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ARTICLES

CORPORATIONS, SOCIETY, AND THE STATE: A DEFENSE OF THE CORPORATE TAX

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"[T]he power to tax involves the power to destroy."[1]
– Chief Justice John Marshall

"The power to tax is not the power to destroy while this Court sits."[2]
– Justice Oliver Wendell Holmes, Jr.

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[1] McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316, 431 (1819).

[2] Panhandle Oil Co. v. Mississippi ex rel. Knox, 277 U.S. 218, 223 (1928) (Holmes, J., dissenting).

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INTRODUCTION

CORPORATIONS are both everywhere and nowhere. They are everywhere, first and foremost, on the economic scene: a large percentage of economic activity in the United States is effectuated through the corporate form.[3] But the reach of corporations is far broader than that. Many of our other institutions, including universities, churches, hospitals, and other non-profit organizations, are in corporate form. Other salient features of our society, such as representative democracy, originated from the use of the

[3] William G. Roy, Socializing Capital: The Rise of the Large Industrial Corporation in America 5 (1997).

corporate form in medieval England.[4] Even the idea of the state itself originated in Roman and Medieval legal notions about corporate bodies.[5]

And yet corporations are nowhere. The leading academic theory about corporations, the nexus of contracts (or contractarian) theory, posits that corporations do not really exist; they are merely a convenient connection point for a bundle of relationships between shareholders, bondholders, employees, customers, and others. Any useful academic analysis of the corporation must begin by denying its existence and looking at the various groups of people interacting through the corporation. This is the aggregate view of the corporation that sees it primarily as the amalgam of its owners.

It was not always so. Around 1909, when the corporate income tax was first adopted, there was a variety of corporate theories, and some of them posited that corporations had a real existence separate from both shareholders and the state. Of course, the corporation itself was but a legal fiction, but corporate management was real, and the power of corporate management over employees, shareholders, and society at large was real as well.

The goal of this Article is to examine the relationship among corporations, society, and the state through the lens of the corporate income tax. The corporate income tax offers a unique opportunity to examine this broader issue because, first, it is one way in which the state intervenes directly in the affairs of corporations; and second, because various theories of why the corporate income tax exists illustrate the dichotomy between the real and aggregate views of the corporation. When the corporate tax was first adopted in 1909, the real view was dominant and the tax was conceived primarily as a device to regulate corporate management in relation to other stakeholders and the state. Today, however, the aggregate (nexus of contracts) view predominates, and the tax is seen primarily as an indirect way of taxing shareholders.

[4] On representative democracy and its connection to the borough as a corporation see, for example, Gaines Post, Studies in Medieval Legal Thought (1964); Brian Tierney, Religion, Law, and the Growth of Constitutional Thought 1150–50 (1982).

[5] On the Roman origins see P.W. Duff, Personality in Roman Private Law (1938); Otto Gierke, Associations and Law: The Classical and Early Christian Stages 95–142 (George Heiman ed. & trans., 1977); Fritz Schultz, Classical Roman Law 86–102 (1951). On medieval developments, see Ernst H. Kantorowicz, The King's Two Bodies: A Study in Medieval Political Theology 273–313 (1957).

This Article is divided into four parts. Part I will examine the current justifications for the existence of the corporate tax. This examination is needed for two reasons. First, it is necessary because some academics and practitioners (including the former Secretary of the Treasury) dispute the need for a corporate tax. Second, it is necessary because certain practical trends (primarily corporate tax shelters and tax competition) are eroding the existing corporate tax base, and it is hard to mount a convincing normative defense of the corporate tax against these trends without understanding why we need the tax in the first place. Part I will conclude that the dominant current justifications for the tax are based on the aggregate model and are fundamentally flawed, and that current attempts to find alternative grounds for the tax are unconvincing as well.

Part II will reconstruct the original reasons for the enactment of the corporate tax in 1909 and will show that it was based on a real theory of the corporation, and that the tax was viewed primarily as a regulatory device to limit the power of management. In that way it was different from an earlier corporate tax, the 1894 tax, which was viewed primarily as a way of taxing shareholders.

Part III will begin the normative part of the Article by asking whether the original motivation of the corporate tax has any continuing force today. It will argue that it does, both because the real view is a better approximation of reality than the aggregate view, and because managerial power is still an important issue. In fact, the rise of multinational enterprises ("MNEs") is a new shift in the relationship among corporations, society, and the state that requires a re-examination of the relationship similar to that which took place in 1909. The corporate tax (extended internationally) can still play an important role in regulating that relationship.

Part IV will conclude by examining some of the policy implications of the above argument. In particular, it will argue that the corporate tax should be retained and defended against both corporate tax shelters and tax competition. It also suggests that integration of the corporate and shareholder taxes, as partially adopted by Congress in 2003, is not necessary to prevent "double taxation," although it may perhaps be defended on different grounds.

I. CURRENT JUSTIFICATIONS FOR THE CORPORATE TAX.

The corporate income tax is under attack. Secretary Paul O'Neill, the former Secretary of the Treasury, announced that it should be abolished,[6] and the current drive to eliminate the taxation of dividends can be seen as the first step toward that goal.[7] A significant number of tax academics have argued for repeal of the tax.[8] Other academics have urged radical reform of the tax.[9] And no academic has in recent years mounted a serious, convincing normative defense of why this cumbersome tax should be retained.[10]

This lack of a normative justification for retaining the tax is important for three reasons. First, the corporate tax is very complicated and imposes significant transaction costs on society. Many of

[6] John Hughes, Corporate Income Tax in O'Neill's Sights: Treasury Secretary Hopes to End Levy, Wash. Post, May 20, 2001, at A7; see also Corporate Tax: Time to Hiss: A Bad Tax Whose Time Has Gone, The Economist, Jan. 31, 2004, at 14.

[7] U.S. Treasury Dep't, Fact Sheet: The President's Proposal to End the Double Tax on Corporate Earnings, at http://www.ustreas.gov/press/releases/kd3762.htm (Jan. 14, 2003) (on file with the Virginia Law Review Association).

[8] See, e.g., Joseph M. Dodge, A Combined Mark-to-Market and Pass-Through Corporate-Shareholder Integration Proposal, 50 Tax L. Rev. 265, 266–67 (1995) (proposing to integrate the corporate-shareholder income tax); Daniel Halperin, Fundamental Tax Reform, 48 Emory L.J. 809, 820–22 (1999) (proposing a combination of changes including full indexation and corporate integration); Anthony P. Polito, Note, A Proposal for an Integrated Income Tax, 12 Harv. J.L. & Pub. Pol'y 1009, 1048 (1989) (arguing that integration would advance horizontal and vertical equity).

[9] See, e.g., Joseph Bankman, A Market-Value Based Corporate Income Tax, 68 Tax Notes 1347, 1347–48 (1995) (discussing the operation of a market-value tax regime that could replace the corporate tax); Michael S. Knoll, An Accretion Corporate Income Tax, 49 Stan. L. Rev. 1, 1 (1996) (proposing a corporate-level tax on the change in market value of corporate securities).

[10] Some academics have defended the double tax on corporations, but they have focused on whether the tax should be integrated, not on whether it should exist in the first place. See Terrence R. Chorvat, Apologia for the Double Taxation of Corporate Income, 38 Wake Forest L. Rev. 239, 242–43 (2003); Jasper L. Cummings, Jr., "Taxing Business Income Once": Where's the Beef? A Review and Critique of the Treasury Integration Study, 54 Tax Notes 1391, 1395 (1992); Jeffrey L. Kwall, The Uncertain Case Against the Double Taxation of Corporate Income, 68 N.C. L. Rev. 613, 616 (1990); Herwig J. Schlunk, I Come Not to Praise the Corporate Income Tax, But to Save It, 56 Tax L. Rev. 329, 332–33 (2003). Other academics have proposed ways of integrating while keeping the corporate tax in place. See Anthony P. Polito, Useful Fictions: Debt and Equity Classification in Corporate Tax Law, 30 Ariz. St. L.J. 761, 794–810 (1998); George K. Yin, Corporate Tax Integration and the Search for the Pragmatic Ideal, 47 Tax L. Rev. 431, 504–05 (1992).

the best educated and most talented tax lawyers in this country devote their careers to the intricacies of Subchapter C.[11] Second, there is a widespread consensus among economists that imposing a tax only on certain business entities and not on others leads to significant welfare losses to society as the tax drives business owners away from their preferred form of organization.[12] In the absence of a good reason to have the tax, these two types of costs form a persuasive case for repeal.

Third, and perhaps most importantly, the corporate tax base is being eroded in practice. Revenues from the corporate income tax amounted to about a quarter of all federal tax revenues in 1965;[13] today the tax accounts for less than a tenth of revenues, and that number is declining.[14] There are two major reasons for this decline in revenues in recent years, and neither of them results from a conscious decision by Congress to reduce the tax.[15] The first is the

[11] See Joel B. Slemrod & Marsha Blumenthal, The Income Tax Compliance Cost of Big Business, 24 Pub. Fin. Q. 411, 435–36 (1996).

[12] See Jane G. Gravelle & Laurence Kotlikoff, The Incidence and Efficiency Costs of Corporate Taxation When Corporate and Noncorporate Firms Produce the Same Good, 97 J. Pol. Econ. 749, 750–52 (1989); Austan Goolsbee, The Impact and Inefficiency of the Corporate Income Tax: Evidence from State Organizational Form Data (Nat'l Bureau of Econ. Research Working Paper No. w9141, Mar. 2002), at http://www.nber.org/papers/w9141 (on file with the Virginia Law Review Association). Integration reduces but does not eliminate these welfare losses, because under most forms of integration there is still differential taxation of C corporations and other entities. See Michael J. Graetz & Alvin C. Warren, Jr., Integration of Corporate and Individual Income Taxes: An Introduction to the Issues, *in* Integration of the U.S. Corporate and Individual Income Taxes: The Treasury Department and American Law Institute Reports 3, 15–17 (Michael J. Graetz & Alvin C. Warren eds., 1998).

[13] Decline of Corporate Tax Revenues: Hearing Before the S. Comm. on Fin., 101st Cong. 2 (1990) (statement of Sen. Moynihan); Reuven S. Avi-Yonah, Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State, 113 Harv. L. Rev. 1573, 1619 (2000) [hereinafter Avi-Yonah, Globalization].

[14] Joel Friedman, The Decline of Corporate Income Tax Revenues 4 fig.1, at http://www.cbpp.org/10-16-03tax.pdf (Oct. 24, 2003) (on file with the Virginia Law Review Association).

[15] Corporate tax rates were higher before 1986 but the base was narrower, so that the Tax Reform Act of 1986 (which reduced the rate from 46% to the current 34%) actually raised taxes on corporations. S. Rep. No. 99-313, at 78 (1986); Michael J. Graetz, The Decline (and Fall?) of the Income Tax 133 (1998); Jeffrey H. Birnbaum, Showdown at Gucci Gulch, 40 Nat'l Tax J. 357 (1987). The effective tax rates today, however, are close to what they were before 1986. See George K. Yin, How Much Tax Do Large Public Corporations Pay?: Estimating the Effective Tax Rates of the S&P 500, 89 Va. L. Rev. 1793, 1797 (2003) [hereinafter Yin, Effective Tax Rates]; Friedman, supra note 14, at 8 fig. 3.

growth of a corporate tax shelter industry, in which some of America's best minds scour the Code for ways to reduce corporate tax liabilities by various transactions and then sell these transactions for high fees to corporate clients.[16] Estimates of the revenue loss vary, but there is a consensus that it is significant and that the IRS has so far not been able to stop it with the doctrinal weapons at hand.[17] The second reason for the decline in corporate tax revenues is tax competition among countries to attract corporate investments, which has grown significantly in the last two decades.[18] This competition enables companies like Intel to pay no tax at all on its non-U.S. income.[19] The most recent manifestation of this trend has been inversion transactions, in which U.S.-based corporations nominally move their headquarters to a tax haven like Bermuda. This type of transaction can result in a dramatic decrease in worldwide effective tax rates for the inverting corporation.[20]

The response to both of these trends has been attempts by Congress and the IRS to combat corporate tax shelters domestically,[21]

[16] See, e.g., Joseph Bankman, The New Market in Corporate Tax Shelters, 83 Tax Notes 1775, 1780–82 (1999); David A. Weisbach, The Failure of Disclosure as an Approach to Shelters, 54 SMU L. Rev. 73, 74 (2001); see also George K. Yin, Getting Serious About Corporate Tax Shelters: Taking a Lesson from History, 54 SMU L. Rev. 209, 214 (2001)[hereinafter Yin, Tax Shelters] (describing legislative responses to tax shelters).

[17] See Yin, Tax Shelters, supra note 16, at 216. The litigation record is mixed. See, e.g., Compaq Computer Corp. v. Comm'r, 277 F.3d 778, 788 (5th Cir. 2001) (finding economic substance and business purpose); United Parcel Serv. v. Comm'r, 254 F.3d 1014, 1020 (11th Cir. 2001) (same); ACM P'ship v. Comm'r, 157 F.3d 231, 263 (3d Cir. 1998) (finding insufficient economic substance but allowing certain limited deductions for actual economic losses).

[18] See Avi-Yonah, Globalization, supra note 13, at 1575–76; Julie Roin, Competition and Evasion: Another Perspective on International Tax Competition, 89 Geo. L.J. 543, 546–49 (2001).

[19] Avi-Yonah, Globalization, supra note 13, at 1589.

[20] See Reuven S. Avi-Yonah, For Haven's Sake: Reflections on Inversion Transactions, 95 Tax Notes 1793, 1794 (2002) [hereinafter Avi-Yonah, Haven's Sake]; Mihir Desai & James R. Hines, Jr., Expectations and Expatriations: Tracing the Causes and Consequences of Corporate Inversions, 55 Nat'l Tax J. 409, 421 (2002).

[21] See Staff of Joint Comm. on Taxation, 107th Cong., Background and Present Law Relating to Tax Shelters (Comm. Print 2002), available at http://www.house.gov/jct/x-19-02.pdf (Mar. 21, 2002) (on file with the Virginia Law Review Association); Gerald W. Miller, Jr., Corporate Tax Shelters and Economic Substance: An Analysis of the Problem and its Common Law Solution, 34 Tex. Tech L. Rev. 1015, 1065–67 (2003); Jeffrey H. Paravano & Melinda L. Reynolds, 798 Tax Mgmt. Tax Shelters (BNA 2003).

and attempts by international actors like the Organization for Economic Cooperation and Development ("OECD") and the European Union to restrict harmful tax competition.[22] Both of these efforts, however, have been hampered by the lack of a convincing normative justification for the corporate tax. In the absence of such a justification, opponents of these efforts can portray them as a pure revenue grab, and supporters find it difficult to explain what is so bad about letting the corporate tax wither away as a result of taxpayer self-help.[23]

In this Part, I survey the existing, and unconvincing, attempts to defend the existence of the corporate tax.[24] These defenses can generally be divided into three types, which correspond to the three theories of the corporation adumbrated above: aggregate, real entity, and artificial entity.[25] The first and most common type

[22] See, e.g., Avi-Yonah, Globalization, supra note 13, at 1652–1666; Yoram Margalioth, Tax Competition, Foreign Direct Investment and Growth: Using the Tax System to Promote Developing Countries, 23 Va. Tax Rev. 161, 197–98 (2003); Roin, supra note 18, at 547–48.

[23] See, e.g., David J. Shakow, Wither, "C"!, 45 Tax L. Rev. 177, 182–83 (1990) (suggesting in response to Bernard Wolfman, Whither "C"?, 38 Tax Notes 1269 (1988), that it would be better if the corporate tax were eliminated).

[24] A simple justification of the corporate tax might be: The state has certain legitimate revenue requirements, part of which it must fulfill by taxation. Corporations have significant financial resources. Thus, the state is justified in taxing corporations to meet its revenue needs.

This argument is similar to Willie Sutton's immortal response to the question why he robbed banks ("that's where the money is"). The argument is clearly inadequate, however, because the state can fulfill its revenue needs in other ways such as by taxing individuals more—the revenue raised by the corporate tax in developed countries is a sufficiently low percentage of Gross Domestic Product ("GDP") that it can easily be made up by raising individual taxes. This is particularly true for the United States; a very low Value Added Tax ("VAT") rate would more than make up for the corporate tax, and if the revenues are used for redistributive purposes, they might be more regressive. The corporate tax would be more difficult to replace in Europe (with existing high individual income tax and VAT rates), and even more so in developing countries, where it can amount to 25% of total tax revenues. See Asegedech WoldeMariam, Summary Tax Structure Tables, 1975–92, *in* Tax Policy Handbook 287, 294 tbl.6, 300 tbl.12, 303 tbl.18, 306 tbl.24, 312 tbl.30 (Parthasarathi Shome ed., 1995). Therefore, a more elaborate justification of the corporate tax is required.

