive to use the corporate form as a vehicle for reducing taxes. The 13.5% tax on undistributed corporate profits was still substantially lower than the 33.5% maximum combined tax on distributed corporate profits and the 25% maximum combined tax on partnership profits.

²⁴⁹ *Id.* § 218(a), 44 Stat. at 32.

²⁵⁰ *Id.* § 216(a), 44 Stat. at 29.

²⁵¹ *Id.* § 220(a), 44 Stat. at 34.

²⁵² *Id.* § 220(e), 44 Stat. at 34-35.

²⁵³ *Id.* Interestingly, this provision was added to the bill by the Senate Finance Committee, which in 1924 removed a similar measure from the revenue bill. Under that rejected measure, if the Commissioner of Internal Revenue concluded that a corporation had been availed of in order to evade the individual surtax, the shareholders could have elected (with the Commissioner's consent) to be taxed on their respective shares of the corporation's net income for the year. *See* text accompanying notes 238-41. Such an election would have been a substitute for the corporate penalty tax.

²⁵⁴ *Id.* § 218(b), 44 Stat. at 32.

²⁵⁵ This foreshadows the way the rules of subchapter S operated when they were first adopted. Under those rules, the profits of the corporation were taxed to the shareholders on a pro rata basis as a dividend. *See* I.R.C. § 1373(b) (1958).

1928

With the passage of the Revenue Act of 1928, Congress neither revised the basic structure, nor adjusted the rates for the normal tax and the surtax.²⁵⁶ It did, however, reduce the corporate tax to 12%, down from 13.5% under existing law.²⁵⁷ This incremental change probably did not have a material effect on the incentives for a corporation to retain profits instead of distributing them to shareholders. Congress continued to rely on the accumulated earnings penalty tax to discourage the illegitimate retention of corporate profits.²⁵⁸ Those provisions did not change.²⁵⁹ However, Congress made a concerted effort to put more teeth into the law.

The effort began in the House Committee of Ways and Means. The original bill reported out of that Committee divided the existing provision into two parts.²⁶⁰ First, it retained the original rule that imposed a penalty tax on any corporation that accumulated profits in order to avoid the surtax on individual incomes.²⁶¹ The committee reduced the penalty tax from 50% to 25% on the theory that the lower rate would eliminate unnecessarily harsh features of the tax and help enhance its practical effectiveness.²⁶²

The second part of the bill included a provision directed at so-called personal holding companies.²⁶³ The provision defined a personal holding company by reference to the corporation's concentration of ownership. Specifically, a personal holding company was any corporation where ten or fewer individuals directly or indirectly owned at least 80% of the vote or value.²⁶⁴ The Committee members believed that this class of corporations was more likely than other corporations to accumulate surplus in order to evade

²⁵⁶ As under prior law, a 1.5% tax applied to the first \$4,000 of net income above an exempt amount, a 3% tax applied to the next \$4,000 of net income, and a 5% tax applied to all remaining net income. Revenue Act of 1928, ch. 852, § 11, 45 Stat. 791, 795. The personal exemption remained unchanged at \$1,500 for a single person and at \$3,500 for a married couple or the head of a family. *Id.* § 25(c), 45 Stat. at 803. The exemption for dependents also remained unchanged at \$400 for each dependent. *Id.* § 25(d), 45 Stat. at 803. The surtax continued to have 20 separate brackets with rates ranging from 1% to 20%. *Id.* § 12(a), 45 Stat. at 796. Any partner of a partnership had to pay normal tax and surtax on his share of any partnership profits, whether distributed to him or not. *Id.* § 182(a), 45 Stat. at 840. Meanwhile, dividends were subject to the surtax, but they were exempt from the normal tax. *Id.* § 25(a)(1), 45 Stat. at 802.

²⁵⁷ *Id.* § 13(a), 45 Stat. at 797. The Act increased the statutory exclusion that was available to corporations. A corporation was generally allowed to reduce its net income by \$3,000 (up from \$2,000) for purposes of computing its income tax liability. *Id.* § 26(b), 45 Stat. at 803.

²⁵⁸ *Id.* § 104, 45 Stat. at 814-15.

²⁵⁹ As under prior law, if a corporation accumulated profits in order to prevent the shareholder level surtax from coming into play, the corporation was subject to a penalty tax equal to 50% of its net income, in addition to the corporate tax. *Id.* § 104(a), 45 Stat. at 814. However, as under prior law, the penalty tax would never apply to a corporation in any year that all of the shareholders included in income as a dividend their shares of the corporation's net income for the year. *Id.* § 104(d), 45 Stat. at 815.

²⁶⁰ H.R. REP. NO. 70-2, at 17-18 (1927).

²⁶¹ *Id.*

²⁶² *Id.* at 18.

²⁶³ *Id.* at 17.

²⁶⁴ *Id.*

individual surtaxes on corporate earnings.²⁶⁵ Moreover, during House floor debates, one lawmaker suggested that it may not be proper to respect the corporation as being separate and distinct from its owner when such a concentration of ownership exists.²⁶⁶

Any corporation qualifying as a personal holding company would be subject to a 25% tax on a certain portion of its undistributed profits. The taxable portion consisted of the amount that exceeded the firm's net income in addition to any dividends it paid plus any tax-free interest it received.²⁶⁷ The Senate believed it was time for a new approach to the taxation of undistributed profits partly because the Treasury Department was not enforcing the existing rules.²⁶⁸

Opponents to the new rule cited two related problems. First was the fact that the new rule would impose a higher tax on undistributed profits than on distributed profits. According to Representative William R. Green, there would be "a differential of 20 per cent between profits distributed and those which were not."²⁶⁹ The second problem with the new set of rules was that it did not distinguish between companies that had legitimate reasons for accumulating its earnings and those that did not. Representative Green of Iowa expressed the situation in these words:

This provision proposed by the advisory committee, which was not approved by the joint committee, and approved by the gentleman from Texas, would penalize those gentlemen who are honestly endeavoring to build up a surplus which they needed in their business, and without which they could not make a success of their business, and they are hit as hard or harder than those trying to avoid the tax.²⁷⁰

The personal holding company rules were rejected by the Senate Finance Committee, which amended the bill in conformity with existing law.²⁷¹ The Committee described the definition of a personal holding company as an "arbitrary" one that would effectively penalize corporations that were properly accumulating a surplus and failed to recognize business necessities and sound practices.²⁷² In addition, the Committee believed that the need for such a provision was declining as the disparity between the individual and corporate tax

²⁶⁵ *Id.*

²⁶⁶ 69 CONG. REC. 521 (1927) (statement of Rep. Green). In the words of Rep. William R. Green of Iowa, "As I said before, in nearly all of these cases there was one person who really got the benefit of all the profits of the company, but escaped the surtax by reason of the corporation." *Id.*

²⁶⁷ H.R. REP. NO. 70-2, at 17.

²⁶⁸ Representative Garner of Texas put it this way:

[The existing rule] was intended to enable the Secretary of the Treasury to force corporations to distribute their profits and subject their shareholders to the tax levied by Congress. It has been in the statute for some years.

The advisory committee, in a very delicate way, intimated that the Treasury Department has not enforced the law. . . .

. . . .

Now the committee . . . has in good faith undertaken to draw a provision that will be mandatory on the Treasury Department.

⁶⁹ CONG. REC. 519 (1927) (statement of Rep. Garner).

²⁶⁹ *Id.* at 520 (statement of Rep. Green).

²⁷⁰ *Id.*

²⁷¹ S. REP. NO. 70-960, at 1-2 (1928).

²⁷² *Id.* at 12.

Fall 2008]

PARITY LOST

165

rates was decreasing.²⁷³ Finally, the Committee believed that changes made in 1924 and 1926 made the provision easier to administer and had begun to result in it being applied in greater numbers of cases.²⁷⁴

Those who commented on the proposal during the floor debates expressed discomfort with the use of a rigid rule to address situations that required more flexibility. Senator William H. King viewed the government's predicament this way:

In dealing with questions of this character, as well as many others in revenue measures, the legislative branch of the Government has difficulty in steering between Charybdis and Scylla. If there are too many limitations in statutes, difficulties arise. It is impossible to foresee all the complications and conditions that will arise. . . .

