CORPORATIONS THAT WEREN'T: THE TAXATION OF FIRM PROFITS IN HISTORICAL PERSPECTIVE

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I. INTRODUCTION

The modern income tax in the United States ("US") has always had two different sets of rules for taxing the profits of a business. Under the first set of rules, the firm itself does not pay tax on its profits.[1] Instead, the owners of the firm are required to pay tax on their respective shares of the profits.[2] Moreover, the owners must pay the tax whether they actually receive their share of profits or not. In effect, the firm is treated as an extension of its owners and not as a separate and distinct taxpaying unit. This is the default set of rules that now applies to any firm that is not organized as a corporation under state law.[3] That would include partnerships and limited liability companies.[4]

Under the second set of rules, the business and its owners are treated as separate and distinct taxpaying units. As a result, the business must pay tax on any profits it makes.[5] In addition, if the firm pays any after-tax profits to its owners, the owners must pay tax on any amounts they receive.[6] This two-tiered system of taxing profits is the default set of rules that now applies to any business that is organized as a corporation under state law.[7]

Current tax rules in the US permit most firms to opt out of the default tax rules that would ordinarily apply to them. Thus, a partnership or limited liability company can choose to have its profits taxed as if the firm were a corporation, with the profits first being taxed to the firm and later taxed to

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1 *E.g.*, I.R.C. § 701 (2009).

2 *Id.*

3 Treas. Reg. § 301.7701-3(b)(1)(i) (2006).

4 Treas. Reg. § 301.7701-2(c)(1) (2009). However, these rules do not apply to any partnership that qualifies as a publicly traded partnership. By statute, any such firm is treated as if it is a corporation for tax purposes. *See* I.R.C. § 7704(a), (b) (2009).

5 I.R.C. § 11 (2009).

6 I.R.C. § 61(a)(7) (2009).

7 Treas. Reg. § 301.7701-2(b)(1) (2009). These rules also control the taxation of firms organized as joint stock companies and associations. *See* Treas. Reg. § 301.7701-2(b)(2)–(7) (2009). The same rules also apply to any partnership that qualifies as a publicly traded partnership. *See* I.R.C. § 7704(a) (2009).

the owners in the event the profits are paid out to them.[8] Meanwhile, some corporations can choose to have firm profits taxed as if the business were an extension of its owners. Thus, the shareholders would be taxed on their share of the profits while the firm itself would not be liable for tax.[9]

This framework for determining the tax classification of business firms essentially embodies a tax policy to permit firms to control tax outcomes. After all, the two systems for taxing business profits are likely to have vastly different tax implications in two key respects: (1) the amount of tax owed on a firm's profits; and (2) the time when the tax must be paid. So, giving a firm the opportunity to choose its tax classification effectively permits it to control how much will be due in tax and when the tax must be paid.[10]

The U.S. tax system did not always employ the entity classification rules to achieve this objective. However, the U.S. has a long tradition of taxing business profits in a way that disregards a firm's state law business form at least some of the time. As a result, in some cases a state law corporation has not been treated as a corporation for tax purposes, while in other cases the tax law has treated as a corporation a firm that was not organized as one under state law. In both situations, one might view the firms as corporations that weren't.

This article examines the nation's earliest income tax laws, focusing on the provisions that tax business profits in a way that disregards a firm's state law business form. The study reveals that these early provisions were largely intended or designed to achieve an objective that is very different from the one that is achieved under current tax classification rules. The earliest rules were almost always directed at either preserving equitable outcomes or preventing inequitable outcomes in the way business profits were taxed.[11] Paradoxically, the current entity classification rules, that seem to focus on achieving equality of opportunity to control tax outcomes, may actually produce unequal outcomes and undermine the interests of equity.

II. THE TAXATION OF FIRM PROFITS–THE FORMATIVE YEARS

The history of the income tax in the U.S. can be divided into two parts. The first part covers the period before the enactment of the Sixteenth Amendment in 1913, which eliminated any constitutional barrier to the imposition of a comprehensive income tax that did not have to be levied on the basis of each state's population.[12] The second period covers the period after the adoption of the Sixteenth Amendment. Each of these periods is

[8] Treas. Reg. § 301.7701-3(a) (2006). A statutory provision permits a partnership to elect not to be subject to the rules that would otherwise apply to one. I.R.C. § 761(a) (2009). However, the rule does not technically reclassify the partnership as a corporation for tax purposes.
[9] I.R.C. §§ 1363(a), 1366 (2009).
[10] One scholar has been more pointed in his criticisms, noting how the current set of rules benefits the well advised and operates as a potential trap for the ill advised. George K. Yin, The Taxation of Private Business Enterprises: Some Policy Questions Stimulated by the "Check-The-Box" Regulations, 51 SMU L. Rev. 125, 136 (1997).
[11] Whether these objectives were actually achieved is another matter.
[12] U.S. Const. amend. XVI.

characterized by a different theme in the taxation of business profits. In the pre-Sixteenth Amendment period, Congress actually did not make any distinction between partnerships and corporations for federal income tax purposes. Thus, all firms, regardless of their business form, were subject to a virtually identical set of rules for taxing their profits.

After the Sixteenth Amendment, Congress drew a distinction between corporations and partnerships and adopted different rules for taxing the profits of each. However, in a narrow set of cases during the early years of the modern income tax, the taxation of a firm's profits did not reflect the firm's business form. In those instances, Congress suspended the rules that would ordinarily apply largely in an effort to ensure that a firm would not be subject to those default rules when it did not possess the substantive qualities that justified the application of those rules. Lawmakers appeared to be focused on preserving the ability of the system to effectively distinguish firms so it would not produce distorted tax outcomes. Eventually, however, U.S. tax policy evolved to the point at which the country's business entity classification rules are used to provide firms with an equal opportunity to control tax outcomes—an objective that may come at the expense of achieving equal outcomes.

A. THE NINETEENTH CENTURY TAX ACTS

1. *1862—All Firms Are Exempt from Tax on Profits, While Firm Owners Are Taxed on any Profits Received*

The country's first income tax was enacted in 1862 to finance the Civil War.[13] The tax was designed to operate in a modestly progressive way so that individuals with higher incomes would pay higher tax rates. Everyone was exempt on the first $600 of income.[14] A person had to pay 3% in tax on the rest of his income if it did not exceed $10,000, while a person had to pay 5% in tax on the rest of his income if it did exceed $10,000.[15]

The statute was designed so that the profits of any business would be subject to tax when paid out to its owners.[16] In most cases, the owners would have to pay tax on their share of business profits that they received. This seems to be the effect of the statute's definition of an individual's

[13] JOHN F. WITTE, THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX 68 (1985). As a technical matter, this was not the country's first income tax. In 1861 Congress passed, and the President signed into law, a 3% tax on income. Act of August 5, 1861, ch. 45, § 49, 12 Stat. 292, 309. However, the Treasury made no effort to assess or collect the tax. Steven A. Bank, *Origins of a Flat Tax*, 73 DENV. U. L. REV. 329, 345 (1995). As a result, for all practical purposes, the income tax adopted in 1862 represents the country's first experiment with an income tax.

[14] Act of July 1, 1862, ch. 119 § 90, 12 Stat. 432, 473.

[15] *Id.*

[16] This stands in contrast to a rule that would apply a tax to all the profits derived by a business, whether paid out to the owners or not. That model was expressly adopted later in the Revenue Act of 1864, which is discussed in the next section. The Revenue Act of 1862 does not expressly limit the tax to profits that are paid out. However, it would be inconsistent with the statutory scheme to conclude that certain undistributed profits should be taxed. Moreover, it may be that this issue has little practical significance. At the time the law was in effect it was the general practice for a business to distribute all of its earnings to its owners. Steven A. Bank, *A Capital Lock-In Theory of the Corporate Income Tax*, 94 GEO. L.J. 889, 915 (2006) [hereinafter *A Capital Lock-In Theory*] (citing WILLIAM Z. RIPLEY, RAILROADS: FINANCE AND ORGANIZATION 244 (1915)).

taxable income. The term was defined to include all "profits," "dividends" and income "from any other source whatever."[17] However, the recipient did not have to pay tax on any dividends from certain companies that were required to withhold a tax on dividends paid to shareholders. [18] Specifically, certain financial institutions, including banks, trust companies, savings institutions, and insurance companies had to pay a 3% tax on any profits paid out as dividends.[19] This tax had to be deducted from the dividends actually paid out.[20] In a similar fashion, all railroad companies had to pay a 3% tax on any profits paid out as dividends, withholding the tax from the dividend.[21] The tax withheld from these payments was designed to be a substitute for the tax that the recipient would have had to pay. Lawmakers intentionally structured the tax to operate in this way so as to avoid a double tax.[22]

However, there was one disparity that arose out of the interaction of the progressive tax on individuals and the flat tax that was withheld on dividends paid by taxable businesses. The income from a taxable business would be overtaxed to a person whose total income was less than $600. In such a situation, the 3% tax paid by the business on the owner's share of the profits would exceed the 0% tax that would have applied had the dividend been paid by a business not subject to the firm level tax. Meanwhile, the income from the business would be undertaxed to a person whose total income was over $10,000. In such a situation, the 3% tax paid by the business on the owner's share of the profits would be less than the 5% tax that would have applied had the individual been required to pay the tax on that income.

The possibility that profits of the business could be overtaxed was not without controversy.[23] However, as a practical matter, it probably did not represent a major problem. It seems unlikely that an individual whose income fell below the $600 exemption ceiling received any dividends, or very little if they did. This seems to be supported by the fact that the tax on dividends accounted for a very small share of total income tax revenues.[24]

By contrast, the possibility that profits of a business could be undertaxed was viewed with enough concern that the Commissioner of Internal Revenue issued a regulation to address the inequity. Under that rule, a 2% tax would be owed on dividends and interest received by individuals whose income exceeded $10,000.[25] That tax, combined with the 3% tax paid by the business, would equal the 5% tax that would have

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[17] Act of July 1, 1862, ch. 119 § 90, 12 Stat. 432, 473.
[18] § 91, 12 Stat. at 473–74.
[19] §§ 81–82, 12 Stat. at 469–71.
[20] *Id.*
[21] §§ 81–82, 12 Stat. at 469–71. Railroads had to deduct and withhold a similar 3% tax on interest paid to bondholders. *Id.*
[22] Steven A. Bank, *Entity Theory as Myth in the Origins of the Corporate Income Tax*, 43 WM. & MARY L. REV. 447, 453–54 (2001).
[23] HAROLD Q. LANGENDERFER, II, THE FEDERAL INCOME TAX 1861–1872, at 507–09 (1954).
[24] ROBERT STANLEY, DIMENSIONS OF LAW IN THE SERVICE OF ORDER: ORIGINS OF THE FEDERAL INCOME TAX 1861–1913, at 279 n.74 (1993).
[25] GEORGE S. BOUTWELL, A MANUAL OF THE DIRECT AND EXCISE TAX SYSTEM OF THE UNITED STATES 197 (1863).

applied if the statute required the individual to be taxed on his share of the profits of the business.

