Corporations, Society and the State: A Defense of the Corporate Tax

Reuven S. Avi-Yonah
University of Michigan Law School, aviyonah@umich.edu

UNIVERSITY OF MICHIGAN

JOHN M. OLIN CENTER FOR LAW & ECONOMICS

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REUVEN AVI-YONAH

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ABSTRACT

This article attempts to provide the first comprehensive rationale for defending the current corporate income tax. It argues that the usual reasons given for the tax (primarily as an indirect way of taxing shareholders, or alternatively as a form of benefit tax) are inadequate. It then explains what the original rationale to adopt this tax was in 1909, namely to regulate managerial power, and that this rationale stems from the "real" view of the corporation, which was the dominant view throughout the many transformations underwent by the corporate form from Roman times to the present. Turning to normative argument, the article then argues that the regulatory rationale given for taxing corporations in 1909 is still valid, since similar social conditions continue to exist, and in fact is strengthened by the rise of multinational enterprises. Finally, the article argues that this rationale is necessary from a normative perspective to support the fight against the two crucial current threats to the corporate tax posed by the corporate tax shelter and tax competition phenomena.

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[1] **Irwin I. Cohn Professor of Law, the University of Michigan. B.A. (History), Hebrew University, 1983; Ph.D. (History), Harvard University, 1986; J.D., Harvard Law School, 1989.** **I would like to thank Bill Andrews, Steve Bank, Michael Barr, Suzie Blumenthal, David Bradford, John Braithwaite, Yariv Brauner, John Coates, Victor Fleischer, Rich Friedman, Bruce Frier, Bill Gale, Tom Green, Daniel Halperin, Al Harberger, David Hasen, Don Herzog, Jim Hines, Doug Kahn, Louis Kaplow, Marjorie Kornhauser, Rich Lavoie, David Lenter, Kyle Logue, Deborah Schenk, David Schizer, Steve Shavell, Dan Shaviro, David Skeel, Joel Slemrod, Kirk Stark, Bernie Wolfman, Eric Zolt, and participants in workshops at Columbia, Harvard, Michigan, NYU, Northwestern and UCLA Law Schools and at the Brookings Institution, and in the 2003 RegNet conference at Australian National University. Many thanks to Amir Chenchinski for meticulous research assistance.**

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

"The power to tax involves the power to destroy"[2]
(John Marshall)

"The power to tax is not the power to destroy while this Court sits"[3]
(Oliver Wendell Holmes)

Corporations are everywhere and nowhere in our society. They are everywhere, first and foremost, on the economic scene: over 80% of economic activity in the US is effectuated through the corporate form. But the reach of corporations is far broader than that. Many of our other institutions, including universities, churches, hospitals, and other non-profit organizations are in corporate form. Other salient features of our society, such as representative democracy, originated from the use of the corporate form in medieval England. Even the idea of the state itself originated in Roman and medieval legal notions about corporate bodies.

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

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

The goal of this article is to examine the relationship among corporations, society and the state through the lens of the corporate income tax. The corporate income tax offers a unique opportunity to examine this broader issue because, first, it is one way in which the state intervenes directly in the affairs of corporations; and second, because various theories of why the corporate income tax exists illustrate the dichotomy between the "real" and "aggregate"

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2 McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316, 431 (1819).

3 Panhandle Oil Co. v. Mississippi ex rel. Knox, 277 U.S. 218, 223 (1928).

views of the corporation. When the corporate tax was first adopted in 1909, the "real" view was dominant and the tax was conceived primarily as a device to regulate corporate management in relation to other stakeholders and the state. Today, on the other hand, the aggregate (nexus of contracts) view predominates, and so the tax is seen primarily as an indirect way of taxing shareholders.

The article is divided into four parts. Part 1 examines the current justifications for the existence of the corporate tax. Such an examination is needed first, because some academics and practitioners (including the former Secretary of the Treasury) dispute the need for a corporate tax, and second, because certain practical trends (primarily corporate tax shelters and tax competition) are eroding the existing corporate tax base, and it is hard to mount a convincing normative defense of the corporate tax against these trends without understanding why we need the tax in the first place. Part 1 concludes that the dominant current justifications for the tax are based on the aggregate model and are fundamentally flawed, and that current attempts to find alternative grounds for the tax are unconvincing as well.

Part 2 reconstructs the original reasons for the enactment of the corporate tax in 1909 and shows that it was based on a "real" theory of the corporation, and that the tax was viewed primarily as a regulatory device to limit the power of management. In that way it was different from an earlier corporate tax, the 1894 tax, which was viewed primarily as a way of taxing shareholders.

Part 3 begins the normative part of the article by asking whether the original motivation of the corporate tax has any continuing force today. It argues that it does, both because the real view is a better approximation of reality than the aggregate view, and because managerial power is an issue that is still very much with us. In fact, the rise of multinational enterprises is a new shift in the relationship among corporations, society and the state that requires a similar re-examination of the relationship as took place in 1909, and the corporate tax (extended internationally) can still play an important role in regulating that relationship.

Part 4 concludes by examining some of the policy implications of the above argument. In particular, it argues that the corporate tax should be retained and defended against both corporate tax shelters and tax competition. It also suggests that integration of the corporate and shareholder taxes, as partially adopted by Congress in 2003, is not necessary to prevent "double taxation", although it may perhaps be defended on different grounds.

1. Current Justifications for the Corporate Tax.

The corporate income tax is under attack. The former Secretary of the Treasury has announced that it should be abolished, and the current drive to eliminate the taxation of dividends can be seen as the first step toward that goal.[4] A significant number of tax academics have argued for repeal of the tax.[5] Other academics have urged radical reform of the tax.[6] And no serious academic has in recent years mounted a convincing normative defense of why this cumbersome tax should be retained.[7]

This lack of a normative justification for retaining the tax is important for three reasons. First, the corporate tax is very complicated and imposes significant transaction costs on society. Many of the best-educated and most talented tax lawyers in this country devote their careers to the intricacies of Subchapter C.[8] Second, there is a widespread consensus among economists that imposing a tax only on certain business entities and not on others leads to significant welfare losses to society as the tax drives business owners away from their preferred form of organization.[9] In the absence of a good reason to have the tax, these two types of costs form a persuasive case for repeal.

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[4] O'Neill Reiterates Desire to Kill Corporate Tax, 2001 TNT 109-27 (May 20, 2001) ; *See* also the President's proposal, U.S. Department of the Treasury, News Release, "Fact Sheet: The President's Proposal to end the Double Tax on Corporate Earnings" (14 January 2003), online: U.S. Department of the Treasury <http://www.ustreas.gov/press/releases/kd3762.htm> (last accessed 20 August 2003).

[5] *See*, e.g., Joseph M. Dodge, A Combined Mark-to-Market and Pass Through Corporate-Shareholder Integration Proposal, 50 Tax L. Rev. 265 (1995); Daniel Halperin, Fundamental Tax Reform, 48 Emory L.J. 809, 821-22 (1999) (proposing a combination of changes including full indexation and corporate integration); Anthony P. Polito, A Proposal for an Integrated Income Tax, 12 Harv. J.L. & Pub. Pol'y 1009 (1989).

[6] Joseph Bankman, A Market-Value Based Corporate Income Tax, 68 Tax Notes 1347 (Sept. 11 1995); Michael S. Knoll, An Accretion Corporate Income Tax, 49 Stan. L. Rev. 1 (1996).

[7] *See* discussion of various partial defenses below. Some academics have defended the double tax on corporations (*See* e.g., Jeffrey L. Kwall, The Uncertain Case Against the Double Taxation of Corporate Income, 68 N.C. L. REV. 613, (1990); Jasper L. Cummings, "Taxing Business Income Once": Where's the Beef? A Review and Critique of the Treasury Integration Study, 54 Tax Notes 1391 (Mar. 16, 1992); Terrence R. Chorvat, Apologia for the Double Taxation of Corporate Income, 38 Wake Forest Law Review 239 (2003); Herwig J. Schlunk, I Come Not to Praise the Corporate Income Tax, But to Save It, 56 Tax L. Rev. 329, (2003)), but that argument relates more to the question of whether the tax should be integrated, not whether it should exist in the first place. *See* also George K. Yin, Corporate Tax Integration and the Search for the Pragmatic Ideal, 47 Tax L. Rev. 431, (1992); Anthony Polito, Useful Fictions: Debt and Equity Classification in Corporate Tax Law, 30 Ariz. L. J. 760 (1998), for ways of implementing integration while keeping the corporate tax in place.

[8] *See* Joel B. Slemrod & Marsha Blumenthal, The Income Tax Compliance Cost of Big Business, 24 Pub. Fin. Q. 411 (1996), for an estimate of the transaction costs of the tax.

[9] *See* discussion of efficiency issues below. *See* e.g. Austan Goolsbee, The Impact and Inefficiency of the Corporate Income tax: Evidence from State Organizational Form Data (Nat'l Bureau of Econ. Research, Working Paper No. W9141, 2002). Integration reduces but does not eliminate these welfare losses, because under most forms of integration there is still differential taxation of C corporations and other entities.

Third, and perhaps most importantly, the corporate tax base is being eroded in practice. Revenues from the corporate income tax amounted to about a quarter of all federal tax revenues in 1965; today the tax accounts for less than 10% of revenues and that number is declining. There are two major reasons for this decline in revenues in recent years, and neither of them results from a conscious decision by Congress to reduce the tax.[10] The first is the growth of a corporate tax shelter industry, in which some of America's best minds scour the Code for ways to reduce corporate tax liabilities by various transactions and then sell these transactions for high fees to corporate clients.[11] Estimates of the revenue loss vary, but there is a consensus that it is significant and that the IRS has so far not been able to stop it with the weapons at hand.[12] The second reason for the world-wide decline in corporate tax revenues is tax competition among countries to attract corporate investments, which has grown significantly in the last two decades.[13] This competition enables companies like Intel to pay no tax at all on its non-US income. The most recent manifestation of this trend has been inversion transactions, in which US-based corporations nominally move their headquarters to a tax haven like Bermuda. This type of transaction can result in a dramatic decrease in worldwide effective tax rates for the inverting corporation.[14]

The response to both of these trends has been an attempt by Congress and the IRS to combat corporate tax shelters domestically, and an attempt by international actors like the OECD and the EU to restrict harmful tax

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10 Corporate tax rates were higher before 1986, but the base was narrower, so that the 1986 tax reform act (which reduced the rate from 46% to the current 35%) actually raised taxes on corporations. However, the effective tax rates today are close to what they were before 1986. *See* George K. Yin, Getting Serious About Corporate Tax Shelters: Taking a Lesson From History, 54 SMU L.Rev. 209 (2001).

11 *See*, e.g., Joseph Bankman, The New Market in Corporate Tax Shelters, 83 Tax Notes 1775, 1780 (1999); David A. Weisbach, The Failure of Disclosure as an Approach to Shelters, 54 SMU L.Rev. 73, 74 (2001); Yin, *supra* note -- at 213.

12 The litigation record is mixed- *See* e.g. ACM P'ship v. Comm'r, 157 F.3d 231 (3rd Cir. 1998); Compaq Computer Corp. v. Comm'r, 277 F.3d 778, 781-82 (5th Cir. 2001); United Parcel Service v. Comm'r, 254 F.3d 1014 (11th Cir. 2001).

13 *See* Reuven S. Avi-Yonah, Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State, 113 Harv. L. Rev. 1573 (2000); Julie Roin, Competition and Evasion: Another Perspective on International Tax Competition, 89 Geo. L.J. 543 (2001).

14 *See* Reuven S. Avi-Yonah, For Haven's Sake: Reflections on Inversion Transactions, 95 Tax Notes 1793 (June 17, 2002); James R. Hines, Jr. & Mihir Desai, Expectations and Expatriations: Tracing the Causes and Consequences of Corporate Inversions, 55 Nat'l Tax J. 409 (2002).

competition.[15] However, both of these efforts have been hampered by the lack of a convincing normative justification for the corporate tax. In the absence of such a justification, opponents of these efforts can portray them as a pure revenue grab, and supporters find it difficult to explain what is so bad about letting the corporate tax wither away as a result of taxpayer self help.[16]

In what follows, I will survey the existing, and to me unconvincing, attempts to justify the existence of the corporate tax.[17] These defenses can generally be divided into three types, which correspond to the three theories of the corporation adumbrated above (aggregate, real entity, and artificial entity).[18] The first and most common type is defenses that view the corporate tax as an

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15 *See* e.g., Gerald W. Miller, Jr, CORPORATE TAX SHELTERS AND ECONOMIC SUBSTANCE: AN ANALYSIS OF THE PROBLEM AND ITS COMMON LAW SOLUTION,. 34 Tex. Tech L. Rev. 1015, 1060 (2003); H.R. 5095, 107th Cong. (2002); Joint Comm. on Taxation, JCT Reports on Tax Shelters, Tax Notes Today, Mar. 19, 2002, TaxBase, TA Doc. No. 2002-6891; Jeffrey H. Paravano & Melinda L. Reynolds, CORPORATE TAX SHELTERS: EVALUATING RECENT DEVELOPMENTS, AN ANALYSIS OF THE PROBLEM AND ITS COMMON LAW SOLUTION, 34 Tex. Tech L. Rev. 1015, 1065 (2003);Concerning tax competition, *See* e.g., Yoram Margalioth, Tax Competition, Foreign Direct Investment and Growth: Using the Tax System to Promote Development, 23 Va. Tax Rev. 161, 181 (2003); Avi-Yonah, supra note --; Roin, supra note --; Toward Tax Coordination in the European Union, A Package to Tackle Harmful Tax Competition. Doc. COM (97) 495 final (Oct. 1, 1997); Harmful Tax Competition: An Emerging Global Issue 7 (OECD 1998); Toward Global Tax Cooperation: Progress in Identifying and Eliminating Harmful Tax Practices, Report to the 2000 Ministerial Council Meeting and Recommendations by the Committee on Fiscal Affairs, 5 (OECD 2000); The Determinants of Foreign Direct Investment: A survey of the Evidence, U.N. Doc. ST/CTC/121, U.N. Sales No. E.92.II.A.2 (1992); Tax Incentives and Foreign Direct Investment: A Global Survey, U.N. Doc. CTAD/ITE/IPC/Misc.3, U.N. Sales No. E.01.II.D.5 (2000); Taxation and foreign direct investment: The experience of the economies in transition (OECD 1995); World Bank Tax Policy Handbook 165 (Parthasarathi Shome ed., 1995).