[25] For a fuller exposition of these three theories, see infra Part III. These theories are the standard ones described in the literature. See, e.g., William W. Bratton, Jr., The New Economic Theory of the Firm: Critical Perspectives from History, 41 Stan. L. Rev. 1471, 1475–76 (1989); Henry N. Butler, The Contractual Theory of The Corporation, 11 Geo. Mason L. Rev. 99, 99–101 (1989); Mark M. Hager, Bodies Politic: The Progressive History of Organizational "Real Entity" Theory, 50 U. Pitt. L. Rev.

of defense views the corporate tax as an administratively convenient device to collect tax on shareholders. This view reflects the currently dominant aggregate (contractarian, nexus of contracts) theory of the corporation as an amalgam of its shareholders. The second type of defense views the corporate tax as payment for some kind of benefit conferred by the state. This defense reflects the artificial theory of the corporation as owing its existence to the state. Finally, the third type of defense relates the corporate tax to the relationship between shareholders and management and views the corporate tax as a mechanism to regulate this relationship. This defense is closest to the real view of the corporation as separate from both the shareholders and the state.

A. Aggregate Defenses of the Corporate Tax

The most common current defense of the corporate tax is based on the aggregate theory of the corporation in that it views the corporate tax as an indirect way of taxing the shareholders.[26] The argument goes as follows: If there were no corporate tax imposed, given that corporations are treated as separate legal entities from shareholders, individuals could shelter their income from tax by earning it through corporations.[27] This would result at least in deferral of the tax until a dividend is paid or the shareholder sells the shares, and might result in total income tax exemption if the shareholder holds the shares until her death and a step-up in basis is available.[28] In addition, it is argued, collecting the tax from corporations rather than directly from shareholders has administrative advantages because there are fewer corporations than shareholders

575, 578–82 (1989); David Millon, Theories of the Corporation, 1990 Duke L.J. 201, 201–05 (1990). Ultimately, they stem from the work of three great nineteenth-century German jurists: Savigny (artificial entity), Ihering (aggregate), and Gierke (real entity). See Sanford A. Schane, The Corporation is a Person: The Language of a Legal Fiction, 61 Tul. L. Rev. 563, 565–67 (1987).

[26] Charles E. McLure Jr., Must Corporate Income Be Taxed Twice? 20 (1979).

[27] See, e.g., Roger H. Gordon & Jeffrey K. MacKie-Mason, Why Is There Corporate Taxation In a Small Open Economy? The Role of Transfer Pricing and Income Shifting, *in* The Effects of Taxation on Multinational Corporations 67, 69 (Martin Feldstein et al. eds., 1995); Richard M. Bird, Why Tax Corporations? (Comm. on Bus. Taxation, Can. Dep't of Fin., Working Paper No. 96-2, Dec. 1996), at http://www.fin.gc.ca/taxstudy/wp96-2e.html (on file with the Virginia Law Review Association).

[28] See I.R.C. § 1014 (a)(1) (2000).

and because shareholders may be hard to reach (for example, because they are foreign or tax exempt).[29]

From this perspective, the corporate tax can be viewed as a withholding tax imposed on the shareholders at the corporate source of their income. In fact, that was the view of the tax when it was first imposed in 1894.[30] It naturally follows that shareholders should not be taxed again when dividends are distributed to them, just like employees receive a credit for taxes withheld from their paychecks by employers. There are a variety of ways to accomplish this goal, which has been named "integration." Under a recent proposal by the Bush administration, a form of which is followed by many countries (and has been partially adopted by Congress), dividends are exempt from tax when received by shareholders.[31] Alternatively, as in other countries, shareholders get a credit for taxes paid by the corporation against their individual tax liability.[32] A third alternative that is rarely adopted but is also consistent with the aggregate view is to impose a corporate tax but permit corporations to deduct dividends from their corporate tax base, thus in effect eliminating the corporate tax to the extent profits are distributed to and taxed in the hands of shareholders.[33]

It is far from clear, however, that there are no practical ways of taxing shareholders on corporate income without imposing a cor-

[29] Bird, supra note 27, at 9–12.

[30] Steven A. Bank, Entity Theory as Myth in the Origins of the Corporate Income Tax, 43 Wm. & Mary L. Rev. 447, 497–98 (2001).

[31] See U.S. Treasury Dep't, supra note 7; Reuven S. Avi-Yonah, The Pitfalls of International Integration: A Comment on the Bush Proposal and its Aftermath, Int'l Tax & Pub. Fin. (forthcoming 2004) (manuscript at 1, on file with the Virginia Law Review Association) [hereinafter Avi-Yonah, Pitfalls]. See Section IV.C for a fuller discussion of integration.

[32] See, e.g., Michael J. Graetz & Alvin C. Warren, Jr., Integration of Corporate and Individual Income Taxes: An Introduction, 84 Tax Notes 1767, 1769 (1999); Richard J. Vann, General Report: Trends in Company/Shareholder Taxation: Single or Double Taxation?, *in* International Fiscal Association 2003 Sydney Conference 21, 30–32 (2003); Alvin Warren, The Relation and Integration of Individual and Corporate Income Taxes, 94 Harv. L. Rev. 717, 773–74 (1981). The main difference between the two methods is that with dividend exemption, the corporate tax is final and thus no taxpayer pays tax at a rate higher than the corporate rate, while shareholder credits permit more progressivity. As Vann notes, the trend is toward the exemption method. See Vann, supra, at 68.

[33] See Graetz & Warren, supra note 32, at 1769. This alternative is rarely adopted because it does not easily permit collection of tax from foreign and tax-exempt shareholders.

porate level tax.[34] Corporations can, for this purpose, be divided into two categories—closely held and publicly traded. For closely held corporations, the obvious solution is to tax shareholders directly on corporate income as it is earned, since it can easily be attributed to them (whether or not it is distributed). This is, in fact, the way most closely held corporations are currently taxed in the United States—they are either so-called "S corporations" or Limited Liability Companies ("LLCs") that are treated as partnerships or sole proprietorships for tax purposes. In both cases, no corporate-level tax is imposed, and shareholders are taxed directly on corporate profits as they are earned. It seems a simple matter to extend this treatment, which is currently elective, to all closely held corporations.[35]

Most of the corporate tax, however, is collected from publicly traded corporations, and for those it is generally assumed that pass-through taxation is not administratively feasible.[36] Precisely because they are publicly traded, however, a ready alternative presents itself to address the deferral problem—taxing shareholders on a mark-to-market basis on the appreciation and depreciation of their shares. The usual objections to mark-to-market taxation are

[34] In addition, it is not clear that the corporate tax in fact falls on shareholders as an economic matter—in some circumstances it may be shifted to consumers or labor. Most economists assume, however, that the tax falls at least in part on shareholders in the short run, and on all capital providers in the long run. See, e.g., Martin Feldstein, Incidence of a Capital Income Tax in a Growing Economy with Variable Savings Rates, 41 Rev. Econ. Stud. 505, 510–11 (1974); Graetz & Warren, supra note 32, at 1774; Ronald E. Grieson, The Incidence of Profits Taxes in a Neo-Classical Growth Model, 4 J. Pub. Econ. 75, 82–84 (1975); Masaaki Homma, A Dynamic Analysis of the Differential Incidence of Capital and Labour Taxes in a Two-Class Economy, 15 J. Pub. Econ. 363, 374–77 (1981); Kenneth L. Judd, Redistributive Taxation in a Simple Perfect Foresight Model, 28 J. Pub. Econ. 59, 59–60 (1985); Don Fullerton & Gilbert E. Metcalf, Tax Incidence 20–23 (Nat'l Bureau of Econ. Research, Working Paper No. w8829, 2002), at http://www.nber.org/papers/w8829.pdf (on file with the Virginia Law Review Association); Casey B. Mulligan, Capital Tax Incidence: First Impressions from the Time Series 18–19 (Nat'l Bureau of Econ. Research, Working Paper No. w9374, 2002), at http://www.nber.org/papers/w9374.pdf (on file with the Virginia Law Review Association). All of these studies refine the classic work of Arnold Harberger. See Arnold Harberger, The Incidence of the Corporation Income Tax, 70 J. Pol. Econ. 215 (1962).

[35] See George K. Yin, The Future Taxation of Private Business Firms, 4 Fla. Tax Rev. 141, 151–53 (1999) (stating the basic case for taxing shareholders).

[36] But see Polito, supra note 8, at 1032–34 (suggesting various methods to make integration administratively feasible).

based on liquidity and valuation concerns, and neither of these is an issue for publicly traded shares. They are liquid by definition, and their value can be ascertained on a daily basis by opening the financial pages of any newspaper.

Mark-to-market, or accrual taxation, is the normative ideal of a Haig-Simons income tax, and many commentators support moving in that direction to the extent it is administratively feasible to do so.[37] Professor Dodge has exhaustively explored and demonstrated the feasibility of mark-to-market taxation for shareholders in publicly traded corporations.[38] Moreover, this type of taxation also exists in practice—U.S. shareholders in certain foreign corporations earning mostly passive income (Passive Foreign Investment Companies, or PFICs) are given the choice between either paying tax on the corporation's income directly (if the corporation agrees to furnish the necessary information, which usually applies only when it is closely held), paying tax on the shares on a mark-to-market basis, or paying an interest charge when they receive a dividend or dispose of the shares.[39] A similar system could be applied to all publicly traded corporations.

Mark-to-market taxation is complex, and imposing tax on unrealized gains is likely to run into significant political opposition. The costs of these administrative complexities are not, however, likely to be larger than the costs imposed by the existing corporate tax, and the political opposition needs to be offset against the political support of corporate management for repealing the corporate tax.[40] The adoption of the PFIC rules in 1986 shows that this solution is not politically unimaginable.

Finally, other administrative advantages of maintaining a corporate tax should be addressed. It is indeed easier to collect tax from a few corporations than from many shareholders, but even if one assumes that one tax in fact substitutes for the other, this advan-

[37] Halperin, supra note 8, at 817; David J. Shakow, Taxation Without Realization: A Proposal for Accrual Taxation, 134 U. Pa. L. Rev. 1111, 1113–18 (1986). Note that to the extent the corporate tax is needed to increase progressivity in the overall tax system, taxing shareholders directly is a more accurate way of doing so, as some shareholders in lower brackets are overtaxed by the current corporate tax.

[38] See Dodge, supra note 8, at 294–97.

[39] I.R.C. §§ 1291–97 (2000).

[40] A separate issue is political opposition to corporate tax repeal, which is discussed elsewhere. See infra notes 70–76 and accompanying text.

tage needs to be offset against the many costs of having the tax.[41] The most convincing argument from this perspective is that a corporate tax is necessary when shareholders are hard to reach because they are tax exempt or foreign. A large percentage of corporate equity is in fact held by tax–exempt shareholders, but it is not clear as a normative matter why these shareholders should be taxed on income they earn through corporations, but not on other income.[42] As for foreigners, it may be possible to tax at least large foreign shareholders on both dividends and capital gains through withholding.[43] In addition, maintaining the entire corporate tax just in order to reach foreign shareholders in a country like the United States, in which the large majority of shareholders are domestic, seems like letting the tail wag the dog.[44]

Thus, the most common rationale for retaining the corporate tax—that it is necessary from a deferral and administrability perspective as an indirect way of taxing shareholders—seems to rest on shaky ground. Both the deferral and the administrability issues can be resolved by other means, such as pass-through taxation of closely held corporations and mark-to-market taxation of shareholders in publicly traded corporations.

B. Artificial Entity Defenses of the Corporate Tax

A second type of defense links the corporate tax to benefits provided by the state and treats it as a type of benefit tax.[45] The tax is

[41] Bird, supra note 27, at 10–11.

[42] The issue of "unfair competition" with taxable businesses can be addressed by imposing an unrelated business income tax ("U.B.I.T.") at the shareholder level. See I.R.C. §§ 511–515 (2000).

[43] The United States does in fact tax most dividends, and many countries tax capital gains of large foreign shareholders. See Hugh J. Ault et al., Comparative Income Taxation: A Structural Analysis 411 (1997).

[44] This is a stronger justification for developing countries in which the entire corporate sector is foreign owned and the corporate tax on such enterprises is a significant percentage of all revenues. For a defense of the corporate tax in that context, see Avi-Yonah, Globalization, supra note 13, at 1640–41; Bird, supra note 27, at 6–8.

[45] See Richard A. Musgrave & Peggy B. Musgrave, Public Finance in Theory and Practice 373–74 (5th ed. 1989); Bird, supra note 27, at 4–5. This was also part of the argument in favor of enactment in 1909, in which the tax was described as an excise tax on the privilege of doing business in corporate form, but this was done to avoid treating the tax as a direct tax that would be unconstitutional under the Supreme

conceived as a payment in return for the benefits of incorporation, such as limited liability. This defense is linked to the artificial entity view of the corporation, which views it purely as a creature of the state.

There are several objections to this defense. First, some of the benefits conferred by government also flow to non-incorporated businesses not subject to the tax. Second, the specific benefits of incorporation are provided by state government, not by the federal government. Finally, there is no correlation between corporate income and the benefits provided, since the same benefits apply (and in the case of limited liability, apply more forcefully) to corporations that lose money.[46]

A more sophisticated variant of the benefits theory is advanced by Professor Rebecca Rudnick, who argues that the corporate tax can be justified as a payment for the greater liquidity afforded by access to the public equity market.[47] Under the current regime, there is a correlation between access to public equity markets and the corporate tax, which makes this analysis appealing.[48] It is unclear, however, whether there is any correlation between corporate income and liquidity; most publicly traded entities benefit from the same degree of liquidity but vary greatly in profitability. Rudnick argues that liquidity facilitates the creation of economic rents, and she would therefore revamp the tax to focus on these.[49] Similarly, Professors Joseph Bankman and Michael Knoll have proposed basing the corporate tax on changes in the value of outstanding corporate equity.[50] Such changes in the tax base would perhaps create a better link to liquidity, but they are not a defense of the corporate income tax we currently have in place. Similarly, Professor Herwig

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Court's 1895 decision, *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429 (1895), aff'd on reh'g, 158 U.S. 601 (1895). See also infra Section II.B.

[46] Musgrave & Musgrave, supra note 45, at 373–74; Bird, supra note 27, at 5. The Musgraves also argues that some benefits, such as limited liability, are costless to society and therefore cannot justify a tax, Musgrave & Musgrave, supra note 45, at 373–74 (although I am not sure they are right about limited liability having no costs).

[47] Rebecca S. Rudnick, Who Should Pay the Corporate Tax in a Flat Tax World?, 39 Case W. Res. L. Rev. 965, 985–86 (1989).

[48] William A. Klein & Eric M. Zolt, Business Form, Limited Liability, and Tax Regimes: Lurching Toward a Coherent Outcome?, 66 U. Colo. L. Rev. 1001, 1015–17 (1995).

[49] Rudnick, supra note 47, at 985–86.

[50] Bankman, supra note 9, at 1347; Knoll, supra note 9, at 1.

Schlunk has proposed to substitute for the corporate tax an "entity income tax" to be levied on all large entities (incorporated *vel non*) for the benefit of operating as a Coasian "firm."[51] This likewise is not a defense of the current corporate tax; in fact, Schlunk argues that no "colorable" defense of the current tax exists.[52]

Finally, the strongest benefits argument for the corporate tax is for a tax on foreign corporations doing business in a source jurisdiction.[53] In that regard, it has long been accepted that source jurisdictions may collect a tax from corporations doing business (above a certain minimal threshold) within their borders, because the host government created the market conditions that enable the income to be earned.[54] There probably is some correlation between, for example, the quality of infrastructure or education in the host country and the degree of profitability of foreign direct investment in it.[55] As argued above, however, it seems strange in the U.S. context to maintain the entire corporate tax just to collect a benefits payment from foreign corporations, since most of the corporations subject to the tax are domestic corporations.[56] Additionally, if one argues that the same infrastructure benefits justifying the corporate tax on foreign corporations also apply to domestic corporations, the argument would hold equally true for non-incorporated or closely held businesses that are not subject to the corporate tax.

In sum, the artificial entity or benefits argument for the corporate tax is unconvincing because there is no correlation between the existing corporate tax and the kind of benefits (if any) that the

[51] Schlunk, supra note 10, at 382. It is not clear why this is a benefit provided by the federal government. In fact, the inability to decide which government (if any) provides this particular benefit lies at the heart of the difficulty of allocating the income of multinational enterprises among tax jurisdictions. For a discussion of this problem in the context of transfer pricing, see Reuven S. Avi-Yonah, The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation, 15 Va. Tax Rev. 89 (1995).

[52] Schlunk, supra note 10, at 332.

[53] Of course, it is also easier politically to tax foreigners than to tax domestic corporations, which is precisely the reason tax treaties make it hard to discriminate against foreign corporations.

[54] Michael J. Graetz & Michael M. O'Hear, The "Original Intent" of U.S. International Taxation, 46 Duke L.J. 1021, 1036–37 (1997).

[55] See Reuven S. Avi-Yonah, International Taxation of Electronic Commerce, 52 Tax L. Rev. 507, 521 (1997).

[56] See supra text accompanying note 44.

federal government provides only to those entities that are subject to the tax, namely publicly traded corporations.