Thus, when the country first adopted an income tax, the rules for computing the tax on business profits made no distinction between firms. Firm profits were taxed in the same way no matter what business form was used to conduct the business.[26] In short, a firm's tax classification had nothing to do with its business form, producing equal tax outcomes across all firms.

Admittedly, there were special rules that applied to certain financial institutions and transportation companies. However, those special rules did not produce materially different outcomes. In all cases, only profits that were actually paid out to a firm's owners were subject to tax at a rate that reflected the recipient's income level. The only difference was the manner in which the tax was collected. In cases not covered by the special rules, the owners were personally responsible for paying the tax; while in cases covered by the special rules, the firm was responsible for paying at least a portion of the tax on behalf of the owners.

2. *1864–All Firms Are Exempt from Tax, While Firm Owners Are Taxed on Their Share of Profits Derived by the Firm*

By 1864, the country needed more money to finance the Civil War and restructured the income tax to alleviate its financial condition.[27] The measure enacted by Congress differed from the 1862 Act in three important ways. First, the tax rates themselves were increased. Second, the schedule of tax rates applied in bracketed fashion so that each rate applied only to income that fell within a certain range, not to an individual's entire income. Third, the profits of a business were expressly taxed to its owners, whether it was paid out to them or not. This flow-through method of taxing firm profits is the approach that will ultimately characterize the rules for taxing the income derived by a modern-day partnership. However, as under prior law, the 1864 Act made no distinction between firms based on the business form used to conduct the business. As a result, the Act had the effect of treating a corporation as a partnership for tax purposes.

Under the 1864 Act, an individual was exempt on his first $600 of income. Further, a 5% tax applied to income over $600 and up to $5000, while a 10% tax applied to all income over $5000.[28] The profits of a

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[26] The financial institutions and transportation companies that had to withhold tax on dividends paid to shareholders happened to represent the lion's share of corporations in existence at this time. Steven A. Bank, *Entity Theory as Myth in the Origins of the Corporate Income Tax*, 43 Wm. & Mary L. Rev. 447, 512 n.341 (2001) (citing JAMES WILLARD HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES 1780-1970 (1970)). Nevertheless, the tax system did not overtly target corporations for special treatment by virtue of their corporate status. More important, the tax on corporate profits did not materially differ from the tax on other forms of income.

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

[28] Act of March 3, 1865, ch. 78, 13 Stat. 469, 479, amending Act of June 30, 1864, ch. 173 § 116, 13 Stat. 223, 281. Prior to the amendment, an individual was exempt on his first $600 of income, a 5% tax applied on income over $600 and up to $5000, a 7.5% tax applied on income over $5000 and up to $10,000, and a 10% tax applied on income over $10,000. Congress made the change in order to reduce a shortfall in expected revenues. ROBERT STANLEY, DIMENSIONS OF LAW IN THE SERVICE OF ORDER: ORIGINS OF THE FEDERAL INCOME TAX 1861–1913, at 35 (1993).

business were expressly taxed to the individual owners, regardless of whether the business was incorporated or whether the profits were paid out to the owners.[29] Thus, as in the Act of 1862, the Act of 1864 contained a uniform rule for taxing the profits of a business. The two tax acts differed, however, in that the former limited the tax to profits paid out to owners, while the latter applied the tax to profits that were paid out in addition to profits that were retained by the business.

As under prior law, the 1864 Act contained special rules for collecting the tax on the profits of certain firms. Technically speaking, a business that operated in certain industries had to pay a flat tax on its annual profits. Certain financial institutions had to pay a 5% tax on all dividends paid to shareholders and on any undistributed surplus.[30] A separate provision required certain transportation companies to do the same.[31] In each case the tax on the dividends had to be withheld from the payments made to the shareholders, just as they had under the 1862 Act.

As originally enacted, if an individual received a dividend from any taxable firm, the recipient was not subject to tax on the dividend.[32] This was the very same way the 1862 Act coordinated the taxes on individuals and firms. Of course, this solution was an imperfect one for the same reasons that it did not completely eliminate the disparities in the taxation of business profits under the 1862 Act. The approach was effective in preventing business profits from being overtaxed or undertaxed in situations in which the shareholder's income fell between $600 and $5000—the range that was already subject to the 5% tax rate that applied to the business. However, this approach did not alleviate the problem of overtaxed or undertaxed profits that occurred when the shareholder's income fell outside of that range. Because the 5% tax on the business was more than the zero tax rate on income up to $600, an individual in that income bracket would be overtaxed on their share of the profits from such a business. Meanwhile, because the 5% tax on the business was lower than the 10% tax on individual income over $5000, an individual in that income tax bracket would be undertaxed on their share of the profits from such a business.[33]

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[29] Act of June 30, 1864, ch. 173, § 117, 13 Stat. 223, 282 ("[T]he gains and profits of all companies, whether incorporated or partnership . . . shall be included in estimating the annual gains, profits, or income of any person entitled to the same, whether divided or otherwise."). Under the interpretation of the Commissioner of Internal Revenue, the amounts taxed to an individual included the undivided profits of a corporation. *See* DIGEST OF DECISIONS AND REGULATIONS MADE BY THE COMMISSIONER OF INTERNAL REVENUE, 1864–1898, at 16, 36, 37, 39, 40 (1906). In dictum, the Supreme Court concurred with this interpretation. Collector v. Hubbard, 79 U.S. 1 (1870). Taxing partnerships and corporations in the same way under a uniform rule seems to be consistent with the prevailing view about the nature of a partnership and a corporation. At the time, both business forms were considered to be an aggregate of its owners. *See* Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L.J. 53, 58 (1990).

[30] § 120, 13 Stat. at 283–84. A business was subject to this provision if it was a bank, trust company, savings institution, or fire, marine, life, or inland insurance company. *Id.*

[31] § 122, 13 Stat. at 284–85. The same withholding tax applied to any interest paid to bondholders. *Id.* A business was subject to this provision if it was a railroad, canal, turnpike, canal navigation or slackwater company. *Id.*

[32] § 117, 13 Stat. at 284.

[33] The possibility of overtaxed and undertaxed income did not exist under the bill that was originally introduced by the House Ways and Means Committee. That piece of legislation imposed a flat 5% tax

The problem of overtaxed and undertaxed business profits was corrected by amendments incorporated into the 1864 Act before it went into effect. Under the amended version, an individual had to include in income any dividends on which the payor withheld tax.[34] However, the tax withheld on any payment was counted towards the recipient's tax liability.[35] This tax credit mechanism stands in contrast to the provisions of the original Act that simply excluded these items of tax paid income from the recipient's gross income. Under the revised design, the potential for an item to be undertaxed was eliminated because if the recipient had income in excess of $10,000, placing the individual in the 10% tax bracket, a tax of 5% would still be owed on any dividend on which the payor withheld 5%.

In effect, the revised set of rules treated all firms, including corporations, like modern day partnerships, where the partners, not the partnership, are taxed on firm profits. The only difference is that the 1864 Act contained a distinctive mechanism for collecting the tax. In most cases, the owners were personally responsible for paying the tax. However, in certain cases the firm was responsible for paying at least a portion of the tax on behalf of the owners. These were the rules that applied regardless of a firm's business form, including those organized as corporations.

In 1867, Congress amended the 1864 Act so as to restructure the income tax in some notable ways. But it did not abandon the uniform way of taxing firm profits. A flow through approach (like the current method for taxing partnership profits) continued to apply to all firms, including corporations, so that the tax outcome would be virtually the same in all cases. First, Congress replaced the two-tiered graduated rates with a flat 5% tax on all income in excess of a $1000 exemption amount.[36] The change reduced the amount of progressivity built into the tax system, but it did not eliminate it entirely; for all practical purposes there were two tax brackets: a 0% bracket and a 5% bracket. Even this structure would cause an individual's tax burden to gradually increase with his ability to pay because the effective tax rate would rise with the person's income level.

Congress also changed the way the tax on individuals was coordinated with the tax on transportation companies and financial institutions. The existing law required an individual to take the dividends into account but permitted the recipient's tax liability to be reduced by the tax withheld on the payment by the firm. Under the amended law, any dividends received from a taxable business would not be taken into account when computing an individual's tax liability.[37] Despite these changes, the rules continued to

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on all income, including business profits. EDWIN R. A. SELIGMAN, THE INCOME TAX: A STUDY OF THE HISTORY, THEORY, AND PRACTICE OF INCOME TAXATION AT HOME AND ABROAD 440 (The MacMillan Company 2d prtg. 2004) (1911). The problem only arose after the bill was modified during congressional debates to include a graduated rate structure. *Id.* at 441.

[34] Act of March 3, 1865, ch. 78, 13 Stat. 469, 479. Any interest from a taxable firm was also excluded from the recipient's income. *Id. See also* § 122, 13 Stat. at 284–85.

[35] Act of March 3, 1865, ch. 78, 13 Stat. 469, 479.

[36] Act of March 2, 1867, ch. 169, § 13, 14 Stat. 471, 477–78.

[37] *Id.* At a superficial level, this change did not create any disparities because the 5% flat tax withheld from the payment was identical to the 5% flat tax imposed on the individual. However, because an individual was exempt on the first $1000 of income, there was at least the potential for a dividend to be overtaxed to the extent it was paid to someone whose income did not exceed $1000.

operate in a way that effectively made all firm profits taxable to the owners, with the firm having to pay the tax on behalf of the owner in some cases. Although this approach has come to represent the way the U.S. taxes partnership profits, it was applied equally to partnership and corporations under the Act, resulting in equal tax outcomes across all firms.[38]

In 1879, Congress reduced the tax rate to 2.5%.[39] The reduced tax remained in effect until 1873.[40] Once hostilities between the states ended, wealthy individuals successfully pressured the government to repeal the tax, stressing that it was a temporary measure intended to meet the demands of the war and nothing more.[41] Subsequently, Congress reinstituted a tax on incomes as part of the Tariff Act of 1894.[42] Under that measure, individuals had to pay a 2% tax on incomes in excess of $4000.[43] All corporations and associations, but not partnerships, had to pay a 2% tax on their profits, including those paid out to shareholders as dividends.[44] However, such dividends were not included in the taxable incomes of the shareholders.[45] No prior revenue act used a firm's organizational form as the basis for determining how its profits would be taxed. However, the income tax of 1894 was never actually implemented because it was struck down by the Supreme Court as an unconstitutional direct tax that could not be imposed because it was not levied on the basis of a state's population.[46]

B. THE TAX ACTS OF THE EARLY TWENTIETH CENTURY

Congress addressed the constitutional shortcomings of the 1894 Act by passing the 1909 Corporate Excise Tax. That measure imposed a tax on "every corporation, joint stock company or association, . . . and every insurance company."[47] Technically speaking it was an excise tax, not an income tax, on the privilege of doing business in corporate form.[48] However, the tax itself was computed by taking 1% of the firm's net income over $5000.[49] When challenged, the Act was upheld as a constitutionally permissible excise tax and not an income tax.[50] Later, the

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[38] This may reflect the fact that at the time a corporation was largely considered to be a contract among individuals, making it necessary to treat the firm as an aggregate of its members, just like a modern day partnership. See Marjorie E. Kornhauser, Corporate Regulation and the Origins of the Corporate Income Tax, 66 Ind. L.J. 53, 58 (1990). This widely held view was ultimately replaced by one that views a corporation as a separate entity. Id. at 61. See also Patrick E. Hobbs, Entity Classification: The One Hundred-Year Debate, 44 Cath. U. L. Rev. 437, 446 (1995) (describing how legislators justified the decision to single out the corporation as an organizational form that deserved to be treated as an entity).