16 *See*, e.g., David J. Shakow, Wither, "C"!, 45 TAX L. REV. 177 (1990); Bernard Wolfman, Whither "C" ?, 38 Tax Notes 1269 (1988).

17 A simple justification of the corporate tax might be as follows: The state has certain legitimate revenue requirements, part of which it must fulfill by taxation. Corporations have significant financial resources. Thus, the state is justified in taxing corporations to meet its revenue needs. This argument is similar to Willie Sutton's immortal response to the question why he robbed banks ("that's where the money is"). But it is clearly inadequate, because the state can fulfill its revenue needs in other ways (e.g., by taxing individuals more; the revenue raised by the corporate tax in developed countries is a sufficiently low percentage of GDP that it can easily be made up by raising individual taxes). This is particularly true for the U.S.; a very low VAT rate would more than make up for the corporate tax, and if the revenues are used for redistributive purposes might not be more regressive. The corporate tax would be more difficult to replace in Europe (with existing high individual income and VAT rates) and even more so in developing countries where it can amount to 25% of total tax revenues, see World Bank, Tax Policy Handbook 165 (Parthasarathi Shome ed., 1995), but not impossible. Therefore, a more elaborate justification of the corporate tax is required.

18 For a fuller exposition of these three theories *See* Part 3. These theories are the standard ones described in the literature. *See*, e.g., Mark Hager, "Bodies Politic: The Progressive History of Organizational 'Real Entity' Theory," 50 U. Pitt. L. Rev. 575 (1989); William W. Bratton, Jr., The New Economic Theory of the Firm: Critical Perspectives from History, 41 STAN. L. REV. 1471, 1475 (1989); Henry N. Butler, The Contractual Theory of The Corporation, 11 GEO. MASON U. L. REV. 99 (1989); David Millon, Theories of the Corporation, 1990 Duke LJ 201 (April, 1990). Ultimately, they stem from the work of three great German 19th century jurists- Savigny (aggregate), Jhering (artificial entity), and Gierke (real entity). *See* Sanford A. Schane, The Corporation is a Person: The Language of a Legal Fiction, 61 Tulane L. Rev. 563 (1987).

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

a. Aggregate Defenses of the Corporate Tax

The most common current defense of the corporate tax is based on the aggregate theory of the corporation in that it views the corporate tax as an indirect way of taxing the shareholders.[19] The argument goes as follows: If there were no corporate tax imposed, given that corporations are treated as separate legal entities from shareholders, individuals could shelter their income from tax by earning it through corporations.[20] This would result at least in deferral of the tax until a dividend is paid or the shareholder sells the shares, and might result in total income tax exemption if the shareholder holds the shares until her death and a step up in basis is available.[21] In addition, it is argued, collecting the tax from corporations rather than directly from shareholders has administrative advantages because there are fewer corporations than shareholders and because shareholders may be hard to reach (e.g., because they are foreign or tax exempt).

From this perspective, the corporate tax can be viewed as a withholding tax imposed on the shareholders at the corporate source of their income. In fact, that was the view of the tax when it was first imposed in 1894.[22] It naturally follows that shareholders should not be taxed again when dividends are distributed to them, just like employees receive a credit for taxes withheld from their paychecks by employers. There are a variety of ways to accomplish this goal, which has been named “integration.” Under the recent proposal by the Bush administration, which is followed by many countries (and has been partially adopted by Congress), dividends should be exempt from tax when

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[19] *See*, e.g., Michael J. Graetz and Alvin C. Warren Jr., Integration of the US Corporate and Individual Income Taxes: The Treasury Department and American Law Institute Reports (Tax Analysts, 1998); Charles E. McLure Jr., Must Corporate Income Be Taxed Twice? (Washington, D.C.: The Brookings Institution, 1979).

[20] *See* e.g., Jeffrey K. MacKie-Mason & Roger H. Gordon, Why Is There Corporate Taxation in a Small Open Economy? The Role of Transfer Pricing and Income Shifting, NBER Working Paper No. 4690 (March 1994)
; Richard M. Bird, Why Tax Corporations? Working Paper 96-2 (prepared for the Technical Committee on Business Taxation), International Centre for Tax Studies, University of Toronto (Dec. 1996).

[21] *See* IRC § 1014. The estate tax, currently scheduled for repeal in 2010 (but revival in 2011), partially remedies this problem for wealthy individuals.

[22] Steven A. Bank, Entity Theory as Myth in the Origins of the Corporate Income Tax, 43 William & Mary L. Rev. 447 (2001).

received by shareholders.[23] Alternatively, as in other countries, shareholders should get a credit for taxes paid by the corporation against their individual tax liability.[24] A third alternative that is rarely adopted but is also consistent with the aggregate view is to impose a corporate tax but permit corporations to deduct dividends from their corporate tax base, thus in effect eliminating the corporate tax to the extent profits are distributed to and taxed in the hands of shareholders.[25]

However, it is far from clear that there are no practical ways of taxing shareholders on corporate income without imposing a corporate level tax.[26] Corporations can for this purpose be divided into two categories- closely-held and publicly-traded. For closely-held corporations, the obvious solution is to tax shareholders directly on corporate income as it is earned, since it can easily be attributed to them (whether or not it is distributed). This is, in fact, the way most closely-held corporations are currently taxed in the US: They are either so-called "S corporations" or Limited Liability Companies (LLCs) that are treated as partnerships or sole proprietorships for tax purposes. In both cases, no corporate level tax is imposed, and shareholders are taxed directly on corporate profits as they are earned. It seems a simple matter to extend this treatment, which is currently elective, to all closely held corporations.[27]

Most of the corporate tax, however, is collected from publicly-traded corporations, and for those it is generally assumed that pass-through taxation

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[23] Graetz and Warren, *supra* note --. *See* Part 4 for fuller discussion of integration.
[24] *See* e.g., Graetz & Warren, note – supra; Alvin C. Warren Jr., "The Relation and Integration of Individual and Corporate Income Taxes" 94 Harv. L. Rev. 717 (1981)
; Richard J. Vann, "General Report: Trends in Company/Shareholder Taxation: Single or Double Taxation?" 88a Cahiers de droit fiscal international 21 (2003). The main difference between the two methods is that under the first the corporate tax is final and thus no taxpayer pays tax at a rate higher than the corporate rate, while the second permits more progressivity. As Vann notes, the trend is toward the exemption method.
[25] This alternative is rarely adopted because it does not easily permit collection of tax from foreign and tax exempt shareholders.
[26] In addition, it is not clear that the corporate tax in fact falls on shareholders as an economic matter- in some circumstances it may be shifted to consumers or labor. But most economists assume the tax falls at least in part on shareholders in the long run. *See*, e.g., Graetz & Warren, supra note--; see also Casey B. Mulligan, "Capital Tax Incidence: First Impressions from the Time Series," National Bureau of Economic Research, Working Paper 9374 (December 2002); Don Fullerton and Gilbert E. Metcalf, "Tax Incidence," in Handbook of Public Economics, edited by Alan J. Auerbach and Martin Feldstein (Elsevier Science BV 2002); Kenneth L. Judd, "Redistributive Taxation in a Simple Perfect Foresight Model" 28 Journal of Public Economics 59 (1985); Masaaki Homma, "A Dynamic Analysis of the Differential Incidence of Capital and Labour Taxes in a Two-Class Economy," 15 Journal of Public Economics 363 (1981); Ronald E. Grieson, "The Incidence of Profits Taxes in a Neo-Classical Growth Model" 4 Journal of Public Economics 75 (February 1975); Martin Feldstein, "Incidence of a Capital Income Tax in a Growing Economy with Variable Savings Rates," 41 The Review of Economic Studies 505 (1974), all refining the classic work of Arnold Harberger, "The Incidence of the Corporation Income Tax," 70 Journal of Political Economy 215 (1962).
[27] *See* George K. Yin, The Future Taxation of Private Business Firms, 4 Fla. Tax Rev. 141, 153-54 (1999).

is administratively not feasible.[28] However, precisely because they are publicly traded, a ready alternative presents itself to address the deferral problem: Taxing shareholders on a mark to market basis on the appreciation and depreciation of their shares. The usual objections to mark to market taxation are based on liquidity and valuation concerns, and neither of these is an issue for publicly traded shares: They are liquid by definition, and their value can be ascertained on a daily basis by opening the financial pages of any newspaper.

Mark to market or accrual taxation is the normative ideal of a Haig-Simons income tax, and many commentators support moving in that direction to the extent it is administratively feasible to do so.[29] Prof. Dodge has exhaustively explored and demonstrated the feasibility of mark to market taxation for shareholders in publicly traded corporations.[30] Moreover, this type of taxation also exists in practice: US shareholders in certain foreign corporations earning mostly passive income (Passive Foreign Investment Companies, or PFICs) are given the choice between either paying tax on the corporations' income directly (if the corporation agrees to furnish the necessary information, which usually applies only when it is closely held), paying tax on the shares on a mark to market basis, or paying an interest charge when they receive a dividend or dispose of the shares.[31] A similar system could be applied to all publicly traded corporations.

Mark to market taxation is complex, and imposing tax on unrealized gains is likely to run into significant political opposition. But the costs of these administrative complexities are not likely to be larger than the costs imposed by the existing corporate tax in all its glory, and the political opposition needs to be offset against the political support of corporate management for repealing the corporate tax.[32] The adoption of the PFIC rules in 1986 shows that this solution is not politically unimaginable.

Finally, the other administrative advantages of maintaining a corporate tax should be addressed. It is indeed easier to collect tax from a few corporations than from many shareholders, but even if one assumes that one tax in fact substitutes for the other, this advantage needs to be offset against the many costs of having the tax.[33] The most convincing argument from this perspective is that a corporate tax is necessary when shareholders are hard to reach because they are tax exempt or foreign. A large percentage of corporate equity is in fact held by tax-exempts, but it is not clear as a normative matter why this kind of shareholders should be taxed on income they earn through

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[28] But *See* Polito, *supra* note -- at 1031.
[29] David Shakow, Taxation without Realization: A Proposal for Accrual Taxation, 134 U.Pa.L.Rev. 1111 (1986); Halperin, *supra* note -- at 817. Note that to the extent the corporate tax is needed to increase progressivity in the overall tax system, taxing shareholders directly is a more accurate way of doing so (since some shareholders in lower brackets are overtaxed by the current corporate tax).
[30] *See* Dodge, *supra* note -- at 294.
[31] IRC sections 1291-1297.
[32] A separate issue is political opposition to corporate tax repeal, which is discussed below.
[33] Bird, supra note --.

corporations, but not on other income.[34] As for foreigners, it may be possible to tax at least large foreign shareholders on both dividends and capital gains through withholding.[35] In addition, maintaining the entire corporate tax just in order to reach foreign shareholders in a country like the US in which the large majority of shareholders are domestic seems like letting the tail wag the dog.[36]

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

b. Artificial Entity Defenses of the Corporate Tax

A second type of defenses link the corporate tax to some kind of benefit provided by the state, and thus treat it as a type of benefit tax.[37] The tax is conceived as a payment in return for the benefits of incorporation, such as limited liability. This line of defense is linked to the artificial entity view of the corporation, which views it purely as a creature of the state.[38]

There are several objections to this defense: First, some of the benefits conferred by government also flow to non-incorporated businesses, which are not subject to the tax. Second, the specific benefits of incorporation are provided by state government, not by the federal government. And finally, there is no correlation between corporate income and the benefits provided, since the same benefits apply (and in the case of limited liability, apply more forcefully) to corporations that lose money.[39]

A more sophisticated variant of the benefits theory is advanced by Rebecca Rudnick, who argues that the corporate tax can be justified as a payment for the greater liquidity afforded by access to the public equity market.[40] Under the current regime, there is a correlation between access to public equity markets and the corporate tax, which makes this analysis appealing. However,

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[34] The issue of "unfair competition" with taxable businesses can be addressed by imposing UBIT at the shareholder level. See IRC sec. 511-515.

[35] We do in fact tax most dividends, and many countries tax capital gains of large foreign shareholders.

36 This is a stronger justification for developing countries in which the entire corporate sector is foreign owned and the corporate tax on such enterprises is a significant percentage of all revenues. For a defense of the corporate tax in that context *See* Avi-Yonah, *supra* note --, at 1640; Bird, supra note --.

[37] *See*, e.g., Richard Musgrave, Public Finance in Theory and Practice (5th ed., 1989), 371-375; Bird, supra note --. This was also part of the argument in favor of enactment in 1909, in which the tax was described as an excise tax on the privilege of doing business in corporate form, but this was done to avoid treating the tax as a direct tax that would be unconstitutional under the Supreme Court's 1895 Pollock decision, Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429 (1895). *See* Part 2 below.

[38] *See* Part 3 below for a fuller description of this view.

[39] Musgrave, supra note --; Bird, supra note --. Musgrave also argues that some benefits, such as limited liability, are costless to society and therefore cannot justify a tax (although I'm not sure he is right about limited liability having no costs).

[40] Rebecca S. Rudnick, "Who Should Pay the Corporate Tax in a Flat Tax World?", 39 Case Western L. Rev. 965 (1988-89).

it is unclear whether there is any correlation between corporate income and liquidity; most publicly traded entities benefit from the same degree of liquidity but vary greatly in profitability. Rudnick argues that liquidity facilitates the creation of economic rents, and she would therefore revamp the tax to focus on these. Similarly, Joseph Bankman and Michael Knoll have proposed basing the corporate tax on changes in the value of outstanding corporate equity.[41] Such changes in the tax base would perhaps create a better link to liquidity, but they are not a defense of the corporate income tax we currently have in place. Similarly, Herwig Schlunk has proposed to substitute for the corporate tax an "entity tax" to be levied on all large entities (incorporated *vel non*) for the benefit of operating as a Coasian "firm."[42] This likewise is not a defense of the current corporate tax; in fact, Schlunk argues that no "colorable" defense of the tax exists.[43]

Finally, the strongest benefits argument for the corporate tax is for a tax on foreign corporations doing business in a source jurisdiction.[44] In that regard, it has long been accepted that source jurisdictions may collect a tax from corporations doing business (above a certain minimal threshold) within their borders, because the host government created the market conditions that enable the income to be earned. There probably is some correlation between, for example, the quality of infrastructure or education in the host country and the degree of profitability of foreign direct investment in it.[45] However, as argued above, it seems strange in the US context to maintain the entire corporate tax just to collect a benefits payment from foreign corporations, since most of the taxpayers subject to the tax are domestic corporations.[46] And if one argues that the same benefits of infrastructure, education, police protection etc. also apply to domestic corporations, that is also true for non-incorporated or closely held businesses that are not subject to the corporate tax.

