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A Tax Theory of the Firm

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I. INTRODUCTION

The United States taxes business profits in two fundamentally different ways, depending on how the firm is classified by the tax system.[1] In some cases, the rules treat the firm as an extension of its owners and impose no obligation on the firm to pay tax on its profits.[2] Instead, the firm's owners have to pay tax on their share of those profits, whether they receive a distribution from the firm or not.[3] This describes the partnership model for taxing business profits and it is the default rule that applies to partnerships and other unincorporated business firms, including limited liability companies.[4] Sole proprietorships are taxed in a similar fashion.[5]

Under the second approach for taxing business profits, the firm and its owners are treated as separate and distinct taxpaying units. Accordingly, the firm has an independent obligation to pay tax on any profits it derives, regardless if it retains those earnings or distributes them to its owners.[6] Additionally, the owners have a separate obligation to pay tax on any profits they actually receive from the firm.[7] Thus, any earnings paid to the firm's owners are subject to tax at both the firm level and the owner level.[8] This two-tiered system describes the corporate model for taxing

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1. These two different approaches have existed in one form or another ever since Congress adopted an income tax after it gained full Constitutional power to enact such a tax without having to allocate the tax burden among the states based on population. *See* U.S. Const. amend. XIV.

2. *E.g.*, I.R.C. § 701.

3. *Id.*

4. Treas. Reg. § 301.7701-3(b)(1)(i). The Internal Revenue Code contains several variations of the partnership model of taxation. *See* Willard Taylor, *Can We Clean This Up? A Brief Journey Through the United States Rules for Taxing Business Entities,* 19 FLA. TAX REV. 323 (2016). The vast majority of those rules apply to specialized industries and situations. However, the rules of subchapter S give many incorporated firms the option to have their profits taxed under a partnership model of taxation. *See* I.R.C. §§ 1361-1379.

5. *See* I.R.C. §§ 61(a)(2) and 162(a).

6. I.R.C. § 11.

7. I.R.C. § 61(a)(7).

8. This is why many refer to this scheme as one that imposes a "double tax" on dividends. *E.g.*, Jeffrey L. Kwall, *The Uncertain Case Against the Double Taxation of Corporate Income*, 68 N.C.L. REV. 613 (1990); Terrence R. Chorvat, *Apologia for the Double Taxation of Corporate Income*, 38 WAKE FOREST L. REV. 239 (2003); Michael Doran, *Managers, Shareholders, and the Corporate Double Tax*, 95 VA. L. REV. 517 (2009). The implication is that dividends are taxed at twice the rate that would ordinarily apply. However, that is misleading because the tax is not necessarily twice what it would be.

business profits. It is the default method that now applies to any business that is organized as a corporation under state law.[9]

Many scholars have questioned the merits of having two vastly different approaches for taxing business profits.[10] However, Congress is unlikely to adopt a uniform method for taxing business profits anytime soon. That makes it imperative to have a rational way to determine when one approach should yield to the other. That requires one to examine the tax law's entity classification rules, because a firm's tax classification dictates how its profits are taxed.

For decades, the tax rules for classifying business firms focused on legal and formalistic factors. This practice can be traced back to the formative years of the modern income tax when the corporate tax applied to any firm that was incorporated under state law.[11] However, under regulations issued by the Treasury Department, any unincorporated firm could also be subject to the tax if it possessed certain distinctively corporate characteristics.[12] Over time, the government made certain modifications to the rules, which became known as the resemblance test. The focus, however, has always been whether the firm possessed the legalistic and formalistic characteristics that are distinctively corporate.[13] By 1960, the regulations were refined to include the following list of six

9. Treas. Reg. § 301.7701-2(b)(1). These rules also control the taxation of firms organized as joint stock companies and associations. *See* Treas. Reg. § 301.7701-2(b)(2)-(7). The same rules also apply to any partnership that qualifies as a publicly traded partnership. *See* I.R.C. § 7701(a).

10. *See, e.g.,* Joseph M. Dodge, *A Combined Mark-to-Market and Pass-Through Corporate-Shareholder Integration Proposal*, 50 TAX L. REV. 265 (1995) (proposing to integrate the corporate-shareholder income tax); Daniel Halperin, *Fundamental Tax Reform*, 48 EMORY L.J. 809 (1999) (proposing a combination of changes, including full indexation and corporate integration); and Anthony P. Polito, *Note, A Proposal for an Integrated Income Tax*, 12 HARV. J.L. & PUB. POL'Y 1009 (1989) (arguing that integration would advance horizontal and vertical equity). However, there have been several arguments advanced defending the policy of applying the corporate tax to incorporated firms. *See* Heather M. Field, *Checking in on "Check-the-Box"*, 42 LOY. L.A. L. REV. 451, 509-15 (2009) (summarizing the arguments, critiquing them, and citing sources).

11. It was not entirely clear whether the initial legislation creating the modern income tax actually imposed the corporate tax on business entities other than state law corporations and joint-stock companies. *See* Patrick E. Hobbs, *Entity Classification: The One Hundred-Year Debate*, 44 CATH. U. L. REV. 437, 459-466 (1995) (discussing the ambiguities imbedded in the Revenue Acts of 1913 and 1916). However, by 1918, it was clear that an unincorporated business entity could indeed be subject to the corporate tax. *Id.* at 467.

12. *See* Treas. Reg. 45, art. 1502, T.D. 3146, 23 Treas. Dec. Int. Rev. at 591 (1921). Thus, a trust would be treated as equivalent to a corporation if it engaged in an active business and if the beneficiaries had control over the manner in which the trustees conducted the business. Treas. Reg. 45, art. 1504, 23 Treas. Dec. Int. Rev. at 591. Meanwhile, a partnership could be subject to the corporate tax if the firm's interests were freely transferable and some of its members were passive investors. Treas. Reg. 45, art. 1503, 23 Treas. Dec. Int. Rev. at 591. A third rule treated a limited partnership as a corporation for tax purposes if it provided for limited liability, freely transferable interests and the right to bring suit in a common name. Treas. Reg. 45, art. 1506, 23 Treas. Dec. Int. Rev. at 592.

13. *See* Hobbs, *supra* note 11, at 437 (recounting in rich detail the evolution of the rules for classifying firms as corporations for tax purposes).

corporate characteristics: (1) associates, (2) an objective to carry on business activity and to distribute the resulting profits, (3) continuity of life, (4) centralized management, (5) limited liability, and (6) free transferability of interests.[14]

Even though the government has consistently used such factors to determine whether an unincorporated firm resembles a corporation, it has not taken a consistent approach in the way it evaluates and weighs those factors. Instead, the government has recalibrated the test in response to taxpayer efforts to qualify for a tax classification that yields a particular tax outcome. Thus, in the early years, when corporate dividends were taxed more heavily than other business profits, taxpayers structured their business ventures in ways that would prevent a business entity from qualifying as a corporation. The Treasury's response was to make the rules apply in a way that was biased in favor of treating such an unincorporated firm as a corporation.[15] Later, when it became more tax advantageous to be treated as a corporation, Treasury recalibrated the rules so that it was more difficult for an unincorporated firm to qualify as one.[16] It was apparent that the factors listed in the regulations could be manipulated by taxpayers to achieve a certain tax result without adversely affecting the desired economic outcome.[17] This exposed the inherent defect in the government's entity classification rules: the factors used to classify business entities were entirely formalistic and legalistic; they had no bearing on the economic realities that truly mattered to taxpayers.

After decades of less than satisfactory results with its approach for classifying business entities, the Internal Revenue Service abandoned the emphasis on legal formalities. Today, a firm can explicitly opt out of the default tax rules that would ordinarily apply to it in the vast majority of cases. Thus, a partnership can choose to be classified as a corporation so that its profits are first taxed to the firm and later taxed to the owners in the event the firm actually distributes its profits to them.[18] Similarly, many corporations can choose to have their profits taxed under a modified version of the partnership model, so that the shareholders are taxed on their shares of the firm's profits while the firm itself pays no tax.[19]

Understandably, taxpayers welcome the flexibility to choose the rules

14. Treas. Reg. §§ 301.7701-2 (1960), T.D. 6503, 1960-2 C.B. 409.

15. Hobbs, *supra* note 11, at 477 (discussing the regulations issued under the 1934 Revenue Act).

16. *Id.* at 486; Field, *supra* note 10, at 460 (citing 26 C.F.R. § 301.7701-2(a)(1) (1960)).

17. This was particularly true if the firm was organized as a limited liability company under state law. The Internal Revenue Service acknowledged as much. *See* I.R.S. Notice 95-14, 1995-14 I.R.B. 7.

18. Treas. Reg. § 301.7701-3(a) (as amended in 2006). A separate statutory provision permits a partnership to elect not to be subject to the rules that would ordinarily apply to the firm. I.R.C. § 761(a). However, that rule does not technically reclassify the partnership as a corporation for tax purposes.

19. *See* I.R.C. §§ 1363, 1366.

that apply to them.[20] After all, this allows them to control two key things: (1) the amount of tax owed on the firm's profits, and (2) the timing of the tax liability. However, this freedom to choose has been criticized on equitable and other grounds.[21] Importantly, giving individual taxpayers the power to choose what to pay and when to pay it does not represent sound tax policy, especially in a tax system that purports to operate on the basis of an individual's ability to pay.[22] For example, when individuals can choose the rules that apply to them, taxpayers with the same capacity to pay may end up paying different tax amounts solely because one taxpayer can disguise her ability to pay, violating the principle of horizontal equity. That, in turn, makes it harder for the tax system to fulfill a related principle known as vertical equity, which generally requires individuals with greater ability to pay to actually pay more than individuals who have a lower ability to pay. If some taxpayers can artificially lower their tax bill despite their ability to pay, then individuals with the greatest capacity to pay will not pay an amount that reflects their ability to pay relative to other taxpayers.

The misplaced emphasis on legal formalities comes into sharp focus if you consider the case of a wholly owned corporation. In such a case, the firm's sole owner has complete control over the firm and is entitled to any profits derived by the firm. As an economic matter, the firm is indistinguishable from its owner. Yet the tax code treats the corporation as a separate and distinct entity.[23] That makes the firm–not the owner– solely responsible for the tax on any profits it generates and retains. This would not be particularly problematic if the corporation and its owner were taxed at the same rate. But that is rarely the case. Given the shortcomings of the entity classification election, scholars have offered alternative ways to classify firms on a mandatory basis. One popular idea is to treat small firms differently from large ones. Specifically, many scholars argue that publicly traded firms should be classified as corporations, while all other firms should be taxed like partnerships.[24] Other scholars suggest using a different set of factors, such as whether the firm offers its owners limited liability from the firm's debts, to determine

20. Field, *supra* note 10, at 466-69.

21. *E.g.*, George K. Yin, *The Future Taxation of Private Business Firms*, 4 FLA. TAX REV. 141, 149-50 (1999); Field, *supra* note 10, at 451.

22. *See, e.g.*, Allison Christians, *Introduction to Tax Policy Theory* (unpublished manuscript 2018) (describing the fundamental objectives of tax policy).

23. *See* Moline Properties v. Commissioner, 319 U.S. 436 (1943).

24. American Law Institute, Federal Income Tax Project – Taxation of Private Business Enterprises (George K. Yin & David J. Shakow reps.) (1999); Phillip I. Blumberg, *Limited Liability and Corporate Groups*, 11 J. CORP. L. 573 (1986); Susan Pace Hamill, *The Limited Liability Company: A Catalyst Exposing the Corporate Integration Question,* 95 MICH. L. REV. 393 (1996).

the firm's tax classification.[25]

However, these proposals are unlikely to adequately address the inequities that now plague the taxation of business profits because they do not account for the one factor that may be the most salient for tax purposes: the way a firm behaves. Because the tax code conceptualizes a firm as either an extension of its owners or as a separate and distinct entity, any entity classification rules should focus solely on factors that affect whether the firm *behaves* in one of those two ways. Such factors might form the basis of what this Article describes as a "tax theory of the firm." A sound tax theory of the firm justifies a firm's tax classification because it accurately identifies the factors that explain certain behaviors of the firm that are relevant and meaningful for tax purposes.

This Article proposes a tax theory of the firm by examining the origins and evolution of the modern American approach for taxing business profits. This approach first took shape when the Constitution was amended to authorize Congress to impose an income tax without having to apportion the burden among the states based on population. Up to that point, the U.S. had a uniform rule for taxing all business profits. That rule effectively treated all firms as extensions of their owners, a reflection of the fact that virtually all firms were, in fact, closely held and generally operated in partnership form.

It was only when massive corporations began to dominate the economic landscape starting in the late 1800s that Congress introduced a second method for taxing business profits. Although the new rules applied to all corporations, Congress consistently recognized that closely held corporations raised special concerns because the owners could hide behind the entity to avoid certain tax obligations without sacrificing any meaningful control over the assets held by the firm or the income derived by it. For that reason, there have always been provisions that suspend the ordinary rules for taxing corporate profits in certain cases. At first, there was a subjective test that proved to be ineffective, leading Congress to adopt an objective test that has since been replicated in various ways to serve the same principal objective: to prevent taxpayers from using a corporation to avoid the full tax on their business profits.

This Article recounts the journey that Congress took to devise an objective way to distinguish cases where the ordinary rules for taxing corporate profits should be suspended. This history reveals that Congress always used concentration of ownership as the basis for making this distinction. Moreover, the emphasis on concentration of ownership is consistent with the insights offered by well-established economic theories

25. Jeffrey A. Maine, *Linking Limited Liability and Entity Taxation: A Critique of the ALI Reporters' Study on the Taxation of Private Business Enterprises*, 62 U. PITT. L. REV. 223 (2000).

that attempt to explain the behavior of business firms. Such theories view ownership of the firm as central to any understanding about how the firm behaves vis-à-vis the owner. Thus, there is strong historical and theoretical support to use concentration of ownership as the basis for any meaningful tax theory of the firm. Such a theory acknowledges that a firm can be expected to act as an extension of its owners whenever the ownership of the firm is sufficiently concentrated. That would create a presumption that the profits of the business should be taxed under partnership-type rules. Conversely, if a firm lacks a sufficiently high concentration of ownership, the firm can be expected to behave like an entity that is separate and distinct from its owners. That would justify taxing the firm profits under corporate-type rules.

The concentration of ownership principle plays a central role a wide range of anti-abuse tax rules designed to prevent taxpayers from using corporations to disguise their identities. Moreover, each of these rules measures concentration of ownership by applying an objective test that generally asks whether five or fewer persons own over half the value of the company, a formulation that first appeared in a provision known as the personal holding company rules.[26] Because the "five-or-fewer" formula and its variations have been battle tested over the years, it offers a promising way to determine whether a firm should be treated as an entity that is separate and distinct from its owners for tax purposes.

The 2017 Tax Act changed the Internal Revenue Code in ways that make it more urgent than ever to reform the rules for classifying business entities. Under prior law, the vast majority of closely held firms chose not to be classified as corporations for tax purposes because the tax on the firm's profits was generally lower. Thus, closely held firms were usually classified in the same way they would likely be classified under the mandatory entity classification system that this Article is proposing. However, the 2017 Tax Act changed the tax landscape in substantial ways. It reduced the corporate tax rate from 35 percent to 21 percent and introduced a new 20 percent deduction for all firms not classified as corporations.[27] The combination of these new rules will complicate the process of choosing the most tax advantageous entity classification for the firm.[28] At the very least, the corporate classification will become more tax advantageous for some firms than it was under prior law. Firms that reclassify themselves will no longer be treated as if they are an extension

26. *See* I.R.C. § 542(a)(2).

27. *See* Pub. L. No. 115-97 §§ 11011, 13001 (2017) (codified at I.R.C. §§ 11, 199A).

28. Bradley T. Borden, *Income-Based Effective Rates and Choice-of-Entity Considerations under the 2017 Tax Act*, 71 NAT'L TAX J. 613 (2018); Erin Henry, George A. Plesko & Steven Utke, *Tax Policy and Organizational Form: Assessing the Effects of the Tax Cuts and Jobs Act of 2017*, 71 NAT'L TAX J. 635 (2018).

of their owners, even though the firm can be expected to behave in precisely that way. The mandatory entity classification system being proposed in this Article will help ensure that the tax consequences match the economic realities. It will also eliminate the complexities that plague the current system.