I am not satisfied with this section, and yet I am not in [a] position to offer an amendment to supersede it. The Finance Committee considered the House amendment, which was intended to clarify the situation; and I think that after due consideration the committee reached the conclusion that instead of clarification it would add to the uncertainty and dubiety if attempts were made to prescribe the limitation upon the amount allowed as reserves and the circumstances under which such reserves should be set up.²⁷⁵

Senator Furnifold M. Simmons expressed similar sentiments:

In all of our discussions about this question, however, we have all realized the fact that sound economy in the conduct of a business by a corporation made it necessary that they should set aside a certain part of their annual earnings for purposes of enlargement, for purposes of improvement of their methods and their equipment, and that the requirements of one class of corporations in this respect were different from those of another class of corporations; that it was almost impossible to lay down any fixed rule to regulate the distribution of these accumulated surpluses which would not be to the disadvantage of some and to the advantage of other corporations. In that state of inability to adjust what the several corporations of the country might legitimately and reasonably require in order to be upon a safe footing in the conduct of their business, and to enlarge and develop their business and improve their methods, we felt that we were hopeless unless the Secretary of the Treasury would enforce this provision of the law.²⁷⁶

Although the personal holding company rules were not enacted in 1928, the proposal inspired later attempts to pass similar versions of these rules in 1932 and (successfully) in 1934.²⁷⁷

1932

Congress increased all tax rates in 1932 and also restructured the normal tax and the surtax rate tables.²⁷⁸ Starting in 1932, a two-tiered schedule of

²⁷³ *Id.*

²⁷⁴ *Id.*

²⁷⁵ 69 CONG. REC. 7976-77 (1928) (statement of Sen. King).

²⁷⁶ *Id.* at 7977 (statement of Sen. Simmons).

²⁷⁷ See *infra* notes 290-91, 299-302 and accompanying text.

²⁷⁸ Joint Resolution Reducing Rates of Income Tax for the Calendar Year 1929, ch. 2, 46 Stat. 47. In 1929, Congress adopted a joint resolution that temporarily reduced certain tax rates for 1929 only. *Id.* The three tiered normal income tax on individuals was revised under this measure so that the first \$4,000 of net income was taxed at .5% (down from

rates replaced the three-tiered normal tax rate schedule. A 4% tax applied to the first \$4,000 of net income above an exempt amount, while an 8% tax applied to amounts above \$4,000.²⁷⁹ Existing law imposed a maximum normal tax of 5%.²⁸⁰ The surtax was also substantially restructured and revised. The number of tax brackets was increased from twenty to fifty-three, with a 55% tax applying to net income in excess of one million dollars.²⁸¹ The lowest surtax was a 1% levy that applied to net income above \$6,000 and up to \$10,000.²⁸² The basic structure of the tax system remained the same.²⁸³ The 1932 Act increased the corporate income tax rate to 13.75% (compared to 12% under prior law).²⁸⁴ The combination of these changes substantially increased the incentive to accumulate earnings in a corporate shell as a way to avoid tax. Undistributed corporate profits were subject to a 13.75% tax, while distributed corporate profits were subject to a combined maximum tax of 68.75%. Meanwhile, partnership profits were subject to a combined maximum tax of up to 63%. Once again the need for an effective measure to curb potential abusive practices was evident.

There were no changes to the accumulated earnings penalty tax provisions.²⁸⁵ However, the House considered and rejected an amendment that would have imposed a tax on a corporation's accumulated surplus.²⁸⁶ Representatives Fiorello LaGuardia and Thomas Blanton offered the rationale for the amendment. They focused on two practices employed by operating corporations to avoid the surtax on corporate profits. First, they cited the practice of piling up a surplus to avoid tax and to use the money for call money or even to gamble in the stock market.²⁸⁷ Another practice was to pay dividends in stock, not cash, solely to avoid the surtax.²⁸⁸

The lawmakers resurrected a modified version of the personal holding company tax to address the abuses. Under the proposal, offered by Representative LaGuardia, a personal holding company was defined as any holding or

1.5%), the second \$4,000 was taxed at 2% (down from 3%), and net income above \$8,000 was taxed at 4% (down from 5%). *Id.* In addition, the corporate income tax was lowered to 11% (compared to 12%). *Id.* There was no change to the individual surtax. *See id.*

²⁷⁹ Revenue Act of 1932, ch. 209, § 11, 47 Stat. 169, 174. The personal exemptions were reduced. A single person was allowed a \$1,000 personal exemption for purposes of the normal tax only, while a married couple or the head of a family was allowed a \$2,500 personal exemption (compared to \$3,500 under prior law). *Id.* § 25(c), 47 Stat. at 184. The exemption for dependents remained at \$400. *Id.* § 25(d), 47 Stat. at 184.

²⁸⁰ Revenue Act of 1928, ch. 852, § 11, 45 Stat. 791, 795.

²⁸¹ Revenue Act of 1932 § 12(a), 47 Stat. 174-77.

²⁸² *Id.* § 12(a), 47 Stat. at 174.

²⁸³ Partners continued to be taxed on their share of partnership income for the year. *Id.* § 182(a), 47 Stat. at 222. Dividends continued to be exempt from the individual normal tax, but not the surtax. *Id.* § 25(a)(1), 47 Stat. at 184.

²⁸⁴ *Id.* § 13(a), 47 Stat. at 177. Unlike prior law which included a \$3,000 statutory exemption to corporations, no such statutory exemption was available to corporations under the 1932 Act.

²⁸⁵ *See id.* § 104, 47 Stat. at 195.

²⁸⁶ Under the amendment, a 25% tax on net income would apply to any personal holding company that permitted more than 30% of its net income to accumulate. 75 CONG. REC. 6978 (1932).

²⁸⁷ 75 CONG. REC. 6477 (1932) (statement of Rep. LaGuardia).

²⁸⁸ *Id.* at 6478 (statement of Rep. Frear).

Fall 2008]

PARITY LOST

167

investment company that satisfied two conditions. First, at least 80% of its voting stock was owned or controlled directly or indirectly by not more than fifty individuals.²⁸⁹ Second, at least 80% of its gross income for the year was derived from rents, royalties, dividends, interest (excluding tax-exempt interest), and (except in the case of regular dealers in securities) gain from the sale of securities or other assets producing such income.²⁹⁰ This definition was substantially similar to the one that appeared in the personal holding company proposal included in the 1928 revenue bill reported out of the House Committee, with one material difference. Under the 1928 House Committee proposal, the stock ownership test was met if ten or fewer individuals owned 80% of the voting stock or had a right to receive 80% of the value.²⁹¹ By contrast, the LaGuardia proposal capped the number of shareholders at fifty, which would cover more cases.

1934

The Revenue Act of 1934 restructured and revised both the normal tax and the surtax on individuals. The legislation imposed a normal tax of 4% on an individual's net income.²⁹² Under prior law the normal tax had two brackets, with an 8% tax applying in the top bracket. The revised surtax consisted of twenty-nine separate rate brackets, ranging from 4% to 59%.²⁹³ The normal tax and the surtax still applied to any individual's share of partnership profits, whether received or not.²⁹⁴ Dividends remained exempt from the normal tax, but not the surtax.²⁹⁵ The corporate tax remained at 13.75% of net income.²⁹⁶

The 1934 Act revised the accumulated earnings penalty tax. Under the new rules, any corporation found to have illegitimately accumulated its profits had to pay a 25% surtax on the first \$100,000 of undistributed earnings for the year, and a 35% surtax on any amount in excess of \$100,000.²⁹⁷ Under prior law, the corporation was subject to a 50% penalty tax. As under prior law, a corporation would be relieved of its obligation to pay the penalty if all of the shareholders included in net income as a dividend their share of the corporation's net income for the year.²⁹⁸

²⁸⁹ *Id.* at 6978.

²⁹⁰ *Id.*

²⁹¹ H.R. REP. NO. 70-2, at 17 (1927).

²⁹² Revenue Act of 1934, ch. 277 § 11, 48 Stat. 680, 684. The personal exemptions remained unchanged. A single person was entitled to exclude \$1,000 from net income for purposes of computing his normal tax liability, while married couples and the head of a family was entitled to exclude \$2,500 for this purpose. *Id.* § 25(b)(1), 48 Stat. at 693. The exemption for dependents remained at \$400 for each dependent. *Id.* § 25(b)(2), 48 Stat. at 693.

²⁹³ *Id.* § 12(b), 48 Stat. at 684-86. The 4% tax applied to net income over \$4,000 and up to \$6,000, while the 59% tax applied to net income in excess of \$1 million. *Id.* § 12(b), 48 Stat. at 684, 686.

²⁹⁴ *Id.* § 182, 48 Stat. at 730.

²⁹⁵ *Id.* § 25(a)(1), 48 Stat. at 692.

²⁹⁶ *Id.* § 13(a), 48 Stat. at 686.

²⁹⁷ *Id.* § 102(a), 48 Stat. at 702.

²⁹⁸ *Id.* § 102(d), 48 Stat. at 702.