In sum, the artificial entity or benefits argument for the corporate tax is unconvincing because there is no correlation between the existing corporate tax and the kind of benefits (if any) that the federal government provides only to those entities that are in fact subject to the tax, namely publicly traded corporations.

c. Real Entity Defenses of the Corporate Tax

[41] Bankman, *supra* note--; Knoll, *supra* note --, at 327.
[42] Schlunk, *supra* note --, at 382. It is not clear why this is a benefit provided by the federal government. In fact, the inability to decide which government (if any) provides this particular benefit lies at the heart of the difficulty of allocating the income of multinational enterprises among tax jurisdictions. *See* Reuven S. Avi-Yonah, The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation, 15 Va. Tax Rev. 89 (1995).
[43] Schlunk, *supra* note --, at 332.
[44] Of course, it is also easier politically to tax foreigners than to tax domestic corporations, and precisely for that reason tax treaties make it hard to discriminate against foreign corporations.
[45] Reuven Avi-Yonah, The Structure of International Taxation: A Proposal for Simplificaton, 74 Tex. L. Rev. 1301 (1996); Reuven S. Avi-Yonah, International Taxation of Electronic Commerce, 52 Tax L. Rev. 507, 515 (1997).
[46] Which may be subsidiaries of foreign corporations.

The view of the corporation as a "real" entity, separate from both its shareholders and from the state, has not had much resonance in the tax area. After all, as Richard Musgrave points out in his classic public finance textbook, a view of the corporation as a distinct entity with economic resources under its control is "hardly tenable" in the tax context because the economic burden of taxes must ultimately fall on natural persons, and there is no reason the income of those natural persons should be subject to a second level of tax simply because it is earned through a corporation.[47]

Nevertheless, there is one way in which the corporation clearly exists as a separate entity from the shareholders and the state, and that is as an organization under the control of corporate management. It is management who make the decisions on deploying the corporation's economic resources, and in that sense they can be regarded as the "real" corporation. This is particularly true for the publicly traded corporation in which ownership is (to use Berle and Means' famous phrase) separated from control.[48]

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

Thus, Levmore and Tanaka argue that the corporate tax is necessary because otherwise the agency cost problem will be exacerbated when management (who may or may not be shareholders) face a different tax rate for corporate actions than some shareholders. For example, if management are shareholders and there is no corporate tax, they may face a tax rate of 35% upon selling a corporate asset while other shareholders are taxed at zero. Management may thus be deterred by their individual tax burden from taking actions that are in the best interests of all shareholders. With a corporate tax in place, all corporate actions face the same tax rate.[49]

This argument is unpersuasive, for several reasons. First, if we assume that the corporate tax is borne by shareholders, the same argument would apply even with a corporate tax- management who are taxable shareholders would ultimately face the double tax on dispositions while tax-exempt shareholders face only a single tax.[50] If the corporate tax is not borne by shareholders, then its existence *vel non* should have no impact on management actions. Second, if the Levmore and Kanda analysis is correct, it would apply to any positive corporate tax rate as long as it is imposed on all corporate level activity, so it would at best justify a minimal tax. Finally, it seems far-fetched to hang the

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[47] Musgrave, supra note --.
[48] Adolf A. Berle & Gardiner C. Means, The Modern Corporation and Private Property (1932).
[49] *See* Hideki Kanda & Saul Levmore, Taxes, Agency Costs, and the Price of Incorporation, 77 Va. L. Rev. 211 (1991); for a similar agency-cost based argument *See* also Snoe, who focuses more on the integration issue: Joseph A. Snoe, The Entity Tax and Corporate Integration: An Agency Cost Analysis and a Call for a Deferred Distributions Tax, 48 U. Miami L. Rev. 1, 43 (1993).
[50] If dividends are exempt (as under President Bush's proposal), then all shareholders face the same zero rate at the shareholder level whether or not there is a corporate tax.

entire corporate tax on this type of consideration. Agency cost problems are pervasive in any public corporation and it seems easier to address them by corporate law means rather than through the tax code.[51]

More recently, Mihir Desai and his colleagues have argued that imposing a corporate tax can be a way of preventing management from diverting corporate resources to their own pockets. Specifically, Desai et al. argue that if corporate income must be declared for tax purposes, it becomes harder to conceal its theft from the shareholders as well.[52] This is an ingenious argument, which (as we shall see) also reflects some of the original intent in enacting the corporate tax in 1909. However, from today's perspective, it seems like a shaky foundation for the entire corporate tax.[53] Management theft can be combated by other means, and a requirement to report income without tax (or with only a minimal tax) would do just as well to achieve the goal promoted by Prof. Desai.

Thus, there is currently no convincing defense of the corporate tax based on the real entity view either. Nevertheless, as explained below, this view of the corporation provides the best argument in favor of the tax.[54]

d. Summary

It thus seems that there is no convincing defense of the corporate tax in the academic literature. The mainstream view of the corporate tax as an indirect way of taxing shareholders, which is based on the aggregate theory, is flawed, because it is quite possible to tax shareholders directly without a corporate level tax. Alternative defenses of the corporate tax that are based on the artificial and real entity views are likewise unpersuasive. This leads some commentators to the conclusion that the corporate tax, with all its efficiency and complexity costs, should simply be repealed.[55] Other commentators favor letting the tax gradually disappear as a result of taxpayer actions.[56]

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

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

[52] Mihir Desai, Alexander Dyck, and Luigi Zingales, Corporate Governance and Taxation (unpublished ms. on file with author).

[53] It may, however, have some application in countries like Russia, from which Desai and his colleagues draw most of their examples. In the case of his US example, however, which is Tyco, it should be noted that Tyco managers were ultimately caught by the criminal justice system, and that their behavior (stealing hundreds of millions of dollars from the corporation) seems rather extreme to base a defense of the corporate tax on.

[54] *See* Part 3, infra.

[55] *See*, e.g., Dodge, *supra* note -- at 268.

[56] *See*, e.g. Goolsbee, *supra* note --.

Flat Tax proposal would maintain a corporate level tax on above-normal returns.[57] When former Secretary of the Treasury Paul O'Neill announced that he favored repealing the corporate tax on the basis of his experience as a CEO, the proposal did not have any political traction. In the current political climate, demise of the corporate tax due to taxpayer self-help seems much more likely than actual repeal.

Why is the corporate tax so politically resilient? The reason seems to be the same as the reason the corporate alternative minimum tax was enacted in 1986- ordinary Americans have a viscerally negative reaction to the notion that large, profitable corporations should pay no tax while they bear the income tax burden.[58] This is universally dismissed as an example of ordinary people's "fiscal illusion", the misguided belief that corporations bear the burden of the tax, while every economically literate person knows that taxes can only be borne by natural persons.[59]

But are people really that ignorant? I would argue that the answer is no, and that in fact what people perceive is closer to reality than the economic models of incidence would suggest. The corporate tax is imposed on corporate income, which adds to the economic resources of the corporation. These resources are managed by individual corporate managers, and their control over such resources gives them significant economic, social and political power. In that sense, imposing a corporate tax reduces the economic resources and therefore also the power of corporate management. Whatever the economic incidence of the corporate tax,[60] from this perspective its most immediate burden falls on corporate management, and not surprisingly they are the strongest supporters of corporate tax repeal.[61]

This argument will be further developed in Part 3. In the meantime, however, it is useful to link it to another question- why was the corporate tax enacted in the first place? What was the "original intent" of its adopters, almost a

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[57] The flat tax and other consumption tax proposals effectively exempt the normal return to corporate equity by permitting corporations to currently deduct all capital expenditures, but they retain the corporate tax for infra-marginal (above normal) returns. Proposals to repeal the income tax (including the corporate tax) and replace it with a sales tax seem less politically prominent, although the practical effect may be the same as the flat tax proposal.

[58] The corporate AMT was reacted in response to newspaper reports about GE and other large corporations paying no tax. *See* Terrence R. Chorvat and Michael S. Knoll, The Case for Repealing the Corporate Alternative Minimum Tax, 56 SMU L. Rev. 305 (2003); Reuven S. Avi-Yonah, The Case for Retaining the Corporate AMT, 56 SMU L. Rev. 333 (2003).

[59] Musgrave, supra note --; Bird, supra note --; Bank, *supra* note --; Chorvat and Knoll, *supra* note --, at 314; Michael L. Marlow, A Primer on the Corporate Income Tax: Incidence, Efficiency, and Equity Issues (Tax Foundation, Background Paper No. 38, 2001).

[60] The incidence issue is important, since if it could be shown that the tax is in fact shifted to employees or consumers, management might not care about it as much (since the tax would not affect profit accumulation). But as an empirical matter, it is unclear whether the tax can be shifted in most cases. *See* the literature cited in note – above and the discussion in part 3, infra.

[61] Traditionally, they are much more lukewarm about dividend tax relief. In fact, corporate management has largely been responsible for the current classical (double) tax system, which they saw as a way to avoid higher corporate level taxes as well as pressure to distribute dividends. *See* Bank, *supra* note --, at 466; Jennifer H. Arlen & Deborah M. Weiss, A Political Theory of Corporate Taxation, 105 Yale L.J. 325, 335 (1995).

hundred years ago? Examining this question can help us shed some light on the current debate. As we will see, a major reason for enactment was precisely to regulate and place limits on the power of corporate management.[62]

[62] The regulatory argument for the corporate tax is raised briefly but dismissed by Musgrave, *supra* note --, who argued that regulatory aims can be more efficiently achieved by other means. For a discussion, *See* Part 3.

2. A Historical Perspective: Why Was the Corporate Tax Enacted?

a. Antecedents: Aggregate-Based Taxation Before 1909.

The first federal income tax, enacted to raise revenues during the civil war, did not tax corporations, although a withholding tax was imposed on dividends and interest paid by railroad corporations and financial institutions, as well as on amounts added to surplus.[63] Instead, under the 1864 version of the tax, "the gains and profits of all companies, whether incorporated or partnership, other than the companies specified in this section, shall be included in estimating the annual gains, profits, or income of any person entitled to the same, whether divided or otherwise."[64] The civil war income tax thus included a form of pass-through taxation that applied to corporations, and the imposition of the tax on the undivided profits of corporations was specifically upheld by the Supreme Court.[65]

Pass-through treatment of corporate profits reflected the aggregate view of the corporation prevalent at the time.[66] It also reflected the fact that most corporations were small, closely held enterprises, and therefore (like today) it was relatively easy to identify the shareholders and to tax them on corporate profits. For those enterprises that were more widely held, like railroads, a withholding tax collected by the corporation effectively replaced the tax on the shareholder.[67]

The civil war version of the income tax was allowed to expire with the end of reconstruction in 1872. In 1894, after the financial panic of 1893 and the economic dislocation that followed, the Democrats in Congress were able to pass an income tax bill. The debate at the time focused on the protective tariff, which was the main source of revenue for the federal government. The tariff functioned as a highly regressive consumption tax, and benefited the manufacturing centers of the Northeast at the expense of the more agricultural South and West. The Democrats argued that relying solely on tariffs allowed the newly super-rich railroad, steel and sugar magnates to escape any meaningful tax burden. Their argument was further bolstered by the fact that

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[63] Act of July 1, 1862, ch. 119, sec. 81-82, 12 Stat. 432, 473. Shareholders and bondholders were permitted to exclude dividends and interest subject to withholding from income. *Id.*, sec. 91, 12 Stat. 473-74. On the early history of the corporate tax in the U.S. *See* generally Steven A. Bank, Entity Theory as Myth in the Origins of the Corporate Income Tax, 43 William & Mary L. Rev. 447 (2001) ("Bank").

[64] Act of June 30, 1864, sec. 117, 13 Stat. 282. Under this act as well a withholding tax was imposed on dividends and interest paid by certain types of corporations and those dividends and interest were excluded from income. Id., sec. 120-122, 13 Stat. At 283-85.

[65] Collector v. Hubbard, 79 US (12 Wall) 1 (1870).

[66] *See* below; Morton J. Horwitz, *Santa Clara* Revisited: The Development of Corporate Theory, 88 W. Va. L. Rev. 173 (1985).

[67] Note, however, that this was not a perfect replacement since the corporate rate was 5% with no exemption whereas the top shareholder rate was 10% with a $600 exemption. *See* Bank, *supra* note --, at 457-58. The decision to treat the withholding tax as the final tax in the case of widely held enterprises presumably reflected the practical difficulty of collecting tax on a pass-through basis in those cases. Id. 516-517.

the state level personal property taxes were notoriously ineffective in reaching intangible forms of property, such as stocks and bonds.

The 1894 Act for the first time imposed a tax of 2% on the net income of all "corporations, companies, or associations doing business for profit in the United States, no matter how created or organized, but not including partnerships."[68] At first impression this appears to be a stark departure from the civil war income tax, which taxed corporate income in the hands of the shareholders and only employed withholding at the corporate level as a collection device. However, Steven Bank has convincingly demonstrated that such a reading of the 1894 Act is misleading.[69] First, he points out that dividends from taxable corporations were excluded from shareholder income, so that the corporate tax could be viewed as a collection device for the shareholder level tax (imposed at the same rate).[70] Second, the House version of the 1894 Act followed the civil war income tax in imposing a withholding tax on dividends and interest, except that the tax was also applied to undistributed income and to all corporations.[71] Thus, the progression from the civil war income tax to the House bill to the final version of the 1894 Act can be seen as a gradual process of modifying what was fundamentally a withholding tax imposed on the shareholders.[72] Third, the Congressional debates on the 1894 Act show that the principal motive for the corporate level tax was to reach the shareholders, most of whom were precisely the kind of rich individuals who were able to escape the state-level personal property tax and whose corporations benefited from the high tariffs.[73] And finally, Bank points out that the norm throughout the latter half of the 19th century was for most corporations to distribute their net earnings out as dividends. In that context, imposing a withholding tax on dividends was the most effective way to tax shareholders in widely-held enterprises, and imposing the same tax on additions to surplus was merely another enforcement device to prevent accumulated income from escaping tax. By 1894, the withholding tax was transformed to a tax on all the income of the corporation (distributed or not), but was still seen primarily as a device to tax shareholders.[74]

Thus, throughout the 19th century, there was little evidence at the federal level of direct taxation of corporations as such. Withholding taxes were imposed at the corporate level on both distributed and undistributed income, but those were seen as an indirect way of taxing shareholders, consistently with the aggregate view of the corporation.

b. The 1909 Act: A Real Entity Measure.