C. Real Entity Defenses of the Corporate Tax

The view of the corporation as a real entity, separate from both its shareholders and from the state, has not had much resonance in the tax area. After all, as Professors Richard and Peggy Musgrave point out in their classic public finance textbook, a view of the corporation as a distinct entity with economic resources under its control is "hardly tenable" in the tax context because the economic burden of taxes must ultimately fall on natural persons.[57] There is no reason that the income of those natural persons should be subject to a second level of tax simply because it is earned through a corporation.

Nevertheless, there is one way in which the corporation clearly exists as a separate entity from its shareholders and the state—as an organization under the control of corporate management. Management make the decisions whether to deploy the corporation's economic resources, and in that sense management can be regarded as the real corporation. This is particularly true for the publicly traded corporation in which ownership is (to paraphrase Professors Adolf Berle and Gardiner Means) separated from control.[58]

In recent years, a few academics have focused on the existence of corporate management and the agency-cost problem it creates as a separate justification for the corporate tax.[59] This line of argument is appealing because it applies only to publicly traded corporations that bear the brunt of the existing corporate tax.

Thus, Professors Saul Levmore and Hideki Kanda argue that the corporate tax is necessary because otherwise the agency-cost problem will be exacerbated when management (which may or may not include shareholders) face a different tax rate for corporate actions than some shareholders.[60] For example, if management are shareholders and there is no corporate tax, they may face a tax rate of

[57] Musgrave & Musgrave, supra note 45, at 372–73.

[58] Adolf A. Berle & Gardiner C. Means, The Modern Corporation and Private Property 68 (1932).

[59] See Hideki Kanda & Saul Levmore, Taxes, Agency Costs, and the Price of Incorporation, 77 Va. L. Rev. 211, 213 (1991).

[60] Id. at 229–31.

35% upon selling a corporate asset while other shareholders are taxed at zero. Management may thus be deterred by their individual tax burden from taking actions that are in the best interests of all shareholders. With a corporate tax in place, all corporate actions face the same tax rate.[61]

This argument is unpersuasive for several reasons. First, if we assume that the corporate tax is borne by shareholders, the same argument would apply even with a corporate tax—management who are taxable shareholders would ultimately face the double tax on dispositions while tax-exempt shareholders face only a single tax.[62] If the corporate tax is not borne by shareholders, then its existence *vel non* should have no impact on management actions. Second, if the Levmore and Kanda analysis is correct, it would apply to any positive corporate tax rate as long as it is imposed on all corporate-level activity, so it would at best justify a minimal tax. Finally, it seems far-fetched to hang the entire corporate tax on this type of consideration. Agency-cost problems are pervasive in any public corporation and it seems easier to address them by corporate law means rather than through the tax code.[63]

More recently, Professor Mihir Desai and his colleagues have argued that imposing a corporate tax can be a way of preventing management from diverting corporate resources to their own pockets.[64] Specifically, if corporate income must be declared for tax purposes, it becomes harder to conceal its theft from the corporation's shareholders. This is an ingenious argument, which (as we

[61] See id. at 233. For a similar argument based on agency costs that focuses more on the integration issue, see Joseph A. Snoe, The Entity Tax and Corporate Integration: An Agency Cost Analysis and a Call for a Deferred Distributions Tax, 48 U. Miami L. Rev. 1, 43–44 (1993).

[62] If dividends are exempt (as under President Bush's proposal), then all shareholders face the same zero rate at the shareholder level regardless of any corporate tax.

[63] It also seems implausible if shareholders are taxed on a mark-to-market basis and the corporate tax is repealed that management would forego corporate actions that increase the value of the shares they hold just because they have to pay tax on that increase, since their job performance and the value of their stock options depend on share value. Professors Levmore and Kanda seem to assume a pass-through model of taxation in the absence of the corporate tax, which is implausible for publicly traded corporations for administrability reasons.

[64] Mihir Desai et al., The Protecting Hand: Taxation and Corporate Governance 4 (Mar. 2003) (unpublished manuscript, on file with the Virginia Law Review Association).

shall see) also reflects some of the original intent in enacting the corporate tax in 1909.[65] From today's perspective, however, it seems like a shaky foundation for the entire corporate tax.[66] Management theft can be combated by other means, and a requirement to report income without tax (or with only a minimal tax) would do just as well to achieve the goal promoted by Professor Desai.

Thus, there is currently no convincing defense of the corporate tax based on the real entity view either. Nevertheless, as explained below, this view of the corporation provides the best argument in favor of the tax.[67]

D. Summary

It seems that there is no convincing defense of the corporate tax in the academic literature. The mainstream view of the corporate tax as an indirect way of taxing shareholders, which is based on the aggregate theory, is flawed because it is quite possible to tax shareholders directly without a corporate-level tax. Alternative defenses of the corporate tax that are based on the artificial view and real entity view are likewise unpersuasive. This leads some commentators to the conclusion that the corporate tax, with all its efficiency and complexity costs, should simply be repealed.[68] Other commentators favor letting the tax gradually disappear as a result of taxpayer actions.[69]

Yet it does not seem likely that the corporate tax will be repealed any time soon. Current proposals focus more on repealing the tax on dividends while retaining the corporate-level tax, and even more radical reform efforts like the flat tax proposal would

[65] See discussion infra Section II.B.

[66] It may, however, have some application in countries like Russia, from which Desai and his colleagues draw most of their examples. Desai, supra note 64, at 16–25. In the case of his U.S. example (Tyco), it should be noted that Tyco managers were ultimately caught by the criminal justice system, and that their behavior (stealing hundreds of millions of dollars from the corporation) seems a rather extreme basis for a corporate tax defense. See id. at 4–9.

[67] See infra Part III.

[68] See, e.g., Dodge, supra note 8, at 268–78 (proposing a mark-to-market and pass-through shareholder integration system).

[69] Interview with Austan Goolsbee, Professor of Business Administration, University of Chicago, at Office of Tax Policy Research Conference on Worldwide Tax Competition, in Ann Arbor, Mich. (Oct. 2000).

maintain a corporate level tax on above-normal returns.[70] When former Secretary of the Treasury Paul O'Neill announced that he favored repealing the corporate tax on the basis of his experience as a CEO,[71] the proposal did not have any political traction. In the current political climate, demise of the corporate tax due to taxpayer self-help seems much more likely than actual repeal.

Why is the corporate tax so politically resilient? The reason seems to be the same as the reason the corporate alternative minimum tax ("AMT") was enacted in 1986—ordinary Americans have a viscerally negative reaction to the notion that large, profitable corporations should pay no tax while they bear the income tax burden.[72] This is universally dismissed as an example of ordinary people's fiscal illusion, the misguided belief that corporations bear the burden of the tax, while every economically literate person knows that taxes can be borne only by natural persons.[73]

But are people really that ignorant? I would argue that the answer is no, and that in fact what people perceive is closer to reality than the economic models of incidence would suggest. The corporate tax is imposed on corporate income, which adds to the economic resources of the corporation. These resources are managed by individual corporate managers, and their control over such resources gives them significant economic, social, and political power. In that sense, imposing a corporate tax that reduces the economic resources available to corporate managers also reduces the power of corporate management. Whatever the economic inci-

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[70] The flat tax and other consumption tax proposals effectively exempt the normal return to corporate equity by permitting corporations to currently deduct all capital expenditures, while retaining the corporate tax for infra-marginal (above normal) returns. See, e.g., Alvin Warren, How Much Capital Income Taxed Under an Income Tax is Exempt under a Cash Flow Tax, 52 Tax L. Rev. 1 (1996).

[71] Hughes, supra note 6.

[72] The corporate AMT was enacted in response to newspaper reports about General Electric and other large corporations paying no tax. See Terrence R. Chorvat & Michael S. Knoll, The Case for Repealing the Corporate Alternative Minimum Tax, 56 SMU L. Rev. 305, 305 & n.1 (2003).

[73] See Musgrave & Musgrave, supra note 45, 398–401; Bank, supra note 30, 449–52 (discussing historical understanding of the corporate tax); Bird, supra note 27, at 1–3; Chorvat & Knoll, supra note 72, at 315; Michael L. Marlow, A Primer on the Corporate Income Tax: Incidence, Efficiency, and Equity Issues 1 (Tax Foundation, Background Paper No. 38, 2001), at http://www.taxfoundation.org/publications.background.html (on file with the Virginia Law Review Association).

dence of the corporate tax,[74] from this perspective its most immediate burden falls on corporate management, and not surprisingly, they are the strongest supporters of corporate tax repeal.[75]

This argument will be further developed in Part III. In the meantime, however, it is useful to link it to another question: Why was the corporate tax enacted in the first place? What was the "original intent" of its adopters, almost one hundred years ago? Examining this question can help shed some light on the current debate. As we will see, a major reason for its enactment was precisely to regulate and place limits on the power of corporate management.[76]

II. A HISTORICAL PERSPECTIVE: WHY WAS THE CORPORATE TAX ENACTED?

A. Antecedents: Aggregate-Based Taxation Before 1909

The first federal income tax, enacted to raise revenues during the Civil War, did not tax corporations, although a withholding tax was imposed on dividends and interest paid by railroad corporations and financial institutions, as well as on amounts added to surplus.[77] Instead, under the 1864 version of the tax, "the gains and profits of all companies, whether incorporated or partnership, other than the companies specified in this section, shall be included in estimating the annual gains, profits, or income of any person en-

[74] The incidence issue is important because management might be less inclined to protest if it could be shown that the tax is in fact shifted to employees or consumers, leaving corporate profit accumulation unaffected. But as an empirical matter, it remains unclear whether the tax can be shifted in most cases. See literature cited supra note 34 and discussion infra Part III.

[75] Traditionally, they are much more lukewarm about dividend tax relief. In fact, corporate management has largely been responsible for the current classical (double) tax system, which they saw as a way to avoid higher corporate level taxes and pressure to distribute dividends. See Jennifer Arlen & Deborah M. Weiss, A Political Theory of Corporate Taxation, 105 Yale L.J. 325, 338, 341 (1995).

[76] The regulatory argument for the corporate tax is raised briefly but dismissed by Musgrave & Musgrave, supra note 45, at 402–03, who argue that regulatory aims can be more efficiently achieved by other means. For a discussion, see Part III.

[77] Act of July 1, 1862, ch. 119, §§ 81–82, 12 Stat. 432, 469–70 (repealed 1874). Shareholders and bondholders were permitted to exclude dividends and interest subject to withholding from income. Id. § 91, 12 Stat. 473–74 (repealed 1874). On the early history of the corporate tax in the United States, see generally Bank, supra note 30.

titled to the same, whether divided or otherwise."[78] The Civil War income tax thus included a form of pass-through taxation that applied to corporations, and the imposition of the tax on the undivided profits of corporations was specifically upheld by the Supreme Court.[79]

Pass-through treatment of corporate profits reflected the aggregate view of the corporation, which was prevalent at the time.[80] It also reflected the fact that most corporations were small, closely held enterprises, and therefore (like today) it was relatively easy to identify the shareholders and to tax them on corporate profits. For those enterprises that were more widely held, like railroads, a withholding tax collected by the corporation effectively replaced the tax on the shareholder.[81]

The Civil War version of the income tax was allowed to expire with the end of Reconstruction in 1872.[82] In 1894, after the financial panic of 1893 and the economic dislocation that followed, the Democrats in Congress were able to pass an income tax bill.[83] The debate at the time focused on the protective tariff, which was the main source of revenue for the federal government.[84] The tariff functioned as a highly regressive consumption tax and benefited

[78] Act of June 30, 1864, ch. 173, § 117, 13 Stat. 223, 281–82 (repealed 1874). Also under this act, a withholding tax was imposed on dividends and interest paid by certain types of corporations, and such dividends and interest payments were excluded from income. Id. at §§ 120–122, 13 Stat. at 283–85 (repealed 1874).

[79] Collector v. Hubbard, 79 U.S. (12 Wall.) 1, 18 (1870).

[80] See Morton J. Horwitz, *Santa Clara* Revisited: The Development of Corporate Theory, 88 W. Va. L. Rev. 173, 183–86 (1985).

[81] Note, however, that this was not a perfect replacement since the corporate rate was 5% with no exemption whereas the top shareholder rate was 10% with a $600 exemption. See Bank, supra note 30, at 457–58. The decision to treat the withholding tax as the final tax in the case of widely held enterprises presumably reflected the practical difficulty of collecting tax on a pass-through basis in those cases. Id. at 522–24.

[82] W. Elliot Brownlee, Historical Perspective on U.S. Tax Policy Toward the Rich, *in* Does Atlas Shrug? The Economic Consequences of Taxing the Rich 29, 35 (Joel B. Slemrod ed., 2000); Dennis J. Ventry, Jr., Equity Versus Efficiency and the U.S. Tax System in Historical Perspective, *in* Tax Justice: The Ongoing Debate 25, 29 (Joseph J. Thorndike & Dennis J. Ventry, Jr., eds., 2002); Steven R. Weisman, The Great Tax Wars: Lincoln to Wilson—The Fierce Battles Over Money and Power That Transformed the Nation 101 (2002).

[83] Brownlee, supra note 82, at 37; Ventry, supra note 82, at 30; Weisman, supra note 82, at 131–46.

[84] Brownlee, supra note 82, at 37; Ventry, supra note 82, at 29–30; Weisman, supra note 82, at 138.

the manufacturing centers of the Northeast at the expense of the more agricultural South and West.[85] The Democrats argued that relying solely on tariffs allowed the newly super-rich railroad, steel, and sugar magnates to escape any meaningful tax burden.[86] Their argument was further bolstered by the fact that the state-level personal property taxes were notoriously ineffective in reaching intangible forms of property, such as stocks and bonds.[87]

The 1894 Act for the first time imposed a tax of 2% on the net income of all "corporations, companies, or associations doing business for profit in the United States, no matter how created or organized, but not including partnerships."[88] At first impression this appears to be a stark departure from the Civil War income tax, which taxed corporate income in the hands of the shareholders and only employed withholding at the corporate level as a collection device. Professor Steven Bank, however, has convincingly demonstrated that such a reading of the 1894 Act is misleading.[89] First, he points out that dividends from taxable corporations were excluded from shareholder income so that the corporate tax could be viewed as a collection device for the shareholder-level tax (imposed at the same rate).[90] Second, the House version of the 1894 Act followed the Civil War income tax in imposing a withholding tax on dividends and interest, except that the tax was also applied to undistributed income and to all corporations.[91] Thus, the progression from the Civil War income tax to the House bill to the final version of the 1894 Act can be seen as a gradual process of modifying what was fundamentally a withholding tax imposed on the shareholders.[92] Third, the Congressional debates on the 1894 Act show that the principal motive for the corporate-level tax was to reach the shareholders, most of whom were precisely the kind of rich indi-

[85] Weisman, supra note 82, at 138.

[86] Id. at 136–38.

[87] Ventry, supra note 82, at 29–30.

[88] Tariff Act of 1894, ch. 349, § 32, 28 Stat. 509, 556 (held unconstutitional in *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429 (1895), aff'd on reh'g, 158 U.S. 601 (1895)).

[89] Bank, supra note 30, at 504–37.

[90] Id. at 462 (citing Tariff Act of 1894, ch. 349, § 28, 28 Stat. 509, 554). Integration was incomplete because corporations were not eligible for the $4000 exemption, see id. at 462–63, but this can be explained by administrative convenience.

[91] 26 Cong. Rec. 6831 (1894).

[92] Bank, supra note 30, at 517–19.

viduals who were able to escape the state-level personal property tax and whose corporations benefited from the high tariffs.[93] Finally, Bank points out that the norm throughout the latter half of the nineteenth century was for most corporations to distribute their net earnings out as dividends.[94] In that context, imposing a withholding tax on dividends was the most effective way to tax shareholders in widely held enterprises, and imposing the same tax on additions to surplus was merely another enforcement device to prevent accumulated income from escaping tax. By 1894, the withholding tax was transformed to a tax on all the income of the corporation (distributed or not), but was still seen primarily as a device to tax shareholders.[95]

Thus, throughout the nineteenth century, there was little evidence at the federal level of direct taxation of corporations as such. Withholding taxes were imposed at the corporate level on both distributed and undistributed income, but those were seen as an indirect way of taxing shareholders consistent with the aggregate view of the corporation.