Part II of this Article describes the nineteenth century antecedents of the income tax and the conditions that gave rise to a uniform approach for taxing business profits. Part III describes the formative years of the modern income tax when Congress first introduced a unique approach for taxing corporate profits. Part III specifically focuses on the subjective rules initially adopted to deter and penalize taxpayers from using corporations to disguise their true identities. Part IV recounts the events that culminated in the enactment of the personal holding company rules, which not only were the first to embrace the concentration of ownership principle, but also reduced it to an objective test. Part V examines how the approach for taxing corporate profits evolved to where it emphatically operates as a tax on the firm as an entity, not as an indirect tax on its owners. Part VI describes Internal Revenue Code provisions that employ variations of personal holding company ownership test to determine whether the ordinary rules for taxing corporate profits should be suspended. Part VII summarizes the principal economic theories of firm behavior and the way they consistently revolve around a firm's concentration of ownership. Part VIII articulates a tax theory of the firm and offers an initial assessment of its power and potential limitations. Finally, Part IX concludes.

II. THE ANTECEDENTS OF THE MODERN INCOME TAX

The modern U.S. income tax incorporates several key elements that first appeared in the Revenue Acts adopted during the Civil War. Those temporary laws contained one uniform method for taxing business profits. Such income was consistently taxed to the owners of the business, not to the business itself. Thus, the country's earliest rules for taxing income treated all firms as extensions of their owners and applied what we now regard as the partnership model for taxing business profits. This largely reflected the prevailing economic realities. With rare exception, all business firms were closely held partnerships whose owners played an active role in managing the business. Even firms that did not fit this description routinely distributed all their earnings to their owners so that the recipients–not the firms–were in sole possession of the firm's profits.

A. The 1862 Income Tax: Business Profits are Implicitly Taxed to a Firm's Owners at Progressive Rates

Enacted in 1862 to help finance the Civil War,[29] the country's first income tax did not tax business firms directly.[30] Instead, the *individuals* who owned a share of a firm were taxed on their share of the firm's profits.[31] Those profits, along with all other income derived by the taxpayer, were subject to tax at one of two rates, depending on the taxpayer's income level. Individuals with incomes up to $10,000 were taxed at 3 percent, while those with incomes over $10,000 were taxed at 5 percent.[32] In either case, the first $600 of income was tax exempt.[33]

There was one exception to this general rule. The statute imposed a three percent tax on the profits that certain financial institutions and railroad companies paid out to their owners as dividends.[34] However, because that tax actually represented a prepayment of the tax that the shareholders were required to pay on their share of the firm's earnings, the dividends were exempt from tax in the hands of the recipients.[35] This procedure did not produce any distortions or inequities because it was the general practice for businesses of all sizes and legal forms to distribute all their earnings to the owners.[36] The three percent tax that the firm withheld would have understated the actual tax liability for any recipient who was subject to tax at five percent. Although the Act had no mechanism for addressing this discrepancy, the government's policy was to require the

29. JOHN F. WITTE, THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX 68 (1985). The objective was to reduce the government's need to borrow money. DAVID HERBERT DONALD, ET AL., THE CIVIL WAR AND RECONSTRUCTION 296 (2001). As a technical matter, this was not the country's first income tax. In 1861, Congress enacted a 3 percent tax on income. Act of August 5, 1861, ch. 45, § 49, 12 Stat. 292, 309. However, the government never collected any tax under the measure because the Treasury Secretary concluded it would cost more to collect than the government would raise, a result of a relatively high $800 exemption. SHELDON D. POLLACK, WAR, REVENUE, AND STATE BUILDING: FINANCING THE DEVELOPMENT OF THE AMERICAN STATE 224 (2009). *See also*, Steven A. Bank, *Origins of a Flat Tax*, 73 DENV. U. L. REV. 329, 345 (1996). Thus, for all practical purposes, the income tax adopted in 1862 represents the country's first real life experience with an income tax.

30. However, certain firms had to pay a tax on their gross receipts. *E.g.*, Act of July 1, 1862, ch. 119 § 80, 12 Stat. 468 (railroads, steamboats and ferryboats).

31. Taxable income was defined to include all profits, dividends and income "derived" from any source whatever. *Id.* § 90, 12 Stat. 432, 473.

32. *Id.*

33. *Id.*

34. *Id.* §§ 81 and 82, 12 Stat. at 469-71. The financial institutions included banks, trust companies, savings institutions and all fire, marine, life and inland insurance companies, whether operating as stock or mutual institutions. *Id.* § 82. They also had to pay a 3 percent tax on all amounts added to their surplus or contingent funds. *Id.* Railroads also had to withhold tax on interest paid. *Id.* § 81. The recipient was granted a corresponding deduction for the interest. *Id.* § 91.

35. *Id.* § 91.

36. Steven A. Bank, *Is Double Taxation a Scapegoat for Declining Dividends? Evidence from History*, 56 TAX L. REV. 463, 473 (2003).

recipient to pay an additional two percent in tax to make up the difference.[37] Thus, the overall arrangement operated in a way that made the tax paid by the firm a prepayment of the one owed by the recipient of the firm's earnings.

The government had a sound reason to require railroads and financial institutions to pay the tax on behalf of the recipients of the income. The legislation relied on individuals to accurately report and pay tax on any income they derived. Instead of relying solely on the honesty of individual taxpayers for this to happen, Congress effectively enlisted certain firms to act as tax collection agents for the government.[38] Railroads were especially well suited for this job. At the time of the legislation, they constituted the largest and most visible commercial enterprise in the country, making it potentially difficult and risky for them to renege on their obligation to withhold tax on any payments.[39] By shifting the obligation to pay from the recipient to the company, the government accomplished two things: (1) it made it easier to administer the laws, and (2) it limited the possibility of tax evasion.[40]

All subsequent tax legislation enacted during the nineteenth century followed the basic structure of the 1862 Act. Namely, each piece of legislation imposed a tax on individuals, often under a progressive schedule of rates. In addition, no revenue law taxed business firms as such. Instead, they required certain firms to collect and remit the tax on the business profits payable to the firm's owners. A quick description of those revenue laws will reveal just how carefully the rules were drafted to ensure that the tax collected by the government on business profits neither understated nor overstated the amount that would have been due had the firm's owners been required to pay it themselves. This examination reveals just how strongly Congress intended to tax business profits in a uniform way and to treat business firms as mere extensions of

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37. GEORGE S. BOUTWELL, A MANUAL OF THE DIRECT AND EXCISE TAX SYSTEM OF THE UNITED STATES 197 (1863). One could imagine that a dividend would be overtaxed in the hands of a recipient whose income was low enough to make them exempt from tax. However, it seems unlikely that an individual whose income did not exceed the $600 exemption would have been in a position to invest in dividend paying stock. This seems supported by the fact that the tax on dividends accounted for a very small share of total income tax revenues. ROBERT STANLEY, DIMENSIONS OF LAW IN THE SERVICE OF ORDER: ORIGINS OF THE FEDERAL INCOME TAX 1961 – 1913, at 279 n. 74 (1993).

38. Congress modeled its system of tax collection after the British, who devised it as a bulwark against tax evasion. *See* Ajay K. Mehrotra, *"From Contested Concept to Cornerstone of Administrative Practice": Social Learning and the Early History of U.S. Tax Withholding*, 7 COLUM. J. TAX L. 144, 153-55 (2016) (describing the British experience with taxing income at its source and the extent to which it inspired U.S. lawmakers).

39. Thomas R. Navin & Marian V. Sears, *The Rise of a Market for Industrial Securities, 1887-1902*, 29 BUS. HIST. REV. 105, 106 (1955).

40. Frederick C. Howe, *The Federal Revenues and the Income Tax*, 4 ANNALS AM. ACAD. POL. SOC. SCI. 557, 568 (1894); Joseph A. Hill, *The Civil War Income Tax*, 8 Q.J. ECON. 416, 427 (1894).

their owners.

B. The 1864 Income Tax: Business Profits Are Explicitly Taxed to a Firm's Owners at Progressive Rates

Congress more emphatically treated all firms as extensions of their owners in all cases in the Revenue Act of 1864. This legislation amended and restructured the income tax in order to raise additional money to finance the Civil War.[41] There were two important differences from the Act of 1862. First, the tax rates were higher than before. Second, the schedule of tax rates applied in bracketed fashion, which introduced a bit of complexity into the computation of the tax. Under the bracketed approach, an individual was exempt on the first $600 of income, a five percent tax applied to amounts over $600 and up to $5,000, and a ten percent tax applied to amounts over $5,000.[42] Business profits were expressly taxed to the individual owners of a firm, and it did not matter if the firm actually distributed its profits to them.[43] The government continued to rely on certain firms as its tax collection agents, with such firms having the obligation to pay a five percent tax on the profits derived by the firm, whether paid out as a dividend or added to the firm's surplus.[44]

The Act used a sophisticated tax credit mechanism to ensure that the government collected the correct amount of tax on an individual's share of the profits of firms enlisted to collect tax. The five percent tax paid by the firm would understate the liability of an investor in the ten percent tax

41. Hill, *supra* note 40, at 423.

42. Act of Mar. 3, 1865, ch. 78, 13 Stat. 469, 479, amending Act of June 30, 1864, ch. 173 § 116, 13 Stat. 223, 281. Prior to the amendment, an individual was exempt on the first $600 of income, a 5 percent tax applied to amounts over $600 and up to $5,000, a 7.5 percent tax applied to amounts over $5,000 and up to $10,000, and a 10 percent tax applied to amounts over $10,000. Congress made the change in order to reduce a shortfall in expected revenues. STANLEY, *supra* note 37, at 35 (1993).

43. Act of Mar. 3, 1865, ch. 78, 13 Stat. 469, 480, amending Act of June 30, 1864, ch. 173, § 117, 13 Stat. 223, 282 ("[A taxpayer's] share of the gains and profits of all companies, whether incorporated or partnership, shall be included in estimating the annual gains, profits, or income of any person entitled to the same, whether divided or otherwise."). The regulations issued by the Commissioner of Internal Revenue left no room for doubt: an individual would be subject to tax on the undivided profits of a corporation. *See* DIGEST OF DECISIONS AND REGULATIONS MADE BY THE COMMISSIONER OF INTERNAL REVENUE, 1864 – 1898, at 16, 36, 37, 39, 40 (1906). In dictum, the Supreme Court concurred with this interpretation. Collector v. Hubbard, 79 U.S. 1, 18 (1870). By contrast, under the prior statute, only financial institutions were taxed on their undivided surplus; the railroads were not. *See supra* note 34.

44. The list was expanded to include any canal, turnpike, canal navigation or slackwater company, in addition to the firms singled out under the 1862 Act. Act of June 30, 1864, ch. 173, § 120, 13 Stat. 223, 283-84. Coincidentally, this list closely tracks the list of firms that had historically been organized as corporations even prior to the introduction of general corporation laws. WILLIAM Z. RIPLEY, MAIN STREET AND WALL STREET 21 (1973) (reprint of the 1929 edition) (observing that for long after the adoption of the Constitution, the corporate form was not the normal form of organization except for a few businesses like banking, insurance, turnpikes, and bridges).

bracket. But, two rules eliminated this discrepancy. The first required the dividend to be included in the investor's tax base.[45] The second gave the investor credit for the five percent tax paid by the firm, leaving the investor responsible for the difference.[46] This procedure ensured that the method for taxing business profits remained uniform across all taxpayers. It also reaffirmed the fact that the tax on business profits was indeed the liability of the investor, not the firm.[47]

C. 1867-1872: Business Profits Are Explicitly Taxed to a Firm's Owners at a Flat Rate

Congress simplified the tax laws in 1867 by replacing the two-tiered graduated rates with a five percent flat tax on all income in excess of a $1,000 exempt amount.[48] Taxable income continued to include an individual's share of the profits of any business, and it remained irrelevant whether the firm distributed the profits or not.[49] The firms previously enlisted to pay a five percent tax on their profits had to continue doing so, while distributions paid by such firms remained excluded from the recipient's taxable income.[50] This simplified structure resembled the 1862 approach. The government collected a five percent tax on all business profits, with the tax paid by either the firm or the shareholder. In 1870, Congress reduced the tax rate and increased the exemption, but made no changes to the basic method for taxing business profits.[51] It also scheduled the income tax to expire after 1871, which did occur, partially thanks to strong lobbying efforts against an income tax.[52]

45. *See supra* note 43.

46. *Id.* Under the legislation originally enacted in 1864, there was no provision for a tax credit. Instead, an individual was simply not subject to tax on any dividend received from a taxable firm. *See* Act of June 30, 1864, ch. 173, § 117, 13 Stat. 281. Congress amended those rules in 1865 before its provisions went into effect to address the possibility that specific individuals would be overtaxed or undertaxed. *See* Richard Winchester, *Corporations That Weren't: The Taxation of Firm Profits in Historical Perspective,* 19 S. CAL. INTERDISC. L.J. 501, 506 (2010).

47. The Supreme Court made this abundantly clear, too. U.S. v. Balt. & Ohio R.R., 84 U.S. 322 (1872). *The case* involved a challenge to the withholding rule as it applied to interest payments. However, the operative provision of the statute also applied to dividends. The railroad refused to withhold tax on interest payments made to a tax-exempt recipient. The government sued, and a unanimous court rejected the government's claim. *Id.* at 326.

48. Act of Mar. 2, 1867, ch. 169, § 13, 14 Stat. 471, 477-78.

49. *Id.* § 13, 14 Stat. 478.

50. *Id.*

51. Act of July 14, 1870, ch. 255 § 8, 16 Stat. 258. The 5 percent levy remained in effect through 1870. *Id.* § 17, 16 Stat. 261. The 2.5 percent levy applied for the next two years. *Id.* § 15, 16 Stat. 260.

52. Act of July 14, 1870, ch. 255 § 6, 16 Stat. 256, 257. Once hostilities between the states ended, wealthy individuals successfully pressured the government to repeal the tax, stressing that it was a temporary measure intended to meet the needs of the war and nothing more. Dennis J. Ventry, Jr., *Equity versus Efficiency and the U.S. Tax System in Historical Perspective*, in TAX JUSTICE: THE ONGOING DEBATE 25, 29 (Joseph J. Thorndike & Dennis J. Ventry, Jr. eds., 2002); Edwin R.A. Seligman, THE

D. The 1894 Income Tax: Congress Resurrects the Income Tax and the Supreme Court Rejects It

Congress resurrected the income tax in 1894 in response to growing political pressure to reform the existing system of tariffs, which reached historic levels under the McKinley Tariff of 1890.[53] Notoriously inequitable, the tariffs effectively protected domestic manufacturing industries from foreign competition while forcing farmers and urban workers to shoulder the cost in the form of higher prices for manufactured goods.[54] Congress addressed the inequity by eliminating the sugar tariff and adopting a modest income tax to make up for the lost revenue.[55] The legislation contained an income tax that resembled the one that expired in 1872. It required individuals to pay a flat two percent tax on income above a $4,000 exempt amount.[56] It also imposed a two percent tax on the entire net income of certain business firms, whether distributed or not.[57] This time, the list of taxpayers grew to include all "corporations, companies, or associations doing business for profit" other than partnerships.[58] As in the past, any distributions by such firms were tax

INCOME TAX: A STUDY OF THE HISTORY, THEORY, AND PRACTICE OF INCOME TAXATION AT HOME AND ABROAD 466-68 (1911).

53. Tariff Act of 1890, ch. 1244, 26 Stat. 567. *See also* Sheldon D. Pollack, *Origins of the Modern Income Tax, 1894-1913,* 66 TAX LAW. 295, 297-98 (2013).

54. Pollack, *supra* note 53, at 297-98. *See also* FRANK W. TAUSSIG, THE TARIFF HISTORY OF THE UNITED STATES (1888) for a definitive account of U.S. tariff policy in the nineteenth century.

55. *Id.* at 302, 304-05 (describing the reasons certain Republicans supported the measure). *See also* Sven Steinmo, TAXATION AND DEMOCRACY: SWEDISH, BRITISH, AND AMERICAN APPROACHES TO FINANCING THE MODERN STATE 70 (1993) (describing the positions of populists within and outside the Democratic Party).

56. Act of Aug. 27, 1894, ch. 349, § 27, 28 Stat. 509, 553. Under prior law, the tax was 2.5 percent and the exemption was $1,000. Act of Mar. 2, 1867, ch. 169, § 13, 14 Stat. 471, 477-78 amended by Act of July 14, 1870, ch. 255 § 6, 16 Stat. 256, 257. An individual's tax base consisted of all "profits, and income . . . of every business, trade, or profession . . . ." Act of Aug. 27, 1894, ch. 349, § 27, 28 Stat. 509, 553.