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68 Tariff Act of 1894, ch. 349, sec. 32, 28 Stat. 509, 556.
69 Bank, *supra* note--, at 459.
70 Tariff Act of 1894, ch. 349, sec. 28, 28 Stat. 509, 554; Bank Id., at 462. Integration was incomplete because corporations were not eligible for the $4000 exemption, but this can be explained by administrative convenience.
71 26 Cong. Rec. 6831 (1894).
72 Bank, Id., at 504.
73 Bank, Id., at 528-530.
74 Bank, Id., at 530-31.

In 1895, the Supreme Court struck down the 1894 Act as an unconstitutional direct tax without apportionment.[75] The Democrats immediately made reinstatement of the income tax a major plank of their platform for the 1896 and 1900 elections, but to no avail. With the decisive victory of William McKinley (author of the notorious McKinley tariff of 1890) and his corporate allies in 1900, the income tax issue seemed dead.

The situation changed with the rise of the Progressives and the accession of Theodore Roosevelt to the White House in 1901. Roosevelt spent his seven years in office greatly expanding the powers of the federal government vis-à-vis corporations. He was the first President to attempt to use the Sherman Antitrust Act, adopted in 1890 but left largely unused until his time, to break up the great monopolies, such as John D. Rockefeller's Standard Oil Company. In addition, he established the Bureau of Corporations to assemble information on, and ultimately perhaps to regulate, corporations.[76] He also proposed that all corporations should be incorporated under the authority of the federal government.[77]

On the tax front, Roosevelt expressed support in 1907 (after another financial panic) for a graduated income tax, but supporters of the tariff within the Republican Party were able to delay consideration of the issue until after the 1908 election. The newly elected President Taft was less of a supporter of the income tax than his predecessor, and was worried about enacting another tax that will be found to be unconstitutional. However, he was also faced with increased support for the income tax in Congress and a possible split within his own party between Northeastern opponents of the tax and Midwestern supporters. Eventually, Taft proposed a compromise: Enact a corporate excise tax measured by income, which could withstand judicial scrutiny, and simultaneously submit an amendment to the constitution to permit enactment of an income tax.[78]

The legislative debate on the proposed tax was set in the broader context of the debate on tariff reduction. Opponents of tariff reduction, mostly from Northeastern states, viewed high tariffs as essential to protecting American industry, and argued that the benefits of such tariffs extend to ordinary workers as well as to captains of industry. Proponents of tariff reduction, mostly from the West and the South, argued that high tariffs raised the price of goods consumed by ordinary Americans to benefit the rich. They argued that an income tax was more progressive and was also better suited to the fluctuations in economic conditions (since income is more responsive to recessions than consumption).

Initially, it seemed likely that the tariff bill (named after its co-sponsors the

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[75] Pollock, *supra* note --, 7.
[76] Act of Feb. 14, 1903, ch. 552, sec. 6, 32 Stat. 825.
[77] Marjorie E. Kornhauser, Corporate Regulation and the Origins of the Corporate Income Tax, 66 Ind. L.J. 53 (1990). *See* discussion below.
[78] See, e.g., Randolph E. Paul, Taxation in the United States, 94 (1954); Steven R. Weisman, The Great Tax Wars: Lincoln to Wilson- The Fierce Battles over Money and Power That Transformed the Nation (2002).

Payne-Aldrich Tariff) would get enacted by the Republican majority in both houses. In the House, income tax proponents like Cordell Hull (D-Tenn.) were unable to attach an income tax amendment to the tariff bill. In the Senate, however, progressive Republicans like Robert La Follette (R-Wis.) and Democrats like Joseph Bailey (Tex.) were more effective in arguing for the income tax. La Follette and Bailey argued that since the rich benefited more than the poor from government protection, they should pay more for it, and that enacting the income tax would silence the "envious voice of anarchy" (socialism).

Ultimately, Sen. Nelson Aldrich (R.-R.I.), the main opponent of the income tax, realized that with nineteen Republicans threatening to join the Democrats and vote for the income tax, he might lose. In a crucial meeting at the White House, Aldrich and Taft agreed to support instead a corporate tax plus a constitutional amendment empowering Congress to levy the income tax, while maintaining high tariffs. Aldrich stated that "I shall vote for a corporation tax as a means to defeat the income tax."[79] This compromise ultimately passed the Senate 45-34 and the House 195-183, and was signed into law by the President on August 5, 1909.

The 1909 Act imposed "a special excise tax with respect to the carrying on or doing business" of 1% of net income over $5,000 of "every corporation, joint stock company or association organized for profit" under U.S. law, and every foreign corporation engaged in business in the U.S. Dividends from taxable corporations were excluded from corporate income.[80]

What was the rationale for the 1909 Act, which is the origin of our current corporate income tax? Proponents of the tax gave several reasons, including the benefits theory and viewing the corporate tax as an indirect tax on shareholders. However, as Marjorie Kornhauser has pointed out, a major motive for the act was to regulate corporations.[81] The principal vehicle for regulation was the filing of tax returns, which were to be made public. But more broadly, the tax itself fulfilled a potential regulatory function: It could serve as a vehicle to restrict the accumulation of power in the hands of corporate management.

The various motives for enacting the corporate tax, which reflect the three theories of the corporation, can be seen in President Taft's message to Congress and in the debate that preceded enactment in the Senate. President Taft's message of June 16, 1909 gives three reasons for enacting a corporate tax (rather than a general income tax, which may be unconstitutional, or an inheritance tax, which did not have sufficient political support among Republicans in the Senate). The first reason is that "[t]his is an excise tax upon the privilege of doing business as an artificial entity and of freedom from a general partnership liability enjoyed by those who own the stock."[82] This

[79] 44 Cong. Rec. 3929 (June 29, 1909).
[80] Tariff Act of 1909, sec. 38, 36 Stat. 112.
[81] Kornhauser, *supra* note -- at 53.
[82] 44 Cong. Rec. 3344 (June 16, 1909).

argument is clearly based on an artificial entity view of the corporation as a creature of the state. However, Taft was aware that it is difficult to make this argument for a federal tax when the privileges enjoyed by the corporation derived from state law. The reason he made the argument nevertheless was that this formulation was necessary to ensure the tax's constitutionality, since the Supreme Court had upheld such an excise tax on sugar and oil companies in the Spreckles case.[83] Taft added that nevertheless the tax "accomplishes the same purpose as a corporation income tax."[84]

The second argument made by Taft was that the corporate tax "imposes a burden at the source of the income at a time when the corporation is well able to pay and when collection is easy."[85] The reference to collection "at the source" relates to the aggregate view of the corporation, since the tax is viewed as a withholding tax imposed on the shareholders (referred to at the time as "stoppage at source"). This is similar to the mainstream modern view of the tax, although the reference to the corporations' ability to pay (as opposed to the shareholders') has a real entity overtone. Taft probably did not emphasize the nature of the tax as an indirect tax on shareholders because that would have made it more suspect to the opponents of the income tax as well as more vulnerable to a constitutional challenge.

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

> Another merit of this tax is the federal supervision which must be exercised in order to make the law effective over the annual accounts and business transactions of all corporations. While the faculty of assuming a corporate form has been of the utmost utility in the business world, it is also true that substantially all of the abuses and all of the evils which have aroused the public to the necessity of reform were made possible by the use of this very faculty. If now, by a perfectly legitimate and effective system of taxation, we are incidentally able to possess the Government and the stockholders and the public of the knowledge of the real business transactions and the gains and profits of every corporation in the country, we have made a long step toward that supervisory control of corporations which may prevent a further abuse of power.[86]

This remarkable paragraph rests on the real entity of the corporation as separate from both the state and the shareholders. It identifies corporate

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[83] Spreckles Sugar Refining Co. v. McClain, 192 US 397 (1899), cited by Taft in 44 Cong. Rec. 3344 (1909).
[84] *Id*.
[85] 44 Cong. Rec. 3344 (1909).
[86] *Id*.

management as the source of "abuses of power" and suggests that the imposition of the corporate tax will enable the government, the shareholders and the public to obtain information that will serve as the basis for restricting such managerial abuses of power. While the tax itself is incidental to the regulatory mechanism, this statement is important because it delineates a reason to tax corporations that is unrelated to the tax on shareholders or to the benefits conferred by the state. The tax is imposed on corporations because of the power exercised by corporate management, and management is clearly regarded as distinct from the shareholders (who will in fact be beneficiaries of the supervision over management actions).[87]

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

The artificial entity view of the tax was expressed primarily by those proponents who sought to defend it from a constitutional attack.[88] Sen. Root, for example, who was one of the main drafters of the bill, defended the tax in part as based on the privilege of limited liability.[89] Opponents, however, were quick to point out that since corporations were created under state law, the federal government had no right to tax them under an artificial entity view.[90] In addition, opponents pointed out that unincorporated businesses obtained from the federal government the same benefits as corporations.[91]

The aggregate view was advanced by proponents who argued that the corporate tax was an indirect way to tax wealthy shareholders. Opponents argued that the tax did not discriminate between wealthy and less wealthy shareholders.[92] Sen. Cummins stated that "[s]o far as taxes are concerned, corporations are mere trustees for their shareholders; and their shareholders must pay the tax."[93] Others argued that the tax would be shifted to consumers or wage earners, at least by the strongest corporations in the best position to

[87] Similarly, in a letter dated June 27, 1909, Taft identified the publicity feature as a particularly important element of the tax, stating that "publicity gives a kind of federal supervision over corporations, which is quite a step in the direction of similar reforms I am going to recommend at the next session of Congress." Letter to Horace Taft, cited in Kornhauser, *supra* note -- at 99.
[88] *See,* e.g., 44 Cong. Rec. 4237 (July 7, 1909) (Sen. Daniel).
[89] 44 Cong. Rec. 4006 (July 1, 1909).
[90] "The United States did not create these corporations" (Sen. Cummins, 44 Cong. Rec. 3977 (June 30, 1909)).
[91] "I deny the right of Congress to levy a tax upon the business of corporations as such." (Sen. Cummins, 44 Cong. Rec. 3976 (June 30, 1909).
[92] "Shall we levy an income tax upon the stockholders of all corporations for pecuniary profit, without respect or regard to the extent of the income earned or enjoyed by those stockholders" (Sen. Cummins, 44 Cong. Rec. 3955 (June 29, 1909)). *See* also 44 Cong. Rec. 4008 (July 1, 1909) (statement of Sen. Clapp to same effect).
[93] 44 Cong. Rec. 3975 (June 30, 1909). *See* also the Bureau of Corporations Report on State Taxation (May 17, 1909): "Obviously a tax on the corporation is really a tax upon its stockholders, for otherwise than as a matter of legal reasoning a corporation and its stockholders are one." Kornhauser, *supra* note--, at 94.

avoid competition- the trusts.[94]

But by far the most significant debate centered on the real entity view of the corporation and the argument that the tax was a regulatory device. Some of this debate centered on the publicity feature of the tax, but some of it viewed the tax as a preliminary measure to control and limit managerial power directly. For example, Sen. Flint (a supporter of the tax) stated that “it would give a certain amount of control of corporations by the national government, publicity as to the conditions and affairs of corporations, and supervision to a certain extent over those corporations.”[95] Publicity was part of the regulatory scheme, but not the only part.

The publicity feature was stressed by many. Sen. Dixon, for example, stated that he favored the tax primarily because of the publicity feature, because it would not reach wealthy shareholders.[96] Sen. Newlands likewise supported the tax as “securing, through publicity and otherwise, such supervisory control by the National Government as can be constitutionally exercised over corporations.”[97] Even Sen. Aldrich, the ultra-conservative chair of the Finance Committee, supported the publicity feature.[98] And Sen. Cummins, who opposed the tax, nevertheless supported the publicity feature because the “revolution in industry” resulting from the rise of large corporations “is simply a prelude to industrial commercial slavery unless the Government intervenes with its strong arm, and it can not intervene unless it has the information necessary to enable it to act intelligently and wisely.”[99]

Other Senators, however, emphasized the potential of the tax to directly limit managerial power. Sen. Newlands stated that “I favor also present legislative action imposing an excise tax in such form as to reach the great accumulated wealth of the country, or its earnings, engaged in corporate enterprise.”[100] Nor did he mean by this indirect taxation of wealthy shareholders, because he went on to state that “there was no reason why the great combinations monopolizing these industries [protected by the tariff] should not pay some part of national expenses as well as the masses of the people who use and

[94] *See* statement of Sen. Borah, 44 Cong. Rec. 3985-87 (June 30, 1909); Sen. Cummins likewise considered that the tax may be shifted from shareholders, 44 Cong. Rec. 3975 (June 30, 1909), as did Sen. Clapp, 44 Cong. Rec. 4008 (July 1, 1909).
[95] 44 Cong. Rec. 3937 (June 29, 1909).
[96] 44 Cong. Rec. 3941 (June 29, 1909). *See* also 44 Cong. Rec. 4000-01 (July 1, 1909) (statement of Sen. Bourne in favor of the publicity feature: “I personally concur with the President that the corporation net-earnings tax, in view of the publicity feature incident to it, is of infinitely greater importance and will be far more beneficial to this country than either the inheritance or income tax.”)
[97] 44 Cong. Rec. 3756 (June 24, 1909). *See* also 44 Cong. Rec. 3759 (June 24, 1909) (“securing information which would enable Congress to act intelligently in future with reference to taxation, the regulation of industrial combinations, and the imposition of tariff duties.”)
[98] 44 Cong. Rec. 3930 (June 29, 1909); *See* also 44 Cong. Rec. 4006-07 (July 1, 1909) (statement by Sen. Root in support of the publicity feature).
[99] 44 Cong. Rec. 3965 (June 30, 1909).
[100] 44 Cong. Rec. 3756 (June 24, 1909).

consume [their products]."[101] Newlands thus viewed the tax as falling on the accumulated wealth in the hands of the corporation itself, i.e., upon corporate management.[102] Sen. Owen likewise spoke of the "enormous volume of corporate wealth": "The most important need of the people of the United States of this generation requires the abatement of the gigantic fortunes being piled up by successful monopoly…which have brought about a grossly inequitable distributions of the proceeds of human labor."[103] Like other Democrats, he would have preferred an income or inheritance tax, but supported the corporate tax for its direct potential impact on corporate (i.e., managerial) wealth.