The legislation introduced a new set of rules directed at the use of the corporation to achieve tax savings. Under the personal holding company provisions, the corporation had to pay a 30% surtax on the first \$100,000 of any undistributed net income, and a 40% surtax on any undistributed amounts in excess of \$100,000.²⁹⁹ A corporation qualified as a personal holding company if it was not a bank and if it satisfied a gross income test and an ownership test. A corporation passed the gross income test if at least 80% of its gross income for the year consisted of certain passive items of income, like interest and dividends.³⁰⁰ A corporation passed the ownership test if five or fewer individuals owned (directly or indirectly) over 50% of the value of the corporation at any time during the last half of the year.³⁰¹ As with the accumulated earnings penalty tax, a corporation would have no exposure to the personal holding company tax whenever all of the shareholders included in net income as a dividend their share of the corporation's net income for the year.³⁰²

The personal holding company rules were adopted after several years of Congressional attention to the subject of tax avoidance. The examination formally dates back to June 9, 1933, when a subcommittee of the House Committee on Ways and Means was appointed to investigate methods of preventing the evasion and avoidance of the tax laws.³⁰³ The recommendations included a provision addressing so-called personal holding companies. The Subcommittee described the classic personal holding company technique as follows:

Perhaps the most prevalent form of tax avoidance practiced by individuals with large incomes is the scheme of the "incorporated pocketbook." That is, an individual forms a corporation and exchanges for its stock his personal holdings in stock, bonds, or other income-producing property. By this means the income from the property pays corporation tax, but no surtax is paid by the individual if the income is not distributed.³⁰⁴

In order to address this situation, the Subcommittee recommended dividing the existing accumulated earnings penalty tax provisions into two parts.³⁰⁵ The idea was to preserve the existing rule in one section while providing a special rule for personal holding companies in a second section. This special rule contained two principal parts. The first part defined a personal holding company.³⁰⁶ The second part imposed a tax on a portion of the undistributed earnings of any corporation that qualified as a personal holding company.³⁰⁷

²⁹⁹ *Id.* § 351(a), 48 Stat. at 751. The accumulated penalty tax would not apply to any corporation that had to pay the personal holding company tax. *Id.* § 102(a), 48 Stat. at 702.

³⁰⁰ *Id.* § 351(b)(1)(A), 48 Stat. at 751.

³⁰¹ *Id.* § 351(b)(1)(B), 48 Stat. at 751. Attribution rules applied to determine stock ownership. *Id.* § 351(b)(1)(C)-(E), 48 Stat. at 751-52.

³⁰² *Id.* § 351(d), 48 Stat. at 752. The shareholders would not be taxed on the receipt of any earnings that were previously taxed to them under this rule. *Id.*

³⁰³ H.R. Res. 183, 73d Cong. (1933).

³⁰⁴ STAFF OF HOUSE COMM. ON WAYS AND MEANS, 73D CONG., 2D SESS., PREVENTION OF TAX AVOIDANCE: HEARING BEFORE THE SUBCOMM. 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 6 (Comm. Print 1933) [hereinafter PREVENTION OF TAX AVOIDANCE].

³⁰⁵ *Id.* at 7.

³⁰⁶ *Id.*

³⁰⁷ *Id.*

Under the special rule, a personal holding company was defined to be any corporation that satisfied an ownership test and a gross income test. The ownership test would be met if over 50% of the voting stock was owned by five or fewer individuals at the close of the taxable year.³⁰⁸ The gross income test would be met if at least 80% of the company's gross income came from rents, royalties, dividends, interest, annuities, and gains from the sale of securities.³⁰⁹ When these conditions were met in any year, the corporation would have to pay a 35% personal holding company tax.³¹⁰ The tax applied to an amount referred to as undistributed adjusted net income. This figure was arrived at by first taking the corporation's net income increased by dividends received from other corporations and any partially tax-exempt interest, and reduced by federal income taxes, excluded contributions and gifts, and disallowed capital losses.³¹¹ The result, referred to as adjusted net income, was further reduced by a 10% allowance and any dividends actually paid to stockholders during the year to arrive at undistributed adjusted net income.³¹²

The 35% personal holding company tax stood in contrast to a 25% tax on corporations that improperly accumulated surplus. The Subcommittee recommended a 25% tax in place of the existing 50% levy on the theory that the 50% tax was "too high to be readily enforceable."³¹³

Perhaps because the Subcommittee framed the personal holding company rules as a subset of the original rules directed at tax avoidance, the proposed rules were viewed through the lens of tax avoidance and evasion. However, later hearings suggest that a majority of the Subcommittee viewed the rules as a way to establish tax parity between incorporated and unincorporated businesses.³¹⁴

The administration's official reaction to the personal holding company proposal was not enthusiastic. The Treasury Department agreed with the Subcommittee's plan to subject the undistributed income of personal holding companies to a higher rate of tax than that of other corporations.³¹⁵ However, the Department thought that by defining a personal holding company with such detail, the rule would be both overinclusive and underinclusive, applying to corporations that legitimately accumulated surplus as well as failing to cover all corporations that were improperly accumulating surpluses.³¹⁶

Those concerns were echoed in the statements made by individuals who appeared before the full House Committee on Ways and Means during the hearings on the 1934 Act. In his prepared statement to the Committee, F.H. Clausen, Chairman of the Committee on Federal Taxation of the United States Chamber of Commerce made this observation: "It is believed, however, that the method proposed by the sub-committee of the Ways and Means Committee

³⁰⁸ *Id.*

³⁰⁹ *Id.*

³¹⁰ *Id.*

³¹¹ *Id.*

³¹² *Id.*

³¹³ *Id.* at 8.

³¹⁴ See *infra* notes 317-22 and accompanying text.

³¹⁵ PREVENTION OF TAX AVOIDANCE, *supra* note 304, at 8.

³¹⁶ *Id.*

for dealing with this matter is inequitable because it would unjustly penalize innocent individuals and legitimate business enterprises falling within the proposed definition of a personal holding company.”³¹⁷

The members of the Subcommittee revealed their interest in establishing tax parity between incorporated and unincorporated businesses during the appearance of Harry J. Gerrity, who represented the National Association of Building Owners and Managers. Mr. Gerrity made the point that under the proposed definition of personal holding company, any company whose sole purpose was to own and manage real estate would qualify and be required to pay the 35% tax on undistributed earnings in excess of the 10% allowance.³¹⁸ Four members of the seven member Subcommittee questioned him in an attempt to understand why earnings from a real estate business should be exempt from the surtax solely because it is incorporated, while an unincorporated business would remain subject to tax on its earnings.³¹⁹ The exchange between Mr. Gerrity and Representative Samuel B. Hill, the Chairman of the Subcommittee, went this way:

Mr. Hill. In case it is an individual instead of a corporation that is managing these office buildings, the individual has to pay his tax, and if it gets up into the surtax bracket, he has to pay the tax according to the bracket in which he finds himself. That is true, isn't it?

Mr. Gerrity. That is true.

Mr. Hill. Now why should a corporation be utilized for the purpose of avoiding that payment of tax of the individual, and that is what it amounts to. You would incorporate for bookkeeping and let this corporation handle the matter instead of handling it individually. That is the class of individuals we are trying to reach, and it seems to fit your case pretty closely.

Mr. Gerrity. We are not in that class. You build an office building and invariably it is built by a corporation and you may own all of the stock of it.

Mr. Hill. You don't have to own all of it, you could build it without being a corporation.

Mr. Gerrity. That is true, but corporations have grown up.

Mr. Hill. I know they have, but why use the corporate agency instead of acting as an individual—simply because of certain advantages that come through the corporation.

Mr. Gerrity. Yes; but not for the purpose of avoiding taxes.

Mr. Hill. But it does operate in that direction.

. . . .

If the stock is owned by one person or controlled by one person he might or might not declare dividends as it might be of advantage to him in a taxpaying way, and that is what the subcommittee had in mind, to put these people on the same basis with individuals who are operating office buildings or other similar institutions, who have to pay their taxes. Yet through the agency of a corporation in such a case as you have described here, this particular character of investments has escaped the tax that individuals operating in a similar way have to pay.³²⁰

³¹⁷ *Revenue Revision, 1934: Hearings Before the Comm. on Ways and Means, 73d Cong. 293 (1934)* (statement of F.H. Clausen).

³¹⁸ *Id.* at 296-97 (statement of Rep. Gerrity).

³¹⁹ Those four members were Representatives Hill, Cooper, Treadway and Vinson. *Id.* at 296-99. The other three members were Representatives Cullen, Crowther, and Frear.

³²⁰ *Id.* at 297-98.

