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CORPORATE INCOME TAX ACT OF 1909

Reuven S. Avi-Yonah

Excerpt from the Corporate Income Tax Act of 1909

That every corporation, joint stock company or association, organized for profit and having a capital stock represented by shares ... now or hereafter organized under the laws of the United State or of any State ... shall be subject to pay annually a special excise tax with respect to carrying on or doing business by such corporation ... equivalent to one per centum on the entire net income over and above five thousand dollars received by it from all sources during such year....

excise tax: a tax levied on the manufacture or sale of specific—usually non-essential—commodities such as tobacco or liquor

The Corporate Tax Act of 1909 (36 Stat. 11, 112) imposed an **excise tax** on corporations for the privilege of doing business in corporate form. However, the excise tax was measured by corporate income. Thus the act was the origin of the current corporate income tax, which has been part of our federal tax system ever since and is currently the source of about 10 percent of federal revenues.

In 1895 the Supreme Court decided that Congress could not impose an income tax directly on individuals, because that would violate the constitutional requirement that all "direct" taxes be apportioned (that is, divided in a proportionate way) among the states on the basis of their population. The 1909 act defined the corporate tax as an excise tax and therefore as an "indirect" tax that was not subject to apportionment. The constitutional problem of imposing an income tax without apportionment was resolved with the passage of the Sixteenth Amendment in 1913, so that from that point on the tax could be redefined as a direct income tax.

CIRCUMSTANCES LEADING TO ADOPTION OF THE ACT

consumption tax: tax imposed on outlay for goods and services

In the nineteenth century, federal revenues were derived primarily from tariffs, which were a form of **consumption tax** on imported goods. Like all consumption taxes, the tariffs were regressive (that is, imposed a heavier burden on the poor, because the poor consume a higher proportion of their income than the rich). State revenues depended primarily on property taxes, which because of enforcement difficulties were collected almost exclusively from real property. In the late nineteenth century there was a significant increase in wealth held in intangible forms, such as stocks and bonds. This wealth escaped both the federal tariff (because it was not consumed) and the state property tax (because it was intangible rather than "real").

The first income tax was imposed during the Civil War and raised significant revenues, but it was allowed to expire at the end of **Reconstruction** in 1872. Proponents of the income tax believed that this tax was fairer than the tariffs because it was progressive (that is, taxed the rich more than the poor) and was able to reach intangible wealth. The first post–Civil War income tax (imposed both on individuals and on corporations) was enacted in 1894 following the financial panic and recession of 1893, which was widely blamed on over-concentration of wealth (too few people holding too much wealth) and financial speculation (transactions that involve high risk). The Supreme Court struck down the 1894 tax in 1895, but proponents continued to push for an income tax. (The issue featured prominently in the election campaigns of 1896 and 1900.)

Reconstruction: the political and economic reorganization and reestablishment of the South after the Civil War

Support for the income tax grew with the rise of the progressive movement in the early years of the twentieth century. In 1907 President Theodore Roosevelt expressed support for the idea of a graduated income tax, but pro-tariff Republicans were able to delay its consideration until after the 1908 election. The newly elected president William H. Taft was less of a supporter of the income tax than his predecessor and was worried about enacting another tax that might be found 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.

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President Taft's message to Congress not only solved the constitutional impasse, it also suggested that a corporate tax had two additional advantages. First, it was an indirect way of taxing shareholders, which were the kind of wealthy individuals that the progressives sought to tax with the 1894 income tax. The Civil War income tax already included the idea of collecting the tax on shareholders at the corporate level because such a tax would be easier to administer. This idea was given full force in the aborted 1894 tax. Second, Taft and the progressives viewed the tax as a way to regulate corporations and their management, resembling the antitrust actions begun by Roosevelt and also the regulatory efforts of the newly established Department of Commerce. They saw the corporate tax as both a way to collect information on corporations and make it public (since returns were to be published) and a way to restrain the accumulation of power in corporations that benefited from monopoly or near-monopoly status.

Department of Commerce

The Department of Commerce was established in 1903 by Theodore Roosevelt as the Department of Commerce and Labor. Its original mission was to regulate both domestic and international commerce and oversee mining, manufacturing, shipping, and transportation. The agency expanded dramatically under Herbert Hoover, who served as commerce secretary from 1920 to 1928 and president from 1928 to 1933. However, Hoover's successor as president, Franklin Delano Roosevelt, held the agency in low regard and severely reduced its responsibilities. Over the next fifty years many of the agency's original functions were handed off or came to be shared with other agencies, but the Department of Commerce remains a strong voice for U.S. business both at home and abroad, with 40,000 workers and a budget of $5 billion. The agency collects economic data, issues patents, helps to set industrial standards, and lobbies other governments on behalf of U.S. business.

LEGISLATIVE DEBATE

The legislative debate on the 1909 act took place 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. They 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 fluctu-

ations in economic conditions (because income is more responsive to economic **recessions** than is consumption).

recession: a period of reduced economic activity, but less severe than a depression

Initially, it seemed likely that the Republican majority in both houses of Congress would enact the tariff bill (named the Payne-Aldrich Tariff after its co-sponsors). In the House, income tax proponents like Cordell Hull, a Democrat from Tennessee, were unable to attach an income tax amendment to the tariff bill. In the Senate, however, progressive Republicans like Robert La Follette of Wisconsin and Democrats like Joseph Bailey of Texas were more effective in arguing for the income tax. La Follette and Bailey argued that because 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" (by which they meant **socialism**).

socialism: any of various economic and political theories advocating collective or governmental ownership and administration of the means of production and distribution of goods

Ultimately, Republican Senator Nelson Aldrich of Rhode Island, 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, "I shall vote for a corporation tax as a means to defeat the income tax." This compromise ultimately passed the Senate by a vote of 45 to 34 and the House by a vote of 195 to 183. The act was signed into law by the president on August 5, 1909.