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

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

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

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

[101] 44 Cong. Rec. 3761 (June 24, 1909). *See* also 44 Cong. Rec. 3762 ("Justice demands that the various forms of manufactured wealth, in whose favor the taxing power of the Nation is so freely exercised, should make some substantial contribution to the national expenses.").
[102] 44 Cong. Rec. 4048-49 (July 2, 1909) and 44 Cong. Rec. 4233 (July 7, 1909) (advocating a tax concentrated on the management of the great trusts, and exempting small corporations); 44 Cong. Rec. 4229-30 (statement of Sen. Dolliver to same effect).
[103] 44 Cong. Rec. 3950 (June 29, 1909).
[104] 44 Cong. Rec. 4003 (July 1, 1909); *See* also 44 Cong. Rec. 4006 (distinguishing between earned income and "accumulated capital" which should be taxed). Sen. Cummins argued that the corporate tax would not achieve this purpose since it would fall on all shareholders, rather than just on management. 44 Cong. Rec. 4038 (July 2, 1909).

105 while.

Cummins, however, was not opposed to any federal regulation through the corporate tax, just to a tax that indiscriminately applied to all corporations, big or small, as opposed to those corporations that should be the proper target- the great trusts:

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

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Other opponents of the tax likewise supported regulating the large trusts through taxation, referring to the excise tax imposed on the gross income of the sugar and oil trusts in 1898. However, they opposed the proposed corporate tax because it exempted dividends received from other taxable corporations from the tax base, thereby encouraging the formation of holding companies- precisely those companies that formed the legal basis for the trusts (after New Jersey permitted the formation of holding companies in 1890).[107] Proponents of the tax replied, however, that it was better to attack the trusts via a tax on all corporations, than to refrain from attacking them at all.[108]

c. Summary.

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

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[105] 44 Cong. Rec. 3978 (June 30, 1909). *See* also 44 Cong. Rec. 4047 (July 2, 1909) (statement of Sen. Hughes arguing that regulation should be done directly).
[106] *Id*. He suggested that much higher rates would drive the trusts out of business, 44 Cong. Rec. 4232 (July 7, 1909).
[107] 44 Cong. Rec. 4010 (July 1, 1909) (statement of Sen. Clapp); 44 Cong. Rec. 4230 (July 7, 1909) (Sen. Dolliver). Sen. Aldrich replied that this was necessary to avoid double corporate taxation and that no for profit corporation was exempt from tax. *Id*., at 4231.
[108] 44 Cong. Rec. 4036 (July 2, 1909) (statement of Sen. Davis).

The shift that occurred can clearly be seen if one compares two Supreme Court opinions dealing with the corporate tax. In 1870 the Court decided that the civil war income tax may be applied to tax shareholders upon the undivided profits of a corporation.[109] Fifty years later the Court held that a shareholder may not be taxed on a stock dividend distributed by a corporation since that would be tantamount to taxing her on the undistributed income of the corporation, which is not her "income" under the Sixteenth Amendment.[110] The Court stated that:

> We have no doubt of the power or duty of a court to look through the form of the corporation and determine the question of the stockholder's right, in order to ascertain whether he has received income taxable by Congress without apportionment. But, looking through the form, we cannot disregard the essential truth disclosed; ignore the substantial difference between corporation and shareholder; treat the entire organization as unreal; look upon stockholders as partners, when they are not such; treat them as having in equity a right to a partition of the corporate assets, when they have none; and indulge the fiction that they have received and realized a share of the profits of the company which in truth they have neither received nor realized. We must treat the corporation as a substantial entity separate from the stockholder, not only because such is the practical fact but because it is only by recognizing such separateness that any dividend- even one paid in money or property- can be regarded as income of the stockholder. Did we regard the corporation and stockholder as altogether identical, there would be no income except as the corporation acquired it; and while this would be taxable against the corporation as income under the appropriate provisions of law, the individual stockholders could not be separately and additionally taxed with respect to their several shares even if divided, since if there were entire identity between them and the company they could not be regarded as receiving anything from it, any more than if one's money were to be removed from one pocket to another.[111]

Thus, by 1920, the Court viewed the corporation as a real entity separate and distinct from the shareholders "because such is the practical fact."[112] The same real entity view underlay most (although not all) of the arguments made when the corporate tax was adopted in 1909.

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[109] Collector v. Hubbard, *supra* note --.

[110] Eisner v. Macomber, 252 US 189 (1920).

[111] *Id*. The Court then went on to state that Collector v. Hubbard (*supra* note --) was overruled by Pollock (*supra* note --) and was not reinstated by the Sixteenth Amendment. *Id*.

[112] The other argument advanced by the Court (that cash dividends could not be taxed) interestingly ignores the fact that between 1913 (when the Sixteenth Amendment was adopted and the first individual income tax adopted) and 1936 cash dividends were to some extent exempt from tax to shareholders. But dividends were taxed to the extent the individual rate exceeded the basic or normal rate, and the corporate rate was set higher than the normal rate from 1918, resulting in partial double taxation. *See* Bank, *supra* note --, at 516.

What accounts for the change between 1894 (when as we have seen the corporate tax was seen as a withholding device, and the aggregate view was dominant) and 1909 (when the real entity view was the main reason for adopting a corporate tax)? The principal reason is a significant change in the nature of the corporation that occurred in these 15 years. The period from 1890 to 1916 marked the transformation of American capitalism from a system of owner/manager enterprises operating in largely unregulated competitive markets to a system dominated by relatively few large, mostly non-owner managed corporations in a regulated competitive market.[113] In particular, although there were large scale corporations (especially the railroads) before the Progressive Era, consolidation began only in the early 1890s and accelerated to a wave of consolidation by merger between 1898 and 1904.[114] The key legal change was the adoption by New Jersey in 1890 of a new corporate law that for the first time permitted holding corporations.[115] This enabled the consolidators to avoid the cumbersome "trust" structures (in which shareholders contributed their shares to a trust in exchange for certificates of beneficial ownership) for the simpler holding company structure of parent and operating subsidiaries. The result was a wave of corporate migration to New Jersey, followed in the 1910s by another migration to Delaware when New Jersey balked at further pro-management rule changes.[116]

The reaction to the emergence of the "trust issue" from around 1896 onward was a chorus of calls for more regulation.[117] For example, in 1906 Rep. Martin of South Dakota defined a trust as "a combination of corporations", identified the resulting "evils" as "overcapitalization…the tendency to monopoly, and…the destruction of individual enterprise and success," and called for remedial legislation that will combine "publicity," "free competition" and "close Federal supervision or regulation."[118] One immediate result was the attempt by President Roosevelt to control the trusts by using the Sherman Antitrust Act of 1890, which led to the Supreme Court ultimately breaking up the Standard Oil Company (while declaring at the same time that only "unreasonable" restraints of trade were illegal).[119]

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

> I am in no sense hostile to corporations. This is an age of combination, and any effort to prevent all combination will be not

[113] M. Sklar, The Corporate Reconstruction of American Capitalism, 1890-1916 (1988); *See* also A. Chandler, The Visible Hand: The Managerial Revolution in American Business (1977).
[114] Sklar, *Id*, at 45-46, noting that little further concentration took place between 1904 and 1954.
[115] *See* Lincoln Steffens, New Jersey- The Traitor State, 25 McClure's Magazine 41 (1905).
[116] For the classic debate, see William Cary, Federalism and Corporate Law: Reflections Upon Delaware, 83 Yale L.J. 663 (1974); Ralph Winter, State Law, Shareholder Protection, and the Theory of the Corporation, 6 J. Legal Stud. 251 (1977).
[117] *See*, e.g., the Nationalist Newsletter, edited by Edward Bellamy, arguing that democracy was threatened by the rise of big business.
[118] 40 Cong. Rec. 1849-1851 (Jan. 31, 1906).
[119] Standard Oil v. United States, 221 US 1 (1911); *See* also United States v. American Tobacco Co., 221 US 106 (1911). This "rule of reason" is still the standard today.

> only useless, but in the end vicious… We should, moreover, recognize in cordial and ample fashion the immense good effected by corporate agencies…The corporation has come to stay.[120]

> But he also stated that:

> I strongly advocate that instead of an unwise effort to prohibit all combinations, there shall be substituted [for the Sherman Act] a law which shall expressly permit combinations which are in the interest of the public, but shall at the same time give some agency of the National Government full power of control and supervision over them.[121]

Roosevelt's first concrete proposal was for federal incorporation.[122] The Hepburn Bill, introduced in 1908, would have allowed corporations to voluntarily register with a federal office.[123] The Bill failed, however, because of Republican opposition to such an expansion of executive branch power: If the Federal government registered corporations, it could also de-register them.[124] Ultimately, these concerns led to the Clayton Antitrust Act of 1914 and the establishment of the Federal Trade Commission.

The same concerns regarding trusts are reflected in the debates over the corporate tax, which as Marjorie Kornhauser first pointed out was seen by both supporters and opponents as a regulatory measure.[125] Kornhauser focused primarily on the publicity feature of the tax, but as we have seen this was not its only regulatory aspect- both supporters and opponents saw the tax also as having the potential to directly restrict managerial power.[126] Thus Sen. Root, the principal Senate drafter of the tax, spoke about the accumulation of wealth in the hands of corporations as a principal reason for the tax.[127] Sen. Newlands likewise supported the tax because "there was no reason why the great combinations monopolizing these industries should not pay some part of the national expenses."[128] Similarly Sen. Owen stated that "[t]he most important need of the people of the United States of this generation requires the abatement if the gigantic fortunes being piled

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[120] 42 Cong. Rec. 67-68 (Dec. 3, 1907).
[121] 43 Cong. Rec. 16, 17 (Dec. 8, 1908).
[122] 42 Cong. Rec. 70 (1907).
[123] 42 Cong. Rec. 3769-70 (1908).
[124] Sklar, *supra* note --, at 282-85.
[125] Kornhauser, *supra* note -- at 62.
[126] For a discussion of publicity, *See* Kornhauser, *supra* note --, at 69- 82.
[127] 44 Cong. Rec. 4003 (July 1, 1909).
[128] 44 Cong. Rec. 3761 (June 24, 1909). Newlands supported in particular taxing all industries benefiting from the tariff, 44 Cong. Rec. 3762 (June 24, 1909). He noted in particular the unwillingness of the Supreme Court to break up the Sugar trust as an argument in favor of the tax, 44 Cong. Rec. 3997 (July 1, 1909); 44 Cong. Rec. 4048-49 (July 2, 1909) (proposing an exemption for small corporations so as to "confine our taxation to these great combinations of capital whose profits have been enormous, whose ability to bear is greater than that of any other class of the community, and whose abuses have awakened the attention of the country and demand legislative cure.")

up by successful monopoly."[129] And Sen. Cummins, an opponent of the tax, likewise spoke about "the new force entering American life and American business" which is "a prelude to industrial commercial slavery unless the Government intervenes with its strong arm."[130] Sen. Cummins opposed the tax because it applied to all corporations, rather than just to the great combinations, which should be taxed more heavily.[131] Sen. Clapp was similarly concerned about the trusts but argued that the proposed tax did not address the problem because of the exemption of dividends paid to holding corporations.[132] Sen. Cummins' solution was to tax the trusts more heavily:

> If a company is organized for the purpose of consolidating a dozen other companies with a view to controlling the business in which those companies are engaged for the purpose of being able to direct through a single board the management of the entire field of industry… aside from the contravention of public policy involved in such an organization the privilege enjoyed is of priceless value, and instead of being taxed at 2 per cent on the net earnings it ought to be taxed at 10 or 15 per cent on the net earnings, that it ought to be taxed so heavily that such companies would become not only unfashionable but unprofitable as well.[133]

The principal reason for the difference between the 1894 tax (viewed primarily as a tax on shareholders) and the 1909 tax (viewed primarily as a tax on management) was thus the rise of the great trusts in the period between 1896 and 1904.[134] By 1909, the trust problem was perceived as the most serious issue facing the country.[135] Some Democrats would have liked to turn back the clock and outlaw the trusts, but the majority preferred to follow President Roosevelt and regulate them. A primary vehicle for such regulation was the corporate tax, in part because of its publicity feature, but in part because potentially (to use a phrase cited by many during the Congressional debate) "the power to tax is the power to

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[129] 44 Cong. Rec. 3950 (June 29, 1909). He stated that corporate wealth of publicly traded corporations amounted to one third of national wealth, *Id*. *See* also statement by Sen. Bourne, supporting the tax because the tendency of business to consolidate requires strengthening the government's ability to regulate, 44 Cong. Rec. 4000-01 (July 1, 1909).

[130] 44 Cong. Rec. 3965 (June 30, 1909).

[131] 44 Cong. Rec. 3978 (June 30, 1909) (quoted above).

[132] 44 Cong. Rec. 4009 –10 (July 1, 1909): "the plain invitation, the plain effect of this provision is to encourage the organization of the very kind of corporations, great, powerful, overshadowing, absorbing industries, absorbing industrial life and industrial affairs, by holding out to them immunity from taxation." *See* also the similar sentiments of Sen. Dolliver, who likewise focused on the trust problem, 44 Cong. Rec. 4230 (July 7, 1909). Sen. Davis, on the other hand, thought that the solution to "the corporations of the country invading every avenue of business and trade" was "that if we cannot tax all the corporations, we should tax just as many of them as we can". 44 Cong. Rec. 4036 (July 2, 1909). And Sen. Aldrich pointed out that no corporation was exempt from the tax. 44 Cong. Rec. 4231 (July 7, 1909).

[133] 44 Cong. Rec. 4232 (July 7, 1909); *See* similarly Sen. Newlands, 44 Cong. Rec. 4233 (July 7, 1909).

[134] By 1900, John D. Rockefeller had created the Standard Oil Company and capitalized it at $122 million. The following year J. P. Morgan created U.S. Steel in a $1.4 billion transaction. Between 1898 and 1901, the capitalization of mergers totaled $5.4 billion and 2,274 firms were merged out of existence. Davis, 620.

[135] *See*, E.g., Wilgus, Need of a National Incorporation Law, 2 Mich. L. Rev. 358 (1904).

destroy."[136] To tax the powerful trusts was seen as the beginning of a federal power to regulate and, if need be, destroy them. That was the fundamental rationale for enacting the corporate income tax. But is it still a valid argument today? To answer this question, we need to move from historical to normative analysis.

3. A Normative Perspective: What Is the Justification For The Corporate Tax Today?

    a. The Reality of Corporate Power.

A page of history may be worth a volume of logic as far as explanatory power is concerned, but Holmes also conceded that history *per se* has no normative power.[137] Are there any normative lessons that can be drawn from the above history to justify the existence of the corporate tax today?