Fall 2008]

PARITY LOST

171

An exchange between Mr. Gerrity and Representative Jare Cooper similarly revealed how the Subcommittee was at least partially concerned about establishing tax parity between incorporated and unincorporated businesses:

Mr. Cooper. Talking about the deficits of the last few years, you don't have to pay taxes when you have deficits?

Mr. Gerrity. That is true, but we are paying local taxes, and there is no return in the office buildings today.

Mr. Cooper. And everybody else is paying local, county, municipal, and State taxes; and, of course, many of them have deficits just as you have.

Mr. Gerrity. Yes.³²¹

The third and fourth Subcommittee members to reveal a concern about establishing tax parity were Representatives Treadway and Vinson, who had this exchange with Mr. Gerrity:

Mr. Treadway. One person building a store building—and you have mentioned one person several times in your testimony—now, why shouldn't that one person, if he is going to own all of the stock, go ahead and build it on his own; why form himself into a corporation unless there is some advantage to it somewhere?

Mr. Gerrity. Of course in the local laws there is an advantage in the corporate form; he might also own an apartment which he has in the name of a corporation, and also own two or three other office buildings in the same neighborhood, and he wants to keep them all running separately and not keep them together.

Mr. Vinson. And thereby not get into the upper brackets, if you have an income.

Mr. Gerrity. I don't think that is the purpose.

Mr. Treadway. I don't think your explanation covers it.

Mr. Gerrity. It is just good business.

Mr. Treadway. Of course it is good business.

Mr. Gerrity. It is for the limitation of liability, and the individual might have the question of loans and all that sort of thing. In other words, he keeps the operation of this building separate and distinct from a lot of his other activities, which is quite proper for business purposes.³²²

The full House Committee on Ways and Means adopted the Subcommittee's personal holding company rules without amendment. In doing so, the Committee described it as a measure that would "provide for a tax [that would] be automatically levied upon the holding company without any necessity for providing a purpose of avoiding surtaxes."³²³ In the opinion of the Committee, "the majority of such corporations [were] in fact formed for the sole purpose of avoiding the imposition of the surtax upon the stockholders."³²⁴

Congress made several material modifications to the legislation before it was eventually enacted into law. Many of the changes were designed to exclude real estate corporations from the scope of the new rules. In order to accomplish this goal, the Senate Finance Committee removed "rents" from the list of incomes that would count toward meeting the 80% passive income test.³²⁵ Committee members offered a variety of reasons for the amendment. According to the Senate Committee Report, "A great part of real-estate busi-

³²¹ *Id.* at 298.

³²² *Id.* at 298-99.

³²³ H.R. REP. NO. 73-704, at 12 (1934), *reprinted in* 1939-1 (part 2) C.B. 554, 563.

³²⁴ *Id.*

³²⁵ S. REP. NO. 73-558, at 14 (1934), *reprinted in* 1939-1 C.B. 554, 596-97.

ness is done by small family corporations” that are more in the nature of operating companies, not personal holding companies.³²⁶ Other individual lawmakers shared the view that the real estate business was unique in ways that required excluding such companies from the scope of the new rules. Representative Thomas A. Jenkins explained during House floor debates that distributing profits to shareholders might be inconvenient to real estate companies when they needed the funds to cover repairs on the property.³²⁷ After the House conceded to the Senate amendment, Representative Hill pointed out that the Conferees “thought [it would be] unfair to compel real-estate companies with heavy mortgage indebtedness to distribute earnings accumulated to meet [such obligations].”³²⁸

Another significant modification was that the allowable reserve was increased from 10% to 20%.³²⁹ This amendment was offered in order to prevent the tax from applying to family corporations that legitimately set aside a reserve for future investment in the business.³³⁰ The amendment was included in the final legislation.³³¹

Existing law relieved a corporation from having to pay the accumulated earnings penalty tax if each shareholder included in gross income his pro rata share of the corporation’s net income.³³² An identical option was proposed to be made available in the case of personal holding companies.³³³ The provision was included in the legislation as a result of an amendment made on the floor of the Senate.³³⁴ The provision was criticized for permitting shareholders to avoid the personal holding company tax. Senator James Couzens expressed his views in these terms:

Mr. President, I want to point out that this is one of the most extraordinary amendments that I have ever seen offered. It is offered with the intent of permitting evasion by holding companies of the safeguarding provisions which the committee wrote into the bill. In other words, it permits a stockholder of a corporation to report falsely an income which he has not received.³³⁵

However, the sponsors justified the measure on two grounds. First, they noted how it accommodated the peculiar situation of stockholders of companies that might have had foreign investments.³³⁶ This provision permitted the United States tax to be paid without triggering a liability for any foreign tax.³³⁷ Members of Congress consistently recognized that a distribution of corporate

³²⁶ *Id.*

³²⁷ 78 CONG. REC. 2619 (1934) (statement of Rep. Jenkins).

³²⁸ 78 CONG. REC. 7831 (1934) (statement of Rep. Hill).

³²⁹ 78 CONG. REC. 6240 (1934) (statement of Rep. King).

³³⁰ *Id.*

³³¹ H.R. REP. NO. 73-1385, at 20 (1934).

³³² See Revenue Act of 1932, ch. 209, § 104(d), 47 Stat. 169, 195.

³³³ See H.R. 7835, 73d Cong., § 351 (as passed by Senate, March 28, 1934). Neither the House nor the Senate Finance Committee included such a provision in the legislation. See H.R. 7835, 73d Cong., § 102 (Comm. Print, Feb. 20, 1934) and H.R. 7835, 73d Cong., § 351 (as reported by S. Comm. on Finance, March 28, 1934).

³³⁴ See H.R. 7835, 73d Cong., § 351 (as passed by Senate, March 28, 1934).

³³⁵ 78 CONG. REC. 6307 (1934) (statement of Sen. Couzens).

³³⁶ *Id.* (statement of Sen. Reed).

³³⁷ *Id.*

earnings was one way to avoid the tax.³³⁸ In addition, the sponsors explained that the provision was entirely consistent with the overall goal of preventing tax avoidance through the use of the incorporated pocketbook.³³⁹ Because stockholders would be paying surtax on the corporation's accumulated surplus, the tax would not be avoided.³⁴⁰

The Senate Finance Committee separated the accumulated earnings tax rules from the new personal holding company rules, moving the latter to a new title of the Revenue Act called Additional Income Taxes.³⁴¹ In addition, the Committee modified the structure of the tax itself. It replaced the flat 35% tax with a two-tiered graduated surtax. Under the Senate Bill, a 30% tax applied to the first \$100,000 of undistributed adjusted net income and a 40% tax on the corporation's undistributed adjusted net income in excess of \$100,000.³⁴² By contrast, the accumulated earnings provisions of the Finance Committee bill imposed a 25% tax on the first \$100,000 of adjusted net income and a 35% tax on adjusted net income in excess of \$100,000.³⁴³ Both amendments were included into the 1934 Revenue Act that was signed into law.

The personal holding company rules represent a milestone in the struggle by Congress to deal with the incentives to evade tax produced by the disparities in the taxation of business profits. Until 1934, Congress had either not considered or resisted the urge to define with precision the instances in which a corporation would be denied the partial tax relief that was otherwise available for undistributed corporate profits. However, the nation's abysmal experience with the accumulated earnings tax appeared to push lawmakers to consider a different approach. During the two decades that it was in effect, the accumulated earnings tax had very little impact.³⁴⁴ Its vague standards left too much room for taxpayers to evade tax and placed too heavy a burden on the government to chase them down.³⁴⁵ The personal holding company provisions, with their well defined rules, marked the end of one era and the beginning of another in the

³³⁸ *E.g.*, H.R. REP. NO. 73-704, at 12 (1934).

³³⁹ 78 CONG. REC. 6326 (1934) (statement of Sen. Reed).

³⁴⁰ *Id.*

³⁴¹ S. REP. NO. 73-558, at 44 (1934), *reprinted in* 1939-1 (part 2) C.B. 554, 596.

³⁴² *Id.*

³⁴³ H.R. 7835, 73d Cong., 2d Sess. § 102 (Comm. Print, Feb. 20, 1934).