57. Act of Aug. 27, 1894, ch. 349, § 32, 28 Stat. at 556. The Act specifically provided that:

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

58. *Id.* § 32, 28 Stat. at 556. The entire provision read as follows:

> That there shall be assessed, levied, and collected, except as herein otherwise provided, a tax of two per centum annually on the net profits or income . . . of all banks, banking institutions, trust companies, savings institutions, fire, marine, life, and other insurance companies, railroad, canal, turnpike, canal navigation, slack water, telephone, telegraph, express, electric light, gas, water, street railway companies, and all other corporations, companies, or associations doing business for profits in the united States, no matter how created and organized, but not including partnerships.

exempt to the recipient.[59]

However, the 1894 income tax never took effect because the Supreme Court invalidated it soon after its enactment.[60] In a 5-4 decision, the Court concluded that the measure constituted a "direct" tax, which had to be "apportioned" among the states by population in order to satisfy constitutional requirements.[61] Because the tax did not meet that condition, the Court rejected it,[62] leaving the existing system of tariffs as the sole source of revenue for the government.

E. The 1909 Income Tax: Congress Passes Its First Tax on Corporations

Congress passed its first tax on corporations in 1909. President Taft introduced the legislation as a way to neutralize bipartisan Congressional pressure for a universal income tax.[63] A group of bipartisan lawmakers proposed a tax largely modeled after the ones that preceded it. The measure consisted of a two percent tax on all net income of individuals and corporations in excess of $5,000. Corporate dividends were excluded from a shareholder's taxable income.[64] In addition, in cases where an individual's net income fell within the $5,000 exemption, the government would have reimbursed the amount that the company paid on the recipient's share of its earnings.[65] Although different in certain technical respects, the legislation would have extended the tradition of taxing all business profits in a uniform way. The bipartisan measure eventually attracted enough support to force a vote on it, threatening the fate of the tariff bill.[66]

Firmly opposed to any form of an income tax, Old Guard Republican leaders in Congress worked with President Taft to craft a legislative

The original draft legislation imposed a tax on business forms whose owners had limited liability. 26 CONG. REC. 1594-95 (1894) (section 59 of a proposed amendment to the tariff bill (section 32 of the Act)).

59. Act of Aug. 27, 1894, ch. 349, § 28, 28 Stat. at 554.

60. Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429 (1895).

61. *See* U.S. CONST. art. I, § 2, cl. 3 ("Representatives and direct taxes shall be apportioned among the several States" based on population). *See also id.* art. I, § 9, cl. 4 ("No capitation, or other direct, tax shall be laid, unless in proportion to the census or enumeration herein before directed to be taken.").

62. The decision was very controversial because it seemed to reverse what was thought to be settled law. The Civil War income tax was considered to be an indirect tax when it was drafted. *See* George S. Boutwell, *The Income Tax*, 160 N. AM. REV. 589, 600-01 (1895). Moreover, the Court reaffirmed that position only 15 years earlier. *See* Springer v. U.S., 102 U.S. 586 (1880).

63. Pollack, *supra* note 53, at 316. The administration specifically considered a tax on corporate dividends and a corporate income tax. ROY G. BLAKEY & GLADYS C. BLAKEY, THE FEDERAL INCOME TAX 40-42 (1940).

64. 44 CONG. REC. 1352 (1909).

65. 44 CONG. REC. 3137 (1909).

66. BLAKEY & BLAKEY, *supra* note 63, at 33. Pollack, *supra* note 53, at 315.

counterproposal.[67] Their response took the form of a two percent excise tax on the income of every corporation ostensibly for the privilege of the limited liability protection such firms enjoyed for doing business in corporate form.[68] There were also provisions that required firms to publicize certain financial information.[69] President Taft stressed how these provisions would give the federal government a degree of regulatory authority over corporations so as to prevent an abuse of power.[70] As part of a strategic move to neutralize support for the bipartisan income tax proposal, President Taft also endorsed the idea of a Constitutional amendment that would give Congress the power to enact an income tax.[71] By specifically targeting corporations, the act capitalized on the growing unease about the ubiquitous presence of huge, unregulated commercial enterprises in the national economy.[72] It was also during this period that it became more common to view the corporation as a separate legal entity instead of as an aggregation of its owners.[73]

The bipartisan income tax proposal fell victim to the president's strategy and was eliminated from consideration.[74] That cleared the way for Congress to finalize the terms of the Corporate Excise Tax, which was ultimately signed into law on August 5, 1909.[75] Thus, the legislation passed in large part because many Republicans viewed it as the lesser of two evils. They did not like the idea of taxing corporations, but they liked the idea of an income tax even less.[76]

In its final form, the Corporate Excise Tax of 1909 was a one percent tax on a corporation's net income in excess of $5,000.[77] Net income consisted of all gross income reduced by the firm's operating expenses, losses, taxes, dividends received from taxable corporations, and interest up to the amount of the firm's paid-up capital stock.[78] The firms subject

67. Pollack, *supra* note 53, at 316. The leadership specifically considered a tax on corporate dividends and a corporate income tax. BLAKEY & BLAKEY, *supra* note 63, at 40-42.

68. *See* 44 CONG. REC. 3344-45 (1909) (Message from President Taft). Taft and the Congressional leaders also considered a tax on corporate dividends and a corporate income tax. BLAKEY & BLAKEY, *supra* note 63, at 40-42.

69. 44 CONG. REC. 3344 (1909).

70. *Id.* This is very thoroughly examined by Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L.J. 53 (1990).

71. 44 CONG. REC. 3345 (1909).

72. Kornhauser, *supra* note 70, at 55-57.

73. *Id*. at 57-62.

74. Pollack, *supra* note 53, at 317-19; BLAKEY & BLAKEY, *supra* note 63, at 47.

75. Payne-Aldrich Tariff Act, ch. 6, § 1, 36 Stat. 11, 112-18 (1909). Certain non-profit organizations were exempt from the Act. Although Old Guard Republicans were not thrilled with the tax, they believed it was better than the alternative. Pollack, *supra* note 53, at 320.

76. *See* Pollack, *supra* note 53, at 319-20.

77. Payne-Aldrich Tariff Act, ch. 6, § 38, 36 Stat. 112 (1909).

78. *Id.* at 113-14.

to tax included any corporation, joint stock company or association having capital stock represented by shares.[79] The Supreme Court upheld the tax as constitutional, concluding it was an indirect tax that did not have to be apportioned.[80]

Although labeled an excise tax for the privilege of doing business in corporate form, a firm's tax liability was based on its income. However, it is not entirely clear that the measure was intended to operate as a tax on the firm itself. There is evidence that lawmakers were attempting to reach the wealth of the individuals who owned corporate stock.[81] There is also evidence that the measure would indirectly enable the government to control and regulate corporations.[82] Whatever may have been the justification for the tax, it was a departure from the country's tradition of taxing business profits in a uniform way. The measure remained in existence until 1913, when it was incorporated into the modern income tax that remains in existence to this day.

F. The Economic Backdrop for the Evolving Tax on Business Profits

The government's approach for taxing business profits necessarily contemplated the prevailing business structures operating in the economy, as well as the way business firms were viewed in the eyes of the law. During the Civil War era, the typical business unit was a small, closely held firm whose owners also managed the business.[83] For these firms, the size of the business was generally restricted by the personal wealth of the owners.[84] If the owners needed outside financing, the only viable option was short term loans.[85] Outside equity financing was almost never sought, partly because owners did not want to give anyone else a voice in their business.[86]

Throughout the nineteenth century, the dominant business form was the partnership.[87] This was particularly the case for small business

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79. *Id.* at 112.

80. Flint v. Stone Tracy Co., 220 U.S. 107 (1911).

81. Steven A. Bank, *Entity Theory as Myth in the Origins of the Corporate Income Tax*, 43 WM. & MARY L. REV. 447, 452 (2001).

82. Kornhauser, *supra* note 70.

83. ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 2 (1940 ed.) (1932); Navin & Sears, *supra* note 39, at 107.

84. BERLE & MEANS, *supra* note 83, at 2.

85. Navin & Sears, *supra* note 39, at 107.

86. *Id.*

87. Naomi R. Lamoreaux & Jean-Laurent Rosenthal, *Corporate Governance and the Plight of Minority Shareholders in the United States Before the Great Depression*, *in* CORRUPTION AND REFORM: LESSONS FROM AMERICA'S ECONOMIC HISTORY 125, 129 (Edward L. Glaser and Claudia Goldin eds., 2006); Navin & Sears, *supra* note 39, at 109-112.

firms.[88] During the first half of the nineteenth century, the ubiquity of partnerships largely reflected the absence of an alternative. Until mid-century, corporate charters were only available through a special grant from the legislature.[89] However, these special charters were severely criticized during the Jacksonian period as a source of political bribery and monopoly power.[90] That characterization fueled a nationwide push for statutes that made the act of incorporation universally available to anyone. Between 1850 and 1870, such general incorporation laws gradually became the norm throughout the country.[91] However, when incorporation became an option, small firms did not choose it in large numbers.[92] That is because the corporate form was ill suited to the needs of a closely held firm.[93] Such business ventures valued having a measure of flexibility in allocating ownership, control, and income rights; corporations were too rigid a structure to accommodate that need.

Perhaps most importantly, participants in an incorporated venture had virtually no practical way to exit the venture. They were locked into the venture because there was unlikely to be an efficient market for shares in a small firm, leaving an owner unable to separate himself from the venture by selling his shares to a buyer. This was a particularly unattractive feature in light of the fact that small firms faced a greater risk of being commandeered by an oppressive participant or incapacitated by deadlock between the participants. By contrast, partners in a partnership enjoyed a presumptive right to withdraw from the venture at any time, even though doing so could effectively force the business to dissolve.

Corporations had the advantage of offering shareholders the presumption that they enjoyed limited liability for the debts and obligations of the firm.[94] However, during the early years of free incorporation, this rule frequently had to yield to higher legal authority. During the Civil War era, most states had constitutional or statutory provisions holding shareholders of an insolvent corporation liable for more than the value of their shares.[95] The most typical provision, adopted in almost every state, imposed double liability on a corporation's

88. Lamoreaux & Rosenthal, *supra* note 87, at 129; Henry Hansmann, Reinier Kraakman & Richard Squire, *Law and the Rise of the Firm,* 119 HARV. L. REV. 1335, 1395 (2006).

89. Martin J. Horwitz, *Santa Clara Revisited: The Development of Corporate Theory*, 88 W. VA. L. REV. 173, 181 (1985).

90. *Id.*; Herbert Hovenkamp, *The Classical Corporation in American Legal Thought,* 76 GEO. L.J. 1593, 1635 (1988).

91. Horwitz, *supra* note 89, at 181.

92. Lamoreaux & Rosenthal, *supra* note 87, at 129; Hansmann, et al., *supra* note 88, at 1335, 1395.

93. Hansmann, et al., *supra* note 88, at 1395; Lamoreaux & Rosenthal, *supra* note 87, at 128.

94. *See* Hovenkamp, supra note 90, at 1651-1658 (recounting the origins and evolution of limited shareholder liability).

95. Horwitz, *supra* note 89, at 208.

shareholders.[96] In some cases, the shareholders' exposure was even greater.[97]

Putting aside constitutional and statutory rules, courts would assert the Trust Fund Doctrine to hold innocent shareholders who purchased their shares at a discount liable for the difference between the stock's par value and the purchase price.[98] The Trust Fund Doctrine was honored for most of the nineteenth century until it became the target of attacks during the 1890s. Over time, the doctrine lost its vitality, in part because of the rise of a national stock market, which definitively converted shareholders to impersonal investors.[99]

Considering all the tools available to creditors of an insolvent corporation during the nineteenth century, one scholar has concluded that truly limited shareholder liability was far from the norm in America even as late as 1900.[100] Thus, even the virtues of limited liability may not have offered a benefit that would have permitted the corporate form to represent an appealing alternative to the partnership, which satisfied what may have been an overriding priority for someone investing in a small business: a way to get out. The corporate form gradually became more attractive as a vehicle for operating smaller firms starting in the late nineteenth century, when courts began to recognize the power of the firm to restrict the transferability of shares.[101] However, that power was not firmly established until well into the twentieth century.[102]

Historical data reflects the overwhelming popularity of the partnership form for smaller firms. In 1900, two-thirds of all manufacturing firms owned by more than one person were organized as partnerships. Moreover, firms operating as partnerships were significantly smaller than those choosing to incorporate in that year. Partnerships accounted for \$2.57 billion of goods produced, while corporations accounted for \$7.73 billion even though they were vastly outnumbered by partnerships.[103] Small firm incorporations increased at a steady pace over the next decades, but large numbers of partnerships were also formed. These statistics confirm that the closely held, small firm was almost always a partnership during the nineteenth century, and that the partnership remained the overwhelming entity of choice well into the twentieth century for the small business venture.

96. *Id.*

97. *See* 3 S. THOMPSON, COMMENTARIES ON THE LAW OF PRIVATE CORPORATIONS VI, chs. 46, 50 (1st ed. 1895)

98. Horwitz, *supra* note 89, at 208.

99. *Id.* at 209.

100. *Id.* at 208.

101. Hansmann, et al., *supra* note 88, at 1396.

102. *Id.*

103. Lamoreaux & Rosenthal, *supra* note 87, at 129.

Meanwhile, the largest firms were consistently organized as corporations throughout the nineteenth century and beyond. The railroads were the most prominent example during the Civil War era. Railroads favored the corporate form because it permitted them to raise the large amounts of capital that the business would require, while leaving the management of the firm in the hands of a small team of professionals.[104] In other words, the corporate form made it possible to separate a firm's owners from its managers. Indeed, the very features that made the corporate form unappealing to a closely held business made it well suited to the needs of a large, capital-intensive business that could not be supported solely by the wealth of its owner-managers.

Initially, the largest firms took the form of trusts, not corporations. Such trusts arose during the 1880s when firms in the processing sector faced stiff price competition, leading companies in particular industries to search for a way to manage their activities on a coordinated basis.[105] The first consolidated enterprise to operate as a trust was Standard Oil, which was formed in 1879 under the leadership of John D. Rockefeller.[106] The trust was better suited than the corporation for this task at that time partly because state statutes did not permit corporations to own shares in other corporations.[107] Nor could such firms operate across state lines.[108] Those limitations did not apply to a trust. Trusts were not conceived as a device for obtaining capital from passive investors. To the contrary, the owners of the trusts were typically the partners of the firms that comprised the trust.[109] Thus, even when trusts emerged as a source of economic power, the owner-managed firm remained the dominant model, even for the largest industrial ventures. However, over time, these large commercial enterprises would evolve into ones that were characterized by large numbers of passive owners and a small team of professional managers.

The trend away from the owner-managed firm started during the 1880s when owners of trusts became interested in disposing of their shares. The New York Stock Exchange accommodated them by allowing the trading of trust certificates on an unlisted basis.[110] By the end of the 1880s, the trading volume was so high that the exchange eclipsed the Boston Stock Exchange as the country's preeminent stock market.[111] More importantly,

104. Hovenkamp, *supra* note 90, at 1595.
105. Navin & Sears, *supra* note 39, at 112.
106. *Id.*
107. *Id.*
108. Horwitz, *supra* note 89, at 191.
109. Navin & Sears, *supra* note 39, at 113.
110. *Id.* at 115.
111. *Id.*

from the 1880's onward, securities of all types became an increasingly attractive investment vehicle and the ownership of business firms became more dispersed and mobile. In short, the emergence of an organized securities market facilitated the gradual transition from an economy dominated by small owner-managed firms to one dominated by huge commercial enterprises with widely dispersed, passive investors.

Meanwhile, the corporation became a more attractive way to conduct business on a large scale. The key event occurred in 1889 when New Jersey amended its incorporation statute to permit corporations to own stock in other corporations.[112] The amended statute also permitted incorporation for any lawful purpose, offering virtually unlimited flexibility to corporate managers. Soon thereafter, other states followed suit.[113]

The shift to the corporate form coincided with a shift in the management structure of the largest firms. Those firms were traditionally managed by their owners. However, firms gradually began to rely on passive investors for a portion of their equity capital. The trend accelerated and intensified during the 1890s as a result of two factors. First, existing trusts and partnerships incorporated themselves, with the owners taking advantage of the developing market for industrial securities to liquidate part of their investment. The usual pattern would be for the owners to issue common stock to themselves, while issuing nonvoting preferred stock to executives, employees, distributors and members of the general public.[114] Second, there was an unparalleled wave of industrial combinations that occurred starting in the mid-1890s through 1904, a period referred to as the Merger Movement.[115] The issuance of preferred stock was a key element of these transactions, too.[116]

Preferred stock had several attractive features. First, it was a fixed income instrument that could be more easily priced than common stock by investors who had little knowledge of the issuer's business.[117] Second, compared to common stock, it was more acceptable to an investing public that was accustomed to the regular interest payments that would be paid on a bond.[118] Meanwhile, preferred stock enabled the company to obtain needed capital in a less expensive and less risky way than by issuing debt

112. Horwitz, *supra* note 89, at 195.

113. *Id.*

114. Navin & Sears, *supra* note 39, at 120, 123.

115. NAOMI R. LAMOREAUX, THE GREAT MERGER MOVEMENT IN AMERICAN BUSINESS, 1895-1904 (1985). More than 1,800 firms disappeared into consolidations during this period. *Id.* at 2.