I would argue that the answer is yes, for the following reasons.[138] To get from the Roman origins of the corporate form to today's multinational enterprises, the corporation had to undergo several crucial changes. First, the concept of the corporation as a separate legal person from its owners or members had to be developed, and this development was only completed with the work of the civil law Commentators in the fourteenth century. By the end of the Middle Ages, the membership corporation, i.e., a corporation with several members who chose others to succeed them, had legal personality (the capacity to own property, sue and be sued, and even bear criminal responsibility) and unlimited life, was well established in both civil and common law jurisdictions. The next important step was the shift from non-profit membership corporations to for-profit business corporations, which took place in England and the U.S. in the end of the eighteenth and beginning of the nineteenth century. The third transformation was the shift from closely-held corporations to corporations whose shares are widely held and publicly traded, and with it the rise of limited liability and freedom to incorporate, which took place by the end of the nineteenth century and the beginning of the twentieth. Finally, the last major transformation was from corporations doing business in one country to multinational enterprises whose operations span the globe, which began after World War II and is still going on today.

Each of these four transformations (as well as a smaller, more temporary one which occurred in the U.S. in the 1980s with the advent of hostile takeovers) was accompanied by changes in the legal conception of the corporation. What is

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[136] [136] McCulloch v. Maryland , *supra* note --.

[137] N.Y. Trust Co. v. Eisner, 256 US 345, 349 (1921); Oliver Wendell Holmes, The Path of the Law, 10 Harv. L. Rev. 457, 459 (1897).

[138] The following is based on a companion paper, "Aggregate, Artificial, or Real? The Cyclical Transformations of the Corporate Form" (available from the author).

remarkable, however, is that throughout all these changes spanning two millennia, the three theories of the corporation that we have outlined above can be discerned. Those theories are the aggregate theory, which views the corporation as an aggregate of its members or shareholders; the artificial entity theory, which views the corporation as a creature of the State; and the real entity theory, which views the corporation as neither the sum of its owners nor an extension of the state, but as a separate entity controlled by its managers. Remarkably, every time there was a shift in the role of the corporation, all three theories were brought forward in cyclical fashion.[139] Moreover, every time the real entity theory prevailed, for reasons we will discuss below, and it is the dominant theory during periods of stability in the relationship between the corporation, the shareholders, and the state.[140]

The explanation for this persistence of the real entity view is two-fold. First, the real view persisted because it represents a better approximation of reality that the artificial entity and aggregate views. Moreover, it *became* a better approximation over time because of the transformations that the corporate form underwent. Roman or medieval corporations could plausibly be seen as creatures of the state or as identical with their members because the state had a crucial role in creating them and in permitting them to continue in existence, and the membership was identical with corporate management. These views are much less plausible today, however, since the state plays only a minimal role in creating corporations (and that role is sharply constrained by management's ability to shift the location of incorporation). The shareholders, meanwhile, are (in the case of large, publicly traded multinationals) widespread over the globe and clearly separate from the corporate entity.[141]

Second, another way of looking at the persistence of the real view is that it reflects the power of corporate management.[142] One way of looking at the transformations outlined above is that both the artificial entity and aggregate views were advanced in order to limit the power of management. The artificial entity view was usually brought forward in order to enable the state to regulate corporations, and the aggregate view was usually advanced to enhance the power of shareholders (although sometime it was used to give corporations rights that normally only belong to individuals).[143] The ultimate success of the real entity view resulted

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139 The transition from the 1894 (aggregate) view of the corporate tax to the 1909 (real) view can thus be seen as part of this broader move, which was repeated many times in the history of corporations.
140 See Avi-Yonah, The Cyclical Transformations, supra.
141 The situation is different in countries with interlocking corporate structures, but arguably that means that individual shareholders have even less power and management is more firmly entrenched. *See*, for example, Lucian Bebchuk and Mark Roe, "
A Theory of Path Dependence in Corporate Ownership and Governance," 52 Stanford L. Rev. 127 (1999).
142 *See*, e.g., Vik Khanna, "A Political Economy Theory of Corporate Crime Legislation," *Discussion Paper No. 220*, Center for Law & Economic Studies, Columbia Law School (2003) on why corporations continue to be made criminally liable (because management prefer criminal to civil liability, and both to being held liable themselves).
143 See generally Avi-Yonah, The Cyclical Transformations, supra.

from the fact that it gave more power to management than the other views, and that both legal commentators and courts were ultimately solicitous of the welfare of corporations (i.e., corporate management).[144] But the very success of management to persuade courts to adopt the real entity view also shows that the real entity view is more accurate than the other ones, since it depends on recognizing the power of management. If management has the power to persuade courts to adopt the real entity view, that view must also be accurate (or at least more accurate than the others).

In fact, one good way of describing the aggregate and the artificial entity views is that they represent *normative aspirations* of their proponents. People who believe that corporations are insufficiently regulated by the state advance the artificial entity view to justify more regulation. People (including much current scholarship on corporate law) who believe that the biggest problem with corporations is the agency cost issue, i.e., that management are insufficiently attentive to the welfare of shareholders, advance the aggregate (nexus of contracts, contractarian) view.[145] Neither of these views actually describes corporations as they actually operate in the real world- they represent idealized, normatively based descriptions of what corporations would look like in a better world.[146]

To see what corporations look like in the real world, a more accurate perspective is available in the sociological literature.[147] As one sociologist has stated, "[t]he recurrent problem in sociology is to conceive of corporate organization, and to study it, in ways that do not anthropomorphize it and do not reduce it to the behavior of individuals or of human aggregates."[148] A whole branch of economic sociology centers on the study of organizations, and there are numerous books

[144] But *See* Hager, *supra* note --, at 585, who argues that the real view could sometime be used to limit managerial power, e.g., to justify corporate criminal and tort liability. *See* also E. Merrick Dodd, For Whom Are Corporate Managers Trustees?, 45 HARV. L. REV. 1145, 1153 (1932), who uses real entity theory as the foundation for corporate social responsibility. This article continues that tradition.

[145] For the classic expositions, *See* Alchian & Demsetz, Production, Information Costs, and Economic Organization, 62 American Econ. Rev. 777 (1972); Jensen & Meckling, Theory of the Firm, 3 J. Fin. Econ. 305 (1976); Eugene Fama and Michael C. Jensen, Separation of ownership and control, 26 J. Law and Econ 301 (1983); Daniel R. Fischel and Frank Easterbrook, The Economic Structure of Corporate Law (1991). As stated by two of its original proponents, under this view, the various participants in the corporation do not differ "in the slightest degree from ordinary market contracting between any two people." Alchian & Demsetz, 777. "Ownership of the firm disappears as a meaningful concept under this model because no one can own a "nexus"…Control is reflected in the terms of various contracts entered into by individuals." Dallas, Two Models of Corporate Governance, 22 U. Mich. J. L. Ref. 19, 23 (1989).

[146] The contractarian view almost became the law in the 1980s, but then it didn't- probably for the better, given that it is unclear that an unfettered market for corporate control would have been socially beneficial (for example, recent attempts to align the interests of management with shareholders via stock options have had detrimental consequences). Recent law and economics scholarship is in fact beginning to recognize the crucial importance of managerial power in contexts like setting executive compensation. *See* Bebchuck & Jesse M. Fried, Executice Compensation as an Agency Problem, Harvard Law School, John M. Olin Center for Law, Economics, and Business Discussion Paper No. 421 (2003).

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

[148] Guy E. Swanson, The Tasks of Sociology, 192 Science 665 (1976).

devoted to the topic.[149] Most of these books revolve around the study of large corporations, since these are the dominant forms of organization in this society. Moreover, they are informed by the economic perspective inaugurated by Ronald Coase in his classic "Nature of the Firm" article from 1937, and developed by Oliver Williamson and others into transaction cost economics.[150] This branch of economics, which now forms part of the "new institutional economics", begins by recognizing that the firm is fundamentally different from the market because of its hierarchical structure, and proceeds to investigate when operating as a firm as opposed to buying in the market makes sense (the "make or buy" issue). Recently, transaction cost economics has become the leading explanation for the most recent transformation of the corporation- the rise of multinational enterprises.[151]

From a normative perspective, the key observation that emerges from this literature is that corporate management have power (defined as the ability to influence the behavior of others, or more generally "the ability to get what one wants"[152]) by virtue of their position at the top of the corporate hierarchy and the financial resources they therefore control.[153] The economist Kenneth Boulding, for example, distinguishes between threat, economic, and integrative power (the stick, the carrot, and the hug) and ascribes all three to corporations.[154] The political scientist Joseph Nye distinguishes between "hard" power (military and economic) and "soft" power (cultural power, or the ability to persuade others to want to be more like you) and describes how the major U.S. multinationals wield both hard and soft power.[155] Likewise, distinguished tax scholars like Richard Musgrave and

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[149] *See*, e.g., James D. Thompson, Organizations in Action: Social Science Bases of Administrative Theory (1967, reissued 2003); W. Richard Scott, Organizations: Rational, Natural, and Open Systems (5th ed. 2003); Jeffrey Pfeffer and Gerald R. Salancik, The external control of organizations: A resource dependence perspective (1978, reissued 2003); Walter W. Powell and Paul j. DiMaggio (eds.), The New Institutionalism in Organizational Analysis (1991); Neil J. Smelser and Richard Swedberg (eds.), The Handbook of Economic Sociology (1994), especially Part II, Section C, The Sociology of Firms, Organizations, and Industry.

[150] Ronald Coase, The Nature of the Firm, 4 Economica 386 (1937); Oliver E. Williamson, Transaction Cost Economics and Organization Theory, in Organization Theory: From Chester Barnard to the Present and Beyond 207, in Smelser and Swedberg, *Id* ; for a critique *See* Mark Granovetter, Economic action and social structure: The problem of embeddedness, 91 Am J Sociology 481 (1985).

[151] Pitelis and Sugden, The Nature of the Transnational Firm (1991) (esp. Ch. 2).

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

[153] This was clearly recognized by Berle & Means, *supra* note --, in 1932 and was still the prevalent view in 1959, *See* Abram Chayes, The Modern Corporation and the Rule of Law, in E. Mason (ed.) The Corporation in Modern Society (1959), but this view has now (since around 1980) been largely replaced by the nexus of contracts theory. *See* Bratton, *supra* note --, who calls the power-centered view "managerialism". An interesting analogy is to compare corporations and the state (which was a corporation in Roman law, *See* Avi-Yonah, Cyclical Transformation, *supra* note --). Even extreme rational choice oriented political scientists (i.e., the ones most likely to regard the state merely as a collection of rent-seeking politicians) would not deny that the state (i.e., the politicians) wields significant power. This point was made by Machen, who noted in 1911 that "Uncle Sam is a fictitious person; but the government of the United States is a reality." Machen, Corporate Personality, 24 Harv. L. Rev. 253 (1911). *See* also Berle and Means, *supra* note --: "the enterprise becomes transformed into an institution which resembles the state in character."; *See* also Bratton, *supra* note -- at 1497.

[154] Boulding, *supra* note --; *See* also Valeri G. Ledyaev, Power: A Conceptual Analysis (1997); Steven Lukes (ed.), Power (1986); John Scott (ed.), Power: Critical Concepts (1994); Marvin E. Olsen (ed.), Power in Modern Societies (1993).

[155] Nye, The Paradox of American Power (2003).

William Andrews have recognized that control over financial resources is a source of power beyond the pure ability to consume.[156] In fact, corporate management is the best example of this point, because they typically cannot consume corporate resources directly, yet they derive significant power from controlling those resources.[157]

b. The Nature of Corporate Power.

The sociological literature indicates that corporate (managerial) power can generally be divided into three categories.[158] The first is political power- the power of management to affect political outcomes by lobbying and political contributions. That power is somewhat constrained by campaign finance reform laws, but those laws (including most recently McCain-Feingold) are generally recognized as not very effective, and decisions like *Bellotti* (recognizing a first amendment right of corporations to engage in political speech) enhance corporate power.[159] Moreover, even if campaign finance reform completely banned political contributions by corporations (i.e., indirect as well as direct contributions), corporate lobbying would still be effective to the extent corporations have power over the lives of voters in the politician's constituency.

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[156] Richard A. Musgrave, Clarifying Tax Reform, 70 Tax Notes 731, 733-34 (Feb. 5, 1996); see also Institute for Fiscal Studies, The Structure and Reform of Direct Taxation (1978) (Meade Report), at 351 ("[t]he holding of wealth itself… can confer on the owner benefits of security, independence, influence and power, quite apart from any expenditure which the income from it may finance"); William D. Andrews, Fairness and the Personal Income Tax: A Reply to Professor Warren, 88 Harv. L. Rev. 947, 956 (1975) ("It may well be unacceptable to rely solely on consumption as a personal tax base because for some people wealth has a welfare value above and beyond the deferred consumption it may operate to support); Anne L. Alstott, The Uneasy Liberal Case Against Income and Wealth Transfer Taxation: A Response to Professor McCaffrey, 51 Tax L. Rev. 363, 371-2 (1996).

[157] Dan Shaviro argues to the contrary that "many believe that wealthy people escape the burden of a consumption tax by deferring their consumption, and that advocates of such a tax ignore the effects of unconsumed wealth on one's security, political power, and social standing. The argument overlooks the fact that what makes wealth valuable is the real purchasing power that it commands. Otherwise, real money would be no different than Monopoly money. A consumption tax affects the purchasing power even of unspent wealth, and the burden it imposes generally is not reduced by deferring one's consumption." Shaviro, Replacing the Income Tax With a Progressive Consumption Tax (2003). This is wrong because the power of the wealthy (and of corporate management) stems primarily from their ability to invest, not consume, their wealth, and investments are by definition not curtailed by a consumption tax.

[158] The point that corporate management have power was clearly seen in 1932 by Berle and Means, who wrote that "[t]he economic power in the hands of the few persons who control a giant corporation is a tremendous force which can harm or benefit a multitude of individuals, affect whole districts, shift the currents of trade, bring ruin to one community and prosperity to another. The organizations which they control have passed far beyond the realm of private enterprise- they have become social institutions." Berle & Means, *supra* note --, at 46. When this was written, "something over one-third of the national wealth of the country [was] administered by some two hundred corporations who in turn are dominated by less than eighteen hundred men." Today, the top 350 multinationals control about one sixth of the world's productive resources. *See* Reuven S. Avi-Yonah, National Regulation of Multinational Enterprises: An Essay on Comity, Extraterritoriality, and Harmonization, 42 Columbia J. Transnat'l L. 5 (2003).

[159] First Nat'l Bank v. Bellotti, 435 US 765 (1977); for a trenchant critique *See* Hager, *supra* note --, at 640; Carl J. Mayer, Personalizing the Impersonal: Corporations and the Bill of Rights, 41 Hastings L. J. 577 (1989).