B. The 1909 Act: A Real Entity Measure

In 1895, the Supreme Court struck down the 1894 Act as an unconstitutional direct tax without apportionment.[96] The Democrats immediately made reinstatement of the income tax a major plank of their platform for the 1896 and 1900 elections, but to no avail.[97] With the decisive victory of William McKinley (author of the notorious McKinley tariff of 1890) and his corporate allies in 1896, the income tax issue seemed dead.[98]

The situation changed with the rise of the Progressives and the accession of Theodore Roosevelt to the White House in 1901. Roosevelt spent his seven years in office greatly expanding the powers of the federal government vis-à-vis corporations. He was the first President to attempt to use the Sherman Antitrust Act,

[93] Id. at 530.
[94] Id. at 528–29.
[95] Id. at 530–31.
[96] Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429 (1895), aff'd on reh'g, 158 U.S. 601 (1895).
[97] Brownlee, supra note 82, at 37–38; Weisman, supra note 82, at 165–72.
[98] Weisman, supra note 82, at 175–77.

adopted in 1890 but left largely unused until his time, to break up the great monopolies, such as John D. Rockefeller's The Standard Oil Company.[99] In addition, he established the Bureau of Corporations to assemble information on, and ultimately perhaps to regulate, corporations.[100] He also proposed that all corporations should be incorporated under the authority of the federal government.[101]

On the tax front, Roosevelt expressed support in 1907 (after another financial panic) for a graduated income tax, but supporters of the tariff within the Republican Party were able to delay consideration of the issue until after the 1908 election.[102] The newly elected President Taft was less of a supporter of the income tax than his predecessor and was worried about enacting another tax that would be found to be unconstitutional.[103] He also faced increased support for the income tax in Congress and a possible split within his own party between Northeastern opponents of the tax and Midwestern supporters.[104] Eventually, President Taft proposed a compromise: Enact a corporate excise tax measured by income, which could withstand judicial scrutiny, and simultaneously submit an amendment to the Constitution to permit enactment of an income tax.[105]

The legislative debate on the proposed tax was set in the broader context of the debate on tariff reduction. Opponents of tariff reduction, mostly from the Northeast, viewed high tariffs as essential to protecting American industry and argued that the benefits of such tariffs extended to ordinary workers as well as to captains of industry.[106] Proponents of tariff reduction, mostly from the West and the South, argued that high tariffs raised the price of goods consumed by ordinary Americans to benefit the rich.[107]

[99] See Standard Oil Co. of N.J. v. United States, 221 U.S. 1 (1911); United States v. N. Sec. Co., 193 U.S. 197 (1904).

[100] Act of Feb. 14, 1903, ch. 552, § 6, 32 Stat. 825, 827–28.

[101] Marjorie E. Kornhauser, Corporate Regulation and the Origins of the Corporate Income Tax, 66 Ind. L.J. 53, 66 (1990). See discussion infra notes 165–68.

[102] Weisman, supra note 82, 203–05.

[103] Id. at 211.

[104] See id. at 226.

[105] Id. at 227.

[106] Id. at 211.

[107] See id. at 211–12.

Initially, it seemed likely that the tariff bill (named after its co-sponsors the Payne-Aldrich Tariff) would be passed by the Republican majority in both houses. In the House, income tax proponents like Cordell Hull, a Democrat from Tennessee, were unable to attach an income tax amendment to the tariff bill. In the Senate, however, progressive Republicans like Robert La Follette, of Wisconsin, and Democrats like Joseph Bailey, of Texas, were more effective in arguing for the income tax. La Follette and Bailey argued that since the rich benefited more than the poor from government protection, they should pay more for it, and that enacting the income tax would silence the "envious voice of anarchy" (socialism).[108]

Ultimately, Senator Nelson Aldrich, Republican from Rhode Island and the main opponent of the income tax, realized that with nineteen Republicans threatening to join the Democrats and vote for the income tax, he might lose.[109] In a crucial meeting at the White House, Aldrich and President Taft agreed to support instead a corporate tax plus a constitutional amendment empowering Congress to levy the income tax, while maintaining high tariffs.[110] Aldrich stated, "I shall vote for a corporation tax as a means to defeat the income tax."[111] This compromise ultimately passed the Senate 45–34 and the House 195–183, and was signed into law by the President on August 5, 1909.[112]

The 1909 Act imposed "a special excise tax with respect to the carrying on or doing business" of 1% of net income over $5,000 of "every corporation, joint stock company or association, organized for profit" under U.S. law, and every foreign corporation engaged in business in the United States.[113] Dividends from taxable corporations were excluded from corporate income.[114]

What was the rationale for the 1909 Act, which is the origin of our current corporate income tax? Proponents of the tax gave several reasons, including the benefits theory and the corporate tax as

[108] Id. at 220–23.
[109] Id. at 226–27.
[110] Id. 227.
[111] 44 Cong. Rec. 3929 (1909) (statement of Sen. Aldrich).
[112] Weisman, supra note 82, at 230–31.
[113] Tariff Act of 1909, ch. 6, § 38, 36 Stat. 11, 112–13.
[114] Id. § 38, 36 Stat. at 112.

an indirect tax on shareholders view.[115] As Professor Marjorie Kornhauser has pointed out, however, a major motive for the act was to regulate corporations.[116] The principal vehicle for regulation was the filing of tax returns, which were to be made public.[117] More broadly, the tax itself fulfilled a potential regulatory function—it could serve as a vehicle to restrict the accumulation of power in the hands of corporate management.[118]

The various motives for enacting the corporate tax, which reflect the three theories of the corporation, can be seen in President Taft's message to Congress and in the debate that preceded enactment in the Senate. President Taft's message of June 16, 1909, gives three reasons for enacting a corporate tax (rather than a general income tax, which was thought to be possibly unconstitutional, or an inheritance tax, which did not have sufficient political support among Republicans in the Senate).[119] The first reason is that "[t]his is an excise tax upon the privilege of doing business as an artificial entity and of freedom from a general partnership liability enjoyed by those who own the stock."[120] This argument is based on an artificial entity view of the corporation as a creature of the state. President Taft was aware, however, that it is difficult to make this argument for a federal tax when the privileges enjoyed by the corporation derived from state law.[121] The reason he made the argument, however, was that this formulation was necessary to ensure the tax's constitutionality, since the Supreme Court had upheld such an excise tax on sugar and oil companies in *Spreckels Sugar Refining Co. v. McClain.*[122] President Taft added that nevertheless the tax "accomplishes the same purpose as a corporation income tax."[123]

[115] See discussion of Congressional debate, infra notes 130–52 and accompanying text.
[116] Kornhauser, supra note 101, at 53.
[117] See discussion of publicity, infra notes 139–43 and accompanying text.
[118] See discussion of regulatory function, infra notes 144–49.
[119] See Weisman, supra note 82, at 227.
[120] 44 Cong. Rec. 3344 (1909) (statement of President Taft).
[121] See discussion of benefits argument in the Senate, infra note 133.
[122] 192 U.S. 397 (1904), *cited in* 44 Cong. Rec. 3344 (1909) (statement of President Taft).
[123] 44 Cong. Rec. 3344 (1909) (statement of President Taft).

The second argument President Taft made was that the corporate tax "imposes a burden at the source of the income at a time when the corporation is well able to pay and when collection is easy."[124] The reference to collection "at the source" relates to the aggregate view of the corporation, since the tax is viewed as a withholding tax imposed on the shareholders (referred to at the time as "stoppage at source").[125] This is similar to the mainstream modern view of the tax, although the reference to the corporations' ability to pay (as opposed to the shareholders' ability to pay) has a real entity overtone. President Taft probably did not emphasize the nature of the tax as an indirect tax on shareholders because that would have made it more suspect to the opponents of the income tax as well as more vulnerable to a constitutional challenge.

Instead, the principal reason President Taft gave for enacting a corporate tax was the third one—that it would enable the federal government to exercise some degree of supervision, primarily by obtaining information about the business affairs of corporations. President Taft devoted a whole paragraph of his message to this argument, much more than he gave to the first two. He stated the following:

> Another merit of this tax is the federal supervision which must be exercised in order to make the law effective over the annual accounts and business transactions of all corporations. While the faculty of assuming a corporate form has been of the utmost utility in the business world, it is also true that substantially all of the abuses and all of the evils which have aroused the public to the necessity of reform were made possible by the use of this very faculty. If now, by a perfectly legitimate and effective system of taxation, we are incidentally able to possess the Government and the stockholders and the public of the knowledge of the real business transactions and the gains and profits of every corporation in the country, we have made a long step toward that supervisory control of corporations which may prevent a further abuse of power.[126]

[124] Id.
[125] Bank, supra note 30, at 517.
[126] 44 Cong. Rec. 3344 (1909) (statement of President Taft).

This remarkable paragraph rests on the real entity view of the corporation as separate from both the state and the shareholders. It identifies corporate management as the source of "abuse of power" and suggests that the imposition of the corporate tax will enable the government, the shareholders, and the public to obtain information that will serve as the basis for restricting such managerial abuses of power. While the tax itself is incidental to the regulatory mechanism, this statement is important because it delineates a reason to tax corporations that is unrelated to the tax on shareholders or to the benefits conferred by the state. The tax is imposed on corporations because of the power exercised by corporate management, and management is clearly regarded as distinct from the shareholders (who will in fact be beneficiaries of the supervision over management actions).[127]

The same mixture of motives can also be seen in the Congressional debate over enactment. Proponents and opponents of the tax reflected all three theories of the corporation. Some viewed it primarily as a benefits tax,[128] others primarily as a tax on the shareholders.[129] The predominant strain in the debate, however, was to view the tax as a regulatory device to restrict abuses of managerial power.

The artificial entity view of the tax was expressed primarily by those proponents who sought to defend it from a constitutional attack.[130] Senator Root, for example, who was one of the main drafters of the bill, defended the tax in part as based on the privilege of limited liability.[131] Opponents, however, were quick to point out that since corporations were created under state law, the federal government had no right to tax them under an artificial entity

[127] Similarly, in a letter dated June 27, 1909, Taft identified the publicity feature as a particularly important element of the tax, stating that "publicity gives a kind of federal supervision over corporations, which is quite a step in the direction of similar reforms I am going to recommend at the next session of Congress." Letter from William Howard Taft to Horace Taft (June 27, 1909), *in* Papers of William Howard Taft 8, 8 (Library of Congress, Manuscript Division, Reel 497), *cited in* Kornhauser, supra note 101, at 99.

[128] See infra note 133 and accompanying text.

[129] See infra notes 134–37 and accompanying text.

[130] See, e.g., 44 Cong. Rec. 4237 (1909) (statement of Sen. Daniel) (describing a corporation as an artificial entity and defending the constitutionality of a tax on it).

[131] 44 Cong. Rec. 4006 (1909) (statement of Sen. Root).

view.[132] In addition, opponents pointed out that unincorporated businesses obtained from the federal government the same benefits as corporations.[133]

The aggregate view was advanced by proponents who argued that the corporate tax was an indirect way to tax wealthy shareholders.[134] Opponents argued that the tax did not discriminate between wealthy and less wealthy shareholders.[135] Proponent Senator Cummins stated that "[s]o far as taxes are concerned, corporations are mere trustees for their shareholders; and their shareholders must pay the tax."[136] Others argued that the tax would be shifted to consumers or wage earners, at least by the strongest corporations in the best position to avoid competition—the trusts.[137]

By far the most significant debate centered on the real entity view of the corporation and the argument that the tax was a regulatory device. Some of this debate centered on the publicity feature of the tax, but some of it understood the tax as a preliminary measure to control and limit managerial power directly. For example, Senator Flint (a supporter of the tax) stated that "it would give a certain amount of control of corporations by the National Gov-

[132] "The United States did not create these corporations. . . . I should like to know whether there is on the part of any Member of the Senate a belief that the Congress . . . can, through the medium of taxation, destroy the corporations that have been created by the several states?" 44 Cong. Rec. 3977 (1909) (statement of Sen. Cummins).

[133] "I deny the right of Congress to levy a tax upon the business of corporations as such . . . . It is an arbitrary [classification]; it is an unfair one . . . . [I]t is a tax upon the right to do business as a corporation as distinguished from the right to do business as an individual or as a copartnership." 44 Cong. Rec. 3976 (1909) (statement of Sen. Cummins).

[134] See infra note 136.

[135] "Shall we levy an income tax upon the stockholders of all corporations for pecuniary profit, without respect or regard to the extent of the income earned or enjoyed by those stockholders . . . ?" 44 Cong. Rec. 3955 (1909) (statement of Sen. Cummins); see also 44 Cong. Rec. 4008 (1909) (statement of Sen. Clapp) (similar).

[136] 44 Cong. Rec. 3975 (1909) (statement of Sen Cummins); see also Report of the Commissioners of Corporations on the System of Taxing Manufacturing, Mercantile, Transportation, and Transmission Corporations in the States of Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island and Vermont 11 (May 17, 1909) ("Obviously a tax on the corporation is really a tax upon its stockholders, for otherwise than as a matter of legal reasoning a corporation and its stockholders are one.").

[137] See 44 Cong. Rec. 3985–87 (1909) (statement of Sen. Borah). Senator Cummins likewise considered that the tax may be shifted from shareholders, 44 Cong. Rec. 3975 (1909) (statement of Sen. Cummins), as did Senator Clapp, 44 Cong. Rec. 4008 (1909) (statement of Sen. Clapp).

ernment, publicity as to the condition of the affairs of corporations, and supervision to a certain extent over those corporations."[138] Publicity was part of the regulatory scheme, but not the only part.

The publicity feature was stressed by many. Senator Dixon, for example, stated that he favored the tax primarily because of the publicity feature, for he feared the tax itself would not reach wealthy shareholders.[139] Senator Newlands likewise supported the tax as "securing, through publicity and otherwise, such supervisory control by the National Government as can be constitutionally exercised over corporations."[140] Even Senator Aldrich, the ultra-conservative chair of the Finance Committee, supported the publicity feature.[141] Senator Cummins, who opposed the tax, nevertheless supported the publicity feature because the "revolution in industry" resulting from the rise of large corporations "is simply a prelude to industrial commercial slavery unless the Government intervenes with its strong arm, and it can not intervene unless it has the information necessary to enable it to act intelligently and wisely."[142]

Other Senators, however, emphasized the potential of the tax to directly limit managerial power. Senator Newlands stated that "I favor also present legislative action imposing an excise tax in such form as to reach the great accumulated wealth of the country, or its earnings, engaged in corporate enterprise."[143] He did not mean by this indirect taxation of wealthy shareholders, because he went on to state that "there was no reason why the great combinations monopolizing these industries [protected by the tariff] should not pay some part of the national expenses as well as the

[138] 44 Cong. Rec. 3937 (1909) (statement of Sen. Flint).

[139] 44 Cong. Rec. 3941 (1909) (statement of Sen. Dixon); see also 44 Cong. Rec. 4001 (1909) (statement of Sen. Bourne) ("I personally concur with the President that the corporation net-earnings tax, in view of the publicity feature incident to it, is of infinitely greater importance and will be far more beneficial to this country than either the inheritance or income tax.").

[140] 44 Cong. Rec. 3756 (1909) (statement of Sen. Newlands); see also 44 Cong. Rec. 3759 (1909) (statement of Sen. Newlands) (arguing that the corporate income tax will provide valuable regulatory information concerning corporations).

[141] See 44 Cong. Rec. 3930 (1909) (statement of Sen. Aldrich); see also 44 Cong. Rec. 4006–07 (1909) (statement of Sen. Root) (supporting the publicity feature).

[142] 44 Cong. Rec. 3965 (1909) (statement of Sen. Cummins).

[143] 44 Cong. Rec. 3756 (1909) (statement of Sen. Newlands).

masses of the people who use and consume [their products]."[144] Senator Newlands thus viewed the tax as falling on the accumulated wealth in the hands of the corporation itself, that is, upon corporate management.[145] Senator Owen likewise spoke of the "enormous volume of corporate wealth": "The most important need of the people of the United States of this generation requires the abatement of the gigantic fortunes being piled up by successful monopoly, . . . which have brought about a grossly inequitable distribution of the proceeds of human labor."[146] Like other Democrats, he would have preferred an income or inheritance tax, but he supported the corporate tax for its potential direct impact on corporate—that is, managerial—wealth.

Senator Root, a principal draftsman of the tax and personal friend of the President, likewise emphasized the potential of the tax to reach the wealth accumulated in the hands of corporate management because he favored taxing such wealth over earned income:

> Mr. President, it has so happened that in the development of the business of the United States the natural laws of trade have been making the distinction [between earned and unearned income] for us, and they have put the greater part of the accumulated wealth of the country into the hands of corporations, so that when we tax them we are imposing the tax upon the accumulated income and relieving the earnings of the men who are gaining a subsistence for their old age and for their families after them.[147]

[144] 44 Cong. Rec. 3761 (1909) (statement of Sen. Newlands); see also 44 Cong. Rec. 3762 (1909) (statement of Sen. Newlands) ("Justice demands that the various forms of manufactured wealth, in whose favor the taxing power of the Nation is so freely exercised, should make some substantial contribution to the national expenses.").

[145] 44 Cong. Rec. 4048–49, 4233 (1909) (statement of Sen. Newlands) (advocating a tax concentrated on the management of the great trusts and exempting small corporations); 44 Cong. Rec. 4229–30 (1909) (statement of Sen. Dolliver) (similar).

[146] 44 Cong. Rec. 3950 (1909) (statement of Sen. Owen).

[147] 44 Cong. Rec. 4003 (1909) (statement of Sen. Root); see also 44 Cong. Rec. 4006 (1909) (statement of Sen. Root) (distinguishing between earned income and "accumulated capital" which should be taxed). Senator Cummins argued that the corporate tax would not achieve this purpose since it would fall on all shareholders, rather than just on management. 44 Cong. Rec. 4038 (1909) (statement of Sen. Cummins).