³⁴⁴ By 1934 there were five reported cases where the government attempted to assess the accumulated earnings tax, and the governments success rate was less than stellar. The government prevailed in two of the five cases. *Williams Inv. Co. v. U.S.*, 3 F. Supp. 225 (Ct. Cl. 1933) (government assesses tax for 1924 through 1926; court upholds imposition of tax for all three years; corporation was wholly owned by one individual); *Keck Inv. Co. v. Comm'r*, 29 B.T.A. 143 (1933) (government assesses tax for 1923; board upholds the assessment; corporation was wholly owned by a married couple). It lost one case. *R.C. Tway Coal Sales Co. v. United States*, 3 F. Supp. 668 (W.D. Ky. 1933) (government assesses tax for 1922 and 1923; court rejects the assessment; one individual owned a majority of shares while other stockholders held substantial stock interests too). The government scored a partial victory in the other two. *William C. DeMille Prods., Inc., v. Comm'r*, 30 B.T.A. 826 (1934) (government assesses tax for 1924 through 1928; board upholds imposition of tax for 1924 and 1925; corporation was 99.6% owned by one individual); *United Bus. Corp. of Am.*, 19 B.T.A. 809 (1930) (government assesses tax for 1920 and 1921; court upholds imposition of tax for 1921 only; corporation was wholly owned by one individual), *aff'd*, 62 F.2d 754 (2d Cir. 1933).

³⁴⁵ *See supra* notes 204, 242-43, and 268 and accompanying text.

nation's efforts to reconcile its desire to collect tax under a progressive system while simultaneously allowing business profits to be taxed in two drastically different ways.

CONCLUSION

The drafters of our nineteenth century tax laws adopted two different methods for taxing business profits. By and large, the use of two methods did not signify that one type of business deserved to be treated differently for tax purposes than another. To the contrary, the design of the system and other evidence suggest that Congress decided to collect tax at the entity level on certain businesses primarily because it was more efficient and reliable. Indeed, there was a concerted, and largely successful, attempt to prevent the two tax collection methods from producing disparate results. The task of preventing or eliminating disparities was not an overwhelming one during the nineteenth century when the progressive tax system had a relatively crude design, consisting of no more than two rates.

The situation changed considerably in the twentieth century. Congress was under growing pressure to allocate the tax burden in a more equitable way so that wealthier individuals would assume a greater share of the tax burden. In addition, the country's involvement in World War I created a need to raise more revenue. This led Congress to restructure the way individuals computed their tax liability so that there were more rate brackets, a wider range of rates, and increasingly higher rates that applied to individuals with the largest incomes.

At the same time, Congress began to utilize two different procedures for taxing business profits, depending on whether the firm was incorporated or not. The profits of a corporation enjoyed partial tax relief if they were not distributed to shareholders. However, any distributed corporate profits and any profits of a partnership or other unincorporated business were taxed in full. The disparity between the tax on undistributed corporate profits and the maximum combined tax on other forms of business profits was substantial at times and operated on three different levels that are summarized in the tables and charts in the Appendix. First, undistributed corporate profits enjoyed a huge tax advantage over undistributed partnership profits.³⁴⁶ Second, distributed partnership profits enjoyed a slight tax advantage over distributed corporate profits.³⁴⁷ Third, undistributed corporate profits enjoyed a huge tax advantage over distributed corporate profits.³⁴⁸ All of these factors created an incentive to house investments and other income producing activities in a corporate shell and to allow the earnings to accumulate in order to prevent that income from being subject to the higher taxes that would otherwise come into play.

Congress provided undistributed corporate profits with partial tax relief on the theory that the firm would later invest these amounts in the business. However, there was no assurance that a corporation's undistributed profits would actually be used in that way. Thus, it was virtually impossible to know whether

³⁴⁶ See *infra* pp. 176 (Table 1), 178 (Chart 1).

³⁴⁷ See *infra* pp. 179 (Table 2), 181 (Chart 2).

³⁴⁸ See *infra* pp. 182 (Table 3), 184 (Chart 3).

Fall 2008]

PARITY LOST

175

the earnings retained by a corporation were legitimately entitled to the tax relief or not. Understandably, Congress foresaw the need to address the potential for tax evasion. However, the accumulated earnings tax proved to be an ineffective device for curbing and penalizing abusive practices. As a result, there were countless cases where business profits that were not entitled to partial tax relief in fact received it.

The government's inability to curb or penalize abusive practices means that there were likely widespread cases of individuals whose ability to pay tax was either disguised or otherwise understated. This has a number of troublesome implications. First, it means that individuals who appeared to have the same ability to pay (based on whatever measure the tax system employed) in fact did not. Instead, the successful tax evader had a greater ability to pay than he appeared to have. Second, it means that individuals who appeared to have a different ability to pay tax could have had the same ability to pay. That would be the case when one compares the tax avoider with his counterpart whose income was not understated as a result of tax avoidance. Third, it means that the system that was designed to operate on the basis of ability to pay may have failed to do so in practice. To that extent it appears that Congress may have failed to achieve an equitable distribution of the tax burden, thereby preventing the tax from operating in a fair way. What's more, the system seemed to produce these inequitable outcomes with greater frequency whenever Congress attempted to make the tax rates more progressive. Paradoxically, the federal income tax may have actually operated in a less equitable way whenever Congress attempted to fortify its progressive qualities. It is a legacy of the corporate tax that vexes tax policymakers to this day.

APPENDIX

TABLE 1*

Year	Profits Retained by a Corporation			Profits Retained by a Partnership		
	Top Corp. Tax	Other Tax	Total Tax	Top Normal Tax	Top Surtax	Total Tax
1913	1%		1.00%	1%	6%	7.00%
1914	1%		1.00%	1%	6%	7.00%
1915	1%		1.00%	1%	6%	7.00%
1916	2%		2.00%	2%	13%	15.00%
1917	6% ^a	10% ^b	16.00% ^c	4% ^d	63% ^e	67.00% ^f
1918	12%		12.00% ^g	12%	65%	77.00%
1919	10%		10.00% ^h	8%	65%	73.00%

* Source: Revenue Act of 1913, ch. 16, § II(G)(a), 38 Stat. 114, 172 (1913-1915 corporate tax), § II(A)(1), 38 Stat. at 166 (1913-1915 normal tax), § II(A)(2), 38 Stat. at 166 (1913-1915 surtax); Revenue Act of 1916, ch. 463, § 10, 39 Stat. 756, 765 (1916-1917 corporate tax), § 1(a), 39 Stat. at 756 (1916-1917 normal tax), § 1(b), 39 Stat. at 757 (1916-1917 surtax); War Revenue Act, ch. 63, § 4, 40 Stat. 300, 302 (1917 corporate tax), § 1206(2), 40 Stat. at 334 (1917 tax on undistributed corporate profits), § 1, 40 Stat. at 300-01 (1917 normal tax), § 2, 40 Stat. at 301 (1917 surtax); Revenue Act of 1918, ch. 18, § 230(a)(1), 40 Stat. 1057, 1076 (1918-1920 corporate tax), § 210(a), 40 Stat. at 1062 (1918-1920 normal tax), § 211(a), 40 Stat. at 1062-64 (1918-1920 surtax); Revenue Act of 1921, ch. 136, § 230, 42 Stat. 227, 252 (1921-1923 corporate tax), § 210, 42 Stat. at 233 (1921-1923 normal tax), § 211(a)(2), 42 Stat. at 235-37 (1921-1923 surtax); Revenue Act of 1924, ch. 234, § 230, 43 Stat. 253, 282 (1924 corporate tax), § 210(a), 43 Stat. at 264 (1924 normal tax), § 1200, 43 Stat. at 353 (1924 surtax); Revenue Act of 1926, ch. 27, § 230(a)(1)-(2), 44 Stat. 9, 39 (1925-1927 corporate tax), § 210(a), 44 Stat. at 21 (1925-1927 normal tax), § 211(a), 44 Stat. at 22-23 (1925-1927 surtax); Revenue Act of 1928, ch. 852, § 13(a), 45 Stat. 791, 797 (1928-1931 corporate tax), § 11, 45 Stat. at 795 (1928-1931 normal tax), § 12(a), 45 Stat. at 796 (1928-1931 surtax); Joint Resolution Reducing Rates of Income Tax for the Calendar Year 1929, ch. 2, 46 Stat. 47, 47 (1929 corporate tax and normal tax); Revenue Act of 1932, ch. 209, § 13(a), 47 Stat. 169, 177 (1932-1933 corporate tax), § 11, 45 Stat. at 795 (1932-1933 normal tax), § 12(a), 47 Stat. at 174-77 (1932-1933 surtax); Revenue Act of 1934, ch. 277, § 13(a), 48 Stat. 680, 686 (1934 corporate tax), § 11, 48 Stat. at 684 (1934 normal tax), § 12(b), 48 Stat. at 684-86 (1934 surtax).

Notes for Table 1:

- a Reflects both the Income Tax, as amended in 1916, and the War Income Tax of 1917.
 b Temporary tax on undistributed corporate profits.
 c Does not reflect the impact of the war-excess profits tax, which was imposed on all taxpayers.
 d Reflects both the Income Tax, as amended in 1916, and the War Income Tax of 1917.
 e Reflects both the Income Tax, as amended in 1916, and the War Income Tax of 1917.
 f Does not reflect the impact of the war-excess profits tax, which was imposed on all taxpayers.
 g Does not reflect the impact of the war excess profits tax, which was imposed on corporations only.
 h Does not reflect the impact of the war excess profits tax, which was imposed on corporations only.