[39] Act of July 14, 1870, ch. 255 § 6, 16 Stat. 256, 257.

[40] *See* Act of 1874 § 3140, 18 Stat. 604.

[41] 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 and Dennis J. Ventry, Jr. eds., 2002).

[42] Act of August 27, 1894, 28 Stat. 509 (1894). The story behind the 1894 Act can be found in Patrick E. Hobbs, *Entity Classification: The One Hundred-Year Debate*, 44 CATH. U. L. REV. 437, 441–52 (1995).

[43] § 27, 28 Stat. at 503.

[44] § 32, 28 Stat. at 556.

[45] § 28, 28 Stat. at 554.

[46] Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429 (1995) *aff'd on reh'g*, 158 U.S. 601 (1895).

[47] Revenue Act of 1909, ch. 6 § 38, 36 Stat. 11, 112.

[48] *Id.*

[49] *Id.*

[50] Flint v. Stone Tracy Co., 220 U.S. 107, 147–52 (1911).

1909 Act set the stage for the disparate taxation of corporate profits and partnership profits in revenue laws.[51]

Under growing political pressure to supplement the regressive system of tariffs with a progressive tax on incomes, President Howard Taft called on Congress to propose a Constitutional amendment that would give Congress broad power to enact an income tax, thus eliminating the impediment that prevented the 1894 tax from taking effect.[52] On February 25, 1913, the Sixteenth Amendment was ratified. In its wake Congress adopted an income tax on individuals and corporations. One of the overriding objectives was to devise a system that allowed the tax burden to vary with an individual's ability to pay. This was largely motivated by the fact that the existing system of tariffs and excise taxes allocated the tax burden in an inequitable way, causing poorer persons to surrender a greater share of their income to the government than the wealthy.[53]

1. *1913–Any Corporation That Fraudulently Accumulates Profits Is Taxed Like a Partnership*

The tax system adopted in 1913 was slightly more complex than the ones that preceded it, partly because it actually consisted of two separate taxes on individuals. The first was the normal tax and the second was the surtax. There was also an entity level tax on corporations and similar business forms, but not partnerships.[54] The normal tax was calibrated so that it did not overlap with the corporate tax, preventing the double taxation of corporate profits. However, the surtax was not so calibrated, creating disparities in the taxation of firm profits that lawmakers struggled to address.[55] The attempts to resolve the disparities gave rise to the two approaches for taxing firm profits: the partnership model of treating the firm as an extension of its owners, and the corporate model of treating the firm and its owners as separate and distinct taxpaying units. The corporate model for taxing firm profits was devised largely as a response to the growing practice by corporate managers to retain larger portions of their earnings and investing those amounts into the business. Only a firm operating in corporate form could effectively pursue this practice because only the corporate form, not the partnership, virtually eliminated the ability of investors to unilaterally withdraw either their invested capital or the

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[51] A thorough history of the 1909 Corporate Excise Tax can be found in Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L.J. 53 (1990).
[52] *See* 44 CONG. REC. 3344–45 (1909) (recording President's Taft's letter to the Senate as it was read on June 16, 1909).
[53] H.R. REP. NO. 63-5, at 1, 3 (1913) *reprinted in* 1939-1 (part 2) C.B. 1.
[54] The corporate tax applied to "every corporation, joint-stock company or association, and every insurance company, organized in the United States, no matter how created or organized, not including partnerships." Revenue Act of 1913, ch. 16 § II.G.(a), 38 Stat. 114, 172.
[55] It is not entirely clear why Congress designed the system in this way. One possible explanation is that it was adapting an existing set of rules to achieve new objectives. The corporate income tax replicated a virtually identical tax that had been in place since 1909. Act of Aug. 5, 1909, ch. 6, § 38, 36 Stat. 11, 112 (1909). The normal tax seems to have been viewed as an extension of that tax to individuals. *See* 50 CONG. REC. 1302 (1913) (remarks of Representative Anderson). Rather than redesign that tax to achieve its progressive objectives, lawmakers may have simply decided to adopt an entirely separate progressive tax that would operate in tandem with the normal tax.

earnings generated by the firm.[56] However, lawmakers did not subject all state law corporations to this newly devised corporate model of taxation. As explained below, there were certain situations in which corporate profits were effectively taxed as if they were derived by a partnership.

The normal tax was a 1% tax on an individual's net income in excess of an exempt amount.[57] The exempt amount depended on a person's marital status. An unmarried individual was allowed to exclude the first $3000 from the normal tax, while married couples were collectively allowed to exclude the first $4000.[58] An individual's net income included his share of the profits of any partnership, whether those profits were distributed or not.[59] However, it did not include any corporate dividends.[60] Instead, all dividends and any undistributed corporate profits were subject to an identical 1% tax at the firm level under the corporate tax provisions.[61] Thus, as in prior tax laws, the firm level tax paid by certain businesses was the functional substitute for the tax that would have been paid by the recipient. However, because the normal tax only kicked in when an individual's income exceeded the exempt amount, an individual whose income fell below that threshold would have been overtaxed on his share of any corporate profits, assuming the profits were paid out in the same year they were earned.

The disparities produced by the normal tax paled in comparison to the disparities produced by the surtax. Under the surtax, an individual whose income exceeded $20,000 was subject to tax under a schedule of six rates ranging from 1% to 6%.[62] The rates applied in a graduated way with the 1% tax applying to net incomes above $20,000 and up to $50,000, while the 6% rate applied to amounts in excess of $500,000.[63] There appears to have been broad agreement on this overall structure of the surtax.[64] However, lawmakers seemed to struggle before settling on an approach for applying the surtax (or any second level of tax) to business profits. The difficulties partly reflected the fact that there was a vigorous debate over the merits of drawing distinctions between corporations and partnerships for the purpose of taxing their profits.

The application of the surtax to business profits was not expressly addressed in the original bill reported out of the House Ways and Means Committee and later passed by the full House. The Senate Finance Committee addressed it directly by amending the bill to include a provision

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[56] *A Capital Lock-In Theory*, supra note 16, at 917-20 . Not everyone believes this explains the emergence of a unique set of rules for taxing corporate profits. *See, e.g.*, George K. Yin, *The Future Taxation of Private Business Firms*, 4 FLA. TAX REV. 141, 145 (1999) (observing that theory of the corporation as a separate entity influenced the development of the rules for taxing corporate profits).
[57] Revenue Act of 1913, ch. 16, § II.A.1., 38 Stat. 114, 166.
[58] § II.C., 38 Stat. at 168.
[59] § II.D., 38 Stat. at 169.
[60] § II.B., 38 Stat. at 167.
[61] § II.G.(a), 38 Stat. at 172.
[62] § II.A.2., 38 Stat. at 166.
[63] *Id.*
[64] The Senate Finance Committee did not recommend any changes to this aspect of the tax as proposed by the House Ways and Means Committee and adopted by the full House of Representatives. *Compare* S. REP. NO. 63-80, at 24–26 (1913) *reprinted in* 1931-1 (part 2) C.B. 1 *with* H.R. REP. NO. 63-5, at XXXVI–XXXIX (1913) *reprinted in* 1931-1 (part 2) C.B. 1.

that required an individual to pay surtax on his share of the profits of any business, whether incorporated or not, as long as he would be "legally entitled to enforce the distribution or division of the same."[65] The drafters inserted this language out of an apparent concern that both partnerships and corporations would start reducing the amount of profits they distributed to their owners in an attempt to prevent those profits from being subject to the surtax.[66]

The idea of taxing an individual on a portion of firm profits not actually received by them was not new. The 1864 Act set a precedent for that. However, lawmakers began to question whether the law could operate in that way. Specifically, some questioned whether the law could validly permit the undistributed profits of a corporation to be considered the income of any shareholder.[67] For that reason, the provision was sent back to the committee for further consideration.[68] No one appeared to question the validity of taxing a partner on the undistributed profits of a partnership. This dichotomy in approaches for taxing firm profits is consistent with the evolving views about the legal status of incorporated and unincorporated

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[65] SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 1938–1961, at 983 (1938).

[66] Senator Williams offered this explanation in response to a question raised by Senator Elihu Root on the floor of the Senate:

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

50 CONG. REC. 3774 (1913).

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

> Mr. Root. Mr. President, before the amendment goes back to the committee, I desire to ask that the committee consider the question whether it is possible that the gains and profits referred to in this provision can be regarded as the income of the individual stockholder when they are not divided or distributed. As I understand, this clause would have the effect of imposing an income tax on the aliquot share of each stockholder of a corporation in that part of the profits of the corporation for the year which might have been distributed but were not distributed.
>
> Mr. Williams. Not precisely that; but such part of the income of the partnership or corporation as a partnership or shareholder would have the legal right to force the distribution of.
>
> . . . .
>
> Mr. Root. But taking it altogether, particularly considering the concluding words, I think it does aim to tax as income of the stockholder the profits of the corporation which are not divided. . . . I understand the law to be–I think it is the law in all of our States–that no stockholder has a right to demand a dividend from the profits of a corporation against the judgment of the directors or trustees of the corporation.

Id.

[68] However, Senator William Borah openly noted that if the committee decided not to apply the surtax to undistributed corporate profits, Congress would have to contend with reducing the risk that large estates would incorporate in order to escape the surtax. 50 CONG. REC. 3774, 3775 (1913) (remarks of Senator Borah).

firms. Under the common law, a partnership was not a legal person separate and distinct from its owners. That view appears to have been the dominant view around the time Congress passed the Revenue Act of 1913.[69] Meanwhile, the corporation had come to be viewed as a separate entity.[70]

The committee modified the provision by requiring firm owners to pay surtax on their share of the undistributed earnings of a business in those cases where the undistributed amounts were beyond the reasonable needs of the business. Before deciding to limit the rule in this way, the committee received the input of the Southern Railway Company that cautioned against a rule that would put firms in the position of having to defend a decision to reinvest profits in the business.[71] The committee continued to draw no distinction between corporations and other businesses. Thus, the revised rule applied to both incorporated and unincorporated firms.