Opponents of the tax also stressed the regulatory aspect, but suggested that it had the potential of giving the federal government too much power over corporations. For example, Senator Cummins, stated that:

> If this tax is intended not to create a revenue, but if it is intended for the purpose of supervising and regulating corporations, that is quite a different proposition. I should like to know before we get through with this whether it is proposed through this tax to impose supervisory regulations upon all the corporations of the United States. . . . You know there is just a little intimation in the message of the President that that is the end which is finally to be reached. . . . I think that before the Government of the United States enters upon the work of supervising and regulating all those corporations . . . we had better stop and think a while.[148]

Senator Cummins, however, was not opposed to all federal regulation through the corporate tax. Rather he was opposed just to a tax that indiscriminately applied to all corporations, as opposed to the proper targets—the great trusts:

> If we can regulate our corporations simply through the medium of taxation, we can destroy every trust in a fortnight. It would be a great deal better for the Finance Committee to turn its attention to the imposition of such a tax upon corporations and the persons who actually need regulation, who are exercising powers that are injurious to the American people, destroying competition and invading our prosperity, than to attempt to levy a revenue tax upon all the little shareholders of all the little corporations throughout the length and breadth of the United States.[149]

Other opponents of the tax likewise supported regulating the large trusts through taxation, referring to the excise tax imposed on the gross income of the sugar and oil trusts in 1898.[150] They opposed the proposed corporate tax, however, because it exempted dividends

[148] 44 Cong. Rec. 3978 (1909) (statement of Sen. Cummins); see also 44 Cong. Rec. 4047 (1909) (statement of Sen. Hughes) (arguing that regulation should be done directly).

[149] 44 Cong. Rec. 3978 (1909) (statement of Sen. Cummins). Senator Cummins argued that much higher rates would drive the trusts out of business. 44 Cong. Rec. 4232 (1909) (statement of Sen. Cummins).

[150] Cf. 44 Cong. Rec. 4009 (1909) (statement of Sen. Clapp).

received from other taxable corporations from the tax base, thereby encouraging the formation of holding companies—precisely those companies that formed the legal basis for the trusts.[151] Proponents of the tax replied that it was better to attack the trusts via a tax on all corporations than to refrain from attacking them at all.[152]

C. Summary

Between 1894 and 1909 a significant change occurred in regard to the justification for the corporate tax. The 1894 tax was conceived as a continuation of the Civil War tax, that is, as a withholding tax on shareholders. The 1909 tax, on the other hand, while still seen by some opponents as an indirect tax on shareholders, was primarily viewed as a regulatory device to restrict managerial power. This goal was achieved most directly through the publicity feature of the tax, but both proponents and opponents also saw the tax as having the potential to regulate management directly by reducing corporate wealth and therefore restricting managerial power.

This shift can easily be discerned by comparing two Supreme Court opinions dealing with the corporate tax. In 1870 the Court decided that the Civil War income tax may be applied to tax shareholders upon the undivided profits of a corporation.[153] Fifty years later the Court held that a shareholder may not be taxed on a stock dividend distributed by a corporation since that would be tantamount to taxing her on the undistributed income of the corporation, which is not her income under the Sixteenth Amendment.[154] The Court stated:

> We have no doubt of the power or duty of a court to look through the form of the corporation and determine the question of the stockholder's right, in order to ascertain whether he has

[151] See 44 Cong. Rec. 4010 (1909) (statement of Sen. Clapp); 44 Cong. Rec. 4230 (1909) (statement of Sen. Dolliver). Senator Aldrich replied that this was necessary to avoid double corporate taxation and that no for-profit corporation was exempt from tax. 44 Cong. Rec. 4231 (1909) (statement of Sen. Aldrich).

[152] See, e.g., 44 Cong. Rec. 4036 (1909) (statement of Sen. Davis).

[153] Collector v. Hubbard, 79 U.S. (12 Wall.) 1, 18 (1870).

[154] Eisner v. Macomber, 252 U.S. 189 (1920).

> received income taxable by Congress without apportionment. But, looking through the form, we cannot disregard the essential truth disclosed; ignore the substantial difference between corporation and stockholder; treat the entire organization as unreal; look upon stockholders as partners, when they are not such; treat them as having in equity a right to a partition of the corporate assets, when they have none; and indulge the fiction that they have received and realized a share of the profits of the company which in truth they have neither received nor realized. We must treat the corporation as a substantial entity separate from the stockholder, not only because such is the practical fact but because it is only by recognizing such separateness that any dividend—even one paid in money or property—can be regarded as income of the stockholder. Did we regard corporation and stockholders as altogether identical, there would be no income except as the corporation acquired it; and while this would be taxable against the corporation as income under appropriate provisions of law, the individual stockholders could not be separately and additionally taxed with respect to their several shares even when divided, since if there were entire identity between them and the company they could not be regarded as receiving anything from it, any more than if one's money were to be removed from one pocket to another.[155]

Thus, by 1920, the Court viewed the corporation as a real entity separate and distinct from the shareholders "because such is the practical fact."[156] The same real entity view underlay most, although

[155] Id. at 213–14. The Court then went on to state that *Hubbard* was overruled by *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429 (1895), aff'd on reh'g, 158 U.S. 601 (1895), and was not reinstated by the Sixteenth Amendment. *Macomber*, 252 U.S. at 218–19.

[156] *Macomber*, 252 U.S. at 214. The other argument advanced by the Court—that cash dividends could not be taxed—interestingly ignores the fact that between 1913 (when the Sixteenth Amendment was adopted and the first individual income tax was adopted) and 1936, cash dividends were to some extent exempt from tax to shareholders. See Bank, supra note 30, at 533. But dividends were taxed to the extent the individual rate exceeded the basic or normal rate and the corporate rate was set higher than the normal rate from 1918, resulting in partial double taxation. See Steven A. Bank, Corporate Managers, Agency Costs, and the Rise of Double Taxation, 44 Wm. & Mary L. Rev. 167, 181–82 (2002) (discussing the historical evolution of double taxation).

not all, of the arguments made when the corporate tax was adopted in 1909.

What accounts for the change between 1894, when the corporate tax was seen as a withholding device and the aggregate view was dominant, and 1909, when the real entity view was the main reason for adopting a corporate tax? The principal reason is a significant change in the nature of the corporation that occurred in this period. From 1890 to 1916 American capitalism transformed from a system of owner/manager enterprises operating in largely unregulated competitive markets to a system dominated by relatively few large, mostly non-owner managed corporations in a regulated competitive market.[157] In particular, although there were large-scale corporations before the Progressive Era, consolidation began only in the early 1890s and accelerated to a wave of consolidation by merger between 1898 and 1904.[158] The key legal change was New Jersey's adoption in 1890 of a new corporate law that permitted holding corporations.[159] This enabled the consolidators to avoid the cumbersome "trust" structures (in which shareholders contributed their shares to a trust in exchange for certificates of beneficial ownership) for the simpler holding company structure of parent and operating subsidiaries. The result was a wave of corporate migration to New Jersey, followed in the 1910s by another migration to Delaware when New Jersey balked at further pro-management rule changes.[160]

The reaction to the emergence of the "trust issue" from around 1896 onward was a chorus of calls for more regulation. For example, in 1906, Representative Martin of South Dakota defined a trust as "a combination of corporations," identified the resulting "evils" as "overcapitalization . . . the tendency to monopoly, and . . . the de-

[157] See Martin J. Sklar, The Corporate Reconstruction of American Capitalism, 1890–1916 (1988). For background, see generally Alfred D. Chandler, Jr., The Visible Hand: The Managerial Revolution in American Business (1977).

[158] Sklar, supra note 157, at 45–46 & n.4 (noting that little further concentration took place between 1904 and 1954).

[159] See Act of Apr. 21, 1896, ch. 185, 1896 N.J. Laws 309–310 § (9)(104); Lincoln Steffens, New Jersey: A Traitor State: Part II—How She Sold Out to the United States, 25 McClure's Mag. 41 (1905).

[160] For the classic debate on whether this was a "race to the bottom" or a "race to the top," see William L. Cary, Federalism and Corporate Law: Reflections Upon Delaware, 83 Yale L.J. 663 (1974); Ralph K. Winter, Jr., State Law, Shareholder Protection, and the Theory of the Corporation, 6 J. Legal Stud. 251 (1977).

struction of individual enterprise and success," and called for remedial legislation that would combine "publicity," "free competition," and "close Federal supervision or regulation."[161] One immediate result was the attempt by President Roosevelt to control the trusts by using the Sherman Antitrust Act of 1890, which led to the Supreme Court ultimately breaking up The Standard Oil Company, though holding at the same time that only "unreasonable" restraints of trade were illegal.[162]

President Roosevelt was not opposed to the growth of big business; unlike the Populists, he did not believe in turning the clock back to a "golden age" of small producers. But he did favor federal regulation. In his 1907 message to Congress President Roosevelt declared:

> I am in no sense hostile to corporations. This is an age of combination, and any effort to prevent all combination will be not only useless, but in the end vicious. . . . We should, moreover, recognize in cordial and ample fashion the immense good effected by corporate agencies. . . . The corporation has come to stay.[163]

But the following year, he also stated that:

> I strongly advocate that instead of an unwise effort to prohibit all combinations, there shall be substituted [for the Sherman Act] a law which shall expressly permit combinations which are in the interest of the public, but shall at the same time give to some agency of the National Government full power of control and supervision over them.[164]

Roosevelt's first concrete proposal was for federal incorporation.[165] The Hepburn Bill, introduced in 1908, would have allowed corporations to voluntarily register with a federal office.[166] The bill failed, however, because of Republican opposition to such an ex-

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[161] 40 Cong. Rec. 1849–51 (1906) (statement of Rep. Martin).

[162] Standard Oil Co. of N.J. v. United States, 221 U.S. 1 (1911); see also United States v. Am. Tobacco Co., 221 U.S. 106, 179 (1911) (establishing a "rule of reason" standard for interpreting the Sherman Act).

[163] 42 Cong. Rec. 68 (1907) (statement of President Roosevelt).

[164] 43 Cong. Rec. 17 (1908) (statement of President Roosevelt).

[165] 42 Cong. Rec. 70 (1907) (statement of President Roosevelt).

[166] H.R. 19745, 60th Cong. (1908), *reprinted in* An Act to Regulate Commerce, Etc.: Hearings on House Bill 19745 Before Subcomm. No. 3 of the House Comm. on the Judiciary, 60th Cong. 3–6 (1908).

pansion of executive branch power. If the federal government registered corporations, it could also de-register them.[167] Ultimately, these concerns led to the Clayton Antitrust Act of 1914 and the establishment of the Federal Trade Commission.[168]

The same concerns regarding trusts are reflected in the debates over the corporate tax, which was seen by both supporters and opponents as a regulatory measure.[169] Kornhauser focused primarily on the publicity feature of the tax, but this was not its only regulatory aspect—both supporters and opponents saw the tax also as having the potential to restrict managerial power directly.[170] Thus Senator Root, the principal drafter of the tax on the Senate side, spoke about the accumulation of wealth in the hands of corporations as a principal reason for the tax.[171] Senator Newlands likewise supported the tax because "there was no reason why the great combinations monopolizing these industries should not pay some part of the national expenses."[172] Similarly, Senator Owen stated that "[t]he most important need of the people of the United States of this generation requires the abatement of the gigantic fortunes being piled up by successful monopoly."[173] And Senator Cummins, an opponent of the tax, likewise spoke about "the new force entering American life and American business" which is "a prelude to industrial commercial slavery unless the Government intervenes with its strong arm."[174] Senator Cummins opposed the tax because it applied to all corporations, rather than just to the great combina-

[167] Kornhauser, supra note 101, at 67.

[168] Id.

[169] Id. at 62–63.

[170] For a discussion of publicity, see id. at 69–82.

[171] 44 Cong. Rec. 4003 (1909) (statement of Sen. Root).

[172] 44 Cong. Rec. 3761 (1909) (statement of Sen. Newlands). Senator Newlands supported in particular taxing all industries benefiting from the tariff. 44 Cong. Rec. 3762 (1909) (statement of Sen. Newlands); 44 Cong. Rec. 4049 (1909) (statement of Sen. Newlands) (proposing an exemption for small corporations so as to "confine our taxation to these great combinations of capital whose profits have been enormous, whose ability to bear is greater than that of any other class of the community, and whose abuses have awakened the attention of the country and demand legislative cure").

[173] 44 Cong. Rec. 3950 (1909) (statement of Sen. Owen). He stated that corporate wealth of publicly traded corporations amounted to one-third of national wealth. Id.; see also 44 Cong. Rec. 4000–01 (1909) (statement by Sen. Bourne) (supporting the tax because the tendency of business to consolidate requires strengthening the government's ability to regulate).

[174] 44 Cong. Rec. 3965 (1909) (statement of Sen. Cummins).

tions, which he thought should be taxed more heavily.[175] Senator Clapp was similarly concerned about the trusts but argued that the proposed tax did not address the problem because of the exemption of dividends paid to holding corporations.[176] Senator Cummins's solution was to tax the trusts more heavily:

> [I]f a company is organized for the purpose of consolidating a dozen other companies with a view to controlling the business in which those companies are engaged for the purpose of being able to direct through a single board the management of the entire field of industry . . . aside from the contravention of public policy involved in such an organization the privilege enjoyed is of priceless value, and instead of being taxed at 2 per cent on the net earnings it ought to be taxed at 10 or 15 per cent on the net earnings, that it ought to be taxed so heavily that such companies would become not only unfashionable but unprofitable as well.[177]

The principal reason for the difference between the 1894 tax, a tax on shareholders, and the 1909 tax, a tax on management, was thus the rise of the great trusts in the period between 1896 and 1904.[178] By 1909, the trust problem was perceived as the most serious issue facing the country.[179] Some Democrats would have liked to turn back the clock and outlaw the trusts, but the majority preferred to

[175] 44 Cong. Rec. 3978 (1909) (statement of Sen. Cummins).

[176] 44 Cong. Rec. 4009–10 (1909) (statement of Sen. Clapp) ("[T]he plain invitation, the plain effect of this provision is to encourage the organization of the very kind of corporations, great, powerful, overshadowing, absorbing industries, absorbing industrial life and industrial affairs, by holding out to them immunity from taxation."); see also 44 Cong. Rec. 4230 (1909) (statement of Sen. Dolliver) (focusing on the trust problem as well). Senator Davis, by contrast, thought the solution to "the corporations of the country invading every avenue of business and trade" was "that if we can not tax all the corporations, we should tax just as many of them as we can." 44 Cong. Rec. 4036 (1909) (statement of Sen. Davis). And Senator Aldrich pointed out that no corporation was exempt from the tax. 44 Cong. Rec. 4231 (1909) (statement of Sen. Aldrich).

[177] 44 Cong. Rec. 4232 (1909) (statement of Sen. Cummins). Senator Newlands made similar arguments. 44 Cong. Rec. 4233 (1909) (statement of Sen. Newlands).

[178] By 1900, John D. Rockefeller had created the The Standard Oil Company and capitalized it at $122 million. The following year J.P. Morgan created U.S. Steel in a $1.4 billion transaction. Between 1898 and 1901, the capitalization of mergers totaled $5.4 billion and 2,274 firms were merged out of existence. Sklar, supra note 157, at 45–46.

[179] See Horace L. Wilgus, Need of a National Incorporation Law, 2 Mich. L. Rev. 358 (1904) (discussing the nature and scope of the trust problem).

follow President Roosevelt and regulate them.[180] A primary vehicle for such regulation was the corporate tax, in part because of its publicity feature, but in part because, as many claimed during the Congressional debate, the power to tax is the "equivalent of the power to destroy."[181] To tax the powerful trusts was seen as the beginning of a federal power to regulate and potentially destroy them. That was the fundamental rationale for enacting the corporate income tax. Is it still a valid rationale today? Answering this question requires a move from historical to normative analysis.

III. A NORMATIVE PERSPECTIVE: WHAT IS THE JUSTIFICATION FOR THE CORPORATE TAX TODAY?

A. The Reality of Corporate Power

A page of history may be worth a volume of logic[182] as far as explanatory power is concerned, but Justice Holmes also conceded that history per se has no normative power.[183] Are there any normative lessons that can be drawn from the above history to justify the existence of the corporate tax today?

I would argue that the answer is yes, for the following reasons.[184] From the Roman origins of the corporate form to today's multinational enterprises ("MNEs"), the corporation underwent several crucial changes. First, the concept of the corporation as a legal person separate from its owners or members had to be developed, and this development was only completed with the work of the civil law commentators in the fourteenth century. By the end of the Middle Ages, the membership corporation, that is, a corporation with several members who chose others to succeed them, had legal personality—the capacity to own property, sue and be sued, and even bear criminal responsibility—and unlimited life, was well estab-

[180] See Kornhauser, supra note 101, at 63–64 (discussing the political positions on the trusts and the government's preference for regulation).