Fall 2008]

PARITY LOST

177

Year	Profits Retained by a Corporation			Profits Retained by a Partnership		
	Top Corp. Tax	Other Tax	Total Tax	Top Normal Tax	Top Surtax	Total Tax
1920	10%		10.00% ⁱ	8%	65%	73.00%
1921	12.5%		12.50% ^j	8%	65%	73.00%
1922	12.5%		12.50%	8%	50%	58.00%
1923	12.5%		12.50%	8%	50%	58.00% ^k
1924	12.5%		12.50%	6%	40%	46.00%
1925	13%		13.00%	5%	20%	25.00%
1926	13.50%		13.50%	5%	20%	25.00%
1927	13.50%		13.50%	5%	20%	25.00%
1928	12%		12.00%	5%	20%	25.00%
1929	11%		11.00%	4%	20%	24.00%
1930	12%		12.00%	5%	20%	25.00%
1931	12%		12.00%	5%	20%	25.00%
1932	13.75%		13.75%	8%	55%	63.00%
1933	13.75%		13.75%	8%	55%	63.00%
1934	13.75%		13.75%	4%	59%	63.00%

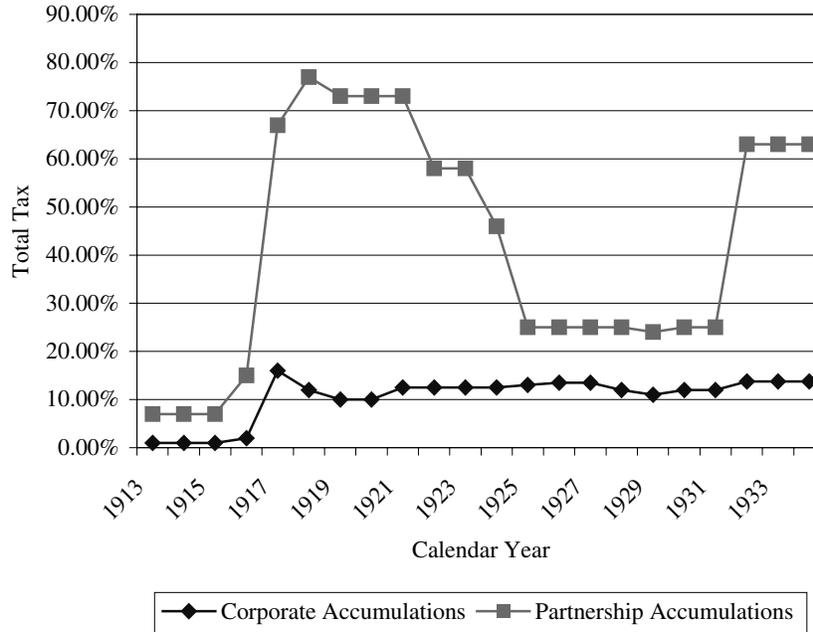
i Does not reflect the impact of the war excess profits tax, which was imposed on corporations only.

j Does not reflect the impact of the war excess profits tax, which was imposed on corporations only.

k Does not reflect the impact of a 25% retroactive rebate of tax allowed to individuals in 1924 for 1923.

CHART 1*

TAX ON PROFITS RETAINED BY A FIRM



* Source: Revenue Act of 1913, ch. 16, § II(G)(a), 38 Stat. 114, 172 (1913-1915 corporate tax), § II(A)(1), 38 Stat. at 166 (1913-1915 normal tax), § II(A)(2), 38 Stat. at 166 (1913-1915 surtax); Revenue Act of 1916, ch. 463, § 10, 39 Stat. 756, 765 (1916-1917 corporate tax), § 1(a), 39 Stat. at 756 (1916-1917 normal tax), § 1(b), 39 Stat. at 757 (1916-1917 surtax); War Revenue Act, ch. 63, § 4, 40 Stat. 300, 302 (1917 corporate tax), § 1206(2), 40 Stat. at 334 (1917 tax on undistributed corporate profits), § 1, 40 Stat. at 300-01 (1917 normal tax), § 2, 40 Stat. at 301 (1917 surtax); Revenue Act of 1918, ch. 18, § 230(a)(1), 40 Stat. 1057, 1076 (1918-1920 corporate tax), § 210(a), 40 Stat. at 1062 (1918-1920 normal tax), § 211(a), 40 Stat. at 1062-64 (1918-1920 surtax); Revenue Act of 1921, ch. 136, § 230, 42 Stat. 227, 252 (1921-1923 corporate tax), § 210, 42 Stat. at 233 (1921-1923 normal tax), § 211(a)(2), 42 Stat. at 235-37 (1921-1923 surtax); Revenue Act of 1924, ch. 234, § 230, 43 Stat. 253, 282 (1924 corporate tax), § 210(a), 43 Stat. at 264 (1924 normal tax), § 1200, 43 Stat. at 353 (1924 surtax); Revenue Act of 1926, ch. 27, § 230(a)(1)-(2), 44 Stat. 9, 39 (1925-1927 corporate tax), § 210(a), 44 Stat. at 21 (1925-1927 normal tax), § 211(a), 44 Stat. at 22-23 (1925-1927 surtax); Revenue Act of 1928, ch. 852, § 13(a), 45 Stat. 791, 797 (1928-1931 corporate tax), § 11, 45 Stat. at 795 (1928-1931 normal tax), § 12(a), 45 Stat. at 796 (1928-1931 surtax); Joint Resolution Reducing Rates of Income Tax for the Calendar Year 1929, ch. 2, 46 Stat. 47, 47 (1929 corporate tax and normal tax); Revenue Act of 1932, ch. 209, § 13(a), 47 Stat. 169, 177 (1932-1933 corporate tax), § 11, 45 Stat. at 795 (1932-1933 normal tax), § 12(a), 47 Stat. at 174-77 (1932-1933 surtax); Revenue Act of 1934, ch. 277, § 13(a), 48 Stat. 680, 686 (1934 corporate tax), § 11, 48 Stat. at 684 (1934 normal tax), § 12(b), 48 Stat. at 684-86 (1934 surtax).

TABLE 2*

Year	Tax on Profits Distributed by a Firm					
	Distributed Corporate Profits			Distributed Partnership Profits		
	Top Corp. Tax	Top Shareholder Tax	Total Tax	Top Normal Tax	Top Surtax	Total Tax
1913	1%	6%	7.00%	1%	6%	7.00%
1914	1%	6%	7.00%	1%	6%	7.00%
1915	1%	6%	7.00%	1%	6%	7.00%
1916	2%	23%	15.00%	2%	13%	15.00%
1917	6% ^a	63% ^b	69.00% ^c	4% ^d	63% ^e	67.00%
1918	12%	65%	77.00% ^f	12%	65%	77.00%
1919	10%	65%	75.00% ^g	8%	65%	73.00%
1920	10%	65%	75.00% ^h	8%	65%	73.00%

* Source: Revenue Act of 1913, ch. 16, § II(G)(a), 38 Stat. 114, 172 (1913-1915 corporate tax), § II(A)(1), 38 Stat. at 166 (1913-1915 normal tax), § II(A)(2), 38 Stat. at 166 (1913-1915 surtax/shareholder tax); Revenue Act of 1916, ch. 463, § 10, 39 Stat. 756, 765 (1916-1917 corporate tax), § 1(a), 39 Stat. at 756 (1916-1917 normal tax), § 1(b), 39 Stat. at 757 (1916-1917 surtax/shareholder tax); War Revenue Act of 1917, ch. 63, § 4, 40 Stat. 300, 302 (1917 corporate tax), § 1206(2), 40 Stat. at 334 (1917 tax on undistributed corporate profits), § 1, 40 Stat. at 301 (1917 normal tax), § 2, 40 Stat. at 301 (1917 surtax/shareholder tax); Revenue Act of 1918, ch. 18, § 230(a)(1), 40 Stat. 1057, 1076 (1918-1920 corporate tax), § 210(a), 40 Stat. at 1062 (1918-1920 normal tax), § 211(a), 40 Stat. at 1062-64 (1918-1919 surtax/shareholder tax); Revenue Act of 1921, ch. 136, § 230, 42 Stat. 227, 252 (1921-1923 corporate tax), § 210, 42 Stat. at 233 (1921-1923 normal tax), § 211(a)(2), 42 Stat. at 235-37 (1921-1923 surtax/shareholder tax); Revenue Act of 1924, ch. 234, § 230, 43 Stat. 253, 282 (1924 corporate tax), § 210(a), 43 Stat. at 264 (1924 normal tax), § 1200, 43 Stat. at 353 (1924 surtax/shareholder tax); Revenue Act of 1926, ch. 27, § 230(a)(1), (2), 44 Stat. 9, 39 (1925-1927 corporate tax), § 210(a), 44 Stat. at 21 (1925-1927 normal tax), § 211(a), 44 Stat. at 22-23 (1925-1927 surtax/shareholder tax); Revenue Act of 1928, ch. 852, § 13(a), 45 Stat. 791, 797 (1928-1931 corporate tax), § 11, 45 Stat. at 795 (1928-1931 normal tax), § 12(a), 45 Stat. at 797 (1928-1931 surtax/shareholder tax); Joint Resolution Reducing Rates of Income Tax for the Calendar Year 1929, ch. 2, 46 Stat. 47, 47 (1929 corporate tax and normal tax); Revenue Act of 1932, ch. 209, § 13(a), 47 Stat. 169, 177 (1932-1933 corporate tax), § 11, 45 Stat. at 795 (1932-1933 normal tax), § 12(a), 47 Stat. at 174-77 (1932-1933 surtax/shareholder tax); Revenue Act of 1934, ch. 277, § 13(a), 48 Stat. 680, 686 (1934 corporate tax), § 11, 48 Stat. at 684 (1934 normal tax), § 12(b), 48 Stat. at 684-86 (1934 surtax/shareholder tax).