Additional language was added on the floor of the Senate to help clarify that the surtax would only reach those instances in which the decision not to distribute or divide profits was motivated by an intention to avoid tax. Specifically, under the proposal, owners would be taxed on their share of undistributed profits only when the companies (whether incorporated or not) were "formed or fraudulently availed of for the purpose of preventing the imposition of such [surtax] through the medium of permitting such gains and profits to accumulate."[72] Senator John Sharp Williams explained the objective of the language as "appl[ying] only to such profits and the heaping up of such surplus as shall justify the Secretary of the Treasury in concluding that it is done for the purpose of evading the tax. Its main purpose is to prevent the formation of holding companies."[73]

It is odd that the Senate Finance Committee adopted a uniform rule for taxing the undistributed profit of both partnerships and corporations because elsewhere in the legislation the committee specified that the partners of a partnership (but not the shareholders in a corporation) would have to pay tax on their share of partnership profits, whether distributed or not.[74] This inconsistency was later eliminated by a Conference Committee consisting of members of both houses of Congress.

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[69] However, around the turn of the century, a number of developments caused scholars and lawyers to reconsider this view. Among other things, many state constitutions contained provisions that treated any non-natural person as a corporation. In addition, there was growing pressure to treat a partnership as a separate entity in order to eliminate any uncertainty about its ability to own property. In fact the original draft of the uniform partnership act viewed the partnership as an entity. However, the final version did not embrace any uniform theory of the partnership as an entity or as an aggregation of its owners. Nevertheless, the final draft did define the term partnership in a way that is consistent with the aggregate theory, describing it as "an association of two or more persons to carry on as co-owners a business for profit." *See* Bradley T. Borden, *The Aggregate-Plus Theory of Partnership Taxation*, 43 GA. L. REV. 717, 735–736 (2009).

[70] This was so even though a half a century earlier the corporation was generally thought to be a contract among individuals, a view that would be inconsistent with treating the firm as an entity and more consistent with treating it as an aggregate of its members. *See* Kornhauser, supra note 51, at 57–62.

[71] *See* 50 CONG. REC. 4378, 4379 (1913).

[72] SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 1938–1861, at 984 (1938).

[73] 50 CONG. REC. 4380 (1913).

[74] 50 CONG. REC. 3855 (1913) ("Provided further, That any persons carrying on business in partnership shall be liable for income tax only in their individual capacity, and the share of the profits of a

Under the compromise reached by that committee, the surtax would apply in two different ways, depending on whether the profits were derived from an incorporated business or not. In the case of an unincorporated business, each owner would have to pay the surtax on his share of the profits of the business, whether received or not.[75] This essentially replicated the approach taken for purposes of the normal tax. However, if the business was a corporation, the conferees took a two pronged approach. First, each shareholder would be required to pay surtax on any corporate profits actually received from the firm as a dividend.[76] Second, the shareholders would also have to pay surtax on their share of any profits that were not paid out if the corporation's failure to do so was motivated by a desire to prevent the surtax from coming into play.[77]

Known as the accumulated earnings tax, the second approach was distinctive in part because it was not self-executing. Instead, the government had to detect cases of unlawful conduct and assess the tax. When cases of unlawful conduct were detected, the government would have to establish that the failure to distribute profits was motivated by the desire to avoid tax. The Act identified two factors that could independently be relied upon as prima facie evidence that there was a fraudulent purpose to escape the surtax. For example, if the corporation was merely a holding company, that would constitute such prima facie evidence.[78] Yet, the Act did not define what a holding company was. Furthermore, a corporation that permitted its gains and profits to accumulate beyond the reasonable needs of the business would also constitute such prima facie evidence.[79] However, the mere fact that the gains and profits were permitted to accumulate and become surplus was not to be construed as evidence of a purpose to escape the surtax, unless the Secretary of the Treasury certified that such accumulation was "unreasonable for the purposes of the business."[80] So the tax writers seemed to agree that certain instances of undistributed corporate profits would be the target of the provisions, based on the theory that there were certain legitimate accumulations of profits that could be distinguished from illegitimate accumulations. However, Congress left it to the Secretary of the Treasury to actually draw the distinctions and make the judgment call. By structuring the accumulated

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partnership to which any taxable partner would be entitled if the same were divided, whether divided or otherwise, shall be returned for taxation and the tax paid, under the provisions of this section . . . .").

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

[76] *Cf.* § II.B., 38 Stat. at 167 (allowing an individual to exclude dividends from taxable income for purposes of the normal tax only).

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

[78] *Id.* at 167.

[79] *Id.*

[80] *Id.*

earnings tax in this way, Congress reaffirmed its implicit rationale for adopting different sets of rules for taxing the profits of partnerships and corporations. The theory justifying the partial tax relief on corporate profits was that a business conducted in corporate form could and would use its undistributed earnings to make investments that would generate future income. Accordingly, the accumulated earnings tax denied that partial tax relief when the firm retained earnings that exceeded its future needs.

In any year the accumulated earnings tax applied, the result seems to be that the firm was taxed like a partnership for purposes of the surtax, with the shareholders having to pay tax both on amounts they actually received and their share of any undistributed profits for the year. However, it would be incorrect to say that the firm and its shareholders were treated in a way that was identical to a partnership. A partner was not taxed on amounts actually received by the partnership. Rather, a partner was taxed solely on the partner's share of profits derived by the partnership in a given year, while any actual distributions were tax free to the partner. By contrast, under the rules of the accumulated earnings tax, a shareholder remained subject to tax on any profits actually received from the corporation as a dividend. If in a later year, such a dividend consisted of amounts that were previously taxed to the shareholder under the accumulated earnings tax, that dividend would remain subject to tax. There was no provision exempting such a dividend from the surtax.[81]

As a practical matter, however, it seems unlikely that this issue ever arose. First, the accumulated earnings tax was assessed in extremely rare situations.[82] Second, in the event that it was assessed, it seems even more unlikely that a corporation would have ever made a distribution of previously taxed earnings in later years. In order for it to have done so, it would have had to pay dividends that exceeded its earnings for the current year. However, by the time the 1913 Act came into effect, it was already the well-established practice for corporations not to distribute all of the profits they derived in any year.[83]

Thus, Congress addressed cases involving corporations that illegitimately accumulated profits by effectively taxing the profits of such

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[81] To that extent, the tax seems to operate as a penalty. However, writing at a more contemporaneous time, one scholar concluded that the provision was "not, strictly speaking, a penalty statute." Lucius A. Buck and Francis Shackelford, *Retention of Earnings by Corporations Under the Income Tax Laws*, 36 VA. L. REV. 141, 153 (1950). However, he reached this conclusion without considering whether shareholders would be taxed on dividends consisting of profits that were previously taxed to them under the accumulated earnings rules in prior years. The one penal quality he did identify was the fact that the surtax would apply to amounts the corporation could have accumulated to meet its reasonable needs. *Id.* By that measure, however, it would seem that the approach for taxing partnerships also had a penal quality. Under those rules, partners were not relieved of surtax on their share of partnership profits retained by the firm to meet its reasonable needs. As a matter of Congressional intent, however, the legislative history for the 1913 Act contains no evidence that lawmakers consciously intended a double tax to apply. Congress affirmatively rejected such an idea five years later when it revised the accumulated earnings tax. Those amended rules expressly exempt from the surtax future distributions of amounts that were previously taxed to shareholders. There is no evidence that the change was motivated by a desire to ease the burden of the tax. To the contrary, an examination of the history of the tax reveals consistent efforts by Congress to strengthen it. *See* Richard Winchester, *Parity Lost: the Price of a Corporate Tax in a Progressive Tax World*, 9 NEV. L. J. 130 (2008).

[82] Winchester, *supra* note 81, at 173 n.344.

[83] A Capital Lock-In Theory, supra note 16, at 918.

firms as if they were derived by a partnership.[84] It seems apparent from the legislative history that lawmakers took this approach in order to eliminate an unfair advantage such corporations over those that did not illegitimately accumulate profits. The latter deserved the partial tax relief made available to incorporated firms because the firm could be expected to finance future investments with its accumulated earnings. That was the entire theory behind the existence and design of the corporate tax. Congress reaffirmed its justification for the corporate tax by denying the partial tax relief to a corporation whose accumulated earnings exceeded its future needs. One might question whether such firms were equivalent to a partnership. However, it seems fairly certain that Congress made the judgment that, at the very least, they did not deserve to be treated in the same way as other corporations. Thus, one can appropriately view the measure as motivated by a desire to eliminate an inequity, even though it may have possibly created a different inequity.

By 1917, Congress replaced the accumulated earnings tax with an undistributed profits tax that did not involve treating the targeted corporations like partnerships. It simply required any corporation to pay a 10% tax on a defined portion of its undistributed profits.[85] That measure was short lived. The following year, Congress discarded the undistributed profits tax and reinstituted the accumulated earnings tax in a slightly modified form.[86] The following section recounts that story.

2. *1918–Three Tax Measures That Disregard a Firm's Business Form*

Congress adopted three measures in 1918 for taxing a firm's profits under a set of rules that did not correspond to the firm's state law business form. Two provisions caused certain corporations to be treated like partnerships for tax purposes. One provision caused certain partnerships to be treated like corporations for tax purposes. These three measures were adopted largely as a way to offset certain inequities produced by the modifications Congress made to the overall tax system in 1918. Therefore, in order to fully appreciate the significance of the three measures, it is helpful to understand the setting in which they occurred.

a. Changes to the Normal Tax and the Corporate Tax

In the Revenue Act of 1918, Congress adjusted the income tax system in ways to make it even more progressive than existing law. This primarily involved tinkering with the tax rates on individuals and corporations. This time, however, Congress did not just adjust the surtax, that previously had

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[84] As an administrative matter, the Treasury Department treated a limited partnership as a corporation. Regulations No. 33Law and Regulations Relative to The Tax on Income of Individuals, Corporations, Joint Stock Companies, Associations, and Insurance Companies Imposed by Section 2, Act of October 3, 1913, art. 86 (1914). Only so-called "ordinary copartnerships" fell outside the scope of the term "corporation". Id. at art. 94. A limited partnership was later defined as any partnership with at least one partner whose liability for the debts of the firm was limited to the amount of capital invested by him. I.R.S. Regulations No. 33 (revised) art. 62, Governing the Collection of the Income Tax Imposed by the Act of September 8, 1916, as Amended by the Act of October 3, 1917 art. 62 (1918).

[85] See War Revenue Act of 1917, ch. 63, § 1206(2), 40 Stat. 300, 334.

[86] Revenue Act of 1918, ch. 18, § 230(a), 40 Stat. 1057, 1075; § 220, 40 Stat. at 1072.

been the sole vehicle for pursuing progressive tax objectives. Congress also restructured the normal tax by replacing the single flat rate with a graduated tax consisting of two brackets.

Under the normal tax for calendar year 1918, the first $4000 of net income above an exempt amount was taxed at 6%, while any remaining net income was taxed at 12%.[87] As under existing law, the normal tax applied to an individual's share of partnership profits.[88] However, corporate dividends were exempt from this tax.[89] To make up for this exemption, the corporation had to pay a 12% tax on its net income.[90]

The adoption of a two-tiered normal tax, alongside a flat corporate tax, perpetuated and magnified the disparities between the taxation of corporate profits and the taxation of other business profits. In cases where a married shareholder's income did not exceed the relatively modest $2000 exemption, there would be a 12% tax on income that would otherwise be tax-free. In addition, if the shareholder's income fell between $2000 and $6000, the corporate tax would be double the tax the shareholder would pay on his share of profits from an unincorporated business. Under existing law, by contrast, corporate dividends were overtaxed in those few cases in which a married couple's income did not exceed a $4000 exempt amount.[91]

After 1918, the normal tax rates were scheduled to be adjusted in a way that would magnify the disparities even further. Starting in 1919, the first $4000 of net income above an exempt amount was taxed at 4%, while all other net income was taxed at 8%.[92] By contrast a flat tax of 10% applied to corporate profits, which was higher than both rates established for the normal tax.[93] As a result, corporate dividends were overtaxed in all cases, with the difference being no less than two percentage points.