The second category of corporate power is economic power, which applies directly to corporate employees and indirectly to communities in which corporations have significant facilities. While the relationship between shareholders and management can perhaps plausibly be analyzed in purely contractual terms (shareholders are free to sell), the same cannot be said of many situations involving corporate employees.[160] Employees have invested human capital in corporations and may find it difficult to find another employer except at significant costs (e.g., the costs of moving to a distant city), especially in industries characterized by monopoly or oligopoly (e.g., Microsoft, Intel, Boeing, Wal-Mart). Nor is contract the best way to describe the relationship between corporations and their communities. When a major corporation closes a plant or moves its headquarters, the effects are felt by both employees and the community. In general, the presence of corporate headquarters in particular is associated with positive externalities that are not reflected in any contractual arrangement. It is very hard to regulate this kind of corporate power without unduly restricting corporate economic flexibility; hence, even unionized plants are not immune to closing. In addition, this is the kind of power that makes developing countries feel so dependent on Multinationals and their decisions where to open new plants.

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

c. Two Arguments for Restricting Corporate Power.

What are the normative consequences of the recognition of corporate managerial power? There are two principal arguments why a liberal democratic state should curb excessive accumulations of private power. The first is the argument from *democracy*: In a democracy, all power should ultimately be accountable to the people.[161] Private accumulations of power are by definition unaccountable, since the holders of power are neither elected by the people nor have their power delegated from the people's representatives. In fact, the American Revolution was founded on the conception that while people have natural, Lockean liberal rights to their property, undue concentrations of private power and wealth should be discouraged.[162] This view found its expression in the republican creed of civic

[160] But *see*, e.g., Thomas L. Hazen, The Corporate Persona, Contract (and Market) Failure, and Moral Values, 69 N.C. L. Rev. 273 (1991), who critiques the contractarian paradigm even in the shareholder context.
[161] This view is further explored in Reuven S. Avi-Yonah, Why Tax the Rich? Efficiency, Equity, and Progressive Taxation, 111 Yale L.J. 1391, 1405 (2002), where it is argued that limiting private power is the best argument for taxing the rich.
[162] Dennis Ventry, Equity versus Efficiency and the U.S. Tax System in Historical Perspective, in Joseph J. Thorndike and Dennis J. Ventry Jr. (eds.), Tax Justice: The Ongoing Debate (Washington, DC, 2002), 25.

humanism, which emphasized public virtue as a balance to private rights. A virtuous republic, the Founders believed, was to be free from concentrations of economic power such as characterized England in the 18th century.[163] Therefore, from the beginning of the republic, federal and state legislators used taxation to restrict privilege and to "affirm communal responsibilities, deepen citizenship, and demonstrate the fiscal virtues of a republican citizenry."[164] As Dennis Ventry has written, "[t]he ideal of civic virtue created a unique form of ability-to-pay taxation that was hostile to excess accumulation and to citizens who asserted entitlement through birth…Inherited wealth, as well as gross concentrations of wealth (inherited or not), characterized an aristocratic society, not a free and virtuous republic."[165] In the 20th century, the same view was best expressed in the corporate context by Berle, who wrote that in a democracy like the United States "it becomes necessary to present a system (none has been presented) of law or government, or both, by which responsibility for control of national wealth and income is so apportioned and enforced that the community as a whole, or at least the great bulk of it, is properly taken care of. Otherwise the economic power now mobilized and massed under the corporate form… is simply handed over, weakly, to the present administrators with a pious wish that something nice will come of it all."[166]

The other principal argument against excessive corporate power is based on a liberal conception of *equality*. Michael Walzer has explained that when liberals talk about equality, they are not concerned with "simple equality", i.e., equalizing everyone's initial means. Instead, they are advocating "complex equality," by which Walzer means that every social "sphere" should have its own appropriate distributive principles and that possession of goods relevant to one sphere should not automatically translate into dominance in other spheres as well. "In formal terms, complex equality means that no citizen's standing in one sphere or with regard to one social good can be undercut by his standing in some other sphere, with regard to some other good."[167] In our capitalist society, money is the "dominant good", and the people who possess it are the most likely to accumulate illegitimate power in other spheres, such as politics.[168] "This dominant good is more or less systematically converted into all sorts of other things- opportunities, power, and reputation."[169] Walzer goes on to explain the insidious effects of money and why it needs to be curbed by redistribution, including redistributive taxation:

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[163] Id. at 25.
[164] W. Elliott Brownlee, Economic History and the Analysis of "Soaking-the-Rich" in 20th Century America, in Ventry and Thorndike, supra note --, at 71.
[165] Ventry, *supra* note --, at 25.
[166] Berle, supra note --. It is ironic that Berle is sometimes regarded as a progenitor of the current nexus of contracts approach. *See* also Hager, *supra* note -- at 639: "Such [corporate] power, insulated from participation, criticism, or revision by a public that cannot escape its effects, poses an enormous obstacle toward achieving maximum democratic control over condition of social life."
[167] *See* Michael Walzer, Spheres of Justice : A Defense of Pluralism and Equality 19 (1983); *See* also Don Herzog, Happy Slaves: A Critique of Consent Theory 199 (1989), ch. 5 (on liberal "differentiation" between different spheres).
[168] Walzer, Id. at 11.
[169] Walzer, Id. at 12.

> Market imperialism requires another sort of redistribution, which is not so much a matter of drawing a line as of redrawing it, What is at issue now is the dominance of money outside its sphere, the ability of wealthy men and women to trade in indulgences, purchase state offices, corrupt the courts, exercise political power…the exercise of power belongs to the sphere of politics, while what goes on in the market should at least approximate an exchange between equals (a free exchange)…When money carries with it the control, not of things only but of people, too, it ceases to be a private resource.[170]

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

> It would be a mistake to imagine, however, that money has political effects only when it "talks" to candidates and officials…It also has political effects closer to home, in the market itself and in its firms and enterprises…Even within the adversary relation of owners and workers, with unions and grievance procedures in place, owners may still exercise an illegitimate kind of power. They make all sorts of decisions that severely constrain and shape the lives of their employees (and their fellow citizens, too). Might not the enormous capital investment represented by plants, furnaces, machines, and assembly lines be better regarded as a political than an economic good? To say this doesn't mean that it can't be shared among individuals in a variety of ways, but only that it shouldn't carry the conventional entailments of ownership. Beyond a certain scale, the means of production are not properly called commodities… for they generate a kind of power that lifts them out of the economic sphere.[171]

Walzer thus advocates taxation as one means of restricting the market to its proper sphere (along with trade unions and limiting property rights). But he also recognizes the inherent limitations of all redistribution, since his aim is not to abolish the market: "All these redistributions redraw the line between politics and economics, and they do so in ways that strengthen the sphere of politics- the hand of citizens, that is, not necessarily the power of the state…But however strong their hand, citizens can't just make any decisions they please. The sphere of politics has its own boundaries…Hence redistribution can never produce simple equality, not so long as money and commodities still exist, and there is some legitimate social space within which they can be exchanged."[172]

d. Ways of Limiting Corporate Power.

How can corporate power be limited? It depends on the type of power. Political power can most obviously be restricted by placing direct limits on campaign contributions, which are an incredibly cheap sort of power for large corporations (a whole campaign can be financed for a few million dollars, whereas an elected

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[170] Walzer, Id. at 119-121.
[171] Walzer, Id. at 122. *See* also his discussion of "company towns", pp. 302-303.
[172] Walzer, Id. at, 122-23.

politician can make decisions worth billions). Admittedly, the experience with this kind of limits since corporations were first banned from directly contributing to political campaigns in 1907 has not been good: The very political power of corporations seem to ensure that campaign finance reform is hard to pass and riddled with loopholes, and Supreme Court decisions like *Bellotti* do not help. Nevertheless, it is conceivable that the direct political power of corporations could be limited by campaign finance reform. The problem, however, is that this will by no means eliminate the political power of corporations, because that power stems from their economic power. As long as GM and Ford employ tens of thousands of Michigan voters, their views will resonate with the Michigan delegation to Congress, even if they are strictly prohibited from donating a penny to any politician (directly or indirectly).

The market power that some corporations possess can be limited through the antitrust laws. Having said that, though, it is important to note that for the past forty years antitrust law has been moving away from curbing corporate market power and toward ensuring that consumers do not pay higher prices. The shift in focus from curbing corporate size and power to consumer protection is particularly striking in US antitrust law, and is evidenced by the failure of the government to break up even monopolies like IBM in the 1970s or Microsoft in the 1990s. In Europe, there is more of a focus on preventing "abuse of a dominant position" even if it only hurts competitors rather than consumers, but even there, it is the abuse rather than the dominant position itself that is at stake. But even if American antitrust law were changed to re-focus more on directly on corporate market power (and that would be a radical re-direction), it is still a very unwieldy and imprecise tool. Proving antitrust violations is hard and in the case of large corporations can take years of litigation, and courts typically shy away from the breakup remedy because they fear damaging the corporation in the economic sphere where the benefits of its existence are most clearly felt.

Finally, it should be emphasized that curbing corporate power cannot be achieved through corporate governance reform. It may be possible to place limits on the power of corporate management vis-a-vis shareholders in this way, although once more the power of management makes this very difficult to do (as shown by the rise and fall of the market for corporate control). But even if management were to operate perfectly in the interests of the shareholders, they would still from my perspective exercise excessive power over the rest of society, and it is that power that the corporate tax seeks to curb. By definition, corporate governance reforms cannot hinder management when they exercise power in ways that are beneficial to shareholders.[173]

[173] Oliver Hart, for example, has argued that corporate debt can be used to discipline managers: corporations use a lot of debt so that managers will not squander too much of shareholders' money, and the corporate tax assists in this function. Oliver Hart, Firms, Contracts, and Financial Structure (1995). *See* also Joseph Stiglitz, The corporate income tax, J. Pub. Econ (1973) (corporations can avoid tax by using debt). But while debt might help restrict managerial power vis-a-vis shareholders, and to some extent vis-a-vis society as well (and that is a good reason to allow corporations to deduct interest), debt cannot limit managerial use of equity or retained earnings. (As noted below, it may from this perspective also be acceptable to let corporations deduct dividends).

In the final analysis, the problem of corporate power can only be addressed by direct regulation of the kind of activities we want corporations to perform, namely production and distribution of goods and services. Some of these activities may have negative externalities that are best regulated by, for example, labor safety or environmental laws. But these laws will still do nothing to limit corporate power that is exercised by producing and distributing goods and services in an environmentally sound and safe way. Given that we do *not* want government to tell corporate management directly how to run their business (that idea was tried and failed in the socialist economies), only the tax law can directly reach these types of activities, which are the ultimate source of corporate power accumulation.

e. The Regulatory Rationale for the Corporate Tax.

My basic argument is therefore that *the corporate tax is justified as a means to control the excessive accumulation of power in the hands of corporate management*,[174] which is inconsistent with a properly functioning liberal democratic polity.[175] As I have argued above, this was also the principal reason why the corporate tax was enacted in 1909, and I believe is also the principal reason for its political resiliency today. People understand that corporations are powerful and that the corporate tax is one way in which the state, as representative of the people, can limit their power.[176]

This argument has particular resonance today as a result of the rise of multinational enterprises. As many academics have pointed out, the rise of MNEs has significantly weakened the regulatory power of the state, since MNEs by definition operate across jurisdictions and can set one jurisdiction off against

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[174] The idea that the tax was a regulatory tool is hinted at in Mayer, *supra* note -- at 583, and raised but rejected by Musgrave, supra note --. Except for Walzer's brief mention (*See supra* note --) I have not found it elsewhere.

[175] *See* Walzer, *supra* note --; Herzog *supra* note --; From this perspective the "incidence" of the corporate tax is on management, since they are the ones whose power is diminished by it. This is a separate question from the knotty problem of who bears the burden of the corporate tax in the sense that their own resources (and not "other people's money") are diminished by it. It is important to note, however, that if one could show that the incidence of the corporate tax is actually shifted to consumers or labor, then presumably management would not care that the tax was imposed since it would not actually diminish the resources they control. This would eliminate the regulatory rationale for the tax. But forty years of research on incidence by economists have failed to demonstrate that the tax can in fact be shifted in most cases, at least in the long run. *See* the incidence literature, cited supra note --. *See*, in particular, the Treasury's extensive 1992 study (up to 50% of tax may be shifted in short run but not in long run), reprinted in Graetz & Warren, supra note--. And corporate management certainly seem to care enough about the corporate tax to engage in significant tax planning to try to avoid it as much as possible. *See* tax shelters literature, cited supra note --.

[176] One interesting corollary of this view is that the corporate tax should apply to non-profit corporations (which have no shareholders) since their management have as much power as the management of for-profit entities. But I accept the mainstream view that since non-for-profits perform functions that would otherwise fall to the state, they should not be taxed. See, e.g., Henry B. Hansmann, The Role of Nonprofit Enterprise, 89 Yale L. J. 835 (1980). It is interesting to consider the mirror image of this argument, i.e., that for profit corporations should be taxed because their management choose not to address problems they could help solve, and therefore create more work for the state. This requires considering the debate on corporate social responsibility, which is a topic for another day.

another.[177] Taxation is one vehicle of regulation, and an area in which extraterritorial jurisdiction is well established in international law.[178] Therefore, it offers a promising venue to regulate MNEs.[179]

It should also be noted that this rationale for the tax applies more or less precisely to the current scope of the tax we have today- i.e., a tax imposed primarily on publicly traded enterprises, since it is only those that exhibit the separation of ownership from control (i.e., managerial power).[180] And this rationale can also explain why we tax corporate equity but not debt, since issuing debt constrains managerial power in ways that issuing equity does not (as many of the leveraged buyout targets of the 1980s discovered).[181]

f. Two Regulatory Functions of the Corporate Tax.