Notes for Table 2:

- a Reflects both the Income Tax, as amended in 1916, and the War Income Tax of 1917.
- b Reflects both the Income Tax, as amended in 1916, and the War Income Tax of 1917.
- c Does not reflect the impact of the war-excess profits tax, which was imposed on all taxpayers.
- d Reflects both the Income Tax, as amended in 1916, and the War Income Tax of 1917.
- e Reflects both the Income Tax, as amended in 1916, and the War Income Tax of 1917.
- f Does not reflect the impact of the war excess profits tax, which was imposed on corporations only.
- g Does not reflect the impact of the war excess profits tax, which was imposed on corporations only.
- h Does not reflect the impact of the war excess profits tax, which was imposed on corporations only.

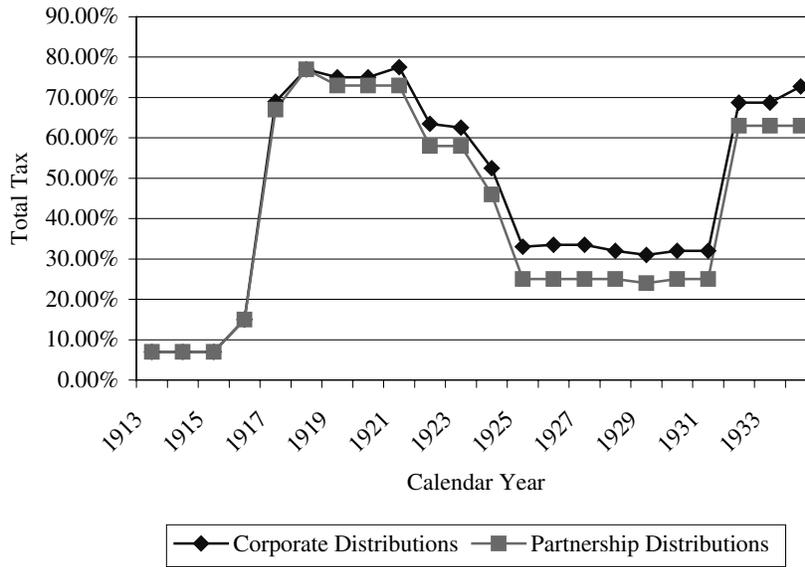
Year	Tax on Profits Distributed by a Firm					
	Distributed Corporate Profits			Distributed Partnership Profits		
	Top Corp. Tax	Top Shareholder Tax	Total Tax	Top Normal Tax	Top Surtax	Total Tax
1921	12.5%	65%	77.50% ⁱ	8%	65%	73.00%
1922	12.5%	50%	63.50%	8%	50%	58.00%
1923	12.5%	50% ^j	62.50%	8%	50%	58.00%
1924	12.5%	40%	52.50%	6%	40%	46.00%
1925	13%	20%	33.00%	5%	20%	25.00%
1926	13.50%	20%	33.50%	5%	20%	25.00%
1927	13.50%	20%	33.50%	5%	20%	25.00%
1928	12%	20%	32.00%	5%	20%	25.00%
1929	11%	20%	31.00%	4%	20%	24.00%
1930	12%	20%	32.00%	5%	20%	25.00%
1931	12%	20%	32.00%	5%	20%	25.00%
1932	13.75%	55%	68.75%	8%	55%	63.00%
1933	13.75%	55%	68.75%	8%	55%	63.00%
1934	13.75%	59%	72.75%	4%	59%	63.00%

ⁱ Does not reflect the impact of the war excess profits tax, which was imposed on corporations only.

^j Does not reflect the impact of a 25% retroactive rebate of tax allowed to individuals in 1924 for 1923.

CHART 2*

TAX ON PROFITS DISTRIBUTED BY A FIRM



* Source: Revenue Act of 1913, ch. 16, § II(G)(a), 38 Stat. 114, 172 (1913-1915 corporate tax), § II(A)(1), 38 Stat. at 166 (1913-1915 normal tax), § II(A)(2), 38 Stat. at 166 (1913-1915 surtax/shareholder tax); Revenue Act of 1916, ch. 463, § 10, 39 Stat. 756, 765 (1916-1917 corporate tax), § 1(a), 39 Stat. at 756 (1916-1917 normal tax), § 1(b), 39 Stat. at 757 (1916-1917 surtax/shareholder tax); War Revenue Act of 1917, ch. 63, § 4, 40 Stat. 300, 302 (1917 corporate tax), § 1206(2), 40 Stat. at 334 (1917 tax on undistributed corporate profits), § 1, 40 Stat. at 301 (1917 normal tax), § 2, 40 Stat. at 301 (1917 surtax/shareholder tax); Revenue Act of 1918, ch. 18, § 230(a)(1), 40 Stat. 1057, 1076 (1918-1920 corporate tax), § 210(a), 40 Stat. at 1062 (1918-1920 normal tax), § 211(a), 40 Stat. at 1062-64 (1918-1910 surtax/shareholder tax); Revenue Act of 1921, ch. 136, § 230, 42 Stat. 227, 252 (1921-1923 corporate tax), § 210, 42 Stat. at 233 (1921-1923 normal tax), § 211(a)(2), 42 Stat. at 235-37 (1921-1923 surtax/shareholder tax); Revenue Act of 1924, ch. 234, § 230, 43 Stat. 253, 282 (1924 corporate tax), § 210(a), 43 Stat. at 264 (1924 normal tax), § 1200, 43 Stat. at 353 (1924 surtax/shareholder tax); Revenue Act of 1926, ch. 27, § 230(a)(1), (2), 44 Stat. 9, 39 (1925-1927 corporate tax), § 210(a), 44 Stat. at 21 (1925-1927 normal tax), § 211(a), 44 Stat. at 22-23 (1925-1927 surtax/shareholder tax); Revenue Act of 1928, ch. 852, § 13(a), 45 Stat. 791, 797 (1928-1931 corporate tax), § 11, 45 Stat. at 795 (1928-1931 normal tax), § 12(a), 45 Stat. at 797 (1928-1931 surtax/shareholder tax); Joint Resolution Reducing Rates of Income Tax for the Calendar Year 1929, ch. 2, 46 Stat. 47, 47 (1929 corporate tax and normal tax); Revenue Act of 1932, ch. 209, § 13(a), 47 Stat. 169, 177 (1932-1933 corporate tax), § 11, 45 Stat. at 795 (1932-1933 normal tax), § 12(a), 47 Stat. at 174-77 (1932-1933 surtax/shareholder tax); Revenue Act of 1934, ch. 277, § 13(a), 48 Stat. 680, 686 (1934 corporate tax), § 11, 48 Stat. at 684 (1934 normal tax), § 12(b), 48 Stat. at 684-86 (1934 surtax/shareholder tax).