The structure of the corporate tax was the result of a compromise. Under the bill reported out of the Ways and Means Committee and passed by the House, a corporation was subject to a two-tiered tax. A 12% tax applied to that portion of the corporation's net income that was either (1) distributed to shareholders as a dividend, (2) paid out to satisfy certain corporate debt, or (3) paid out to buy Liberty Bonds.[94] Meanwhile, an 18% tax applied to the rest of the corporation's net income.[95] This compares to a two-tiered normal tax on individual incomes, consisting of a 4% levy on the first $4000 of income and 12% on the rest.[96]

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[87] § 210(a), 40 Stat. at 1062. When computing net income for purposes of the normal tax only, a single person was allowed to exclude $1000, while a married couple or head of a family could exclude $2000. § 216(c), 40 Stat. at 1069. In addition, any taxpayer was entitled to reduce his net income by an additional $200 for each dependent he could claim. § 216(d), 40 Stat. at 1069.
[88] § 218(a), 40 Stat. at 1070.
[89] § 216(a), 40 Stat. at 1069.
[90] § 230(a)(1), 40 Stat. at 1076. A corporation was allowed to reduce its net income by $2000 for purposes of computing its income tax liability. § 236(c), 40 Stat. at 1080.
[91] The existing exemption for an unmarried individual was $3000. Revenue Act of 1916, ch. 463, § 7(a), 39 Stat. 756, 761, *as amended by* War Revenue Act of 1917, ch. 63, § 1203, 40 Stat. 300, 331.
[92] Revenue Act of 1918, ch. 18, § 210(b), 40 Stat. 1057, 1062.
[93] § 230(a)(1), 40 Stat. at 1076.
[94] H.R. REP. NO. 65-767, at 12 (1918), *reprinted in* 1939-1 (part 2) C.B. 86, 94.
[95] *Id.*
[96] *Id.* at 4.

The House adopted this plan, but the Senate Finance Committee rejected it on the grounds that the House plan failed to recognize the idea that a corporation should not be taxed at a higher rate on investments that would lead to increased production in future years.[97] However, the committee openly acknowledged that it would be difficult to implement a system that would relieve from tax all "legitimate uses of earnings," including amounts that a corporation invested in the business.[98] Because it was impossible to implement such a system, the committee decided to restore the flat 20% tax (8% after 1918) on corporations and to limit the war-excess profits to corporations.[99] Thus, the Senate Finance Committee viewed the flat rate as the best of all options and treated the war-excess profits tax on corporations as a substitute for a tax on undistributed earnings.[100]

The two competing measures were reconciled in the Conference Committee. Under that compromise, the House reluctantly agreed to restore the flat tax on the condition that it would be set at 10% after 1918, and not the 8% that was part of the bill passed by the Senate.[101] The House conferees also believed that the pressure to raise revenue had been considerably reduced between the time the measure was voted out of committee and the time it was in the hands of the Conference Committee. When the Ways and Means Committee was drafting the bill, World War I was still going on and the 18% tax was part of an overall effort to raise all the revenue that the government could reasonably justify. The conferees were particularly mindful of the fact that the high surtax rates on individual incomes would increase the incentive for corporations to accumulate profits and to not pay them out to shareholders as dividends.[102] By the time the conferees met to reconcile the competing revenue bills, the war was over and the government was not under the same pressure to raise money. However, even though the government's need for money had declined, one would still have to question whether the bill contained adequate safeguards or incentives to prevent the unreasonable accumulation of corporate profits.

b. Changes to the Surtax

Congress changed the surtax by adding more brackets and increasing the tax rate for the highest bracket. There were fifty-four surtax brackets (up from thirteen) with rates ranging from 1% to 65%.[103] As in all past

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[97] S.REP. No. 65-617, at 5 (1918), *reprinted in* 1939-1 (part 2) C.B. 117, 120. Indeed this approach was the exact reverse of the one taken under the undistributed profits tax, which did not impose tax on amounts reinvested in the business. Senator Boies Penrose described the arrangement in the House Bill as one that would penalize corporations that practiced "conservative methods of business administration which have characterized the most wisely handled corporations." 57 CONG. REC. 549 (1919).

[98] S. REP. No. 65-617, at 5.

[99] *Id.* At the time the war-excess profits tax applied to every individual, partnership, and corporation. War Revenue Act of 1917, ch. 63, § 201, 40 Stat. 300, 303.

[100] 57 CONG. REC. 3010 (1919) (exchange between Reps. Stafford and Kitchin).

[101] 57 CONG. REC. 3005, 3132 (1919) (remarks of Representative Kitchin, remarks of Senator Furnifold Simmons).

[102] 57 CONG. REC. 3005 (1919) (remarks of Representative Kitchin).

[103] The 1% surtax applied on net income above $5000 and up to $8000, while the 65% surtax applied to net income in excess of $1 million. Revenue Act of 1918, ch. 18, § 211(a), 40 Stat. 1057, 1062–64.

Revenue Acts, the surtax applied to an individual's share of partnership profits, whether distributed or not. However, it only applied to an individual's share of corporate profits actually distributed.[104] The 1917 War Revenue Act addressed this disparity by taxing a corporation on a portion of its undistributed profits.[105] One year later, Congress changed its approach. It discarded the undistributed profits tax in 1918 and replaced it with a slightly modified version of the tax on accumulated earnings that was first adopted in 1913.[106]

Under the revised version of the accumulated earnings tax, any corporation that fraudulently accumulated earnings was subject to the rules that applied to personal service corporations, while the corporate income tax did not apply.[107] The personal service corporation rules expressly required the shareholders to be taxed on their share of firm profits as if they were members of a partnership.[108] The result was that each shareholder had to pay the normal tax and the surtax on their share of firm profits, whether paid out to them or not.[109]

To make up for the absence of a tax on undistributed profits, Congress recalibrated the war-excess profits tax and restricted its application to corporations.[110] This represented a change from existing law that imposed the war-excess profits tax on corporations, partnerships and individuals alike.[111] The recalibrated war-excess profits tax, together with the other taxes that would have to be paid by the firm and its shareholders on corporate profits, had severe consequences for a substantial number of corporations. In order to provide some relief to this class of corporations, Congress adopted a measure that caused them to be treated like partnerships for federal income tax purposes.

c. Corporations Taxed Like Partnerships

A firm's war-excess profits tax liability was the product of a complex formula. At bottom, however, the tax was based on the firm's net income.[112] Thus, the higher the firm's net income, the higher its tax liability. However, the formula operated in such a way that a firm's tax liability would fall as the amount of a firm's invested capital rose.[113] Thus, the more invested

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Individuals were no longer subject to the war profits tax enacted as part of the War Revenue Act of 1917. *Id.*

[104] § 218(a), 40 Stat. at 1070; § 213(a), 40 Stat. at 1065.

[105] War Revenue Act of 1917, ch. 63, § 1206(2), 40 Stat. 300, 334.

[106] Revenue Act of 1918, ch. 18, § 230(a), 40 Stat. 1057, 1075; § 220, 40 Stat. at 1072.

[107] § 220, 40 Stat. at 1072.

[108] § 218(e), 40 Stat. at 1070.

[109] The application of section 220 appeared to be quite cumbersome. The Treasury declared in an early pronouncement that "[w]hether a corporation is taxable under section 200 cannot be determined in advance; it must be determined at a later date in the light of what it has actually done with the profits retained." T.B.M. 2, 1 C.B. 181 (1919). The implication is that the corporation and its shareholders would report income and pay tax as if the provision did not apply. If the government determined that the provision did apply, then adjustments would have to be made at both the firm level and the shareholder level to reverse the original treatment and to conform to partnership treatment.

[110] § 301(a), 40 Stat. at 1088.

[111] War Revenue Act of 1917, ch. 63, § 201, 40 Stat. 300, 303.

[112] *See* Revenue Act of 1918, ch. 18, § 301(a), (b), 40 Stat. 1057, 1088; *Cf.* War Revenue Act of 1917, ch. 63, § 201, 40 Stat. 300, 303.

[113] § 301(a), (b), 40 Stat. at 1088.

capital, the lower the war-excess profits tax liability. Invested capital included, among other things, the amount of cash and the value of any property contributed to the firm by its shareholders.[114] It also included any profits from past years that were invested in the business instead of being paid out to the shareholders.[115]

In the event a firm had no invested capital, the war-excess profits tax was solely a function of its net income. For 1918, a firm with no invested capital had to pay a 30% tax on net income between $3000 and up to $20,000, plus an 8% tax on its net income over $20,000.[116] That tax would be in addition to the 12% corporate tax. Moreover, if the firm paid out after-tax profits to its shareholders, those investors would have to pay surtax at rates ranging from 1% to 65%. Thus, it is not hard to see how a corporation with no invested capital was at risk of being taxed out of existence.[117] Indeed, some lawmakers made that very point.[118]

In order to address this situation, Congress decided to treat a certain class of corporations with no invested capital as partnerships for federal income tax purposes.[119] The relief was restricted to so-called personal service corporations. The term referred to any corporation that met two conditions. First, the firm had to derive its income primarily from the activities of its principal stockholders who were also regularly engaged in the affairs of the business. Second, capital could not be a material income-producing factor for the business.[120]

It took a while for lawmakers to identify a suitable way to address the predicament of corporations with no invested capital. Under the bill reported out of the House Ways and Means Committee, a maximum war-excess profits tax of 20% would have applied to the earnings of any corporation whose activities were to be ascribed to its stockholders and not to the invested capital.[121] Meanwhile, the Senate bill imposed an 8% flat tax on the net income of such corporations.[122] The Conference Committee eventually resolved the situation by treating a personal service corporation like a partnership.[123] Thus, the business was exempt from the 12% (falling to 10% after 1918) corporate tax.[124] It was also exempt from the war-excess profits tax.[125] Instead, the shareholders were taxed on their share of profits