[181] See, e.g., 44 Cong. Rec. 3977 (statement of Sen. Cummins, referring to *McCulloch v. Maryland*, 17 U.S. 316 (1819)).

[182] N.Y. Trust Co. v. Eisner, 256 U.S. 345, 349 (1921).

[183] Oliver Wendell Holmes, The Path of the Law, 10 Harv. L. Rev. 457, 459 (1897).

[184] The remainder of Section III.A is based on a companion paper, Reuven S. Avi-Yonah, Aggregate, Artificial, or Real? The Cyclical Transformations of the Corporate Form (Jan. 9, 2004) (unpublished manuscript, on file with the Virginia Law Review Association) [hereinafter Avi-Yonah, Cyclical Transformations].

lished in both civil and common law jurisdictions. The next important step was the shift from non-profit membership corporations to for-profit business corporations, which took place in England and the United States in the end of the eighteenth century and beginning of the nineteenth century. The third transformation was the shift from closely held corporations to corporations whose shares are widely held and publicly traded, and with it the rise of limited liability and freedom to incorporate, which took place by the end of the nineteenth century and the beginning of the twentieth century. Finally, the last major transformation was from corporations doing business in one country to MNEs whose operations span the globe, which began after World War II and continues today.

Each of these four major transformations was accompanied by changes in the legal conception of the corporation. Throughout the historical evolution of the corporation, the three theoretical conceptions of the corporation—the aggregate, artificial entity, and real entity theories—have been advanced. Remarkably, every time there was a shift in the role of the corporation, all three theories were brought forward in cyclical fashion.[185] Moreover, in each shift, the real entity theory prevailed over the other two, and has consistently been the dominant theory during periods of stability in the relationship between the corporation, the shareholders, and the state.[186]

The explanation for this persistence of the real entity view is twofold. First, the real entity view persisted because it represents a better approximation of reality than the artificial entity view and aggregate view, and this view became a better approximation as the corporate form evolved. Roman or medieval corporations could plausibly be seen as merely creatures of the state because of the state's role in creating them, or they could be seen as mere aggregations of their members because the members also managed the corporation. These views are much less plausible today, however, since the state plays only a minimal role in creating corporations and that role is sharply constrained by management's ability to shift the location of incorporation. The shareholders, mean-

[185] Thus, the transition from the aggregate view of the corporate tax to the real entity view between 1894 and 1909 can be seen as part of this broader phenomenon, which was repeated many times throughout the history of corporations.

[186] See Avi-Yonah, Cyclical Transformations, supra note 184.

while, are often spread all over the globe and are clearly separate from the corporate entity.[187]

Second, another way of looking at the persistence of the real entity view is that it reflects the power of corporate management.[188] One way of looking at the transformations outlined above is that both the artificial entity and aggregate views were advanced in order to limit the power of management. The artificial entity view was usually brought forward in order to enable the state to regulate corporations, and the aggregate view was usually advanced to enhance the power of shareholders, although sometime it was used to give corporations rights that normally belong only to individuals.[189] The ultimate success of the real entity view resulted from the fact that it gave more power to management than the other views, and that both legal commentators and courts were ultimately solicitous of the welfare of corporations (that is, corporate management).[190] But the very success of management to persuade courts to adopt the real entity view also shows that the it is more accurate than the other views, since it recognizes the power of management. If management has the power to persuade courts to adopt the real entity view, that view must also be accurate (or at least more accurate than the others).

One good way of describing the aggregate view and the artificial entity view is that they both represent normative aspirations of their proponents. Those who believe that corporations are insufficiently regulated by the state advance the artificial entity view to

[187] The situation is different in countries with interlocking corporate structures, but arguably that means that individual shareholders have even less power and management is more firmly entrenched. See, e.g., Lucian Arye Bebchuck & Mark J. Roe, A Theory of Path Dependence in Corporate Ownership and Governance, 52 Stan. L. Rev. 127 (1999) (discussing the role of ownership dispersion on corporate governance).

[188] See, e.g., Vikramaditya S. Khanna, Corporate Crime Legislation: A Political Economy Analysis, 82 Wash. U. L.Q. 95 (2004) (arguing that corporations continue to be made criminally liable because management prefer criminal to civil liability, and prefer both to personal liability).

[189] See generally Avi-Yonah, Cyclical Transformations, supra note 184 (discussing the four major corporate transformations and their associated legal conceptions).

[190] But see Hager, supra note 25, at 585 (arguing that the real entity view could sometimes be used to limit managerial power, for example, to justify corporate criminal and tort liability); see also E. Merrick Dodd, Jr., For Whom Are Corporate Managers Trustees?, 45 Harv. L. Rev. 1145, 1153–54 (1932) (arguing that the real entity theory is the foundation for corporate social responsibility).

justify more regulation. Those, including many current corporate law scholars, who believe that the biggest problem with corporations is the agency cost issue—that is, that managers are insufficiently attentive to the welfare of shareholders—advance the aggregate view.[191] Neither of these views actually describes corporations as they actually operate in the real world—they represent idealized, normatively based descriptions of what corporations would look like in a better world.[192]

To see what corporations look like in the real world, a more accurate perspective is available in the sociological literature.[193] As one sociologist has stated, "The recurrent problem in sociology is to conceive of corporate organization, and to study it, in ways that do not anthropomorphize it and do not reduce it to the behavior of individuals or of human aggregates."[194] A whole branch of economic sociology centers on the study of organizations, and there

[191] For the classic expositions, see Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law (1991); Armen A. Alchian & Harold Demsetz, Production, Information Costs, and Economic Organization, 62 Am. Econ. Rev. 777 (1972); Eugene F. Fama & Michael C. Jensen, Separation of Ownership and Control, 26 J.L. & Econ. 301 (1983); Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305 (1976). As stated by two of its original proponents, under this view, the various participants in the corporation do not differ "in the slightest degree from ordinary market contracting between any two people." Alchian & Demsetz, supra, at 777. "Ownership of the firm disappears as a meaningful concept under this model because no one can own a 'nexus.' . . . Control is reflected in the terms of various contracts entered into by individuals." Lynne L. Dallas, Two Models of Corporate Governance: Beyond Berle and Means, 22 U. Mich. J.L. Reform 19, 23 (1988).

[192] The contractarian view almost became the law in the 1980s. See Edgar v. MITE Corp., 457 U.S. 624 (1982). In *CTS Corp. v. Dynamics Corp.*, 481 U.S. 69 (1987), however, the Supreme Court decided not to adopt this view—probably for the better, given that it is unclear that an unfettered market for corporate control would have been socially beneficial. For instance, recent attempts to align the interests of management with shareholders via stock options have had detrimental consequences, incentivizing managers to artificially inflate earnings per share to keep up stock values. The Enron and Worldcom scandals are the latest and most publicized examples. Recent Law and Economics scholarship is in fact beginning to recognize the crucial importance of managerial power in contexts like setting executive compensation. See Lucian Arye Bebchuck & Jesse M. Fried, Executive Compensation as an Agency Problem, 17 J. of Econ. 71 (2003).

[193] This view stems from the work of Durkheim, who was the first to focus on groups as being more than the sum of their members. See Hager, supra note 25, at 582.

[194] Guy E. Swanson, The Tasks of Sociology, 192 Sci. (n.s.) 665, 666 (1976).

are numerous books devoted to the topic.[195] Most of these books revolve around the study of large corporations, since these are the dominant forms of organization in this society.[196] Moreover, they are informed by the economic perspective inaugurated by Ronald Coase in his classic *The Nature of the Firm* article from 1937,[197] and developed by Oliver Williamson and others into transaction-cost economics.[198] This branch of economics, which now forms part of the "new institutional economics," begins by recognizing that the firm is fundamentally different from the market because of its hierarchical structure and proceeds to investigate when operating as a vertically-integrated firm as opposed to buying in the market makes sense (the "make or buy" issue).[199] Recently, transaction-cost economics has become the leading explanation for the most recent transformation of the corporation—the rise of MNEs.[200]

From a normative perspective, the key observation that emerges from this literature is that corporate managers have power, defined as the ability to influence the behavior of others, or more generally "the ability to get what one wants,"[201] by virtue of their position at the top of the corporate hierarchy and the financial resources they control.[202] The economist Kenneth Boulding, for example, distin-

[195] See, e.g., The Handbook of Economic Sociology (Neil J. Smelser & Richard Swedberg eds., 1994) (see especially Part II.C, The Sociology of Firms, Organizations, and Industry); Jeffrey Pfeffer & Gerald R. Salancik, The External Control of Organizations: A Resource Dependence Perspective (1978); W. Richard Scott, Organizations: Rational, Natural, and Open Systems (3d ed. 1992); The New Institutionalism in Organizational Analysis (Walter W. Powell & Paul J. DiMaggio eds., 1991); James D. Thompson, Organizations in Action: Social Science Bases of Administrative Theory (1967).

[196] See, e.g., Roy, supra note 3 (discussing the rise of the large-scale corporation).

[197] R.H. Coase, The Nature of the Firm, 4 Economica (n.s.) 386 (1937).

[198] Oliver E. Williamson, Transaction Cost Economics and Organization Theory, *in* The Handbook of Economic Sociology, supra note 195, at 77. For a critique, see Mark Granovetter, Economic Action and Social Structure: The Problem of Embeddedness, 91 Am. J. Soc. 481 (1985).

[199] See Williamson, supra note 198.

[200] See The Nature of the Transnational Firm (Christos N. Pitelis & Roger Sugden eds., 1991) (see especially Chapter 2).

[201] Kenneth E. Boulding, Three Faces of Power 15 (1989).

[202] This was still the prevalent view in 1959. See Abram Chayes, The Modern Corporation and the Rule of Law, *in* The Corporation in Modern Society 25, 25 (Edward S. Mason ed., 1959). This view has now been largely replaced by the nexus of contracts theory. See Bratton, supra note 25, at 1473 (calling the power-centered view "managerialist").

guishes between threat, economic, and integrative power (the stick, the carrot, and the hug);[203] all three may be ascribed to corporations. The political scientist Joseph Nye distinguishes between "hard" power (military and economic) and "soft" power (cultural power, or the ability to persuade others to want to be more like you) and describes how the major U.S. MNEs wield both hard and soft power.[204] Likewise, distinguished tax scholars like Professors Richard Musgrave and William Andrews have recognized that control over financial resources is a source of power beyond the pure ability to consume.[205] In fact, corporate management are the best example of this point because they typically cannot consume corporate resources directly, yet they derive significant power from controlling those resources.[206]

[203] Boulding, supra note 201, at 24–25. For other discussions of the nature of power, see generally Valeri G. Ledyaev, Power: A Conceptual Analysis (1997); Power (Steven Lukes ed., 1986); 1–3 Power: Critical Concepts (John Scott ed., 1994); Power in Modern Societies (Marvin E. Olsen & Martin N. Marger eds., 1993).

[204] Joseph S. Nye, Jr., The Paradox of American Power: Why the World's Only Superpower Can't Go It Alone 8–9 (2003).

[205] Richard A. Musgrave, Clarifying Tax Reform, 70 Tax Notes 731, 733–34 (1996); see also Institute for Fiscal Studies, The Structure and Reform of Direct Taxation 351 (1978) ("The holding of wealth itself . . . can confer on the owner benefits of security, independence, influence and power, quite apart from any expenditure which the income from it may finance."); Anne L. Alstott, The Uneasy Liberal Case Against Income and Wealth Transfer Taxation: A Response to Professor McCafferey, 51 Tax L. Rev. 363, 371–72 (1996) (discussing political influence and wealth); William D. Andrews, Fairness and the Personal Income Tax: A Reply to Professor Warren, 88 Harv. L. Rev. 947, 956 (1975) ("It may well be unacceptable to rely solely on consumption as a personal tax base because for some people wealth has a welfare value above and beyond the deferred consumption it may operate to support.").

[206] Daniel Shaviro argues to the contrary that many believe that wealthy people

> escape the burden of a consumption tax by deferring their consumption, and that advocates of such a tax ignore the effects of unconsumed wealth on one's security, political power, and social standing. The argument overlooks the fact that what makes wealth valuable . . . is the real purchasing power that it commands. Otherwise, real money would be no different than Monopoly money. A consumption tax affects the purchasing power even of unspent wealth, and the burden it imposes generally is not reduced by deferring one's consumption.

Daniel Shaviro, Replacing the Income Tax With a Progressive Consumption Tax, 103 Tax Notes 91 (2004). This is wrong because the power of the wealthy (and of corporate management) stems primarily from their ability to invest, not consume, their wealth, and investments are by definition not curtailed by a consumption tax.

B. The Nature of Corporate Power

The sociological literature indicates that corporate (managerial) power can generally be divided into three categories.[207] The first is political power—the power of management to affect political outcomes by lobbying and political contributions. That power is somewhat constrained by campaign finance reform laws. Those laws (including most recently McCain-Feingold), however, are generally recognized as not very effective, and decisions like *First National Bank v. Bellotti*[208] enhance corporate power. Moreover, even if campaign finance reform completely banned political contributions by corporations (indirect as well as direct), corporate lobbying would still be effective to the extent corporations have power over the lives of voters in the politician's constituency.

The second category of corporate power is economic power, which applies directly to corporate employees and indirectly to communities in which corporations have significant facilities. While the relationship between shareholders and management can perhaps plausibly be analyzed in purely contractual terms (shareholders are free to sell), the same cannot be said of many situations involving corporate employees.[209] Employees have invested human

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[207] The point that corporate management have power was clearly seen in 1932 by Berle and Means, who wrote:

> The economic power in the hands of the few persons who control a giant corporation is a tremendous force which can harm or benefit a multitude of individuals, affect whole districts, shift the currents of trade, bring ruin to one community and prosperity to another. The organizations which they control have passed far beyond the realm of private enterprise—they have become more nearly social institutions.

Berle & Means, supra note 58, at 46. When this was written, over one-third of the national wealth of the country was administered by some two hundred corporations which in turn were dominated by a few hundred men. See id. at 46 n.34. Today, multinational enterprises produce about 10% of world GDP. See Reuven S. Avi-Yonah, National Regulation of Multinational Enterprises: An Essay on Comity, Extraterritoriality, and Harmonization, 42 Colum. J. Transnat'l L. 6, 6 (2003) [hereinafter Avi-Yonah, National Regulation].

[208] 435 U.S. 765, 776 (1978) (recognizing a First Amendment right of corporations to engage in political speech). For a trenchant critique, see Hager, supra note 25, at 640–41; Carl J. Mayer, Personalizing the Impersonal: Corporations and the Bill of Rights, 41 Hastings L.J. 577, 615–16 (1990).

[209] But see, e.g., Thomas Lee Hazen, The Corporate Persona, Contract (and Market) Failure, and Moral Values, 69 N.C. L. Rev. 273 (1991) (critiquing the contractarian paradigm even in the shareholder context).

capital in corporations and may find it difficult to find another employer except at significant costs (for example, the costs of moving to a distant city), especially in industries characterized by monopoly or oligopoly (for example, Microsoft, Intel, Boeing, and Wal-Mart). Nor is contract the best way to describe the relationship between corporations and their communities. When a major corporation closes a plant or moves its headquarters, the effects are felt by both the employees and the community. In general, the presence of corporate headquarters in particular is associated with positive externalities that are not reflected in any contractual arrangement. It is very hard to regulate this kind of corporate power without unduly restricting corporate economic flexibility; hence, even unionized plants are not immune to closing. In addition, this is the kind of power that makes developing countries feel so dependent on MNEs and their decisions on where to open new plants.

The third category of corporate power, which exists only sporadically but is crucial in several cases, is market power over consumers. Market power exists in several industries through monopoly or oligopoly. The antitrust laws regulate this power to a certain extent, but as was shown recently in the case of Microsoft, their ultimate reach is limited.[210] Under the "rule of reason" adopted by the Supreme Court upon breaking up The Standard Oil Company, market domination by itself is not sufficient to invoke antitrust laws.[211] A similar rule applies in Europe because it is only abuse of a dominant position (not the position itself) that is actionable.[212]

C. Two Arguments for Restricting Corporate Power

What are the normative consequences of the recognition of corporate managerial power? There are two principal arguments why a liberal democratic state should curb excessive accumulations of private power. The first is the argument from democracy—in a democracy, all power should ultimately be accountable to the people.[213] Private accumulations of power are by definition unaccount-

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[210] United States v. Microsoft Corp., 253 F.3d 34 (D.C. Cir. 2001) (per curiam).

[211] Standard Oil Co. of N.J. v. United States, 221 U.S. 1, 62 (1911).

[212] 2 Barry E. Hawk, United States, Common Market and International Antitrust: A Comparative Guide 827 (2d ed. 1994).