116. Navin & Sears, *supra* note 39, at 122.

117. JONATHAN BARRON BASKIN & PAUL J. MIRANTI, JR., A HISTORY OF CORPORATE FINANCE 152 (1999).

118. *Id.*

or by borrowing money.[119] Industrial proprietors and corporate managers liked issuing nonvoting preferred stock to new investors because that enabled them to liquidate part of their investment without endangering their position of control and their ability to exploit the company for their own personal objectives.[120] By contrast, voting power seemed to have little value to small investors whose holdings were unlikely to be large enough to translate into a meaningful voice in corporate governance.[121]

Bankruptcy risk was a third consideration. Bankruptcies were common during this period, even among the largest U.S. corporations. In that context, preferred stock gave managers greater control over payments to investors when financial conditions were not ideal.[122] The popularity of preferred stock is significant in that its use permitted ownership and management of the largest corporations to become separate in fact, not just in theory.

The net effect of these events caused the American economy to undergo a drastic transformation between 1890 and 1916.[123] It began as a period dominated by owner-managed firms operating in largely unregulated competitive markets. That was the context in which Congress adopted the uniform rules for taxing business profits. By the end of 1916, the economy was dominated by relatively few large corporations with passive owners and professional managers operating in a regulated market. This different context led Congress to reconsider the merits of a uniform rule for taxing business profits.

The distribution practices of publicly traded corporations also changed considerably over the years. In the period preceding the First World War, it was the accepted practice for all firms to distribute nearly all of their earnings, no matter what the firm's size or legal form.[124] This had always been the universal norm for partnerships.[125] Firms operating in corporate form observed the same practice for two principal reasons.[126] First, those

119. Navin & Sears, *supra* note 39, at 116.

120. *Id.* at 116, 119 (1955); BASKIN & MIRANTI, *supra* note 117, at 153.

121. BASKIN & MIRANTI, *supra* note 117, at 153.

122. *Id.* at 155.

123. *See* MARTIN J. SKLAR, THE CORPORATE RECONSTRUCTION OF AMERICAN CAPITALISM, 1890-1916 (1988).

124. ROBERT SOBEL, THE GREAT BULL MARKET: WALL STREET IN THE 1920S 32 (1968) ("Before the [First World] war, most large corporations considered earnings after taxes and payments to bondholders and preferred stockholders a "surplus," and much of this was divided among the common stockholders. This meant that such firms would have to depend heavily upon the capital markets for funds needed for expansion, and large bond issues were considered normal."); Bank, *supra* note 36, at 473.

125. SHAW LIVERMORE, EARLY AMERICAN LAND COMPANIES: THEIR INFLUENCE ON CORPORATE DEVELOPMENT 232 (1939).

126. This was the case even though directors had considerable power to withhold payments to shareholders, and there were a variety of rules limiting shareholder access to profits. For example, dividends had to be paid exclusively from the profits of the firm, as opposed to any funds contributed by

firms were simply not in the habit of disclosing financial information to anyone, as financial reporting of any kind did not start to occur until the twentieth century.[127] That made the distributions of profits the principal, tangible way a firm could telegraph how well it was doing and to establish a value for its stock.[128] Second, in the absence of dividends, there would be no way for someone to realize a return on an investment in corporate stock.[129] Today, the existence of an organized stock market offers investors the option to sell their shares to someone else. However, an organized and efficient stock market did not arise until well into the twentieth century.[130] Therefore, companies that issued stock before that market arose had to observe liberal dividend policies in order to attract individuals to invest in a relatively illiquid asset.[131] The emergence of an organized stock market gave firms the freedom to retain a greater share of their earnings and to distribute a smaller share to their investors. Such a shift in distribution practices made it difficult to justify a tax policy that required the investor to pay tax on their share of a firm's earnings that they did not actually receive and could not access.

G. Evolving Legal Conceptions of the Firm

Treating a firm as an extension of its owners—and not as a separate and distinct entity—was not a concept that was unique to tax law. Throughout most of the nineteenth century and beyond, business entities of all kinds were not viewed as having a legal identity apart from their owners. This was especially true for partnerships, which consistently had been viewed as contractual arrangements that did not produce a separate and distinct legal entity. Instead, the partnership was merely an aggregation of the partners.[132]

The legal status of the corporation evolved over the years. During the early part of the nineteenth century, the corporation was viewed as an

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the shareholders. VICTOR MORAWETZ, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS § 435 at 410 (2d ed. 1886). Second, the board of directors possessed complete discretion to determine whether and when to pay a dividend. Cyrus LaRue Munson, *Dividends*, 1 YALE L.J. 193, 196 (1891).

127. Bank, *supra* note 36, at 468-472.

128. *Id.*

129. BASKIN & MIRANTI, *supra* note 117, at 19.

130. A number of stock exchanges did exist during this period. However, they were still evolving and handled a very narrow range of securities for an even more limited clientele. ROBERT SOBEL, INSIDE WALL STREET: CONTINUITY AND CHANGE IN THE FINANCIAL DISTRICT 28-33 (1977). In 1877, for example, there were only 163 stocks and 334 bonds listed for trading on the New York Stock Exchange, with most of them representing railroads, banks and local industries. The Boston Stock Exchange overshadowed the NYSE for industrial securities. *Id.* at 32.

131. Once the securities markets developed, the emphasis on dividends was replaced by a focus on earnings. R.W. SHABACKER, STOCK MARKET THEORY AND PRACTICE 411-12 (1930).

132. Horwitz, *supra* note 89, at 181. *See also* UNIF. PARTNERSHIP ACT (UNIF. LAW COMM'N 1914).

artificial entity.[133] That was consistent with the observed reality. Prior to 1850, the only way to secure a corporate charter was through an act of the legislature.[134] However, such special charters were severely criticized during the Jacksonian period for encouraging bribery and favoritism.[135] That criticism fueled a nationwide push for statutes that made the act of incorporation universally available. By 1870, every state in the union had enacted such laws.

The availability of so-called "free incorporation" called into question the idea of the corporation as an artificial entity. The immediate response was to view a corporation as a contractual arrangement analogous to a partnership.[136] In fact, around the time of the Civil War, the leading treatise on corporations described corporations as "little more than limited partnerships."[137] Moreover, through the 1880s, there was a strong tendency to analyze corporation law not much differently from the law governing partnerships.[138] Because those rules embraced a view of the firm as an aggregation of individuals, all powers of the firm derived from the rights of the individuals who comprised it.[139] This tendency to elevate the role of the individual may have partly reflected the anti-corporate and anti-consolidation bias that characterized the period.[140]

Even though the law initially drew few distinctions between corporations and partnerships, legal theorists vigorously debated whether a corporation was a mere aggregation of individuals or whether it was indeed a real entity that was separate and distinct from the individuals who compose it.[141] Perhaps the first prominent judicial decision that adopted the idea that a corporation was a separate legal entity came in 1886, when the U.S. Supreme Court casually declared in *Santa Clara County v. Southern Pacific Railroad* that a corporation was a person under the Fourteenth Amendment and entitled to the protection granted by its provisions.[142] The Court was hesitant to completely equate the status of corporations with that of individuals. Instead, it conferred parity on a case by case basis in a series of decisions involving discrete constitutional rights.[143]

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133. Horwitz, *supra* note 89, at 181.

134. *Id.* at 181.

135. *Id.*

136. *Id.* at 182.

137. JOSEPH K. ANGELL & SAMUEL AMES, TREATISE ON THE LAW OF PRIVATE CORPORATIONS AGGREGATE, 766 (John Lathrop ed. 7th ed. 1861) (1832).

138. Horwitz, *supra* note 89, at 203-04.

139. *Id.* at 182.

140. *Id.* at 186.

141. *Id.* at 182, 185.

142. 118 U.S. 394 (1886).

143. Horwitz, *supra* note 89, at 182.

In the interim, the entity theory gained momentum and the laws of partnerships and corporations moved in radically different directions. There are two particularly illuminating examples of this trend. The first involved the level of shareholder approval required to undertake a major transaction. Traditionally, it was necessary for a corporation to obtain unanimous shareholder consent to undertake a merger or other fundamental change. The rule was one example of the tendency to view corporations as merely a contractual arrangement similar to a partnership.[144] However, by the time of the Merger Movement at the turn of the century, nearly all states had passed statutes permitting such transactions to proceed with less than unanimous shareholder consent.[145] The common law rule of unanimous consent was also eroded by a consistent line of judicial decisions. The combination of trends led one contemporary scholar to observe that by 1926, there was "hardly a state . . . where the dominant common law rule . . . ha[d] not been abrogated by statute or decision."[146]

In a similar fashion, views on the role of the directors shifted in a dramatic way. Traditionally, the shareholders were considered to possess all the powers of the corporation, with the board acting as their agents and lacking any inherent power to appoint subagents.[147] Such a view is consistent with the idea that the corporation is a contractual arrangement. By 1931, however, the leading treatise on the power of corporate directors reflected a dramatic change in legal opinion, explaining how modern decisions emphasized "the directors' absolutism in the management of the affairs of large corporations."[148] This observation was consistent with the prevailing realities: in a world where corporations regularly merged and individuals held diversified portfolios of industrial securities, shareholders were no longer "co-entrepreneurs," but merely passive investors.[149]

Given the state and structure of business activity during most of the nineteenth century, it is easy to see why Congress adopted a uniform rule for taxing business profits as part of the nation's first experiment with an income tax. Virtually all firms were, in fact, managed by their owners, regardless of the legal form adopted by the business. In the rare case where the firm did not meet this description, taxing the owners on their shares of a firm's profits did not produce any distorted outcomes because firms, in fact, distributed all their earnings to their owners. Moreover,

144. *Id.* at 200.

145. *Id.*

146. Joseph L. Weiner, *Payment of Dissenting Stockholders,* 27 COLUM. L. REV. 547 (1927).

147. ANGELL & AMES, *supra* note 137, at 257.

148. H. SPELMAN, A TREATISE ON THE PRINCIPLES OF LAW GOVERNING CORPORATE DIRECTORS, 4-5 (1931).

149. *Id.*

taxing firms in a uniform way was an extension of the law's uniform views about the nature of business organizations. However, that uniform legal status had to be reconsidered as the economy evolved to be dominated by huge industrial enterprises with widely dispersed passive owners and a small team of professional managers. The tax rules had to be reconsidered to reflect that new reality, too.

III. THE FORMATIVE YEARS OF THE MODERN INCOME TAX

A. 1913: Congress Adopts Two Approaches for Taxing Business Profits

The income tax adopted in 1913 contained, for the first time, two different approaches for taxing business profits. One approach applied to profits derived through a corporation; the other applied to the profits derived through all other business firms. The legislation accomplished this through a system consisting of three separate taxes: a corporate tax, a normal tax on individuals, and a surtax on individuals. The combination of rules interacted in such a way that the individual normal tax and surtax applied to the profits of any unincorporated firm. The tax on corporate profits depended on whether the firm distributed the profits to its shareholders or not. If the firm paid dividends to the owners, the tax on the profits were no different than if they were derived by a partnership or another unincorporated business. However, any profits the firm did not distribute were only subject to the corporate tax.

Individuals were subject to a normal tax and a surtax.[150] The normal tax was a one percent flat tax on an individual's net income in excess of an exempt amount.[151] An individual's net income would include his share of the profits of any partnership, whether those profits were distributed or not.[152] However, net income did not include any corporate dividends.[153] Instead, all dividends and any undistributed corporate profits were subject to a one percent tax imposed on the corporation.[154] Thus, the tax paid by a corporation was the functional substitute for the normal tax that would have been paid by the recipient of any dividend.[155] The overall structure

150. Revenue Act of 1913, § II.A.2, 38 Stat. 114, 166.

151. *Id.* § II.A.1, 38 Stat. at 166. The exempt amount depended on a person's marital status. An unmarried individual was allowed to exclude the first $3,000 from the normal tax, while married couples were collectively allowed to exclude the first $4,000. *Id.* § II.C., 38 Stat. at 168.

152. *Id.* § II.D., 38 Stat. at 169.

153. *Id.* § II.B., 38 Stat. at 167.

154. The corporate tax applied to "every corporation, joint-stock company or association, and every insurance company, organized in the United States, no matter how created or organized, not including partnerships. . . ." *Id.* § II.G.(a), 38 Stat. at 172. The Act's corporate tax replaced a corporate excise tax that was in effect since 1909. 50 CONG. REC. 509 (statement of Rep. Hull) (1913).

155. However, because the normal tax only kicked in when an individual's income exceeded the exempt amount, an individual whose income fell below that threshold would have been overtaxed on his

of the normal tax was very similar to the revenue measures enacted in the nineteenth century.

Meanwhile, the surtax on individuals was a progressive tax that included a schedule of six rates ranging from one to six percent.[156] The members of Congress broadly agreed on the overall structure of the surtax and how it should apply to individuals.[157] However, lawmakers labored long and hard before adopting an approach for applying the surtax to business profits.[158]

The application of the surtax to business profits was not expressly addressed in the original bill reported out of the House Ways and Means Committee and later passed by the full House.[159] The Senate Finance Committee addressed the issue directly by amending the bill to include a provision that required an individual to pay surtax on his share of the profits of any business, whether incorporated or not, as long as the taxpayer would be "legally entitled to enforce the distribution or division of the same."[160] The drafters inserted this language out of an apparent concern that both partnerships and corporations would start reducing the amount of profits they distributed to their owners in an attempt to prevent those profits from being subject to the surtax.[161]

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share of any corporate profits.

156. The rates applied in a graduated way with the 1% tax applying to net income above $20,000 and up to $50,000, while the 6% rate applied to amounts in excess $500,000. *Id.* § II.A.2., 38 Stat. at 166.

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

158. Indeed, Senator Williams stated that it "gave us more trouble than anything" in the bill. 50 CONG. REC. 5318 (1913).

159. *See* H. R. REP. NO. 5 (1913). *See also* J. S. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS: 1938-1861, 983-84 (1938). Indeed, the entire bill was relatively uncontroversial in the House where the Democrats held a large majority. BLAKEY & BLAKEY, *supra* note 63, at 83.

160. SEIDMAN, *supra* note 159, at 983. This provision was adopted despite concerns voiced over the ability of individual shareholders to ascertain their share of a firm's profits and the possibility that the amounts so taxed would be taxed again when distributed by the firm. BLAKEY & BLAKEY, *supra* note 63, at 86.

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

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

50 CONG. REC. 3774 (1913) (statement of Sen. Williams). The idea of taxing an individual on a portion of firm profits not actually received by him was not new. The Revenue Act of 1864 set a precedent for

However, once the bill reached the floor of the Senate, lawmakers questioned the validity of permitting the undistributed profits of a corporation to be considered the income of any shareholder given that a shareholder had no power to force a corporation to pay a dividend.[162] For that reason, the provision was sent back to the Committee for further consideration.[163] The Committee modified the provision by requiring firm owners to pay surtax on their share of the undistributed earnings of a business only in those cases where the undistributed amounts were beyond the reasonable needs of the business.[164] This approach seemed to acknowledge the emerging view that it was prudent for corporations to

that. Under that legislation, the profits of a business were expressly taxed to the individual owners, regardless of whether the business was incorporated and regardless of whether the profits were paid out to the owners. Act of June 30, 1864, § 117, 13 Stat. at 282 ("[T]he gains and profits of all companies, whether incorporated or partnership . . . shall be included in estimating the annual gains, profits, or income of any person entitled to the same, whether divided or otherwise."). Under the interpretation of the Commissioner of Internal Revenue, the amounts taxed to an individual included the undivided profits of a corporation. *See* DIGEST OF DECISIONS AND REGULATIONS MADE BY THE COMMISSIONER OF INTERNAL REVENUE, 1864-1898, at 16, 36, 37, 39, 40 (1906). In dictum, the Supreme Court concurred with this interpretation in *Collector v. Hubbard*. 79 U.S. (12 Wall.) 1 (1870). Taxing partnerships and corporations in the same way under a uniform rule seems to be consistent with the prevailing view about the nature of a partnership and a corporation. At the time, both business forms were considered to be an aggregate of its owners. *See* Kornhauser, *supra* note 70, at 58.