[114] § 326(a), 40 Stat. at 1092; *Cf.* War Revenue Act of 1917, ch. 63, § 207, 40 Stat. 300, 306.
[115] § 326(a), 40 Stat. at 1092.
[116] § 302, 40 Stat. at 1089. The tax was lowered for 1919. In that year a corporation with no invested capital had to pay a 20% tax on its net income over $3000 and up to $20,000, plus a 40% tax on its net income over $20,000. *Id.*
[117] The possibility of being taxed out of existence seemed unlikely under the original war-excess profits tax. It imposed on every corporation an 8% tax on net income over $3000. War Revenue Act of 1917, ch. 63, § 209, 40 Stat. 300, 307. A partnership had to pay an 8% tax on net income over $6000. *Id.*
[118] 57 CONG. REC. 3135, 3135–36 (1919) (remarks of Senator Simmons); *see also* 57 CONG. REC. 501 (1919) (remarks of Senator Reed Smoot).
[119] Revenue Act of 1918, ch. 18, § 218(e), 40 Stat. 1057, 1070.
[120] § 200, 40 Stat. at 1059. However, the term did not refer to any corporation where at least 50% of the gross income was derived from trading as a principal. *Id.*
[121] 57 CONG. REC. 3008 (1919) (statement of Rep. Kitchin).
[122] 57 CONG. REC. 3136 (1919) (statement of Sen. Simmons).
[123] § 218(e), 40 Stat. at 1070.
[124] *Id.*
[125] 57 CONG. REC. 3136 (1919) (statement of Sen. Simmons).

derived by the firm during the year, whether it was paid out to them or not.[126]

The measure was lauded for establishing parity in the taxation of personal service corporations, partnerships and sole proprietors.[127] It may be difficult to appreciate what a personal service corporation has in common with a partnership that would justify taxing their profits under the same set of rules. However, it seems fairly clear that the measure did in fact exclude from the corporate tax regime a subcategory of corporations that may not have deserved to be there in the first place. After all, the special way of taxing corporate profits was justified on the grounds that the firm could and would retain a portion of its earnings so that they could be reinvested in the business. The firms singled out to constitute personal service corporations, however, were those that had no need to retain their earnings for future investment because capital investments were not a material income producing factor for those firms. Thus, by preventing the profits of a personal service corporation from being taxed as if it were derived by a corporation, the measure implicitly reaffirmed the theory underlying the corporate tax regime. The measure also served the interests of equity by preventing a firm from being treated as if it possessed singular quality that justified the application of the corporate tax rules when in fact the firm lacked that very quality. It is far from clear, however, whether Congress was aware that the measure would have this effect. To the contrary, Congress seemed to be solely focused on simply preventing firms from being taxed out of existence.

d. More Corporations Taxed Like Partnerships

Congress revisited the rules directed at corporations that attempted to prevent the shareholder level surtax from coming into play by failing to pay out a sufficient portion of its profits. Until 1917, the law treated such corporations in a way that resembled partnerships under the accumulated earnings tax rules.[128] In 1917, Congress replaced that scheme with a tax on a portion of a corporation's undistributed profits.[129] One year later, in 1918, Congress discarded that tax on undistributed profits and reinstituted the accumulated earnings tax in a modified form.

Under the 1918 Act, any corporation that failed to pay out enough profits was subject to the rules that applied to a personal service corporation.[130] That meant the corporation was expressly treated as a partnership for federal income tax purposes.[131] Thus, the shareholders of the corporation would have to pay both the normal tax and the surtax on their share of the firm's profits, whether paid out to them or not.[132] The

[126] § 218(e), 40 Stat. at 1070.
[127] *See* 57 CONG. REC. 3136 (1919) (statement of Sen. Simmons).
[128] Revenue Act of 1913, ch. 16, § II.A., 38 Stat. 114, 166.
[129] War Revenue Act of 1917, ch. 63, § 1206(2), 40 Stat. 300, 334.
[130] Revenue Act of 1918, ch. 18, § 220, 40 Stat. 1057, 1072.
[131] § 218(e), 40 Stat. at 1070.
[132] As a technical matter, the statute required the shareholders to pay the normal tax and surtax on amounts actually received from the firm and on their respective shares of any undistributed profits for the year. § 218(e), 40 Stat. at 1070. There was only one situation in which this procedure would not

corporation itself was not subject to the corporate tax as had been the case under prior law.[133] However, unlike a partnership, a corporation that unlawfully accumulated profits remained liable for the war-excess profits tax.[134]

The accumulated earnings tax rules were modified in one additional way. In its earlier incarnation, the tax would not kick in unless there was evidence that the corporation was "fraudulently" availed of to avoid the surtax on individuals.[135] The 1918 Act eliminated this requirement of proving fraud when earnings of a corporation were allowed to accumulate for the purpose of preventing the imposition of the surtax upon stockholders. The Senate believed that the government carried too high a burden of establishing fraud, making it too difficult to punish unlawful conduct and preventing the provision from having any practical value.[136]

The accumulated earnings tax provisions evolved over the course of time, as the tax bill was under consideration by Congress. The original bill reported out of the House Ways and Means Committee essentially reinstituted the accumulated earnings tax that was replaced in 1917 by the undistributed profits tax.[137] The Senate Finance Committee introduced the idea of simply treating as a personal service corporation any corporation that unlawfully failed to distribute enough earnings.[138] The Senate proposal also specified that any such corporation would be exempt from the war-excess profits tax.[139] Although the Senate's approach prevailed by the time the revenue bills were reconciled by the Conference Committee, lawmakers eliminated the exemption from the war-excess profits tax.[140]

The measure ultimately enacted did not cause a corporation to be taxed like a partnership in all respects since the accumulated earnings tax provisions did not relieve a corporation from the war-excess profits tax. However, solely from an income tax perspective, the corporation was in fact treated like a partnership. The residual war-excess profits tax liability might be viewed as the penalty for not paying enough dividends. More importantly, for purposes of this analysis, Congress disregarded the firm's business form in order to address the specific inequity that would arise if a

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result in the same tax liability as that produced under the partnership rules. That was when the firm paid out more than it earned in a year. However, that scenario fell outside of the scope of the accumulated earnings tax because its provisions were triggered only when a firm paid out less than what it earned in a given year.

[133] § 220, 40 Stat. at 1072.

[134] H.R. 1037, 65th Cong. at 52–53 (3d Sess. 1918). Any war-excess profits paid by the firm reduced the amount of undistributed earnings that had to be taxed to the shareholders. § 220, 40 Stat. at 1072.

[135] Revenue Act of 1913, ch. 16, § II.A.2, 38 Stat. 114, 166; Revenue Act of 1916, ch. 463, § 3, 39 Stat. 756, 758.

[136] *See* S. REP. No. 65–617, 65th Cong., 3d Sess. at 5 (1918). *See also* 57 CONG. REC. 253 (1918) (Where describing the need to eliminate the element of fraud, Senator Simmons described the class of cases that was the target of the provision by stating that "[t]here is no doubt but that there are a number of so-called close corporations, corporations with only a small number of stockholders that have been organized primarily for the purpose of availing themselves of the privilege of retention to escape surtaxes upon their earnings.").

[137] *See* SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS, 1938–1861, at 924–25 (1938).

[138] *See id.* at 925.

[139] *See id.*

[140] *See id.*

firm were treated as if it possessed the singular quality that justified the application of the corporate tax rules when in fact the firm lacked that very quality. Moreover, because the accumulated earnings tax was triggered when a firm retained more earnings than it needed, the measure was designed in a way that reaffirmed the very theory of the corporate tax rules: the partial tax relief was made available on the assumption that the retained earnings would be invested in the business. However, reasonable minds might question whether the measure was properly targeted, and whether treating the targeted firms as partnerships was the correct solution.

e. Partnerships Taxed Like Corporations

Corporations enjoyed a substantial tax advantage over partnerships under the Revenue Act of 1918. The war-excess profits tax functioned as the corporate counterpart of the individual surtax on partnership profits. In fact, each tax was imposed at a top rate of 65%. However, there was one crucial difference that caused the two taxes to produce significantly different outcomes. A corporation could reduce its war-excess profits tax liability by investing in the business. By contrast, if a partnership invested its earnings in the business, the partners realized absolutely no relief from the surtax, even if the firm invested all of the profits in the business and paid out nothing to the partners.

Congress was well aware of the advantage that corporations were expected to enjoy. One lawmaker even cited the case of one partnership that would have to pay nearly $1 million more in tax than a corporation engaged in the same business and making the same profits.[141] Faced with the possibility of saving tax dollars by operating as a corporation, partnerships were expected to convert to corporate form. However, the Revenue Act of 1918 was not passed until February 24, 1919, even though its provisions took effect on January 1, 1918.[142] That meant that if a partnership decided to convert to corporate form, it would have missed out on a full year of tax savings even if it underwent a conversion immediately after the Act was signed into law. Congress addressed the situation by permitting any partnership or sole proprietorship that incorporated before July of 1919 to be treated as a corporation retroactively to January 1, 1918.[143] This election was only available to a business in which capital was a material income-producing factor.[144] In other words, a firm that was a partnership for up to eighteen months could have made an election to be taxed as if it were a corporation throughout that period of time.

This particular provision is similar to the other twentieth century measures examined above. First, it implicitly reaffirmed the theory behind the existence and design of the corporate tax: Corporate profits enjoyed partial tax relief because at least a portion of the firm's earnings were expected to be reinvested in the firm itself. The only unincorporated firms that could take advantage of the retroactive corporate election were those

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141 57 CONG. REC. 3269 (1919) (remarks of Senator Smoot).
142 *Id.*; Revenue Act of 1918, ch. 18, § 210(a), 40 Stat. 1057, 1062; § 301(a), 40 Stat. at 1088.
143 § 330, 40 Stat. at 1094.
144 *Id.*

for whom capital investments played a material role in generating income. Thus, such unincorporated firms could be expected to use a portion of their profits to finance future capital investments, just as a corporation was expected to do. A firm that derives its income primarily through the provision of services could not make that same claim. Not only did the retroactive corporate election implicitly reaffirm the rationale for the corporate tax, it also helped advance the interests of equity by extending the application of the corporate tax rules to firms that did in fact possess the singular quality that justified the very existence of those rules.