[213] This view is further explored in Reuven S. Avi-Yonah, Why Tax the Rich? Efficiency, Equity, and Progressive Taxation, 111 Yale L.J. 1391, 1406–07 (2002) (book

able since the holders of power are neither elected by the people nor have their power delegated by the people's representatives. In fact, the American Revolution was founded on the conception that while people have natural, Lockean liberal rights to their property, undue concentrations of private power and wealth should be discouraged.[214] This view found its expression in the republican creed of civic humanism, which emphasized public virtue as a balance to private rights.[215] A virtuous republic, the Founders believed, was to be free from concentrations of economic power such as characterized England in the eighteenth century.[216] Therefore, from the beginning of the Republic, federal and state legislators used taxation to restrict privilege and to "affirm communal responsibilities, deepen citizenship, and demonstrate the fiscal virtues of a republican citizenry."[217] As Professor Dennis Ventry has written, "The ideal of civic virtue created a unique form of ability-to-pay taxation that was hostile to excess accumulation and to citizens who asserted entitlement through birth . . . . Inherited wealth, as well as gross concentrations of wealth (inherited or not), characterized an aristocratic society, not a free and virtuous republic."[218] In the twentieth century, the same view was best expressed in the corporate context by Berle, who wrote that in a democracy like the United States

> it becomes necessary to present a system (none has been presented) of law or government, or both, by which responsibility for control of national wealth and income is so apportioned and enforced that the community as a whole, or at least the great bulk of it, is properly taken care of. Otherwise the economic power now mobilized and massed under the corporate form . . . is simply handed over, weakly, to the present administrators with a pious wish that something nice will come out of it all.[219]

review) [hereinafter Avi-Yonah, Progressive Taxation], where it is argued that limiting private power is the best argument for taxing the rich.

[214] Ventry, supra note 82, at 28.

[215] Id.

[216] Id.

[217] Brownlee, supra note 82, at 31.

[218] Ventry, supra note 82, at 28.

[219] A.A. Berle, Jr., For Whom Corporate Managers *Are* Trustees: A Note, 45 Harv. L. Rev. 1365, 1368 (1932). It is ironic that Berle is sometimes regarded as a progenitor

The other principal argument against excessive corporate power is based on a liberal conception of equality. Professor Michael Walzer has explained that when liberals talk about equality, they are not concerned with "simple equality," or equalizing everyone's initial means.[220] Instead, they are advocating "complex equality," by which Walzer means that every social "sphere" should have its own appropriate distributive principles and that possession of goods relevant to one sphere should not automatically translate into dominance in other spheres as well.[221] "In formal terms, complex equality means that no citizen's standing in one sphere or with regard to one social good can be undercut by his standing in some other sphere, with regard to some other good."[222] In our capitalist society, money is the "dominant good," and the people who possess it are the most likely to accumulate illegitimate power in other spheres, such as politics.[223] "This dominant good is more or less systematically converted into all sorts of other things—opportunities, powers, and reputations."[224] Walzer goes on to explain the insidious effects of money and why it needs to be curbed by redistribution, including redistributive taxation:

> Market imperialism requires another sort of redistribution, which is not so much a matter of drawing a line as of redrawing it. What is at issue now is the dominance of money outside its sphere, the ability of wealthy men and women to trade in indulgences, purchase state offices, corrupt the courts, exercise political power. . . . [T]he exercise of power belongs to the sphere of politics, while what goes on in the market should at least approximate an exchange between equals (a free ex-

of the current nexus of contracts approach. See also Hager, supra note 25, at 639 ("Such [corporate] power, insulated from participation, criticism, or revision by a public which cannot escape its effects, poses an enormous obstacle toward achieving maximum democratic control over the condition of social life.").

[220] Michael Walzer, Spheres of Justice: A Defense of Pluralism and Equality 13–17 (1983).

[221] Id. at 19–20.

[222] Id. at 19; see also Don Herzog, Happy Slaves: A Critique of Consent Theory 148–81 (1989) (describing liberal "differentiation" between different spheres).

[223] Walzer, supra note 220, at 11.

[224] Id. at 12.

> change). . . . When money carries with it the control, not of things only but of people, too, it ceases to be a private resource.[225]

Nor, as is noted above, is the power of money limited to direct political power:

> It would be a mistake to imagine, however, that money has political effects only when it "talks" to candidates and officials. . . . It also has political effects closer to home, in the market itself and in its firms and enterprises. . . . Even within the adversary relation of owners and workers, with unions and grievance procedures in place, owners may still exercise an illegitimate kind of power. They make all sorts of decisions that severely constrain and shape the lives of their employees (and their fellow citizens, too). Might not the enormous capital investment represented by plants, furnaces, machines, and assembly lines be better regarded as a political than an economic good? To say this doesn't mean that it can't be shared among individuals in a variety of ways, but only that it shouldn't carry the conventional entailments of ownership. Beyond a certain scale, the means of production are not properly called commodities . . . for they generate a kind of power that lifts them out of the economic sphere.[226]

Walzer thus advocates taxation as one means of restricting the market to its proper sphere (along with trade unions and limiting property rights). But he also recognizes the inherent limitations of all redistribution, since his aim is not to abolish the market:

> All three redistributions redraw the line between politics and economics, and they do so in ways that strengthen the sphere of politics—the hand of citizens, that is, not necessarily the power of the state. . . . But however strong their hand, citizens can't just make any decisions they please. The sphere of politics has its own boundaries. . . . Hence redistribution can never produce simple equality, not so long as money and commodities still exist, and there is some legitimate social space within which they can be exchanged . . . ."[227]

[225] Id. at 120–21.
[226] Id. at 121–22; see also id. at 301–03 (discussing "company towns").
[227] Id. at 122–23.

D. Ways of Limiting Corporate Power

How can corporate power be limited? It depends on the type of power. Political power can most obviously be restricted by placing direct limits on campaign contributions, which are an incredibly cheap sort of power for large corporations—a whole campaign can be financed for a few million dollars, whereas an elected politician can make decisions worth billions. Admittedly, since corporations were first banned from directly contributing to political campaigns in 1907, this kind of limitation has not been effective.[228] The very political power of corporations seems to ensure that campaign finance reform is hard to pass and riddled with loopholes, and Supreme Court decisions like *First National Bank v. Bellotti* do not help. Nevertheless, it is conceivable that the direct political power of corporations could be limited by campaign finance reform. The problem, however, is that this will by no means eliminate the political power of corporations because that power stems from their economic power. As long as General Motors and Ford employ tens of thousands of Michigan voters, their views will resonate with the Michigan delegation to Congress, even if they are strictly prohibited from donating a penny to any politician (directly or indirectly).

The market power that some corporations possess can be limited through the antitrust laws. Having said that, though, it is important to note that for the past forty years antitrust law has been moving away from curbing corporate market power and toward ensuring that consumers do not pay higher prices.[229] The shift in focus from curbing corporate size and power to consumer protection is particularly striking in U.S. antitrust law and is evidenced by the failure of the government to break up monopolies like IBM in the 1970s or Microsoft in the 1990s. In Europe, there is more of a focus on preventing "abuse of a dominant position" even if it only hurts competitors rather than consumers, but even there, it is the abuse rather than the dominant position itself that is at stake.[230] But even if U.S. antitrust law were changed to refocus more directly on cor-

[228] See, e.g., Tillman Act, ch. 420, 34 Stat. 864 (1907).

[229] See Philip Areeda & Louis Kaplow, Antitrust Analysis: Problems, Text, and Cases 26, 828–29 (5th ed. 1997) (discussing Brown Shoe Co. v. United States, 370 U.S. 294 (1962)).

[230] 2 Hawke, supra note 212, at 827.

porate market power (and that would be a radical redirection), it is still a very unwieldy and imprecise tool. Proving antitrust violations is hard and in the case of large corporations can take years of litigation. Additionally, courts typically shy away from the breakup remedy because they fear damaging the corporation in the economic sphere where the benefits of its existence are most clearly felt.[231]

Finally, it should be emphasized that curbing corporate power cannot be achieved through corporate governance reform. It may be possible to place limits on the power of corporate management vis-à-vis shareholders in this way, although once more the power of management makes this very difficult to do (as shown by the rise and fall of the market for corporate control).[232] But even if management were to operate perfectly in the interests of the shareholders, they would still, from my perspective, exercise excessive power over the rest of society. It is that power that the corporate tax seeks to curb. By definition, corporate governance reforms cannot hinder management when they exercise power in ways that are beneficial to shareholders.[233]

In the final analysis, the problem of corporate power can only be addressed by direct regulation of the kind of activities we want corporations to perform, namely production and distribution of goods and services. Some of these activities may have negative externalities that are best regulated by, for example, labor, safety, or environmental laws. But these laws will still do nothing to limit corporate power that is exercised by producing and distributing

[231] See, e.g., United States v. Microsoft Corp., 253 F.3d 34, 46–47 (D.C. Cir. 2001) (per curiam) (reversing and remanding most of the District Court judgment requiring a break-up).

[232] See, e.g., Paramount Communications v. Time, Inc., 571 A.2d 1140, 1155 (Del. 1989) (rejecting shareholder action against Time's tender offer).

[233] Oliver Hart, for example, has argued that corporate debt can be used to discipline managers: corporations use a lot of debt so that managers will not squander too much of shareholders' money, and the corporate tax assists in this function. See Oliver Hart, Firms, Contracts, and Financial Structure 95–120 (1995); see also Joseph E. Stiglitz, Taxation, Corporate Financial Policy, and the Cost of Capital, 2 J. Pub. Econ 1, 4–5 (1973) (noting that corporations can avoid tax by using debt). While debt might help restrict managerial power vis-à-vis shareholders, and to some extent vis-à-vis society as well (and that is a good reason to allow corporations to deduct interest), debt cannot limit managerial use of equity or retained earnings. As noted below, it may from this perspective also be acceptable to let corporations deduct dividends.

goods and services in an environmentally sound and safe way. Given that we do not want government to tell corporate management directly how to run their business (that idea was tried and failed in the socialist economies), only the tax law can directly reach these types of activities, which are the ultimate source of corporate power accumulation.

E. The Regulatory Rationale for the Corporate Tax

My basic argument is therefore that the corporate tax is justified as a means to control the excessive accumulation of power in the hands of corporate management,[234] which is inconsistent with a properly functioning liberal democratic polity.[235] As I have argued above, this was also the principal reason why the corporate tax was enacted in 1909,[236] and I believe is also the principal reason for its political resiliency today. People understand that corporations are powerful and that the corporate tax is one way in which the state, as representative of the people, can limit their power.[237]

[234] The idea that the tax was a regulatory tool is hinted at in Mayer, supra note 208, at 583, and raised but rejected by Musgrave & Musgrave, supra note 45, at 374–75. Except for brief mention in Walzer, supra note 220, at 121–23, I have not found it elsewhere.

[235] See Walzer, supra note 220, at 121–23; Herzog, supra note 222, at 169–70. From this perspective the "incidence" of the corporate tax is on management, since they are the ones whose power is diminished by it. This is a separate question from the knotty problem of who bears the burden of the corporate tax in the sense that their own resources are diminished by it. It is important to note, however, that if one could show that the incidence of the corporate tax is actually shifted to consumers or labor, then presumably management would not care that the tax was imposed since it would not actually diminish the resources they control. This would eliminate the regulatory rationale for the tax. But forty years of research on incidence by economists has failed to demonstrate that the tax can in fact be shifted in most cases, at least in the long run. See the incidence literature, supra note 34. And corporate management certainly seem to care enough about the corporate tax to engage in significant tax planning to try to avoid it as much as possible. See, for example, the tax shelters literature, supra note 16.

[236] See supra Section II.B.

[237] One interesting corollary of this view is that the corporate tax should apply to non-profit corporations (which have no shareholders) since their management have as much power as the management of for-profit entities. But I accept the mainstream view that they should not be taxed because not-for-profits perform functions that would otherwise fall to the state. See, e.g., Henry B. Hansmann, The Role of Nonprofit Enterprise, 89 Yale L.J. 835, 836–37 (1980). It is interesting to consider the mirror image of this argument—that for-profit corporations should be taxed because their management choose not to address problems they could help solve and there-

This argument has particular resonance today as a result of the rise of MNEs. As many academics have pointed out, the rise of MNEs has significantly weakened the regulatory power of the state since MNEs by definition operate across jurisdictions and can set one jurisdiction off against another.[238] Taxation is one vehicle of regulation and an area in which extraterritorial jurisdiction is well established in international law.[239] Therefore, it offers a promising venue to regulate MNEs.[240]

It should also be noted that this rationale for the tax applies more or less precisely to the current scope of the tax we have today—that is, a tax imposed primarily on publicly traded enterprises, because it is only those that exhibit the separation of ownership from control.[241] This rationale can also explain why we tax corporate equity but not debt, since issuing debt constrains managerial power in ways that issuing equity does not (as many of the leveraged buyout targets of the 1980s discovered).[242]

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fore create more work for the state. This requires considering the debate on corporate social responsibility, which is a topic for another day.

[238] See generally, Philip I. Blumberg, The Multinational Challenge to Corporation Law (1993) (discussing the interaction of jurisdictions in relation to MNEs); Raymond Vernon, In The Hurricane's Eye: The Troubled Prospects of Multinational Enterprises (1998) (same); Avi-Yonah, National Regulation, supra note 207 (discussing specific areas of conflict between states regarding MNEs).

[239] See, for example, I.R.C. §§ 951–960 (2000), for the tax treatment of controlled foreign corporations.

[240] Avi-Yonah, National Regulation, supra note 207, at 23–24. Taxation falls in the right column and middle row of the matrix developed in that article to distinguish various areas of state regulation of MNEs. That is, it is an area in which extraterritoriality is required and countries (but not MNEs) agree on its basic principles. Id. at 11.

[241] This is contrary to the view expressed by Schlunk, who argues that "there is no colorable justification for the double taxation scheme currently imposed in the United States" (that is, a tax imposed almost entirely on equity capital of publicly traded enterprises, with full taxation of dividends when distributed). Schlunk, supra note 10, at 332. Admittedly, from a power perspective the tax could be limited to large corporations, such as the S&P 500, which account for a large part of the corporate tax base. An exemption of the first $100 million would be acceptable, just as I support exempting the first $100,000 of individual income from the income tax, an idea advocated in Michael J. Graetz, 100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System, 112 Yale L.J. 261, 282 (2002). It could also be argued that corporations can be powerful without being profitable. This may be true for any given year, but over a longer run there is a correlation between size, power, and profitability, since the corporation would not grow if it were not profitable.

[242] This requires developing ways to distinguish equity from debt. That distinction is hard to defend theoretically but in practice can be defended; transaction costs make it

F. Two Regulatory Functions of the Corporate Tax

How does taxation restrict and regulate managerial power? It does so in two ways. First, by directly limiting the rate of corporate wealth accumulation (the "limiting function"), and second, by providing incentives and disincentives to particular corporate activities (the "regulatory function"). For reasons explained below, both functions are necessary and related to each other, in the same way that both a brake and a steering wheel are necessary for driving a car.

First, the limiting function: Imagine first a 100% tax imposed on corporate profits. Such a tax would effectively eliminate the corporation's reason to exist. Over time, it would also eliminate all sources of corporate power, since it would force the corporation to use its existing resources to pay politicians and employees, and it would remove any incentive to sell goods to consumers. Once these resources are exhausted the corporation would be liquidated. A 100% federal tax (assuming it cannot be avoided) is therefore as effective a corporate death sentence as the mandatory liquidation imposed by state courts on the trusts.[243] The power to tax is indeed potentially the power to destroy.

But a 100% tax is inconceivable. Taxation faces an inherent limit that was well expressed by Justice Holmes when he stated that "the power to tax is not the power to destroy while this court sits."[244] The Constitution places limits on the power to tax, limits that were already implicitly recognized in *Dartmouth College v. Woodward*: The public sector may not use taxation to completely eliminate the private one.[245] This is both a matter of constitutional law (a tax may be a taking if the rate exceeds any reasonable estimate of the state's contribution to private wealth creation)[246] and a matter of practicality—just as in the case of the rich, we do not want to kill

impossible to easily convert all equity into debt, as financial theory would predict. Otherwise, the $200 billion collected annually by the corporate tax would have vanished long ago, as predicted by Stiglitz, supra note 233, at 4.

[243] See People v. N. River Sugar Ref. Co., 24 N.E. 834, 841 (N.Y. 1890); State v. Standard Oil Co., 30 N.E. 279, 291 (Ohio 1892).

[244] Panhandle Oil Co. v. Mississippi ex rel. Knox, 277 U.S. 218, 223 (1928) (Holmes, J., dissenting).

[245] See Dartmouth Coll. v. Woodward, 17 U.S. (4 Wheat.) 638 (1819).

[246] See Liam Murphy & Thomas Nagel, The Myth of Ownership: Taxes and Justice 135 (2002).

the goose that lays the golden eggs by imposing taxation at rates that create huge deadweight losses to the economy at large (the deadweight loss is approximately a square function of the tax rate).[247] The precise limit of desirable taxation thus becomes the quintessential political question of our time, to be refought every four years at the ballot box.