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

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

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

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

164. SEIDMAN, *supra* note 159, at 984. Before deciding to limit the rule in this way, the Committee received the input of the Southern Railway Company, which cautioned against a rule that would put firms in the position of having to defend a decision to reinvest profits in the business. *See* 50 CONG. REC. 4379 (1913).

legitimately retain some portion of their annual earnings for future reinvestment.[165] The Committee continued to draw no distinction between corporations and other businesses. Thus, the revised rule applied to both incorporated and unincorporated firms.[166]

Additional language was added on the Senate floor to help clarify that the surtax would only reach those instances in which an intention to avoid tax motivated the decision not to distribute or divide the profits of the business. Specifically, owners would be taxed on their share of undistributed profits only when the companies (whether incorporated or not) were "formed or fraudulently availed of for the purpose of preventing the imposition of such [surtax] through the medium of permitting such gains and profits to accumulate."[167] Senator Williams explained the objective of the language: "It applies only to such profits and the heaping up of such surplus as shall justify the Secretary of the Treasury in concluding that it is done for the purpose of evading the tax. Its main purpose is to prevent the formation of holding companies."[168]

Under the compromise, the individual surtax would apply in two different ways depending on whether the profits were derived from an incorporated business or not.[169] In the case of an unincorporated business, like a partnership, each owner would have to pay the surtax on his share of the profits of the business whether or not the share was actually distributed to the partner.[170] This rule essentially replicated the approach taken for purposes of the normal tax. However, if the business was a corporation, the conferees took a two-pronged approach. First, each shareholder was required to pay surtax on any corporate profits actually distributed to him as a dividend.[171] Second, the shareholders would also

165. Steven A. Bank, *A Capital Lock-In Theory of the Corporate Income Tax,* 94 GEO. L.J. 889, 918 (2006).

166. SEIDMAN, *supra* note 159, at 983.

167. SEIDMAN, *supra* note 159, at 984; BLAKEY & BLAKEY, *supra* note 63, at 92.

168. 50 CONG. REC. 4380 (1913) (statement of Sen. Williams). The Senate Finance Committee's adoption of a uniform rule for taxing the undistributed profits of partnerships and corporations seems odd. Elsewhere in the legislation, the Committee specified that the partners of a partnership (but not the shareholders of a corporation) would have to pay tax on their share of firm profits, whether distributed or not. 50 CONG. REC. 3855 (1913) ("*Provided further*, That any persons carrying on business in partnership shall be liable for income tax only in their individual capacity, and the share of the profits of a partnership to which any taxable partner would be entitled if the same were divided, whether divided or otherwise, shall be returned for taxation and the tax paid, under the provisions of this section, . . . "). In any event, the bill was reconciled in the Conference Committee, which revised the legislation to prevent the surtax from having two inconsistent rules for taxing undistributed partnership profits.

169. SEIDMAN, *supra* note 159, at 983-84.

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

171. *But cf. id.* § II.B., 38 Stat. at 167 (allowing an individual to exclude dividends from taxable

have to pay surtax on their share of any profits that were not distributed if the corporation's failure to do so was motivated by a desire to prevent the application of the surtax.[172]

This latter provision has become known as the "accumulated earnings penalty." It was distinctive in part because it was not self-executing. Instead, the government had to detect cases of unlawful conduct and assess the tax. When it did, the government would have to establish that the failure to distribute profits was motivated by the desire to avoid tax.[173] However, by the terms of the legislation, the mere fact that the gains and profits were permitted to accumulate and become surplus was not to be construed as evidence of a purpose to escape the surtax unless the Secretary of the Treasury certified that such accumulation was "unreasonable for the purposes of the business."[174] Thus, only certain instances of undistributed surplus would be the target of the penalty based on the theory that there were certain legitimate accumulations of surplus that could be distinguished from illegitimate accumulations. However, Congress left it to the Secretary of the Treasury to draw these distinctions. In any year that the penalty tax applied, the noncompliant firm was taxed similar to a partnership for purposes of the surtax, with the shareholders having to pay tax both on amounts they actually received and their share of any undistributed profits for the year.[175]

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income for purposes of the normal tax only).

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

173. The Act identified two factors that could independently be relied upon as prima facie evidence of a fraudulent purpose to escape the surtax. First, if the corporation was a mere holding company, that would constitute such prima facie evidence. Second, the fact that the corporation permitted its gains and profits to accumulate beyond the reasonable needs of the business would also constitute such prima facie evidence. *Id.* § II.A.2., 38 Stat. at 167.

174. *Id.*

175. It would be incorrect to say that the firm and its shareholders were treated in a way that was identical to a partnership and its partners. A partner was not taxed on amounts actually received by the partnership. Rather, a partner was taxed solely on the partner's share of profits derived by the partnership in a given year, while any actual distributions were tax free to the partner. By contrast, under the rules of the accumulated earnings tax, a shareholder remained subject to tax on any profits actually received from the corporation as a dividend. If in a later year, such a dividend consisted of amounts that were previously taxed to the shareholder under the accumulated earnings tax, that dividend would remain subject to tax. There was no provision exempting such a dividend from the surtax. To that extent, the tax seems to operate as a penalty. However, writing at a more contemporaneous time, one scholar concluded that the provision was "not, strictly speaking, a penalty statute." Lucius A. Buck and Francis Shackelford, *Retention of Earnings by Corporations Under the Income Tax Laws*, 36 VA. L. REV. 141, 153 (1950). It is important to note that this particular scholar reached this conclusion without considering whether shareholders would be taxed on dividends consisting of profits that were previously taxed to them under the accumulated earnings rules in prior years. The one penal quality he did identify was the fact that the "surtax" would apply to amounts "the corporation could have accumulated to meet its reasonable needs."

In the end, the rules for taxing business profits created an incentive for individuals to utilize corporations as a tax shelter. While all partnership profits were subject to as much as seven percent in tax, corporate profits would be subject to that rate only when they were actually distributed to shareholders. Corporate profits that were retained by the firm were only subject to the one percent corporate tax.

Congress granted tax relief to undistributed corporate earnings for two reasons. First, it did not want to make individual shareholders pay surtax when the shareholder was not in a position to effectively access the earnings. Second, Congress did not want a tax to influence decisions about ways to finance corporate investments. A tax on undistributed corporate profits would have discouraged firms from relying on such funds at a time when it was considered to be a responsible and prudent practice to retain such earnings and not to pay all profits out as a dividend. Thus, the unique way of taxing corporations was designed to accommodate a specific business structure: a firm whose managers could, and did, deploy the firm's earnings in a way that served the interests of the firm.

Despite the sound rationale for taxing corporate profits in a unique way, Congress understood how this unequal system of taxation could be abused. Lacking a sufficiently precise test to distinguish between impermissible and permissible cases of undistributed profits, Congress essentially delegated the task to the Internal Revenue Service with instructions to inquire into the taxpayer's intent.

The was not an easy one for the Treasury to execute. Part of the Treasury's difficulties can be traced to the inherent complexities in enforcing a rule that required establishing taxpayer intent. Its difficulties also stemmed from the fact that the disparity in the taxation of undistributed corporate profits and other business profits grew larger over time, increasing the incentive for firms to retain earnings beyond permissible levels.[176] The government was simply ill-equipped to respond to taxpayer efforts to avoid the surtax. As explained in the next section, Congress made a variety of adjustments to the accumulated earnings penalty in order to improve its effectiveness, but the provision

Id. By that measure, however, it would seem that the approach for taxing partnerships also had a penal quality, since—under those rules—partners were not relieved of surtax on their share of partnership profits retained by the firm to meet its reasonable needs. As a matter of Congressional intent, however, the legislative history for the 1913 Act contains no evidence that lawmakers consciously intended a double tax to apply. In fact, Congress affirmatively rejected such an idea five years later when it revised the accumulated earnings tax. Those amended rules expressly exempt from the surtax future distributions of amounts that were previously taxed to shareholders. There is no evidence that the change was motivated by a desire to ease the burden of the tax. To the contrary, as later sections of this Article will illustrate, Congress consistently tried to strengthen it.

176. Richard Winchester, *Parity Lost: The Price of a Corporate Tax in a Progressive Tax World,* 9 NEV. L.J. 130 (2008).

consistently proved to be an ineffective tool to address tax evasion.

B. 1918: The Government Can Explicitly Tax Certain Corporations Like Partnerships

Five years after enacting the accumulated earnings tax, Congress adjusted the remedy provided by the law. Under the revised version of the tax, the corporate income tax simply would not apply to any corporation that fraudulently accumulated earnings. Instead, the shareholders had to pay tax on their share of firm profits as if they were members of a partnership.[177] Thus, both the normal tax and the surtax would apply to each shareholder's share of firm profits, whether the taxpayer received any or not.[178] In other words, the remedy emphatically treated the corporation as a partnership. This change effectively declared that any corporation falling within the scope of the statute should not be respected as such.

C. 1921: Certain Corporations Can Choose to be Taxed Like Partnerships

By 1921, Congress had to reconsider the remedy imposed under the accumulated earnings tax in light of a 1920 Supreme Court decision that cast doubt on the constitutionality of taxing shareholders on the undistributed profits of a corporation.[179] In response, Congress replaced the shareholder tax with a 25 percent tax on the corporation.[180] Under the 1921 Act, all corporations were subject to a 12.5 percent corporate tax,[181]

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177. The statute specifically required the firm to be subject to a newly enacted set of rules that applied to so-called personal service corporations. Revenue Act of 1918, ch. 18, § 220, 40 Stat. 1057, 1072. Under those rules, the shareholders had to pay tax on their share of firm profits as if they were members of a partnership. *Id.* § 218(e), 40 Stat. at 1070. For a more complete description of the personal service corporation rules, see Richard Winchester, *Corporations That Weren't: The Taxation of Firm Profits in Historical Perspective,* S. CAL. INTERDISC. L.J. 501, 518-20 (2010).

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

179. Eisner v. Macomber, 252 U.S. 189 (1920). The *Eisner* Court concluded that a shareholder could not be taxed on the value of a dividend paid in the form of stock in the dividend paying corporation. H.R. REP. NO. 67-350, at 12-13 (1921); S. REP. NO. 67-275, at 16 (1921). Prior to the decision in *Eisner*, the practice of taxing shareholders on their share of a corporation's undistributed profits was never directly tested in the courts. *See* Harry J. Rudick, *Section 102 and Personal Holding Company Provisions of the Internal Revenue Code*, 49 YALE L. J. 171, 174 and note 18 (1939) (discussing cases).

180. Revenue Act of 1921, ch. 136, § 220, 42 Stat. 227, 247.

181. *Id.* § 230, 42 Stat. at 252.

which meant that a total of 37.5 percent in tax would be imposed on undistributed corporate earnings when the accumulated earnings penalty applied.[182]

As an alternative to the 25 percent corporate tax, the 1921 Act permitted the government to waive the accumulated earnings penalty if the shareholders agreed to be taxed on their share of firm profits as if the firm were a partnership.[183] This election was only available when the government determined that the corporation had unlawfully accumulated profits.[184] Here again, the changes made to the accumulated earnings tax continued to reflect the idea that not all corporations are the same and some behave in ways that would require taxing the firm as a partnership, not a corporation. However, the line dividing those firms from all the others remained vague and elusive, a continued sign of Congressional ambivalence about its approach.

D. 1924: Congress Repeals the Option to Tax Certain Corporations Like Partnerships

In 1924, Congress eliminated the aforementioned election for a corporation to be treated like a partnership.[185] In that year, lawmakers were acutely aware that the accumulated earnings tax did not have a very good track record of discouraging tax avoidance.[186] This time, however,

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182. In addition, in the even the firm distributed the earnings in future years, the shareholders would have had to pay a surtax of up to 50 percent on the dividends. *Id.* § 211(a)(2), 42 Stat. at 235-37. Although that was significant, it was still lower than the total tax imposed on corporate dividends and partnership profits. Under the 1921 Act, corporate dividends were taxed as high as 77.5 percent, while partnership profits were taxed as high as 73 percent. The 77.5% tax on corporate dividends consisted of the corporate tax and the individual surtax. *Id.* § 230, 42 Stat. 227, 252 (12.5% corporate tax); *id.* § 211(a)(2), 42 Stat. at 235-37 (individual surtax up to 65%). The 73% tax on partnership profits consisted of the normal tax and the surtax on individuals. *Id.* § 210, 42 Stat. at 233 (normal tax up to 8%); *id.* § 211(a)(2), 42 Stat. at 235-37 (individual surtax up to 65%).

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

184. *Id.* § 220, 42 Stat. at 248.

185. Revenue Act of 1924, ch. 234, § 220(a), 43 Stat. 253, 277.

186. During the floor debates on the 1924 Act, Senator George Norris of Nebraska observed that the use of corporations to evade surtax was a routine device for evading the surtax:

> Everybody knows that it is quite common for men to escape taxation on incomes from Liberty bonds by organizing corporations really for the purpose of holding those Liberty bonds, and thus escaping the surtaxes they would have to pay if they owned them individually.

65 CONG. REC. 7359 (1924) (statement of Sen. Norris). The minority report of the Senate Finance Committee expressed its frustrations this way:

> It is true a penalty against the organization of a corporation for the sole purpose of evading taxation is included in the present law and increased in the proposed bill. In actual result, however, such penalty provision has been and will be for all practical purposes a nullity. The penalty of the

the congressional response was to increase the penalty tax payable by the corporation to fifty percent, a level that was considered high enough to adequately deter any excessive retention of profits because it far exceeded the tax that would otherwise apply.[187] Under the 1924 Act, all undistributed corporate profits remained subject to a 12.5 percent corporate tax.[188] Meanwhile, corporate dividends were taxed as high as 52.5 percent[189] and a tax of up to 46 percent was imposed on partnership profits.[190] A 50 percent penalty on top of a 12.5 percent corporate tax would have resulted in a total tax that exceeded the tax burden on either corporate dividends or partnership profits.

In that respect, the 1924 Act was different from its predecessors. Under the prior revenue laws, whenever a firm fell within the scope of the accumulated earnings tax, the rules effectively taxed the corporation's profits as if they were derived by a partnership. That was no longer true under the 1924 Act. However, as will be evident in the following sections, it was not long before Congress returned to its habit of simply treating a corporation's profits as if they were derived by a partnership.

E. 1926: Shareholders Have the Option to Pay Tax on Undistributed Corporate Earnings

Under the Revenue Act of 1926, Congress retained the fifty percent penalty that could be imposed on any corporation that fell within the scope of the accumulated earnings tax.[191] However, Congress also allowed firms to protect themselves from any exposure to the penalty if all of the shareholders paid tax on their share of the firm's undistributed profits as a constructive dividend.[192] Subsequent distributions of amounts

> present law has only been applied in one or two cases. The Secretary testified before the committee that corporations were not being availed of so as to result in a decrease in taxation. Before another committee of the Senate, a prominent attorney from the city of New York testified that such was generally being done. We believe that so long as the inducements exist in the law they will be availed of by interested taxpayers.

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

187. S. REP. NO. 67-275, at 26 (1921).

188. Revenue Act of 1924, ch. 234, § 230, 43 Stat. 253, 282. The Senate passed a measure that would have imposed an additional tax on a corporation's undistributed earnings. 65 CONG. REC. 8033 (1924). However, that proposal was eliminated from the bill reported by the Conference Committee. H.R. REP. NO. 68-844, at 21 (1924), reprinted in 1939-1 C.B. 300, 305. *See also* Bank, *supra* note 36, at 503-04.

189. Revenue Act of 1924, ch. 234, § 230, 43 Stat. 253, 282. (12.5% corporate tax); *id.* § 1200, 43 Stat. at 353 (individual surtax up to 40%).

190. *Id*. § 210(a), 43 Stat. at 264 (normal tax up to 6%); *id.* § 1200, 43 Stat. at 353 (individual surtax up to 40%).

191. Revenue Act of 1926, ch. 27, § 220(a), 44 Stat. 9, 34.

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

that were previously taxed to the shareholder under this rule were expressly exempt from the shareholder's normal tax and any surtax.[193] In the event a firm's shareholders did not elect to pay tax on their share of the firm's profits, the fifty percent penalty would have been a significant price to pay compared to the alternatives. Under the Act, corporate dividends were subject to an aggregate tax of up to 33.5 percent,[194] while the tax on partnership profits was as high as 25 percent.[195]

The option for shareholders to pay tax on a constructive dividend was distinctive from its predecessor in two important respects. First, the option was available to any corporation; it was not limited to those that the Treasury had already accused of failing to distribute sufficient earnings to shareholders.[196] Second, under this option, the firm's earnings were subject to both the corporate tax and the shareholder tax on dividends, which essentially respected the firm as a separate and distinct entity. By contrast, the existing rule simply treated the firm as if it were a partnership and eliminated the tax at the firm level. This option to pretend that the firm paid a dividend remained available to taxpayers until 1938.[197] It was an example of another congressional attempt to disregard legal formalities in order to ensure that the rules for taxing business profits applied in a coherent way.