In a crucial meeting at the White House, Aldrich and Taft agreed to support a corporate tax plus a constitutional amendment empowering Congress to levy the income tax, while maintaining high tariffs.

POLITICAL ISSUES

The split within the governing Republicans, who had the majority in both houses of Congress and the White House, formed the political context for the enactment. The wing of the party from Northeastern states advocated high tariffs to protect American industry from European competitors, whereas progressives from the Midwest, West, and South favored reducing tariffs and replacing the revenue with an income tax. The corporate tax (and the proposed constitutional amendment), plus the high tariffs being maintained, represented a compromise between the two factions.

MAJOR COURT REVIEW AND INTERPRETATION

In 1911 the Supreme Court held that the corporate tax was an excise tax and not a "direct" tax, and therefore not unconstitutional under the 1895 precedent. This argument was made obsolete in 1913 when the Sixteenth Amendment was ratified, enabling Congress to adopt an income tax on individuals. However, the corporate tax was maintained and added to the individual income tax. It has been part of the Internal Revenue Code ever since.

The Supreme Court issued an important precedent interpreting the corporate tax in 1920. In the case of *Eisner v. Macomber,* the Court held that Congress did not have the power to tax **dividends** of corporate stock. In that context, the Court pointed out that corporations are separate taxpayers from shareholders and that shareholders could not be taxed on the undistributed income of corporations (as was done under the Civil War income tax).

dividend: a payment made by a company, based on its earnings, to its shareholders

AMENDMENTS

The corporate tax has now become Subchapter C of Chapter I of the Internal Revenue Code, containing over 100 sections. The most important changes from its original enactment are the following:

(1) The rate structure: The initial rate was 1 percent on income above $5,000. The current rate is graduated from 15 percent to 35 percent, but most large corporations pay a flat 35 percent. Over the years the rate had been higher, although not as high as the individual income tax rates (which reached 94 percent during World War II).

(2) Scope: Originally the tax applied to all corporations. Currently, it mostly applies to corporations whose shares are publicly traded on stock exchanges, because closely held corporations can usually qualify for special plans that tax their income directly to the shareholders. This is in line with Taft's original regulatory purpose, since only publicly traded corporations operate with the separation of management and control that justifies separate regulation.

(3) Integration: Originally, the corporate tax applied to corporations, and there was no tax on shareholders. When the income tax was introduced for shareholders in 1913, an exemption for dividends was included to prevent double taxation. This exemption was repealed in 1936, so since then corporate income has been taxed at the corporate level and dividends taxed at the shareholder level. In 2003, the tax rate on dividends was reduced from 35 percent to 15 percent, but the United States still separately taxes corporations and shareholders.

(4) Reorganizations: When capital gain taxation (taxing shareholders on their gain from the sale of corporate stock) was introduced in 1913, it applied to corporations and resulted in the taxation of business reorganizations (transactions in which shareholders exchange shares in one company for shares in another). Starting in the 1920s, a very elaborate system of tax-free reorganizations has been added that exempts some of these transactions from taxation. Thus, for example, setting up a new corporation and contributing property to it in exchange for the stock is generally a tax-free transaction.

ENFORCEMENT

One of the advantages of the corporate tax is that it is relatively easy to enforce because of the relatively small number of taxpayers. Currently, the medium- and large-size business division of the IRS is in charge of enforcement. However, the complexity of corporate transactions has actually made the tax difficult to enforce. The number of corporate **tax shelters**, increasing since the 1980s, has made enforcement especially difficult.

tax shelter: a strategy or method that allows one to legally reduce or avoid tax liabilities

IMPACT ON SOCIETY

The corporate tax has been a significant generator of federal revenues, accounting for about 25 percent of all revenues in the 1960s. Since then, however, the importance of the tax has declined, so that it accounts for only about 10 percent of revenues. The effective rate faced by corporations (the tax rate they actually pay as a percentage of the income they report to shareholders) varies tremendously. Figures indicate average effective rate of about

Since the 1960s the importance of the tax has declined, so that it accounts for only about 10 percent of revenues.

30 percent of book income reported to shareholders for large corporations.

It is hard to assess the impact of the tax on society. Economists are unsure as to who bears the economic burden of the tax: shareholders (through reduced profits), employees (through reduced wages), or consumers (through increased prices). Most likely the economic burdens of the tax have varied over time. As a regulatory device the tax provides the government with significant information about corporations, although the value of that information may have declined as returns became more complex and divorced from financial reporting to shareholders. Nevertheless, the fact that corporations pay about a third of their income to the government does provide some limit on corporate power and some limit on corporate monopoly profits. In addition, corporate tax payments can be used by the government to achieve social goals that corporations may not be best positioned to strive for. Thus the tax has contributed to the debate over corporate social responsibility.

See also: THE 1894 INCOME TAX AND THE WILSON-GARMAN TARIFF ACT; FEDERAL INCOME TAX ACT OF 1913; INTERNAL REVENUE ACT OF 1954.

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