Given that we cannot tax at 100%, what is the effect on corporate power of a lower tax rate, such as the current 35%? Even at that historically low rate,[248] the corporate tax does significantly slow down the accumulation of corporate resources, which are the foundation of managerial power.[249] For example, imposing a tax at 35% on corporate assets invested at a 10% yield (compounded annually) over ten years results in approximately 27% less assets being available to management at the end of the period than would be available in the absence of the tax.[250] Thus, taxation at lower rates can meaningfully restrict the build-up of assets that form the base of managerial power, even when it does not destroy it.[251] But since corporate power will continue to exist and grow at any reasonable rate of taxation, we also need the tax to perform a regulatory function.

[247] Harvey S. Rosen, Public Finance 282–301 (6th ed. 2002). It should be noted, however, that to the extent the corporate tax falls on economic rents, it is not inefficient even at very high rates. There is a significant literature that suggests that MNEs in particular earn economic rents. See, for example, Mihir A. Desai & James R. Hines, Jr., Evaluating International Tax Reform, 56 Nat'l Tax J. 487, 489 (2003), and sources cited therein.

[248] The corporate tax rate was 46% as recently as 1986, and higher before then. See Friedman, supra note 14, at 8.

[249] This assumes that management cannot avoid the tax either by corporate tax shelters or tax competition. These two problems are discussed in Part IV infra. It also assumes that the corporate tax cannot generally be shifted. See Stiglitz, supra note 233, at 4–5.

[250] One-hundred dollars invested at 10% over ten years, compounded annually, yields $257 at the end of year ten in the absence of tax and only $188 (27% less) if the earnings are subject to a 35% tax. The key is of course the effective tax rate. George Yin has calculated that the effective rate for the S&P 500 is on average about 30%. Yin, Effective Tax Rates, supra note 15, at 1798.

[251] Note that the corporate tax does not limit the absolute size of corporations; it is not meaningfully progressive and it actually encourages growth through tax-free mergers and acquisitions. Instead, the corporate tax's limiting function is a way for government to control the rate of corporate growth, with the implied potential of stopping it altogether.

Second, the regulatory function: Managerial use of corporate assets (that is, use of its power) may be impacted by the threat that the tax rate will rise if Congress perceives that the assets are not used for the betterment of society. This can be seen by the imposition of higher effective rates on certain forms of behavior Congress disapproved of, like bribes paid to foreign officials and participation in international boycotts.[252] In both cases, empirical research has suggested the tax penalties had a significant impact.[253] More recently, the threat of increased tax rates applied to U.S. corporations that moved their nominal place of incorporation to Bermuda seems to have sufficed to block one such "inversion" transaction and stop other corporations from adopting the same strategy.[254] This is particularly striking since the imposition of an actual tax on the shareholders of inverting corporations in 1994 had no effect whatsoever on the rate of inversions;[255] management does not care enough about the tax on shareholders. Thus, it seems that just as Senator Cummins predicted in 1909, taxation even at rates much less than 100% can suffice to regulate corporate managerial power.[256] But the rates cannot be set too low (1%, as in 1909, is not enough), because then management would not care sufficiently to avoid the tax. This is why we need the limiting function (that is, set rates at sufficiently high levels for management to notice) for the regulatory function to work properly.

Finally, in addition to providing disincentives, the tax can be used to provide incentives as well.[257] For example, investment in-

[252] I.R.C. §§ 162(c), 908 (2000).

[253] James R. Hines, Jr., Taxed Avoidance: American Participation in Unsanctioned International Boycotts 24 (Nat'l Bureau of Econ. Research, Working Paper No. 6116, 1997); James R. Hines, Jr., Forbidden Payment: Foreign Bribery and American Business after 1977, at 20–21 (Nat'l Bureau of Econ. Research, Working Paper No. 5266, 1995).

[254] See Avi-Yonah, Haven's Sake, supra note 20. There have been no inversions since Stanley. See David Cay Johnston, Musical Chairs on Tax Havens: Now It's Ireland, N.Y. Times, Aug. 3, 2002, at C2.

[255] See Avi-Yonah, Haven's Sake, supra note 20, at 1793–94.

[256] 44 Cong. Rec. 4232 (1909) (statement of Sen. Cummins).

[257] This function is controversial. See, e.g., Boris I. Bittker, A "Comprehensive Tax Base" as a Goal of Income Tax Reform, 80 Harv. L. Rev. 925 (1967) (discussing the idea of tax expenditures as a departure from an ideal tax base); R. A. Musgrave, In Defense of an Income Concept, 81 Harv. L. Rev. 44 (1968) (same); David A. Weisbach & Jacob Nussim, The Integration of Tax and Spending Programs, 113 Yale L.J.

centives are provided to corporations as a way of bolstering the economy.[258] Another example is research and development, which has been shown by economists to produce significant positive externalities for society, which justify government in providing a subsidy via the tax code.[259] Now it is of course true that the government could subsidize these functions directly, rather than use tax expenditures, so that this cannot strictly be an argument for taxing corporations. That would require, however, setting up an IRS-like agency to monitor the use of the subsidies, so that any simplification advantage from abolishing the corporate tax is diminished. Additionally, once the corporate tax is in place, it seems like an obvious and convenient vehicle to deliver the desired subsidies at little additional cost.

G. Summary

The corporate tax is justified as a way for a liberal democratic state to limit excessive accumulations of power in the hands of corporate management, which is inconsistent with both democratic and egalitarian ideals. It achieves this goal in two ways: by directly limiting the rate of corporate wealth accumulation and by regulating managerial uses of corporate assets and channeling it in directions deemed beneficial to society as a whole. Neither of these functions can be effectively achieved in a capitalist economy by means other than a corporate tax imposed at a significant rate. The corporate tax can thus be seen as an essential part of a liberal democratic alternative to a socialist command and control economy. In the last Part, I discuss some practical implications that follow from this argument.

(forthcoming 2004) (same); Daniel Shaviro, Rethinking Tax Expenditures (2004) (unpublished manuscript, on file with Virginia Law Review Association) (same).

[258] See Ronald F. King, Money, Time & Politics: Investment Tax Subsidies and American Democracy 1–8 (1993).

[259] James R. Hines, Jr., International Taxation and Corporate R&D, *in* Borderline Case: International Tax Policy, Corporate Research and Development, and Investment 39, 39 (James M. Poterba ed., 1997).

IV. SOME POLICY IMPLICATIONS

The first and most obvious practical conclusion from the above is the negative one: The corporate tax should not be repealed.[260] This outcome seems at present unlikely, but it is important to stress it because of the widespread opposition to (or very lukewarm support for) the corporate tax in academic and policy circles.

There are three areas in which one can draw more specific policy conclusions from the above arguments. These are the two most significant threats to the corporate tax—corporate tax shelters and tax competition—and the current drive to reform the tax by integrating it with shareholder (dividend) taxation.

A. Corporate Tax Shelters

Since the mid-1990s, the corporate tax in the United States has been under significant practical attack by the growing corporate tax shelter movement.[261] Its essence involves promoters (mostly accounting firms and investment banks) who scour the Code for sheltering ideas and then sell them for a hefty fee to a growing list of corporate clients. Ten years ago it was unusual to find mainstream corporate tax departments who would buy these ideas. Today, with the tax department viewed as a profit center, it is rare to find a major corporation that does not use them. As Professor John

[260] The same applies to the corporate Alternative Minimum Tax, which I view as an important backstop to the corporate tax. See Reuven Avi-Yonah, The Case for Retaining the Corporate AMT, 56 SMU L. Rev. 333 (2003).

[261] See, e.g., Bankman, supra note 16, at 1776–80 (describing the features of modern tax shelters); Peter C. Canellos, A Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters, 54 SMU L. Rev. 47, 47 (2001) ("[C]orporate tax shelters are proliferating, in both type and number, and their terms are becoming ever more audacious."); Daniel N. Shaviro, Economic Substance, Corporate Tax Shelters, and the *Compaq* Case, 88 Tax Notes 221, 223–24 (2000) (describing dividend-stripping); David A. Weisbach, Ten Truths About Tax Shelters, 55 Tax L. Rev. 215, 226 (2002) (describing "audit lottery" theory); George K. Yin, The Problem of Corporate Tax Shelters: Uncertain Dimensions, Unwise Approaches, 55 Tax L. Rev. 405, 405 (2002) (noting that the Treasury Department has described tax shelters as proliferating and urged efforts to curb their growth); Yin, Tax Shelters, supra note 16, at 209 (noting that "respected commentators both inside and outside of government seem persuaded" that tax shelters are a problem).

Braithwaite noted, the phenomenon is both supply and demand driven.[262]

Various proposals have been advanced to curb this practice, and the IRS has issued elaborate regulations.[263] Courts (especially appellate courts with little tax expertise), however, have tended to uphold the shelters.[264] It therefore seems that more drastic action is needed to address this problem. Professor George Yin has proposed a solution based on making tax reporting conform better to financial (book) reporting.[265] I support this idea because it would exact a price (in the form of higher tax payments) from corporate management who manipulate financial reporting, and if management chooses to employ tax shelters this would result in reduced earnings per share ("EPS"). Since management tend to care more about short-term EPS than about taxes[266] such a rule (which is similar to the rule adopted in other countries, such as Germany and Japan) is likely to be more effective in curbing tax shelters than financial manipulation, although it also has some drawbacks in terms of reduced flexibility for both tax and accounting rulemakers.

In any case, whatever the solution adopted for the tax shelter problem, the important point derived from this Article is that it is indeed a problem—that from a normative perspective it is not good to let management eliminate the corporate tax through self-help measures. This point is missing from the corporate tax shelter literature, but it is essential to it.

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[262] John Braithwaite, Helter Shelter: Marketing Local and Global Aggressive Tax Planning (forthcoming 2004) (manuscript at 2, on file with the Virginia Law Review Association).

[263] See, e.g., I.R.C. § 6111 (2000) (requiring registration of tax shelters).

[264] See, e.g., Compaq Computer Corp. v. Comm'r, 277 F.3d 778, 781–83 (5th Cir. 2001); United Parcel Serv. v. Comm'r, 254 F.3d 1014, 1018–20 (11th Cir. 2001).

[265] See Yin, Tax Shelters, supra note 16, at 230.

[266] See, for example, the debate on pooling versus purchase accounting for mergers. See Barton Massey, Banking Association Asks FASB to Preserve Pooling Method, 86 Tax Notes 1125, 1125 (2000); Joseph McNamara, Despite Criticism, FASB Won't Alter Plans to Eliminate Pooling, 86 Tax Notes 1259, 1259–60 (2000); Joseph McNamara, FASB Eliminates Pooling of Interests, 90 Tax Notes 802, 802 (2001). Under pooling, earnings per share were higher than under purchase because the latter required amortizing goodwill.

B. Tax Competition

The other main challenge to the corporate tax is tax competition involving MNEs. Currently, some major U.S. MNEs (for example, Intel) pay no tax to non-U.S. jurisdictions because all of their foreign operations benefit from special tax holidays designed to attract the investment.[267] The MNEs can be sure to obtain such tax reductions because they can conduct an auction among the several countries that offer equivalently suitable locations for untaxed investment. More recently, we have seen tax competition flare up in the location of corporate headquarters, with several U.S. MNEs moving their nominal location of incorporation to tax havens like Bermuda.[268]

The OECD and the European Union have both launched projects aimed at curbing such tax competition, but so far they have achieved only limited success.[269] In the academic literature, meanwhile, there is a raging debate between those who believe that tax competition is harmful and those who believe it is beneficial either from a global perspective or from the perspective of the countries involved.[270] Opponents have suggested various ways of combating tax competition, most of which involve some form of cooperation among developed countries (for example, taxing MNEs based on where their headquarters are or where their goods are sold).[271]

There is, however, a major missing element in this literature—even the opponents of tax competition (including myself) have not been successful in explaining why the threat posed by it to the corporate tax should be viewed negatively. The best we could do is to point out the threat posed by it to the welfare state.[272] But this just leads to the counter-charge that bloated welfare leviathans are trying to create a cartel to save themselves from efficient competition at the expense of small Caribbean jurisdictions.[273]

[267] Avi-Yonah, Globalization, supra note 13, at 1589.

[268] Avi-Yonah, Haven's Sake, supra note 20, at 1794.

[269] Avi-Yonah, Globalization, supra note 13, at 1670.

[270] Id. at 1603–10; Roin, supra note 18, at 603–04.

[271] Avi-Yonah, Globalization, supra note 13, at 1670–71. The rise of inversions raises some doubt about taxation based purely on where the parent corporation is incorporated. See Avi-Yonah, Haven's Sake, supra note 20, at 1796–97.

[272] Avi-Yonah, Globalization, supra note 13, at 1632–39.

[273] See, e.g., Daniel J. Mitchell, OECD Tax Competition Proposal: Higher Taxes and Less Privacy, 89 Tax Notes 801, 802 (2000).

This Article, I believe, supplies the missing piece in the armament of tax competition opponents by pointing out the negative consequences of abolishing the corporate tax through self-help, beyond the damage caused to the coffers of the developed countries. If management can defeat regulation by taxation through the simple mechanism of going overseas, the efficacy of the tax as a regulatory mechanism is eliminated.

C. Integration

In early 2003, President Bush proposed to integrate the corporate tax and the individual shareholder tax by exempting shareholders from paying tax on dividends, as long as the dividends were paid from after-tax corporate earnings.[274] Eventually, Congress balked at adopting full integration and instead opted to reduce the tax rate on dividends from 35% to 15% (with the same rate applying to capital gains).[275] Significantly, the lower rate on dividends applies whether or not corporate tax has been paid.[276]

Thus, for the first time since 1936, the United States now has a partially integrated corporate tax system. Indeed, if the corporate tax can be eliminated by self-help (by tax shelters or tax competition), it is now possible for a corporate investment to be taxed at a total rate of 15%—significantly lower than non-corporate investment.[277]

This result is of course inconsistent with the stated rationales for adopting integration, which have to do with taxing corporate income once.[278] But even the economic case for the original Bush proposal, which did not envisage this kind of "super-integration," was debatable.[279] In particular, integration introduces economic biases in regard to cross-border investment that may be no less significant than the biases it attempts to cure domestically.

From the perspective of this Article, the important point to note is that the rationale given for the corporate tax is independent from the tax on shareholders. Thus, it is entirely consistent to tax corpo-

[274] U.S. Treasury Dep't, supra note 7.
[275] I.R.C. § 1 (h)(11) (2000).
[276] Id.
[277] See Avi-Yonah, Pitfalls, supra note 31, at 1.
[278] Id. at 2.
[279] See Id.

rations on their income to regulate management, while at the same time taxing shareholders on dividends.[280] The tax on dividends has to do with the rationale for having an individual income tax (rather than, for example, a Value-Added Tax). I have argued elsewhere that this rationale was to restrict the power of the rich.[281]

It should also be noted that the rationale given above for retaining the corporate tax does not require us to forego integration. As long as the corporate tax is maintained, it is quite possible to exempt shareholders from tax on dividends or give them a credit for economic reasons, without causing harm to the rationale for the corporate tax. In fact, shareholders were partially exempted from tax on dividends from 1913 to 1936, when the regulatory rationale for the tax was well understood.[282] Thus, although this Article gives an answer to why we should tax corporations that is different from the mainstream view that is cited to support integration, it does not necessarily follow from it that we should refrain from adopting integration if we are persuaded by the economic case for doing so.

CONCLUSION

This Article has attempted to provide the first comprehensive rationale for defending the current corporate income tax. It argues that the usual reasons given for the tax (primarily as an indirect way of taxing shareholders, or alternatively as a form of benefit tax) are inadequate. It then explains what the original rationale to adopt this tax was in 1909, namely to regulate managerial power. This rationale stems from the real view of the corporation, which was the dominant view throughout the many transformations of the corporate form from Roman times to the present. Turning to normative argument, this Article then argues that the regulatory rationale given for taxing corporations in 1909 is still valid since similar social conditions continue to exist. Finally, this Article argues that this rationale is necessary from a normative perspective

[280] Cf. Herwig J. Schlunk, How I Learned to Stop Worrying and Love Double Taxation, 79 Notre Dame L. Rev. 127 (2003) (arguing in favor of the double tax on benefit grounds).

[281] Avi-Yonah, Progressive Taxation, supra note 213, at 1412.

[282] Even the third possible method of integration, dividend deduction, which is rarely adopted in practice, is consistent with the above rationale insofar as the corporate tax is reduced only if management relinquish power by distributing corporate assets.

to support the fight against the two crucial current threats to the corporate tax posed by the corporate tax shelter and tax competition phenomena.

In the end, however, it must be emphasized that the function of taxation is inherently limited. As the two quotes cited in the beginning illustrate, the state wields enormous power through taxation, but it is limited in its ability to use it by the fear of destroying or unduly damaging institutions that are essential to the welfare of its citizens. Corporate taxation is an important regulatory tool and an important element in managing the delicate balance between corporations, society, and the state. But because all taxation is to some extent harmful (in the sense of creating welfare loss), taxation cannot be the only mechanism to solve social problems. Ultimately, it is up to all of us—as voters, as politicians, and as managers of corporations—to find the right balance among these competing considerations.