This historical review shows that during the formative years of the modern income tax, Congress felt constrained by two concerns: (1) the desire not to penalize firms that set aside earnings as part of a prudent practice to finance future investments, and (2) the inequity of taxing undistributed earnings to shareholders who simply could not access them. In later years, the need to resolve these tensions became more pressing, leading Congress to experiment with objective ways to measure whether a corporation should be taxed as such.

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193. *Id.* Interestingly, this provision was added to the bill by the Senate Finance Committee, which, in 1924 removed a similar measure from the revenue bill. Under that rejected measure, if the Commissioner of Internal Revenue concluded that a corporation had been availed of in order to evade the individual surtax, the shareholders could have elected (with the Commissioner's consent) to be taxed on their respective shares of the corporation's net income for the year. *See* text accompanying note 183. Such an election would have been a substitute for the corporate penalty tax.

194. *Id.* § 230(a)(2), 44 Stat. at 39 (13.5% corporate tax); *id*. § 211(a), 44 Stat. at 22-23 (maximum 20% tax on dividends).

195. *Id*. § 210, 44 Stat. at 21 (maximum 20% normal tax); *id*. § 211(a), 44 Stat. at 22-23 (maximum 20% surtax).

196. *Id.* § 220(e), 44 Stat. at 34.

197. *See* Revenue Act of 1928, ch. 852, § 104(d), 45 Stat. 791, 815; Revenue Act of 1932, ch. 209, §104(d), 47 Stat. 169, 195; Revenue Act of 1934, ch. 277, § 102(d), 48 Stat. 680, 702; Revenue Act of 1936, ch. 690, § 102(d), 49 Stat. 1648, 1677. In its place, the 1938 Act permitted the penalty to be determined after reducing the firm's undistributed earnings by "consent dividends," which were amounts of undistributed earnings that the shareholders agreed to include in their taxable incomes. *See* Harry J. Rudick, *Section 102 and Personal Holding Company Provisions of the Internal Revenue Code,* 49 YALE L.J. 171, 180 (1939).

IV. EMERGENCE AND EVOLUTION OF THE CONCENTRATION OF OWNERSHIP PRINCIPLE

Unsatisfied with its subjective approach for dealing with tax avoidance opportunities created by the inconsistent way of taxing business profits, Congress began to consider legislation that utilized a more objective mechanism for policing abuse of the corporate form. That process began in 1928 and culminated with the 1938 personal holding company rules.

A. 1928: The Concentration of Ownership Principle First Appears in Legislation

The first tax legislation to include an objective method for distinguishing corporations appeared in 1928. Congress ultimately decided to retain the accumulated earnings penalty adopted in 1926. However, that only occurred after lawmakers devoted time considering an alternative that would serve as the template for future legislation that eventually got signed into law.

That process began when Congress authorized a Joint Committee to investigate the administration of the tax laws.[198] That Committee produced a report that documented the Treasury's track record of enforcing the accumulated earnings tax.[199] The chairman of the Committee, Representative William Green of Iowa, described the creation and use of corporations to avoid the surtax as "the most fruitful method of tax evasion."[200] Indeed, by one estimate, the government was deprived of $168 million between 1922 and 1925 as a result of corporations that were used to accumulate earnings and prevent the imposition of the surtax.[201] Despite this reality, the Treasury Department had pursued very few cases and had not collected one dollar in revenue as a result of their efforts.[202] The agency offered two explanations for its performance. First, it was the agency's position that an investment company had an unlimited need for accumulated profits. In addition, the agency had a policy not to pursue closely held corporations whenever such firms had invested their surplus earnings in expansion or the acquisition of other businesses.[203] These positions were surprising because they effectively exempted from tax precisely the cases that

198. Revenue Act of 1926, ch. 27 § 1203, 44 Stat. 9, 127-28.

199. Joint Comm. on Internal Revenue Tax'n, 69th CONG., DIV. OF INVESTIGATION, vol. 1 – pt. 3, REP. ON EVASION OF SURTAXES BY INCORPORATION (SECTION 220) (Comm. Print 1927) (hereinafter 1927 Tax Evasion Report).

200. WILLIAM RAYMOND GREEN, THE THEORY AND PRACTICE OF MODERN TAXATION 114 (1933).

201. *Id.* at 116 (citing NATIONAL INCOME TAX MAGAZINE, Apr. 1927).

202. 1927 Tax Evasion Report, *supra* note 199, at 38.

203. *Id.* at 33-34.

Congresses intended to reach when it adopted the provision.[204] Indeed, from the very beginning, a corporation's status as an investment company or holding company was *prima facie* evidence of an intent to evade the surtax. In order to rectify the situation, the report concluded that Congress might consider replacing the existing provision with one that operates "more automatically."[205]

In 1928, the Committee on Ways and Means reported a bill that addressed corporate tax shelters in two separate ways. First, the bill reduced the existing accumulated earnings tax from 50 percent to 25 percent, reasoning that the existing penalty was unduly harsh.[206] Second, the bill added a new provision targeted at so-called personal holding companies.[207] Under the proposed rules, a corporation would have to pay a 25 percent tax whenever its undistributed earnings exceeded a certain threshold and the firm satisfied a net income test and an ownership test.[208] The net income test was satisfied whenever the firm derived at least 80 percent of its net income from certain passive sources.[209] The ownership test was met whenever ten or fewer individuals directly or indirectly owned at least 80 percent of the company's voting power or value.[210] The Committee believed that this class of corporations was most likely to accumulate surplus in order to evade individual surtaxes on corporate earnings.[211]

Although the Committee viewed the provision as a tool to combat the use of corporations to avoid the individual surtax, it is not clear what may have informed the specific approach it decided to take. The income test seems to be influenced by the 1927 report, but the origin of the ownership test is a bit of a mystery. The Committee proposal focuses on concentration of ownership. That idea is not reflected in any witness testimony. Nor does it appear to be supported by any research or study, including the 1927 report. Six years earlier, the British enacted a rule to address the use of corporations to avoid tax.[212] That legislation employed a concentration of ownership test to identify the firms that fell within the

204. *Id.* at 36. The statute always declared that it would be prima facie evidence of a purpose to escape the surtax if a corporation were a mere holding company. *See* Revenue Act of 1913, ch. 6, § II(A)(2), 38 Stat. 114, 167. Starting in 1924, being an investment company had the same effect. *See* Revenue Act of 1924, ch. 234, § 220(b), 43 Stat. 253, 277.

205. 1927 Tax Evasion Report, *supra* note 199, at 54.

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

207. *Id.* at 17-18.

208. *Id.* The tax applied if the undistributed earnings exceeded 30 percent of the amount consisting of the firm's net income, dividends and tax-free interest.

209. *Id.*

210. *Id.* at 17.

211. *Id.*

212. Finance Act 1922 § 21 (12 & 13 Geo.) ch. 17 (U.K).

scope of the law. However, that test required five or fewer persons to possess a majority of the voting power or shares in the company.[213] So, if the Committee was influenced by the English approach, that influence appears to have been limited to embracing the general concentration of ownership principle.[214] The Committee adopted its own formula to implement the principle. Whatever the rationale for the personal holding company rules, they apparently responded to a concern that was of great interest to the general public. The *New York Times* saw fit to run a page one article that contained the actual text of the proposed personal holding company bill as passed by the Committee.[215]

Members of the House reacted positively to the personal holding company proposal, viewing it as both a way to address the Treasury's failure to enforce the accumulated earnings penalty tax, and as an effective way to single out firms that were merely a front for their owners.[216] Nevertheless, there were still lingering questions about whether the provisions were sufficiently tailored to not apply to firms that were not mere vehicles to avoid the surtax.[217]

The House accepted the personal holding company proposal without objection.[218] Members of the Senate, on the other hand, stressed the shortcomings of using a bright line rule, criticizing it as an "arbitrary" and "inflexible" approach that would penalize some firms that were observing sound and legitimate business practices.[219] The Finance Committee stressed that the need for the rule was declining since the disparity between the individual and corporate tax rates was shrinking, reducing the incentive to utilize corporations as a tax shelter.[220] The Finance Committee also believed that certain changes made to the accumulated earnings tax in 1924 and 1926 made it easier to administer, as evidenced

213. *Id.* § 21(6).

214. The English were a source of inspiration for other aspects of U.S. tax law. The practice of collecting tax at its source was an idea that American lawmakers borrowed from the British. Blakey, *supra* note 63, at 78-79; Ajay K. Mehrotra, *"From Contested Concept to Cornerstone of Administrative Practice": Social Learning and the Early History of U.S. Tax Withholding*, 7 COLUM. L. REV. 144, 153-155 (2016).

215. *Tax Bill Reported Promptly to House*, N.Y. TIMES, Dec. 7, 1927, at 1.

216. 69 CONG. REC. 519 (1927) (statement of Rep. Garner); *Id.* at 521 (statement of Rep. Green).

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

218. *Id.* at 518-21.

219. S. REP. NO. 70-960, at 12 (1928). Those objections were similar to those made during the floor debates in the House and the Senate. It was also consistent with the views of certain individuals who testified at the hearings. Representatives of the National Association of Real Estate Boards criticized the lines drawn by the ownership test because they penalized the actions of ten shareholders, while not penalizing the same actions of eleven shareholders. *Treadway Demands Revised Tax Cuts*, N.Y. TIMES, Apr. 13, 1928, at 10. The real estate lobby was among the interest groups to insist that Congress reject the proposal. *Long Island Board Endorses Tax Brief*, N.Y. TIMES, Apr. 22, 1928, at 176. See also, 69 CONG. REC. 7976-77 (1928) (statements of Sen. Simmons and Sen. King).

220. S. REP. NO. 70-960, at 12.

by the fact that the Treasury seemed to be imposing the tax in a greater number of cases.[221] Indeed, the report produced by the Joint Committee showed that enforcement increased dramatically in 1925 and 1926.[222] The higher level of enforcement may also reflect some pressure that the Treasury Department received from Chairman Green.[223]

The House yielded to the Senate when the bills were reconciled by the Conference Committee.[224] Two factors may explain why the personal holding company rules did not survive. First, Chairman Green indicated in later years that it was always difficult to enact legislation directed at combating tax avoidance because many members of Congress were simply opposed to the income tax itself.[225] Resistance in the Senate may have been particularly strong because the rules encountered opposition from organized wealth.[226] In addition, by the time the bill was referred to the Conference Committee, Representative William Green himself had been appointed to the U.S. Court of Claims. Not only did he chair both the Joint Committee and the House Committee on Ways and Means, the personal holding company rules were his brainchild.[227] His absence may have deprived the rules of their most articulate advocate. Indeed, he was very frustrated by the Treasury Department's failure to enforce the accumulated earnings tax and even threatened to bring Department officials before Congress.[228]

Whatever the reasons, Congress declined to employ a more objective and meaningful way to distinguish corporations whose undistributed earnings were entitled to tax relief from those that were not. Although the bill did not pass, reaction to it showed that a growing number of members were prepared to reject the fiction that shareholders never have the power to force a distribution, at least in the context of the closely held corporation.

B. 1934: Congress Reduces the Concentration of Ownership Principle to an Objective Formula

In 1934, Congress enacted rules that contained an objective method of

221. *Id.* Presumably those changes included the fact that the agency had to start treating as prima facie evidence of a tax avoidance purpose the fact that the firm was an investment company. That was always the case for holding companies.

222. 1927 Tax Evasion Report, *supra* note 199, at 38. The Bureau of Internal Revenue assessed the tax 52 times between 1919 and 1926. Forty-one of those assessments were for the last two years.

223. 75 CONG. REC. 6979 (1932) (statement of Rep. LaGuardia).

224. H. REP. NO. 70-1882, at 14 (1928).

225. GREEN, *supra* note 200, at 115.

226. 75 CONG. REC. 6979 (1932).

227. *Id.* at 6978-79 (statement of Rep. LaGuardia).

228. *Id.* at 6979 (statement of Rep. LaGuardia).

identifying corporations whose undistributed profits would not be taxed under the rules that ordinarily applied to corporations. The rules were included in the Revenue Act of 1934 as a completely new tax regime that applied in place of the accumulated earnings penalty tax whenever a corporation qualified as a personal holding company.[229] In order to so qualify, the company could not be a bank or trust company and it had to satisfy a gross income test and an ownership test.[230] A corporation passed the gross income test if at least eighty percent of its gross income for the year consisted of certain passive items of income, like dividends and interest.[231] A corporation passed the ownership test if five or fewer individuals owned (directly or indirectly) over fifty percent of the value of the corporation's outstanding stock at any time during the last half of the year.[232] If a corporation satisfied these two tests, it had to pay a thirty percent surtax on the first $100,000 of any "undistributed adjusted net income," and a forty percent surtax on any undistributed amounts in excess of $100,000.[233] This surtax took the place of the shareholder level tax that would have been triggered had the firm actually paid a dividend. If a corporation did not qualify as a personal holding company, it remained exposed to the accumulated earnings tax.[234] However, neither tax would apply in any year all the shareholders voluntarily included in their gross income a fictional dividend representing their share of the corporation's net income for the year.[235] In those cases, the shareholders would not be taxed on the receipt of any actual dividend consisting of these previously taxed amounts.[236]

The personal holding company rules were part of a larger effort to increase revenues by preventing tax avoidance, thereby eliminating the need to increase tax rates.[237] The rules accomplished this objective by operating "automatically," without the need for the government to establish a taxpayer's intent to avoid tax.[238] By one conservative estimate, personal holding companies caused the government to lose more than $1

229. Revenue Act of 1934, ch. 277 § 351(a), 48 Stat. 680, 751.

230. *Id.* § 351(b)(1), 48 Stat. 751.

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

232. *Id.* § 351(b)(1)(B), 48 Stat. 751. An attribution rule caused certain members of a family to count as one individual for these purposes. *Id.* § 351(b)(1)(C)-(E), 48 Stat. 751-52.

233. *Id.* § 351(a), 48 Stat. 751.

234. *Id.* § 102(a), 48 Stat. 702. Congress reduced the penalty from 50% to 25% because a 50% tax would have exceeded the tax that would have been imposed on an actual distribution, making it difficult for the provision to be readily enforceable. H. REP. NO. 73-704, at 12 (1934).

235. *Id.* § 351(d), 48 Stat. 752.

236. *Id.*

237. BLAKEY & BLAKEY, *supra* note 63, at 356.

238. H. REP. NO. 73-704, at 12 (1934). The rules were expected to generate $25 million in revenue each year. PREVENTION OF TAX AVOIDANCE, *infra* note 242 at 8.

billion in tax over the years prior to the enactment of this new rule.[239]

Although the personal holding company rules were foreshadowed by the 1928 proposal, they were specifically the product of a Ways and Means subcommittee[240] whose charge was to investigate a wide range of tax evasion techniques and to propose solutions.[241] The subcommittee considered personal holding companies as the most prevalent form of tax avoidance practiced by wealthy individuals.[242] Referring to the technique as the incorporated pocketbook, the report described this form of tax avoidance like this: "[A]n individual 'forms a corporation and exchanges for its stock his personal holdings in stock, bonds, or other income-producing property. By this means the income from the property pays corporation tax, but no surtax is paid by the individual if the income is not distributed.'"[243] The subcommittee sought to target the most obvious and noncontroversial cases with an objective test that applied automatically, while allowing the Internal Revenue Service to use its judgment to assert penalties under the accumulated earning tax in situations that were not as clear cut.[244]

The subcommittee's proposal was structured in much the same way as the 1928 proposal in that it contained three principal elements: (1) a gross income test, (2) an ownership test, and (2) a formula for computing the tax. The gross income test was not modified from the one proposed in 1928.[245] However, the proposal included significant changes to both the ownership test and the formula for computing the tax.

The ownership test continued to focus on concentration of ownership. However, the subcommittee's proposal required a higher concentration of ownership—five or fewer individuals owning over fifty percent, compared to ten or fewer individuals owning over eighty percent. Furthermore, under the earlier proposal, concentration of ownership could be measured in terms of either voting power or rights to dividends. By

239. GREEN, *supra* note 200, at 140.

240. *See* BLAKEY & BLAKEY, *supra* note 63, at 347. The Roosevelt Administration did not take the lead in drafting the tax legislation during that legislative session. JOHN F. WITTE, THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX 98 (1985).

241. H.R. RES. 183, 73d Cong. (1933).

242. SUBCOMM. OF H. COMM. ON WAYS AND MEANS, 73d CONG., 2d SESS., PREVENTION OF TAX AVOIDANCE: PRELIMINARY REPORT RELATIVE TO METHODS OF PREVENTING THE AVOIDANCE AND EVASION OF THE INTERNAL REVENUE LAWS TOGETHER WITH SUGGESTIONS FOR THE SIMPLIFICATION AND IMPROVEMENT THEREOF 6 (Comm. Print 1933) (hereinafter PREVENTION OF TAX AVOIDANCE).