Still, this particular provision stands out from the other measures that tax a firm in a way that does not correspond to its business form. This is the first occasion in which Congress was not motivated solely by a desire to produce equal (or nearly equal) outcomes. Instead, it would seem more accurate to characterize this provision as one in which Congress seemed at least partly focused on providing firms with an equal opportunity to control tax outcomes. This was so because the profits of an unincorporated firm were not required to be taxed as if they were derived by a corporation whenever capital was a material income producing factor for the firm. It was merely an optional way for the profits to be taxed. To that extent, this provision foreshadows an approach that the government would take in later years.[145]

3. *1921–The Government Could Selectively Allow Certain Corporations to be Taxed Like Partnerships*

Congress waited just two years before revisiting the nation's income tax laws again. The changes it made increased existing disparities between the taxation of corporate profits and the taxation of profits from an unincorporated business. Because the changes effectively gave corporations a greater tax advantage than they had before, the law increased the need for effective measures directed at abuses of the corporate form. Under the 1918 Act, the governmental response was to treat a corporation as a partnership in all cases when there was an unlawful accumulation of profits. Under the 1921 Act, the government simply imposed a severe monetary penalty on the corporation. However, as explained below, the penalty could be waived in certain cases where the Commissioner of Internal Revenue allowed the corporation to be treated as a partnership for tax purposes. As in past years, the measure was largely a response to the government's past experience with the policy to exempt certain undistributed corporate earnings from tax and the modifications it contemplated making to the larger tax system.

a. Changes to the Tax System

Congress increased the corporate tax rate and eliminated the war-excess profits tax on corporations. Under the Revenue Act of 1921, a corporation had to pay a 12.5% tax on its entire net income, up from 10%

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[145] See Treas. Reg. § 301.7701-3(a) (2006) (permitting an unincorporated business entity to elected to be treated as a corporation for tax purposes). See also I.R.C. §§ 1363(a) and 1366 (2009) (permitting certain eligible corporations to elect to have their profits taxed on a flow-through basis, similar to the way that partnership profits are taxed to the partners, not the partnership).

under the existing law.[146] At the same time, the war-excess profits tax was scheduled to expire after 1921.[147] This was significant because the war-excess profits tax was initially viewed as a substitute for a tax on undistributed corporate profits. Now there was neither a tax on undistributed profits, nor a substitute for one; perhaps the increase in the corporate tax was meant to fill the gap. The absence of a war-excess profits tax also eliminated the problems that made it necessary to treat a personal service corporation as a partnership under existing tax law. Understandably, the personal service corporation rules expired along with the war-excess profits tax after 1921.[148]

Meanwhile, the legislation did not materially change the tax on individuals. It retained the two-tiered rate structure that was then part of the normal tax, with the first $4000 of an individual's net income above an exempt amount being taxed at 4%, and all other net income taxed at 8%.[149] Individuals also remained liable for the surtax under a schedule of fifty-four rates ranging from 1% to 65% for 1921.[150] Starting in 1922, the schedule contained forty-eight rates ranging from 1% to 50%.[151] Any partner in a partnership remained liable for both the normal tax and the surtax on his share of partnership profits, whether he received them as a distribution or not.[152] Corporate profits distributed as a dividend remained exempt from the normal tax but subject to the surtax.[153]

b. Corporations Taxed Like Partnerships

The combination of provisions in the 1921 Act made it even less attractive for a corporation to distribute its profits to its shareholders. Any dollar of profits would have already been subject to a 12.5% tax paid by the corporation. In addition, any after-tax profits distributed to a shareholder would have been subject to a surtax of as much as 50%. Meanwhile, any dollar that the corporation did not distribute would have been subject to the 12.5% corporate tax and no other tax other than the war-excess profits tax.

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[146] Revenue Act of 1921, ch. 136, § 230, 42 Stat. 227, 252. A corporation was generally allowed to reduce its net income by $2000 when computing its income tax liability. § 236(b), 42 Stat. at 257.
[147] *See* § 301(a)–(b), 42 Stat. at 272. The tax was imposed for 1921 and was not extended, renewed or reenacted. Jesse I. Miller, *High Lights of the Federal Revenue Act of 1921*, 95 CENT. L.J. 106, 108 (1922).
[148] § 218(d), 42 Stat. at 245–46. *See also* § 231(14), 42 Stat. at 254 (repeal of exemption from corporate tax).
[149] § 210, 42 Stat. at 227. However, the 1921 Act did change the exemptions that were available to individuals. When computing net income for purposes of the normal tax only, a single person was allowed to exclude $1000, while a married couple or head of a family could exclude $2500 (up from $2000). However, the exclusion was capped at $2000 for any married couple or head of a family whose net income exceeded $5000. § 216(c), 42 Stat. at 243. In addition, any taxpayer was entitled to reduce his net income by an additional $400 (up from $200) for each dependent he could claim. § 216(d), 42 Stat. at 243.
[150] A 1% tax applied to net income over $5000 and up to $6000, while the 65% tax applied to net income over $1 million. § 211(a)(1), 42 Stat. at 233–35.
[151] A 1% tax applied to net income over $6000 and up to $10,000, while a 50% tax applied to net income over $200,000. § 211(a)(2), 42 Stat. at 235–37.
[152] § 218(a), 42 Stat. at 245.
[153] § 216(a), 42 Stat. at 242.

Not only did a corporation have a greater incentive to retain as much profit as it could, but when it did so, it also operated at a far greater advantage over any partnership. Any dollar of partnership profits would have been subject to a normal tax up to 8% and a surtax of up to 65% for 1921 (reduced to 50% starting in 1922), a combined tax that far exceeded the 12.5% corporate tax on undistributed corporate profits.

The incentives built into the Act made it necessary to fortify the penalties for abusive practices. Congress revised the accumulated earnings tax in a way that would increase the price to a corporation that failed to distribute enough of its profits. Under the revised rules, the corporation had to pay a 25% penalty tax on its net income in addition to the 12.5% corporate tax that had already been paid.[154] Moreover, the surtax of up to 50% would have applied to any after tax profits that were later distributed to shareholders. Under the prior law, the shareholders were required to pay the penalty by treating the undistributed profits as if they were distributed. The change in procedure was adopted in order to comply with the Supreme Court's decision in *Eisner v. Macomber* that cast doubt on the constitutionality of taxing stockholders on the undistributed profits of a corporation.[155]

The statute gave the Commissioner the power to waive the accumulated earnings penalty if the shareholders agreed to be taxed on their share of firm profits, as if the business were a partnership.[156] This election to treat the firm as a partnership was only available when the corporation had been found to have unlawfully accumulated profits. In the event such permission was granted, the corporation would not be liable for any income tax or war-excess profits tax for the year.[157] A corporation could not eliminate its exposure to the accumulated earnings penalty by electing to treat the corporation as a partnership for income tax purposes.[158] Senator Andrieus Jones of New Mexico suggested that the option of taxing corporate profits under the partnership rules should be an option that ought to be available to all corporations, not just those that are determined to be organized for the purpose of avoiding the surtax; that suggestion was rejected.[159] These views seem out of step at a time when Congress appeared to be trying to draw substantive distinctions between firms when determining how the profits should be taxed. However, these minority views would foreshadow a growing willingness of the government to abandon its attempts to identify and make substantive distinctions between

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[154] § 220, 42 Stat. at 247.

[155] H.R. REP. NO. 67-350, at 12–13 (1921). The *Eisner* Court concluded that a shareholder could not be taxed on the value of a dividend paid in the form of stock in the dividend paying corporation because such a stock dividend represented nothing more than an increase in the value of the investment, not an item of taxable income that has been severed from the investment and received by the taxpayer for his separate use, benefit and enjoyment. *Eisner v. Macomber* , 252 U.S. 189, 209–11 (1920).

[156] Revenue Act of 1921, ch. 136, § 220, 42 Stat. 227, 247. This procedure would apply only if the shareholders unanimously agreed to it and if the Commissioner also consented. *Id.*

[157] *Id.*

[158] *See* I.T. 1289, I-1 C.B. 218 (1922). In that case the stockholders sought permission to be taxed as members of a partnership on the profits of the corporation whose retained profits were to be reinvested in the business. That request was denied on the grounds that the option was only available to a corporation that accumulated earnings in order to avoid the surtax.

[159] 61 CONG. REC. 7483 (1921).

firms, and to simply give them the option to choose how their profits are taxed.[160]

The option to be treated as a partnership remained a part of the accumulated earnings tax provisions until 1924. In that year, Congress doubled the penalty imposed on the corporation and eliminated the ability of the Commissioner to allow shareholders to choose to be taxed like partners in a partnership.[161] However, this was not the approach that was first proposed.

The bill reported out of the House Committee on Ways and Means did not change the existing law. Thus, it provided for a 25% penalty tax on corporate net income with the option for shareholders to eliminate the firm's liability for the penalty if they elected to have the corporation treated as a partnership for income tax purposes. The Senate Committee eliminated the option as a result of a decision to increase the penalty tax rate to 50%, which was considered to place a more effective check on the evasion of the individual surtax.[162] The Senate amendment was ultimately adopted.[163]

Not all lawmakers were convinced that a fortified accumulated earnings penalty would have much of an effect, partly because the provision did not appear to have a very good track record of discouraging tax evasion.[164] The minority report of the Senate Finance Committee expressed its doubts this way.

> It is true a penalty against the organization of a corporation for the sole purpose of evading taxation is included in the present law and increased in the proposed bill. In actual result, however, such penalty provision has been and will be for all practical purposes a nullity. The penalty of the present law has only been applied in one or two cases. The Secretary testified before the committee that corporations were not being availed of so as to result in a decrease in taxation. Before another committee of the Senate a prominent attorney from the city of New York testified that such was generally being done. We believe that so long as the inducements exist in the law they will be availed of by interested taxpayers.[165]

As with past versions of the accumulated earnings tax, the 1921 version reflected a Congressional judgment that it would be inequitable to extend corporate tax relief to a certain class of undeserving corporations. The default response was to impose a penalty on the firm in such cases. However, treating the firm like a partnership was an alternative to paying the penalty. When the partnership rules did apply, the firm's profits were

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[160] *See infra*, notes 168-171 and accompanying text.
[161] Revenue Act of 1924, ch. 234, § 220(a), 43 Stat. 225, 277.
[162] S. REP. NO. 68-398, at 26 (1924).
[163] § 220(a), 43 Stat. at 253, 277.
[164] During the floor debates on the 1924 Act, Senator George Norris observed that the use of corporations to evade surtax was a routine device for evading the surtax. "Everybody knows that it is quite common for men to escape taxation on incomes from Liberty bonds by organizing corporations really for the purpose of holding those Liberty bonds, and thus escaping the surtaxes they would have to pay if they owned them individually." 65 CONG. REC. 7359 (1924).
[165] S. REP. NO. 68-398, at 8–9 (1924) (minority).

not taxed in a way that corresponded to its business form.[166] Congress did this in order to correct a specific inequity. As with the other provisions examined in this study, the measure implicitly reaffirmed the theory that justified giving partial tax relief to corporations: that the earnings not paid out to shareholders would be reinvested in the firm. Thus, the firms singled out under the accumulated earnings tax were limited to those that retained more earnings than necessary to meet their future needs. The measure also served the interests of equity by attempting to prevent the corporate tax rules from applying to firms that did not possess the singular quality that justified the very existence of those rules.

III. A GLANCE AHEAD

In subsequent tax acts, Congress continued to modify the tax rules that applied to certain firms where the default rules would have produced inequitable outcomes. Many of those anti-abuse provisions were directed at corporations that sought to exploit the tax relief on undistributed corporate profits. However, Congress declined to simply treat the corporations as partnerships as part of the solution in those cases.[167] It was not until 1954 that Congress would adopt a measure that would tax a firm's profits in a way that did not correspond to the firm's business form. In that year, Congress enacted subchapter R that gave certain partnerships the option to be taxed under the rules that applied to corporations.[168] Four years later Congress enacted a complementary set of rules that now constitutes subchapter S of the Internal Revenue Code.[169] Those rules permit certain eligible corporations to elect to be taxed under a modified version of the rules that apply to partnerships. Subchapters R and S would foreshadow the check-the-box business entity classification regulation that have now been in effect for a decade.[170] Under those rules, any unincorporated business entity (including partnerships and limited liability companies) can elect to be treated as a corporation for federal income tax purposes by merely checking off a box on a form.[171] The check-the-box entity classification rules completely abandon any effort to identify substantive qualities of the firm that would justify applying one set of tax rules over another.