TABLE 3*

Year	Distributed Corporate Profits			Undistributed Corporate Profits		
	Top Corp. Tax	Top Shareholder Tax	Total Tax	Top Corp. Tax	Other Tax	Total Tax
1913	1%	6%	7.00%	1%		1.00%
1914	1%	6%	7.00%	1%		1.00%
1915	1%	6%	7.00%	1%		1.00%
1916	2%	13%	15.00%	2%		2.00%
1917	6% ^a	63% ^b	69.00% ^c	6% ^d	10% ^e	16.00%
1918	12%	65%	77.00% ^f	12%		12.00%
1919	10%	65%	75.00% ^g	10%		10.00%
1920	10%	65%	75.00% ^h	10%		10.00%
1921	12.5%	65%	77.50% ⁱ	12.50%		12.50%
1922	12.5%	50%	62.50%	12.50%		12.50%

* Source: Revenue Act of 1913, ch. 16, § II(G)(a), 38 Stat. 114, 172 (1913-1915 corporate tax), § II(A)(2), 38 Stat. at 166 (1913-1915 shareholder tax); Revenue Act of 1916, ch. 463, § 10, 39 Stat. 756, 765 (1916-1917 corporate tax), § 1(b), 39 Stat. at 757 (1916-1917 shareholder tax); War Revenue Act of 1917, ch. 63, § 4, 40 Stat. 300, 302 (1917 corporate tax), § 1206(2), 40 Stat. at 334 (1917 tax on undistributed corporate profits), § 2, 40 Stat. at 301 (1917 shareholder tax); Revenue Act of 1918, ch. 18, § 230(a)(1), 40 Stat. 1057, 1076 (1918-1920 corporate tax), § 211(a), 40 Stat. at 1062-64 (1918-1920 shareholder tax); Revenue Act of 1921, ch. 136, § 230, 42 Stat. 227, 252 (1921-1923 corporate tax), § 211(a)(2), 42 Stat. at 235-37 (1921-1923 shareholder tax); Revenue Act of 1924, ch. 234, § 230, 43 Stat. 253, 282 (1924 corporate tax), § 1200, 43 Stat. at 353 (1924 shareholder tax); Revenue Act of 1926, ch. 27, § 230(a)(1)-(2), 44 Stat. 9, 39 (1925-1927 corporate tax), § 210(a), 44 Stat. at 21 (1925-1927 normal tax), § 211(a), 44 Stat. at 22-23 (1925-1927 shareholder tax); Revenue Act of 1928, ch. 852, § 13(a), 45 Stat. 791, 797 (1928-1931 corporate tax), § 12(a), 45 Stat. at 796 (1928-1931 shareholder tax); Joint Resolution Reducing Rates of Income Tax for the Calendar Year 1929, ch. 2, 46 Stat. 47, 47 (1929 corporate tax); Revenue Act of 1932, ch. 209, § 13(a), 47 Stat. 169, 177 (1932-1933 corporate tax), § 12(a), 47 Stat. at 174-77 (1932-1933 shareholder tax); Revenue Act of 1934, ch. 277, § 13(a), 48 Stat. 680, 686 (1934 corporate tax), § 12(b), 48 Stat. at 684-86 (1934 shareholder tax).

Notes for Table 3:

- a Reflects both the Income Tax, as amended in 1916, and the War Income Tax of 1917.
- b Reflects both the Income Tax, as amended in 1916, and the War Income Tax of 1917.
- c Does not reflect the impact of the war-excess profits tax, which was imposed on all taxpayers.
- d Reflects both the Income Tax, as amended in 1916, and the War Income Tax of 1917.
- e Temporary tax on undistributed corporate profits.
- f Does not reflect the impact of the war excess profits tax, which was imposed on corporations only.
- g Does not reflect the impact of the war excess profits tax, which was imposed on corporations only.
- h Does not reflect the impact of the war excess profits tax, which was imposed on corporations only.
- i Does not reflect the impact of the war excess profits tax, which was imposed on corporations only.

Fall 2008]

PARITY LOST

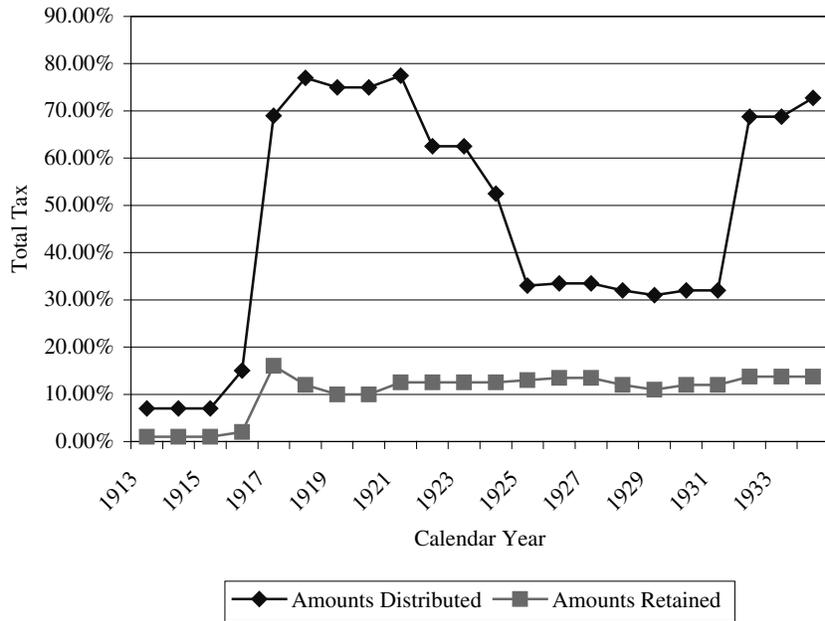
183

Year	Distributed Corporate Profits			Undistributed Corporate Profits		
	Top Corp. Tax	Top Shareholder Tax	Total Tax	Top Corp. Tax	Other Tax	Total Tax
1923	12.5%	50% ^j	62.50%	12.50%		12.50%
1924	12.5%	40%	52.50%	12.50%		12.50%
1925	13%	20%	33.00%	13.00%		13.00%
1926	13.50%	20%	33.50%	13.50%		13.50%
1927	13.50%	20%	33.50%	13.50%		13.50%
1928	12%	20%	32.00%	12%		12.00%
1929	11%	20%	31.00%	11%		11.00%
1930	12%	20%	32.00%	12%		12.00%
1931	12%	20%	32.00%	12%		12.00%
1932	13.75%	55%	68.75%	13.75%		13.75%
1933	13.75%	55%	68.75%	13.75%		13.75%
1934	13.75%	59%	72.75%	13.75%		13.75%

^j Does not reflect the impact of a 25% retroactive rebate of tax allowed to individuals in 1924 for 1923.

CHART 3*

TAX ON PROFITS DERIVED BY A CORPORATION



* Source: Revenue Act of 1913, ch. 16, § II(G)(a), 38 Stat. 114, 172 (1913-1915 corporate tax), § II(A)(2), 38 Stat. at 166 (1913-1915 shareholder tax); Revenue Act of 1916, ch. 463, § 10, 39 Stat. 756, 765 (1916-1917 corporate tax), § 1(b), 39 Stat. at 757 (1916-1917 shareholder tax); War Revenue Act of 1917, ch. 63, § 4, 40 Stat. 300, 302 (1917 corporate tax), § 1206(2), 40 Stat. at 334 (1917 tax on undistributed corporate profits), § 2, 40 Stat. at 301 (1917 shareholder tax); Revenue Act of 1918, ch. 18, § 230(a)(1), 40 Stat. 1057, 1076 (1918-1920 corporate tax), § 211(a), 40 Stat. at 1062-64 (1918-1920 shareholder tax); Revenue Act of 1921, ch. 136, § 230, 42 Stat. 227, 252 (1921-1923 corporate tax), § 211(a)(2), 42 Stat. at 235-37 (1921-1923 shareholder tax); Revenue Act of 1924, ch. 234, § 230, 43 Stat. 253, 282 (1924 corporate tax), § 1200, 43 Stat. at 353 (1924 shareholder tax); Revenue Act of 1926, ch. 27, § 230(a)(1)-(2), 44 Stat. 9, 39 (1925-1927 corporate tax), § 210(a), 44 Stat. at 21 (1925-1927 normal tax), § 211(a), 44 Stat. at 22-23 (1925-1927 shareholder tax); Revenue Act of 1928, ch. 852, § 13(a), 45 Stat. 791, 797 (1928-1931 corporate tax), § 12(a), 45 Stat. at 796 (1928-1931 shareholder tax); Joint Resolution Reducing Rates of Income Tax for the Calendar Year 1929, ch. 2, 46 Stat. 47, 47 (1929 corporate tax); Revenue Act of 1932, ch. 209, § 13(a), 47 Stat. 169, 177 (1932-1933 corporate tax), § 12(a), 47 Stat. at 174-77 (1932-1933 shareholder tax); Revenue Act of 1934, ch. 277, § 13(a), 48 Stat. 680, 686 (1934 corporate tax), § 12(b), 48 Stat. at 684-86 (1934 shareholder tax).