243. *Id.* It was one of many practices uncovered by an investigation conducted by the Senate Banking Committee. 78 CONG. REC. 2662 (1934) (statement of Rep. Samuel B. Hill).

244. *Revenue Revision, 1934, Hearings Before the Comm. On Ways and Means,* 73d Cong., 2d Sess. 55 [hereinafter *Hearings*] (statement of Jere Cooper describing the collective thinking of the subcommittee).

245. Both proposals counted the following items as passive income: rents, royalties, interest, dividends, annuities and gains from the sale of securities.

contrast, the 1934 proposal applied solely to voting stock, further limiting the number of cases falling within the scope of the new tax. Both changes made the provision more targeted.

One modification to the ownership test occurred when it was debated on the floor of the House. The House rejected the idea of using only voting stock to measure concentration of ownership, replacing it with the rule that considered all shares of stock—both voting and nonvoting. The change was adopted without objection. Indeed, the House of Representatives entertained very little debate on any aspect of the entire income tax bill, for two reasons. First, the members simply deferred to the work of the subcommittee because the subject matter was so technical.[246] Second, debate on the bill was limited to 16 hours with amendments being restricted to those offered by the committee,[247] which made it virtually futile to question any aspect of the proposal.[248] Still, it is noteworthy that the specific formula for measuring concentration of ownership was not contested or questioned at later points in the legislative process either. The noncontroversial nature of the ownership test could reflect the fact that the subcommittee invested a good deal of time crafting it, resulting in a formula that produced a broad-based legislative consensus.[249]

The formula for computing the resulting tax was substantially revised between the 1928 proposal and the 1934 proposal. In both years, the tax was imposed on the portion of a firm's undistributed earnings that exceeded an exempt amount of its net income for the year. However, the exempt portion was substantially reduced from thirty percent to ten percent. The subcommittee believed that the vast majority of the firms singled out by the proposal were formed for the sole purpose to avoid the imposition of the surtax,[250] which increased the willingness of the subcommittee to minimize the amount of earnings that a firm should be permitted to retain.

Although relatively modest in scope, the personal holding company rules are a milestone in the way the government taxed business profits. Lawmakers were always concerned that using legal formalities as the sole basis for distinguishing firms would produce inequities. They relied on the accumulated earnings penalty tax to address those inequities on a case-by-case basis before they could identify an objective and systematic way

246. BLAKEY & BLAKEY, *supra* note 63, at 356.

247. *Id.*

248. The bill passed by an overwhelming majority: 390 to 7. 78 CONG. REC. 3005 (1934).

249. During an exchange with Roswell Magill of the Treasury Department, Subcommittee member Jere Cooper said that the subcommittee "worked some time to get [the] definition. *Hearings*, *supra* note 244, at 55. The definition consists of both the gross income test and the concentration of ownership test. Because the gross income test is identical to the one incorporated into the 1928 proposal, the statement implies that the deliberations were focused on the ownership test.

250. PREVENTION OF TAX AVOIDANCE, *supra* note 242, at 7.

to do so. The personal holding company ownership test accomplishes that task by asking whether the firm's concentration of ownership exceeds the "5 or fewer" threshold.[251] The test reflects the fundamental reality that the interests of the firm and those of its owners overlap whenever ownership of the firm is sufficiently concentrated. Isolating firms whose interests aligned with those of its owners is imperative when the payment of a dividend partly determines the total tax on corporate profits. It is only when those interests overlap that the corporation would be inclined to consider the impact of the shareholder tax when deciding whether to pay a dividend. Otherwise, the shareholder tax would be largely irrelevant to the firm.

In future years, both the concentration of ownership principle and the specific threshold articulated in the personal holding company rules would be adapted and extended to other situations. One particularly meaningful fortification was included in the Revenue Act of 1936.[252] That legislation did not disturb the core "5 or fewer" requirement,[253] but it did incorporate a new provision describing how stock owned by certain entities would be treated as owned by their owners.[254] This rule supplemented an existing rule that required certain groups of related persons to count as one individual for purposes of the test.[255] An even more elaborate set of attribution rules appeared in the Revenue Act of 1937.[256] Together, these changes helped ensure that taxpayers could not divide their shareholdings among related persons to avoid satisfying the ownership test.

V. THE EVOLUTION OF THE TAX ON CORPORATE PROFITS

While Congress experimented with ways to address the use of corporations to avoid tax, the disparities in the taxation of business profits grew more pronounced over time, underscoring the need for an effective way to distinguish the cases where the corporate tax rules would apply from those where they would not.

Congress initially devised two separate ways for taxing business profits in 1913 because changes in the distribution practices of firms made it difficult for the existing uniform rules to function without producing

251. The 5 or fewer formulation brought the American approach very close to the one adopted by the British in 1922. In its own version of personal holding company anti-tax avoidance legislation, a firm was subject to the law if 5 or fewer persons possessed over 50 percent of the firm's voting power *or* shares. Finance Act of 1922, 12 & 13 Geo. 5 c. 19, § 21(6) (12 & 13 Geo.) ch. 17 (U.K.).

252. Revenue Act of 1936, ch. 690, 49 Stat. 1648.

253. *See id.* § 351(b)(1)(B), 49 Stat. at 1732.

254. *Id.* § 351(b)(1)(C), 49 Stat. at 1732.

255. *Id.* § 351(b)(1)(D), 49 Stat. at 1732.

256. *Id.* § 354(a) (added by Revenue Act of 1937, ch. 815, § 1, 50 Stat. 813, 815-816).

distortions. When it was routine for firms to distribute all their earnings, the tax system produced no meaningful inequities for taxpayers who were required to pay tax on their shares of a firm's profits. However, such a rule produces distortions and inequities once firms start to retain substantial portions of their annual earnings. Lawmakers faced that dilemma in 1913, leading them to adopt a set of rules that allowed undistributed corporate earnings to be partially taxed while all other business profits remained fully taxed.

The difference in the applicable rates was not very large during the first few years. Therefore, the distortions and disparities were not significant enough to merit much attention. However, that changed when the country entered World War I, leading Congress to experiment with ways to reduce the inequities. The Revenue Act of 1917 included surtax rates up to 50 percent, at a time when corporations appeared to be retaining roughly half their annual earnings.[257] Leaving such a substantial sum exempt from the surtax would simply deny the treasury too much revenue. To address this, Congress considered a number of options, including a fifteen percent tax on all undistributed profits.[258] Ultimately, Congress chose to simply raise the corporate tax rate 2 percentage points above the normal individual rate, effectively making the corporate tax less of a substitute for the normal tax on the shareholders and more a freestanding tax on the firm.[259]

The debate on the taxation of corporate retained earnings continued to simmer in the 1920s, but Congress did not make any changes until the early 1930s when the country was preoccupied with identifying a cause for the Great Depression.[260] The unreasonable accumulation of corporate profits was a prime suspect because the practice was believed to upset the balance between consumption and production, resulting in the misallocation of economic resources.[261] So, to fill a budget gap, President Roosevelt proposed a tax on undistributed corporate profits, viewing it as a way to discourage corporations from hoarding earnings.[262] Despite opposition from corporate management, Congress passed the measure, while also keeping the existing corporate tax and eliminating the rule that made corporate dividends exempt to shareholders.[263] The undistributed profits tax was substantial, ranging from seven percent to twenty-seven percent.[264] Meanwhile, the corporate tax ranged from eight percent to

257. Steven A. Bank, *The Dividend Divide in Anglo-American Corporate Taxation*, 30 J. CORP. L. 1, 18-19 (2004).

258. *Id.* at 19-20.

259. *Id.* at 20-22.

260. Bank, *supra* note 36, at 494-506.

261. Bank, *supra* note 257, at 22-23.

262. *Id.* at 24.

263. *Id.* at 25-28.

264. Revenue Act of 1936, ch. 690, § 14(b), 49 Stat. 1648, 1656.

fifteen percent.[265] The combination of measures helped transform corporations into separate taxpaying entities, not merely agents for collecting a tax imposed on the shareholders.

By 1938, corporate managers successfully lobbied to eliminate the undistributed profits in exchange for an increase in the corporate tax rate to 19 percent.[266] The change removed the disincentive to retain earnings, while leaving dividends to be taxed at both the firm level and the shareholder level. For corporate managers, the double taxation of corporate dividends was not an ideal outcome, but it was preferable to a tax on undistributed earnings because such a tax would have interfered with their discretion over the firm's retained earnings.[267]

This system of double taxing corporate dividends remains the most distinctive feature of the American system for taxing corporate profits today. Among other things, it undeniably treats the firm as a separate and distinct entity, making it more important to restrict that approach to cases where there is a meaningful basis for treating the firm and its owners as separate and distinct taxpaying units.

VI. VARIATIONS OF THE CONCENTRATION OF OWNERSHIP PRINCIPLE ENACTED INTO LAW

Over the years various iterations of the ownership test embedded in the personal holding company rules have been incorporated into several other anti-tax avoidance provisions. Each of them suspends the application of the conventional rules for taxing corporate profits and effectively apply a variation of the rules that would apply to partnerships and other unincorporated business entities. At the very least, the pattern suggests that Congress is satisfied that the concentration of ownership principle is an effective and meaningful way to distinguish corporations that behave as extension of their owners from those that do not.

A. Foreign Personal Holding Companies

In principle, the personal holding company rules and the accumulated earnings penalty tax should apply regardless if a corporation is domestic or foreign. However, foreign corporations present a special problem because they are beyond the taxing jurisdiction of the U.S., making it impossible to enforce any anti-abuse rule that requires such a corporation to pay tax. Thus, absent a special rule, a taxpayer could simply transfer certain income producing assets to a foreign corporation to skirt their

265. *Id.* § 13(b), 49 Stat. at 1655.

266. Bank, *supra* note 257, at 29.; Revenue Act of 1938, ch. 289, § 13(c), 52 Stat. 447, 455.

267. Bank, *supra* note 257, at 29-30.

obligation to pay tax on their worldwide income.[268] This made it necessary for Congress to adopt a different approach.

The answer came in the form of the foreign personal holding company rules. The rules, passed by Congress in 1937, required any U.S. shareholder of a foreign personal holding to pay tax on his share of the corporation's undistributed earnings as a constructive dividend.[269] In order to determine whether a firm qualified as a foreign personal holding company, the statute applied a gross income test and an ownership test.[270] The latter test was borrowed from the personal holding company rules but adapted for foreign corporations. Specifically, the statute asks whether the five or fewer individuals are either U.S. citizens or residents.[271] These entities were believed to serve the same purpose as their domestic counterparts. In the words of Treasury Secretary Henry Morgenthau, "[o]ne characteristic runs through all [the efforts to avoid tax]. It is the creation of a multiple personality in the taxpayer."[272] Quite simply, individuals were masquerading as corporations to avoid their full tax obligations.

Although the personal holding company rules provided an antecedent for the ownership test, the idea of taxing the owners on their share of the firm's profits was one Congress had deliberately abandoned in 1921 out of fear that it might be unconstitutional.[273] No doubt, the absence of an alternative for collecting the tax compelled Congress to resurrect that approach in the context of foreign personal holding companies. However, Congress also noted that Canada had already taken a similar approach for addressing foreign personal holding companies.[274] Whatever the reason, because the statute requires the firm's owners have to pay tax on their share of the firm's earnings, the firm's status as an extension of its owners becomes more explicit.

The foreign personal holding company rules were repealed in 2004, once Congress concluded that they served no purpose in light of the rules addressing controlled foreign corporations and passive foreign investment companies, adopted in 1962 and 1986, respectively.[275]

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268. This technique would insulate foreign source income from U.S. tax. The U.S. source earnings would be subject to tax under §§ 881 and 882 (2019).

269. Revenue Act of 1936, ch. 690 § 331 et seq. (added by Revenue Act of 1937, ch. 815 § 201, 50 Stat. 813, 818).

270. *Id.* § 331, 50 Stat. at 818.

271. *Id.* § 331(a)(2), 50 Stat. at 818.

272. *Tax Evasion and Avoidance: Hearings Before the J. Comm. on Tax Evasion and Avoidance*, 75th Cong. 11 (1937) (statement of Henry Morgenthau, Jr., Secretary of the Treasury).

273. *Supra*, note 179 and accompanying text.

274. Tax Evasion and Avoidance, Report of the J. Comm. On Tax Evasion and Avoidance of the Cong. Of the U.S., 75th Cong., 1st Sess. 17 (1937).

275. *See* American Jobs Creation Act of 2004, Pub. L. 108-357, § 413, 118 Stat. 1418, 1506-1510.

B. Controlled Foreign Corporations

Although effective in other regards, the foreign personal holding company rules did not reach situations involving a foreign corporation that was a wholly owned subsidiary of a widely held U.S. corporation. Thus, if a publicly traded company formed a subsidiary in a low tax foreign jurisdiction, none of the earnings derived by that subsidiary would be subject to U.S. tax. This result directly violates the general U.S. policy to require U.S. taxpayers to pay tax on their worldwide incomes. To address this gap in the law, Congress enacted subpart F of the Internal Revenue Code.[276]

The rules in subpart F generally require certain U.S. shareholders in certain foreign corporations to pay tax on their share of a portion of the foreign corporation's earnings. Only corporations that qualify as controlled foreign corporations ("CFCs") fall within the scope of the rule. When a corporation so qualifies, a portion of its undistributed earnings will be taxed directly to the U.S. owners who own at least 10 percent of the firm's voting power or value.[277] Only if such 10 percent owners collectively own over 50 percent of the vote or value of the foreign corporation will the firm qualify as a CFC.[278] In short, a foreign corporation will not be a CFC if its five largest shareholders each own exactly ten percent of its shares, because those shareholders will own exactly fifty percent of the firm's value. However, if just one of those shareholders owns over ten percent of the shares, that group of shareholders will collectively own over fifty percent of the firm's value, causing the firm to qualify as a CFC. In essence, these rules are another iteration of the "five-or-fewer" formulation that appears in the personal holding company ownership test.

In fact, when the subpart F provisions were first proposed, one early idea was to apply the foreign personal holding company tax to certain foreign base companies where five or fewer corporations held more than fifty percent of the stock.[279] That would have effectively made each of the foreign corporation's shareholders liable for tax on their entire share

276. The government was well aware of the gap for years. It deliberately did not address it, viewing the tax benefit as a way of promoting American investment and private enterprise in "free world" countries, which served America's economic and geo-political interests. Government policy did not shift until concerns about the balance of payments gained greater prominence. Vasujith Ram, *Contextualizing the History of Subpart F*, 161 TAX NOTES 315 (Oct. 15, 2018).

277. I.R.C. § 951(a)(1)(A) (2019).

278. I.R.C. § 957(a) (2019).

279. *See Revenue Act of 1962: Hearings on H.R. 10650 Before the S. Comm. On Finance*, 87th Cong., 2d Sess. at 3458 (1962) [hereinafter 1962 *Hearings*] (statement submitted by N.R. Danielian of the International Economic Policy Association). See also *id.* at 3785 (New York State Bar Association Report on Foreign Income Provisions of Revenue Bill of 1962, H.R. 10650) and *id.* at 3932 (statement submitted by Thomas G. Corcoran).

of the company's undistributed profits. However, the Ways and Means Committee ultimately reported a bill that only required a firm's ten percent shareholders to pay tax on a certain portion of the firm's earnings. That effectively gives the firm a split personality.[280] A portion of its earnings is taxed under the conventional rules that apply to incorporated firms, while the remainder is subject to tax under rules that resembled the ones that apply to partnerships. However, the resemblance to partnership taxation is imperfect. Among other things, the partners in a partnership report both their share of the firm's income and its losses.[281] Under the rules of subpart F, the ten percent shareholders cannot report their share of the firm's losses.[282]

When subpart F was originally proposed, some questioned the merits of its particular approach for reaching the undistributed earnings of a foreign corporation. Some expressed concerns that U.S. investors would not be in a position to know whether they invested in a controlled foreign corporation because their level of ownership would not give them access to the records they would need to make that determination.[283] Others questioned whether the 10 percent threshold wrongly assumed that the investor could exercise the kind of power to control the declaration of dividends and other matters pertinent to the legislation.[284]

Despite these concerns, subpart F was enacted into law. Although its basic structure has remained unchanged over the years, certain rules have

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280. H. REP. NO. 87-1447, at 461 (1962), *reprinted in* 1962-3 C.B. 405. *See also* S. REP. NO. 87-1881, at 785 (1962), *reprinted in* 1962-3 C.B. 707.

281. *See* I.R.C. § 702(a) (2019).

282. This was one of the criticisms voiced about the proposal. 1962 *Hearings*, *supra* note 279, at 3735 (New York State Bar Association Report on Foreign Income Provisions of Revenue Bill of 1962, H.R. 10650).