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[166] As a practical matter, it does not appear that very many corporations had to pay the accumulated earnings tax. By 1934, there were five reported cases where the government attempted to asses the tax, and it did not prevail in all of those cases. Richard Winchester, Parity Lost: The Price of a Corporate Tax in a Progressive Tax World, 9 Nev. L.J. 130, 173 n.344 (2008). Still, the mere existence of the provision and its operative rules sheds light on what lawmakers viewed to be the relevant factors for drawing distinctions among incorporated firms and the proper methods for taxing the profits of the firms in each subgroup.

[167] Rather, the general pattern was to treat the corporation as one that had distributed the profits it had actually retained. *See* Revenue Act of 1926, ch. 27, § 220(e), 44 Stat. 9, 34–35 (accumulated earnings provisions); Revenue Act of 1934, ch. 277, § 351(d), 48 Stat. 680, 752 (personal holding company provisions); Revenue Act of 1937, ch. 815, § 201, 50 Stat. 813, 822, enacting § 337(a) and (b) as a new provision of the Revenue Act of 1936 (foreign personal holding company provisions); Revenue Act of 1938, ch. 289, § 28(f), 52 Stat. 447, 472 (consent dividends provisions).

[168] I.R.C. § 1361, 68A Stat. 350 (LexisNexis 1954), *repealed by* Act of April 14, 1966, Pub. L. No. 89-389, 80 Stat. 111.

[169] Technical Amendments Act of 1958, Pub. L. No. 85-866, § 64(a), 72 Stat. 1606, 1650.

[170] *See* Treas. Reg. § 301.7701-3 (2006).

[171] Treas. Reg. § 301.7701-3(a) (2006).

IV. ANALYSIS AND CONCLUSION

Scholars typically apply three criteria to evaluate a tax: fairness, efficiency and simplicity.[172] Of these three, fairness may be considered the most fundamental quality that a tax should possess because it reflects the universal desire for equity and equal treatment.[173] Indeed, the public has consistently displayed an expectation that equity should play a role in setting tax policy, even if it is not the dominant role.[174] Equity is usually understood to have two different dimensions in the tax setting: horizontal and vertical. Horizontal equity requires equal treatment to those with equal status. This is usually tested by asking whether those starting with the same before-tax income end up with the same after-tax income.[175] Vertical equity generally requires that those with less ability be treated favorably relative to those with greater ability.[176] Progressive tax systems such as the U.S. income tax are understood to better serve the interests of vertical equity precisely because higher tax rates are imposed on individuals with larger incomes.[177] However, a tax system's ability to achieve vertical equity depends in part on its ability to achieve horizontal equity in the first place. It seems clear from the foregoing account that horizontal equity in the taxation of firm profits has suffered with the passage of time.

The nation seemed to have its greatest success at achieving horizontal equity in the taxation of firm profits during the nineteenth century. During that period, lawmakers made the policy judgment that all firms were alike for tax purposes. Accordingly, the rules that applied were virtually uniform across all firms, producing uniform outcomes across all firms.

The experience was mixed during the early part of the twentieth century. It was during that period that Congress made the policy judgment that corporations were materially different from other business forms in ways that mattered for tax purposes. Thus, the profits of unincorporated firms were taxed in full under the normal tax and the surtax in the year they were earned. However, corporate profits enjoyed partial tax relief from the surtax on the theory that a business conducted in corporate form could and would use its undistributed earnings to make investments that would generate future income. Congress consistently reaffirmed this underlying theory on several occasions when it decided to tax a firm's profits in a way that did not correspond to its state law business form. Those measures, however, did not meet with uniform success in actually improving horizontal equity.

The theory underlying the distinction between firms was embraced by the way the accumulated earnings tax came into play. The measure denied a corporation the partial tax relief it would otherwise enjoy whenever the

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[172] MICHAEL A LIVINGSTON, TAXATION: LAW, PLANNING, AND POLICY, at xxxiv (2003).
[173] C. Eugene Steuerle, *And Equal (Tax) Justice for All?*, *in* TAX JUSTICE: THE ONGOING DEBATE 253, 254-57 (Joseph J. Thorndike & Dennis J. Ventry Jr. eds., 2002).
[174] *Id.* at 255-57.
[175] *Id.* at 258.
[176] *Id.*
[177] Wealth can be another indication of a person's ability to pay, but income has become the preferred measure. *Id*. *supra* note 176, at 270–71.

firm retained more earnings than necessary to meet its future needs. Whenever a corporation fell into that category, the firm's profits were taxed in a way that was virtually identical to the way the 1913 Act taxed the profits of a partnership. By 1918 the provision was revised to more directly state that the rules for taxing partnership profits would apply to those corporations falling within the scope of the provision. Because *Eisner v. Macomber* cast doubt on the constitutionality of taxing corporate profits as if they were derived by a partnership, Congress took a different approach in 1921 by simply requiring the offending firm to pay a penalty equal to 25% of its entire net income. However, the penalty could be eliminated if the shareholders agreed to be taxed on their share of the corporation's profits as if those amounts were derived by a partnership. Thus, even when forced to redesign the provision, lawmakers continued to implicitly reaffirm the idea that it was appropriate to tax corporate profits as if they were derived by a partnership when the corporation retained more earnings than necessary to meet its future needs.

Although intended and designed to deny partial tax relief to corporations that were not entitled to it, the accumulated earnings tax met with limited success in achieving its objectives. Throughout its history, lawmakers revisited the provision and made adjustments so that it might be a more effective deterrent against abusive practices. However, that never quite happened, largely because the measure was not self-executing. Instead, the government had to detect cases of abuse and prosecute them. Because this appears to have happened on very rare occasions, one must conclude that there were a substantial number of cases where a corporation enjoyed the partial tax relief available under the law even though the firm lacked the very quality that would entitle it to that relief.

The personal service corporation rules appear to have done more to enable the taxation of firm profits to occur in an equitable way. The firms singled out for treatment as a personal service corporation were precisely those that had no need to retain their earnings for future investment because a firm would qualify as a personal service corporation only if capital investments were not a material income producing factor for the firm. The profits derived by such firms were expressly taxed as if they were derived by a partnership, preventing a corporation from enjoying the partial tax relief available to a corporation because the firm was virtually certain not to possess the singular quality that would justify the relief.

Congress once again reaffirmed the theory for applying the corporate model of taxing firm profits when it decided to offer certain partnerships and sole proprietorships a limited retroactive election to be treated as a corporation. In this case, lawmakers for the first time permitted the profits of an unincorporated business to be taxed as if they were derived by a corporation. However, this option was only available if capital was a material income producing factor for the firm. In other words, the firm had to be one that would likely have a need to retain a portion of its earnings and reinvest them in the business. This measure may have done more to prevent than to promote the achievement of horizontal equity in the taxation of firm profits. On the one hand, the option was only available to unincorporated firms that were likely to possess the singular quality that justified the partial tax relief made available to corporations. However, because the firm's profits would be taxed as if derived by a corporation only if the business took advantage of the option, the measure left open the real possibility that the rule for taxing partnerships would apply to firms that in fact possessed the quality that would justify treating them like corporations—an outcome that would violate the principal of horizontal equity.[178]

The shortcoming of this elective measure is shared by the current check-the-box entity classification regulations and, to a lesser extent, the provisions of subchapter S of the Internal Revenue Code. Under those rules, a firm can elect whether its profits will be taxed in a way that corresponds to its state law business form. This elective feature is distinctive because it undermines the ability of a provision to achieve equitable outcomes or to prevent a provision from achieving inequitable outcomes. Rather, it is directed at giving a firm an equal opportunity to control tax outcomes.[179]

Rules that give taxpayers unbounded freedom to control tax outcomes are likely to produce outcomes that are more random than rational.[180] Logically, each firm will assess the merits of the option in light of its individual situation with an eye toward minimizing its tax bill. Some firms may take advantage of the option, while others may not. In the end, the laws are unlikely to apply in any principled way, and the results will reflect nothing more than the independent efforts by firms to minimize tax.[181]

It is hard to see how the principle of horizontal equity is served when there has been no effort to identify the qualities or characteristics that are shared by those firms opting out of the default set of rules. Horizontal equity also seems to be at risk when there is no attempt to identify the qualities or characteristics that set those firms apart from the ones that have not opted out of the default set of rules. Instead, the only thing that the electing firms have in common is that they have each determined that they will pay less tax by making the election to opt out of the default set of rules.

In any event, the trend over time seems clear. The interests of horizontal equity were best served in the nineteenth century when tax rules

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[178] Giving a firm the option to choose how its profits should be taxed may adversely impact horizontal equity in another way. Although the option may be technically available to all eligible firms, as a practical matter, it may only be available to only the wealthiest, most sophisticated ones who can navigate the complexity of the election process. Heather M. Field, *Choosing Tax: Explicit Elections as an Element of Design in the Federal Income Tax System*, 47 HARV. J. ON LEGIS. 21, 31-32 (2010).

[179] One scholar refers to this as a form a tax deregulation that is frequently wrongfully characterized as a form of tax simplification. *See* Steven A. Dean, *Attractive Complexity: Tax Deregulation, the Check-the-Box Election, and the Future of Tax Simplification*, 34 HOFSTRA L. REV. 405, 467 (2005).

[180] Such unbounded choices, like the check-the-box entity classification election, also runs the risk of increasing complexity for the taxpayer and the government, increasing costs incurred by the taxpayer, distorting the taxpayer's economic and business choices, and reducing revenue collections. Heather M. Field, *Choosing Tax: Explicit Elections as an Element of Design in the Federal Income Tax System*, 47 HARV. J. ON LEGIS. 21, 27-30 (2010).

[181] George K. Yin, *The Taxation of Private Business Enterprises: Some Policy Questions Stimulated by the "Check-The-Box" Regulations*, 51 SMU L. REV. 125, 130 (1997).

first disregarded a firm's business form and applied a virtually uniform rule in all cases. When the country adopted two different approaches for taxing business profits, Congress attempted, with limited success, to apply each approach only to those firms that had some meaningful quality in common. However, it did not take long before the country first experimented with the idea of giving firms the option to choose how their profits would be taxed. A policy of giving firms an equal opportunity to choose the tax rules that will apply to them has superficial appeal. However, because it comes at the expense of achieving equality of outcomes among taxpayers who share some relevant quality in common, equality of opportunity does not serve the interests of horizontal equity. There is little doubt that elective business entity classification rules, including the check-the-box rules adopted a decade ago, impair the ability of the tax system to operate in an equitable way. What may be more surprising and discouraging is the fact that the country initially made concerted efforts to achieve horizontal equity in the taxation of firm profits, and was actually largely successful at achieving it during the earliest experiments with an income tax. However, the principal of horizontal equity seems to have been largely abandoned today; the culmination of a journey that appears to have begun barely five years after the ratification of the Sixteenth Amendment, cleared the way for an income tax that could operate in an equitable way.