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

First, the limiting function: Imagine first a 100% tax imposed on corporate profits. Such a tax would effectively eliminate the corporation's reason to exist. Over time, it would also eliminate all sources of corporate power, since it would force the corporation to use its existing resources to pay politicians and employees, and it would remove any incentive to sell goods to consumers. Once these resources are exhausted the corporation would be liquidated. A 100% federal tax (assuming

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177 Philip I. Blumberg, The Multinational Challenge to Corporation Law (1993) [hereinafter Blumberg, Multinational Challenge]; Raymond Vernon, In The Hurricane's Eye: The Troubled Prospects of Multinational Enterprises (1998); Avi-Yonah, National Regulation, supra note --.
178 See, e.g., the treatment of controlled foreign corporations, IRC sec. 951-960.
179 Avi-Yonah, National Regulation, supra note --: Taxation falls in the right column and middle row of the matrix developed in that article to distinguish various areas of state regulation of MNEs, i.e., it is an area in which extraterritoriality is required and countries (but not MNEs) agree on its basic principles.
180 This is contrary to the view expressed by Schlunk, who argues that "there is no colorable justification for the double taxation scheme currently imposed in the United States" (Schlunk, *supra* note --, at 332), i.e., a tax imposed almost entirely on equity capital of publicly traded enterprises, with full taxation of dividends when distributed. Admittedly, from a power perspective the tax could be limited to large corporations, such as the S&P 500, which account for over 85% of the corporate tax base. An exemption of the first $100 million would be acceptable, just as I support exempting the first $100,000 of individual income from the income tax (an idea advocated by Graetz: *See* Michael J. Graetz, 100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System, 112 YALE L.J. 261, 282 (2003).) It could also be argued that corporations can be powerful without being profitable; this may be true for any given year, but over a longer run there is a correlation between size, power and profitability.
181 This requires developing ways to distinguish equity from debt. That distinction is hard to defend theoretically but in practice can be defended; transaction costs make it impossible to easily convert all equity into debt, as financial theory would predict. Otherwise, the $200 billion collected annually by the corporate tax would have vanished long ago. *See* Stiglitz, supra note --.

it cannot be avoided) is therefore as effective a corporate death sentence as the mandatory liquidation imposed by state courts on the trusts.[182] The power to tax is indeed potentially the power to destroy.

But a 100% tax is inconceivable. Taxation faces an inherent limit that was well expressed by Holmes when he stated that "the power to tax is not the power to destroy while this court sits."[183] The constitution places limits on the power to tax, limits that are implicit already in *Dartmouth College*: The public sector may not use taxation to completely eliminate the private one. This is both a matter of constitutional law (a tax may be a taking if the rate exceeds any reasonable estimate of the state's contribution to private wealth creation)[184] and a matter of practicality: Just as in the case of the rich, we do not want to kill the goose that lays the golden eggs by imposing taxation at rates that create huge deadweight losses to the economy at large (the deadweight loss is approximately a square function of the tax rate).[185] The precise limit of desirable taxation thus becomes the quintessential political question of our time, to be refought every four years at the ballot box.

Given that we cannot tax at 100%, what is the effect on corporate power of a lower tax rate, such as the current 35%? Even at that historically low rate,[186] the corporate tax does significantly slow down the accumulation of corporate resources, which are the foundation of managerial power.[187] For example, imposing a tax at 35% on corporate assets invested at a 10% yield (compounded annually) over ten years results in approximately 27% less assets being available to management at the end of the period than would be available in the absence of the tax.[188] Thus, taxation at lower rates can meaningfully restrict the build-up of assets that forms the base of managerial power, even when it does not destroy it.[189] Bust since corporate power will continue to exist and grow at any reasonable rate

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[182] *See* People v. North River Sugar Refining Co., 121 N.Y. 282 (1890); State v. Standard Oil Co., 49 Ohio St. 137 (1892).
[183] *See supra* note --.
[184] *See* Liam Murphy & Thomas Nagel, The Myth of Ownership: Taxes and Justice 135 (2002).
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Harvey S. Rosen, Public Finance (6th ed. 2002). It should be noted, however, that to the extent the corporate tax falls on economic rents, it is not inefficient even at very high rates. And there is a significant literature that suggests that MNEs in particular earn economic rents. See, e.g., Mihir A. Desai and James R. Hines, Jr., Evaluating International Tax Reform, 56 Nat'l Tax J. 487 (2003), and sources cited therein.
[186] The corporate tax rate was 46% as recently as 1986, and higher before then.
[187] This assumes that management cannot avoid the tax either by corporate tax shelters or tax competition. These two problems are discussed in Part 4 below. It also assumes that the corporate tax cannot generally be shifted. *See supra* note --.
[188] 100 invested at 10% over ten years, compounded annually, yields 257 at the end of Year 10 in the absence of tax and only 188 (or 27% less) if the earnings are subject to a 35% tax. The key is of course the effective tax rate; George Yin has calculated that the effective rate for the S&P 500 is on average about 30%. George K. Yin, How Much Tax Do Large Public Corporations Pay? Estimating the Effective Tax Rates of the S&P 500, 89 Va. L. Rev. 1793 (2003).
[189] Note that the corporate tax does not limit the absolute size of corporations; it is not meaningfully progressive, and it actually encourages growth through tax-free mergers and acquisition. Instead, the corporate tax's limiting function is a way for government to control the rate of corporate growth, with the implied potential of stopping it altogether.

of taxation, we also need the tax to perform a regulatory function.

Second, the regulatory function: Managerial use of corporate assets (i.e., its use of its power) may be impacted by the threat that the tax rate will be raised if it is perceived that the assets are not used for the betterment of society. This can be seen by the imposition of higher effective rates on certain forms of behavior Congress disapproved of, like bribes paid to foreign officials and participation in international boycotts. In both cases, empirical research has suggested the tax penalties had a significant impact.[190] More recently, the threat of increased tax rates applied to US corporations that moved their nominal place of incorporation to Bermuda seems to have sufficed to block one such "inversion" transaction and stop other corporations from adopting the same strategy.[191] This is particularly striking since the imposition of an actual tax on the *shareholders* of inverting corporations in 1994 had no effect whatsoever on the rate of inversions; management do not care enough about the tax on shareholders. Thus, it seems that just as Senator Cummins predicted in 1909, taxation even at rates much less than 100% can suffice to regulate corporate managerial power.[192] But the rates cannot be set too low (1%, as in 1909, is not enough), because then management would not care sufficiently to avoid the tax. This is why we need the limiting function (i.e., set rates at sufficiently high levels for management to notice) for the regulatory function to work properly.

Finally, in addition to providing disincentives, the tax can be used to provide incentives as well.[193] For example, investment incentives are provided to corporations as a way of bolstering the economy.[194] Another example is research and development, which has been shown by economists to produce significant positive externalities for society, which justify government in providing a subsidy via the tax code.[195] Now it is of course true that the government could subsidize these functions directly, rather than use tax expenditures, so that this cannot strictly be an argument for taxing corporations. However, that would require setting up an IRS-like agency to monitor the use of the subsidies, so that any simplification advantage from abolishing the corporate tax is diminished. And once the corporate tax is in place, it seems like an obvious and convenient vehicle to deliver the desired subsidies at little additional cost.

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[190] James R. Hines, Jr., Taxed Avoidance: American Participation in Unsanctioned International Boycotts, NBER Working Paper 6116 (June 1997); James R. Hines Jr., Forbidden Payment: Foreign Bribery and American Business after 1977, NBER Working Paper 5266 (September 1995).

[191] See Avi-Yonah, For Haven's Sake, note – supra; Hines and Desai, Expectations and Expatriations, note – supra.

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44 Cong. Rec. 4232 (July 7, 1909), cited above at note --.

[193] This function is controversial. See, e.g., Boris I. Bittker, A "Comprehensive Tax Base" As A Goal of Income Tax Reform, 80 Harv. L. Rev. 925 (1967); Richard A. Musgrave, In Defense of an Income Concept, 81 Harv. L. Rev. 44 (1968).

[194] See Ronald F. King, Money, Time and Politics: Investment Tax Subsidies and American Democracy (1993).

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

g. Summary.

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

4. Conclusion: Some Policy Implications.

The first and most obvious practical conclusion from the above is the negative one: **The corporate tax should not be repealed**.[196] This outcome seems at present unlikely, but it is important to stress it because of the widespread opposition to (or very lukewarm support for) the corporate tax in academic and policy circles.

Having said that, there are three areas in which one can draw more specific policy conclusions from the above arguments. Those are the two most significant threats to the corporate tax- corporate tax shelters and tax competition, and the current drive to reform the tax by integrating it with shareholder (i.e., dividend) taxation.

a. Corporate tax shelters.

Since the mid 1990s, the corporate tax in the U.S. has been under significant practical attack by the growing corporate tax shelter movement. This movement has been described elaborately elsewhere.[197] Its essence involves promoters (mostly accounting firms and investment banks) who scour the Code for sheltering ideas and then sell them for a hefty fee to a growing list of corporate clients. Ten years ago it was unusual to find mainstream corporate tax departments who would buy these ideas. Today, with the tax department viewed as a profit center, it is rare to find a major corporation that does not use them. As John Braithwaite noted, the phenomenon is both supply and demand driven.[198]

Various proposals have been advanced to curb this practice, and the IRS has issued elaborate regulations.[199] However, courts (especially appellate courts with little tax expertise) have tended to uphold the shelters.[200] It therefore seems that more drastic action is needed to address this problem. Prof. George Yin has proposed a solution based on making tax reporting conform better to financial (book) reporting.[201] I support this idea because it would exact a price (in the form of higher tax payments) from corporate management who manipulate financial reporting, and if management chooses to employ tax shelters this would result in reduced earnings per share (EPS). Since

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[196] The same applies to the corporate AMT, which I view as an important backstop to the corporate tax. *See* Avi-Yonah, The Case for Retaining the Corporate AMT, note -- supra.

[197] *See*, e.g., Daniel N. Shaviro, Economic Substance, Corporate Tax Shelters, and the Compaq Case, 88 Tax Notes 221, 223-24 (July 10, 2000); Bankman, *supra* note --; Peter C. Canellos, Business Purpose, Economic Substance, and Corporate Tax Shelters: A Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters, 54 SMU L. REV. 47, 50 (2001); David A. Weisbach, Ten Truths About Tax Shelters, 55 TAX L. REV. 215, 226 (2002); George K. Yin, The Problem of Corporate Tax Shelters: Uncertain Dimensions, Unwise Approaches, 55 Tax L. Rev. 405 (2002); Yin, *supra* note 10.

[198] John Braithwaite, Helter Shelter: Marketing Local and Global Aggressive Tax Planning (2004).

[199] See, e.g., IRC sec. 6111 and Treas. Reg. 1.6111-1 (requiring registration of tax shelters).

[200] See cases cited above, note --.

[201] *See* Yin, *supra* note -- at 230.

management tend to care more about short term EPS than about taxes[202] such a rule (which is similar to the rule adopted in other countries, like Germany and Japan) is likely to be more effective in curbing tax shelters than financial manipulation, although it also has some drawbacks in terms of reduced flexibility for both tax and accounting rulemakers.

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

b. Tax Competition.

The other main challenge to the corporate tax is tax competition involving multinational enterprises (MNEs). Currently, some major U.S. MNEs (e.g., Intel) pay no tax to non-U.S. jurisdictions because all of their foreign operations benefit from special tax holidays designed to attract the investment. The MNEs can be sure to obtain such tax reductions because they can conduct an auction among the several countries that offer equivalently suitable locations to their investment in non-tax terms. More recently, we have seen tax competition flare up in the location of corporate headquarters, with several US MNEs moving their nominal location of incorporation to tax havens like Bermuda.[203]

The OECD and the EU have both launched projects aimed at curbing such tax competition, but so far they have achieved only limited success. In the academic literature, meanwhile, there is a raging debate between those who believe that tax competition is harmful and those who believe it is beneficial from either a global perspective or from the perspective of the countries involved.[204] Opponents have suggested various ways of combating tax competition, most of which involve some form of cooperation among developed countries (for example, taxing MNEs based on where their headquarters are or where their goods are sold).[205]

There is, however, a major missing element in this literature: Even the opponents of tax competition (including myself) have not been successful in explaining why the threat posed by it to the corporate tax should be viewed negatively. The best we could do is to point out the threat posed by it to the

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[202] See, e.g., the debate on pooling vs. purchase accounting for mergers; under pooling, earnings per share were higher than under purchase because the latter required amortizing goodwill. See Banking Association Asks FASB to Preserve Pooling Method, 86 Tax Notes 1125 (2000); Despite Criticism, FASB Won't Alter Plans to Eliminate Pooling, 86 Tax Notes 1259 (2000); FASB Eliminates Pooling of Interests, 90 Tax Notes 802 (2001).
[203] Reuven S. Avi-Yonah, For Haven's Sake: Reflections on Inversion Transactions, 27 TAX NOTES INT'L 225, 226 (2002).
[204] *See* Avi-Yonah, note --; Roin, *supra* note --; Schlunk, *supra* note --.
[205] Avi-Yonah, *supra* note --, at 1670; The rise of inversions raises some doubt about taxation based purely on where the parent corporation is incorporated. *See* Avi-Yonah, For Haven's Sake, supra..

welfare state, and indeed developed welfare states like France and Japan have been at the forefront of the fight. But this just leads to the counter-charge that bloated welfare leviathans are trying to create a cartel to save themselves from efficient competition at the expense of small Carribean jurisdictions.[206]

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

c. Integration.

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

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

This result is of course inconsistent with the stated rationales for adopting integration, which have to do with "taxing corporate income once". But even the economic case for the original Bush proposal, which did not envisage this kind of "super-integration", was debatable, as I have argued elsewhere.[207] In particular, integration introduces economic biases in regard to cross-border investment that may be no less significant than the biases it attempts to cure domestically.

From the perspective of this article, the important point to note is that the rationale given for the corporate tax is independent from the tax on shareholders. Thus, it is entirely consistent to tax corporations on their income to regulate management, while at the same time taxing shareholders on dividends.[208] The tax on dividends has to do with the rationale for having an individual income tax (rather than, for example, a VAT). I have argued elsewhere that this rationale was to restrict the power of the rich.[209]

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[206] *See*, e.g., Daniel J. Mitchell, OECD Tax Competition Proposal: Higher Taxes and Less Privacy, 89 Tax Notes 801 (2000).
[207] Reuven S. Avi-Yonah, The Pitfalls of International Integration: A Comment on the Bush Proposal and its Aftermath, -- International Tax and Public Finance – (2004)

[208] Cf. Schlunk, *supra* note --.
[209] Avi-Yonah, *supra* note --, at 1412.

But it should also be noted that the rationale given above for retaining the corporate tax does not require us to forego integration. As long as the corporate tax is maintained, it is quite possible to exempt shareholders from tax on dividends or give them a credit for economic reasons, without causing harm to the rationale for the corporate tax. In fact, shareholders were partially exempted from tax on dividends from 1913 to 1936, when the regulatory rationale for the tax was well understood.[210] Thus, although this article gives an answer to the question why we should tax corporations that is different from the mainstream view that is cited to support integration, it does not necessarily follow from it that we should refrain from adopting integration if we are persuaded by the economic case for doing so.

d. Summary.

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

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

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