283. *Id.* at 3784-85.

284. *Id.* at 3455 (statement submitted by statement submitted by N.R. Danielian of the International Economic Policy Association). Another witness put it this way:

> The result under the proposed new legislation is that the tax penalties upon the 10-percent stockholder have become far more severe and his capacity to protect himself from these penalties by complying with the law has been reduced—to the point that he will often and increasingly be powerless to avert them and his only practical remedy will be to dispose of his holdings.
>
> The stockholder of a 'foreign personal holding company' can always declare dividends to obtain the necessary funds to pay any tax. By definition, a foreign personal holding company is over 50 percent owned by five or fewer U.S. citizens or residents each of whom, irrespective of his percentage of ownership, is under the same compulsion to find the money to pay his tax-through and who collectively, being over 50 percent, have the necessary control to force the declaration of the required dividends.
>
> Under H. R. 10650, a U.S. person holding 10 percent or more, but less than effective control, in a foreign corporation is in a very different position. Personally, he has a strong motive either to avert tax-through . . . However, his company will often be controlled by fellow stockholders who have no such motive, and frequently have opposing ones.

Id. at 3930-31 (statement submitted by Thomas G. Corcoran). *See also id.* at 3047 (Statement of Adrian A. Kragen).

evolved in ways worth mentioning. Under the original statute, all shares of stock were counted to determine whether a shareholder possessed the ten percent minimum, while only voting stock was counted to determine whether the ten percent shareholders collectively owned enough stock to make the corporation a CFC.[285] In 1986, Congress decided that a foreign corporation would be a CFC if the firm's 10 percent owners (by value) collectively owned over 50 percent of the firm's vote or value.[286] By 2017, a shareholder would qualify as a 10 percent owner based on the either vote *or* value.[287]

The 2017 Tax Act also added new rules that effectively cause a CFC's 10 percent shareholders to include in their income a larger portion of the CFC's undistributed earnings.[288] This change seems to reaffirm a Congressional policy to suspend the ordinary rules for taxing corporate profits when the firm's ownership is sufficiently concentrated, justifying the practice of taxing the owners on their share of the firm's undistributed earnings.

C. Common Controlled Corporations

In 1950, Congress introduced a surtax exemption on the first $25,000 of a corporation's taxable income.[289] In response, taxpayers began to fragment their businesses into several corporations in order to claim multiple exemptions.

There were several attempts to combat the abuse. First, Congress relied on the Treasury Department to use special powers granted to it to address the use of multiple corporations to avoid tax.[290] Congress took a different approach in 1962, imposing a 6 percent penalty on affiliated groups that operated through multiple corporations.[291] The statute targeted three different types of corporate structures. One type was the brother-sister controlled group, which was defined as two or more corporations each of whose stock was owned eighty percent or more (by vote or value) by one individual, estate, or trust.[292] In 1969, Congress redefined a brother-sister

285. H. Rep. No. 88-2508, at 1168 (1962) (Conf. Rep.).

286. I.R.C. § 957 (2019).

287. I.R.C. § 958(b) (2019) (as amended by Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, § 14213, 131 Stat. 2054, 2217).

288. I.R.C. § 951A (2019).

289. *See Tax Reform Act of 1969: Hearings Before the S. Comm. on Finance on H.R. 13270*, 91st Cong. 1164 *et seq*. (1969) [hereinafter 1969 *Hearings*] (statement of James W. Riddell).

290. S. REP. NO. 82-781 at 68-69 (1951). Those powers are described in Code sections 269 and 482, former sections 45 and 129. I.R.C. §§ 269 and 482 (2019) (formerly at I.R.C. §§ 45 and 129).

291. H. REP. NO. 88-749, at 118 (1964).

292. The second was the parent-subsidiary controlled group, which consisted of one or more chains of corporations connected with a common parent corporation through 80 percent or more stock ownership, determined by vote or value. The third was a combined group consisting of three or more corporations,

controlled group to consist of two or more corporations which are owned 80 percent or more (by vote or value) by five or fewer persons.[293] By 2004, Congress reduced the 80 percent threshold to 50 percent, bringing the definition more closely in line with the approach found in the ownership test for the personal holding company rules.[294] The change was made to eliminate the possibility that taxpayers could obtain the benefit of the graduated rates through the use of multiple corporations that are effectively commonly controlled even though the 80 percent test was not satisfied.[295] Under the current rules, a brother-sister controlled group exists when 5 or fewer individuals, estates or trusts own over 50 percent of the vote or value of the corporations.[296]

Now that all corporate income is taxed at a flat rate of twenty-one percent, there may no longer be a need for the rules. However, when the need did exist, Congress not only relied on the concentration of ownership principle to address it, but did so by using a test inspired by the ownership test in the personal holding company rules. In doing so, Congress yet again signaled that such an ownership structure merits treating the firm as a mere extension of its owners, not as a separate entity that is distinct from its owners.[297]

D. The Passive Activity Rules

The passive activity rules explicitly borrow the personal holding company ownership test to define the class of taxpayers subject to its anti-tax avoidance provisions. The passive activity rules are designed to prevent individuals from inappropriately benefitting from the tax savings generated through tax shelters, a term that describes investments in which a significant portion of the taxpayer's return is derived from tax savings, not real economic earnings.[298] The tax savings could take the form of deductions that could offset income from another source. The savings

each of which is a member of a parent-subsidiary group or a brother-sister group, and one of which is a common parent corporation.

293. Tax Reform Act of 1969, Pub. L. No. 91-172, § 401, 83 Stat. 487, 602. In addition, each member of the ownership group had to individually own more than 50% of each corporation being tested.

294. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 900(a), 118 Stat. 1418, 1650.

295. S. Rep. No. 108-192, 108th Cong., 1st Sess. (2003); Conf. Rep. No. 108-755, 108th Cong., 2d Sess. (2004).

296. I.R.C. § 1563(a)(1), (f)(5) (2019). Nonvoting nonparticipating preferred stock does not count as stock for purposes of the test. I.R.C. § 1563(c) (2019).

297. The Kennedy Administration may have been a step ahead of Congress. In 1963, it proposed defining a brother-sister group to exist where five or fewer individuals or corporations owned at least 80 percent of each corporation. *Hearings on the Revenue Act of 1964 before the Committee on Ways and Means*, Feb. 6, 1963 (testimony of Treasury Secretary Douglas Dillon).

298. Joint Committee on Taxation, Tax Reform Proposals: Tax Shelters and Minimum Tax (JCS-39-85), Aug. 7, 1985, at 2.

could also take the form of tax credits that could offset the tax an individual would otherwise have to pay.

Congress believed that tax shelters eroded the perceived and real fairness of the tax system. One legislative response, enacted in 1986, was a set of rules that imposed limits on a taxpayer's ability to claim loss deductions and tax credits from passive activities.[299] The rules apply specifically to individuals, estates, and trusts and generally deny a taxpayer the ability to utilize passive activity losses to offset income from non-passive activities.[300] Thus, the rules directly address the tax shelters whose primary appeal were tax losses that individuals could use to offset income from other sources.

The rules also apply to a targeted group of corporations so that individuals cannot use such entities to hide their personal investments in tax shelters. Thus, a firm could be subject to the passive activity rules if it constitutes a closely held corporation,[301] a term that refers to any corporation that meets the stock ownership test described in the personal holding company rules.[302] A closely held corporation cannot utilize passive losses to offset portfolio income, such as interest and dividends. Rather, it can only use such losses to offset active business income.[303] As incorporated into the passive activity rules, the personal holding company ownership test serves the same purpose that it was intended to perform in the 1934 act: to distinguish corporations that are the alter egos of their owners from those that are separate and independent from them in a meaningful way.

E. Limitation on Benefits under the Model U.S. Tax Treaty

When the U.S. negotiates a bilateral tax treaty (or proposes changes to an existing one), it begins with a template known as the U.S. Model Tax Treaty.[304] The current version of that document contains a lengthy provision designed to ensure that the benefits of the treaty are only enjoyed by persons who are citizens or residents of the two treaty signatory countries.[305] The provision functions as an anti-abuse rule that seeks to identify cases where someone who would ordinarily qualify as a

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299. Tax Reform Act of 1986, Pub. L. No. 99-514, § 501(a).

300. I.R.C. § 469(a).

301. I.R.C. § 469(a)(2)(B).

302. The statutes specifically cover any corporation that qualifies as a closely held corporation. I.R.C. § 469(a)(2)(B). Such a corporation is any corporation that satisfies the personal holding company ownership test. I.R.C. §§ 469(j)(1); 465(a)(1)(B).

303. I.R.C. § 469(e)(2); Treas. Reg. § 1.469-1T(g)(4)(i).

304. CHARLES H. GUSTAFSON, ET AL., TAXATION OF INTERNATIONAL TRANSACTIONS: MATERIALS, TEXT AND PROBLEMS ¶ 1245 (4th ed. 2011).

305. 2016 U.S. Model Tax Treaty, art. 22.

citizen or resident of either treaty partner will not count as one. The rules address both individuals and business entities. One of the rules that applies to business entities contains clear echoes of the ownership test from the personal holding company rules. Under the rule, if the taxpayer is a corporation other than a publicly traded corporation, there are two rules under which a corporation could remain eligible for treaty benefits. The first rule applies to any privately held company. The second is directed at subsidiaries of publicly traded companies. The latter rule applies an ownership test that is satisfied if at least 50 percent of a corporation's voting power and value is owned directly or indirectly by five or fewer publicly traded companies.[306] Thus, the test focuses on concentration of ownership by publicly traded companies.

To understand these rules, it is helpful to know the context in which the provisions were drafted and the purposes that treaties serve. For many years, U.S. tax policy was oriented toward achieving nondiscriminatory tax treatment of U.S. and foreign based multinational corporations abroad. Accordingly, there were very few provisions of U.S. domestic law that provided tax relief to foreign persons.[307] However, in the 1960s, the country's position began to change because it became more important to attract foreign capital to finance domestic investment.[308] That led Congress to enact the Foreign Investors Tax Act, which exempted foreigners from tax on portfolio gains.[309]

However, once the U.S. became one of the world's largest debtor nations with a huge trade deficit and large inflows of capital, Congress became more concerned with limiting the revenue loss that occurred when foreigners either (1) took advantage of rules granting tax relief, or (2) exploited the benefits available under the network of tax treaties.[310] The limitation on benefits rules takes on that job in part by classifying corporations that are extensions of their owners from those that are separate and distinct from their owners. Moreover, a variation of the five or fewer formulation appears yet again to function as the measuring rod. The only difference is that it would be good for the firm to be viewed as an extension of the owner because that would allow the taxpayer to enjoy the benefits available under the treaty. In the anti-abuse rules discussed

306. 2016 U.S. Model Tax Treaty, art. 22(2)(d)(i).

307. Simone M. Haug, *The United States Policy of Stringent Anti-Treaty Shopping Provisions: A Comparative Analysis,* 29 VAND. J. TRANSNAT'L L. 191, 238 (1996) (citing Robert A. Ragland, U.S. INTERNATIONAL TAX POLICY FOR A GLOBAL ECONOMY E-2 (1991)).

308. *Id*. Tax policy was also reoriented to attract foreign capital. This was accomplished by adopting rules that produce uniform treatment of domestic and foreign operations of U.S. persons, a policy referred to as capital export neutrality. This is partly reflected by the adoption of the controlled foreign corporation provisions in 1962.

309. Foreign Investors Tax Act, Pub. L. No. 89-809, 80 Stat. 1539 (1966).

310. Haug, *supra* note 307, at 239 (citing Peter R. Merill & Robert J. Patrick, *U.S. International Tax Policy for a Global Economy*, TAX NOTES INT'L, Jan. 20, 1992, at 137).

above, the taxpayer would not be entitled to tax savings when the firm satisfied the concentration of ownership test.

F. S Corporations

The anti-tax avoidance rules discussed above address situations where a corporation can be used to conceal the identity of a taxpayer who may try take advantage of certain tax benefits that might not otherwise be available. However, Congress has not always been uniformly focused on preserving the integrity of the two-track system for taxing business profits. Perhaps the most prominent instance occurred in the 1950s, when Congress deliberately offered taxpayers the option to elect the method for taxing the profits of a business without regard to the firm's state law business form.

Under one entity classification election adopted in 1954 referred to as subchapter R, sole proprietorships and partnerships could elect to be taxed as if they were corporations.[311] Under another provision adopted in 1958, corporations could elect to be treated as if they were partnerships.[312] Subchapter R was repealed in 1957,[313] while the election for corporations remains in existence today and can be found in subchapter S of the Internal Revenue Code.[314] That election has always been restricted to certain eligible corporations. One eligibility requirement is that the firm's shareholders not exceed a certain number. Initially, the limit was ten; today the limit is 100.[315] The rules of subchapter S will only apply if the shareholders unanimously consent.[316] When the subchapter S rules apply, the profits of the corporation are essentially taxed as if they were derived by a partnership. Thus, the firm itself pays no tax on its earnings; instead, the owners pay tax on their share of the earnings each year, regardless of whether they actually received a distribution from the firm.[317] Conversely,

311. I.R.C. § 1361 (1954).

312. Technical Amendments Act of 1958, Pub. L. No. 85-866, § 64, 72 Stat. 1606, 1650.

313. The Treasury Department was expected to issue regulations addressing the details of the new election. However, after four years, no regulations had been issued. In the interim, taxpayers were reluctant to take advantage of the option in the absence of clarifying guidance from the government. Congress repealed the provision because it had not been effectively used. Mirit Eyal-Cohen, *When American Small Business Hit the Jackpot: Taxes, Politics and the History of Organizational Choice in the 1950's*, 6 PITT. TAX REV. 1, 36-37 (2008).

314. I.R.C. § 1361-1378.

315. Technical Amendments Act of 1958, Pub. L. No. 85-866, § 64, 72 Stat. 1606, 1650 (establishing the ten shareholder limit); American Jobs Creation Act of 1004, Pub. L. No. 108-357, § 232(a), 118 Stat. 1418, 1434 (raising the limit to 100). *See also* I.R.C § 1361(b) for the entire list of conditions that must be met to qualify for the election.

316. I.R.C. § 1362(a)(2).

317. I.R.C. § 1366(a).

the owners enjoy tax savings in any year the firm generates a loss.[318]

Congress enacted subchapters R and S during a time when it began to use the tax system as a tool to achieve certain social and economic goals.[319] In this instance, there was substantial evidence that the existing tax rules were promoting oligopolies and monopolies at the expense of small businesses.[320] Congress adopted subchapter R to eliminate this discriminatory effect of the federal tax law.[321] Similarly, subchapter S was intended to provide tax relief to small businesses so they could more effectively compete in the economy.[322]

Thus, the elections that Congress made available to taxpayers in subchapters R and S are distinct measures designed to achieve specific non-tax policies. They do not represent part of a congressional effort to rationalize the taxation of business profits or to preserve the integrity of the corporate tax.[323] It is significant that the election is just that—an *option*—for the firm to be treated in one way or another. It is also revealing that even after the elections were incorporated into the Internal Revenue Code, Congress adopted additional anti-abuse rules that employed the concentration of ownership principle. That would include all the rules discussed above starting with the rules for controlled foreign corporations.

VII. THEORIES OF FIRM BEHAVIOR

The noncontroversial and durable quality of the personal holding company ownership test and its variations may reflect a longstanding consensus about the distinct dynamics of the modern commercial enterprise. Those dynamics were thoroughly explored in academic writings published both before and after passage of the personal holding company rules. This section summarizes that body of scholarly literature.

A. Berle and Means

Perhaps the most thorough and influential study of corporations was published in 1932, just two years before Congress passed the personal holding company rules. Entitled THE MODERN CORPORATION AND PRIVATE PROPERTY, this study was the product of two Ivy League

318. *Id*.

319. Eyal-Cohen, *supra* note 313, at 20.

320. *Id.* at 15.

321. S. REP. NO. 83-1622, at 118 (1954).

322. S. REP. NO. 85-1237, at 3 (1958).

323. That statement applies with particular force to the rules under subchapter S. *See*, Roberta Mann, *Subchapter S: Vive Le Difference!,* 18 CHAP. L. REV. 65 (2014).

professors: Adolf A. Berle, Jr. and Gardner C. Means.[324] Time magazine described the book as "the economic Bible of the Roosevelt Administration."[325] It would also become the most quoted text in corporate governance studies. Their study showed that the means of production in the U.S. economy was severely concentrated in the hands of the country's 200 largest corporations. It also described how the vast majority of stockholders had effectively lost control of their property, which had become subject to the sole control of professional managers whose interests could not be expected to overlap with those of the company's investors.[326] In short, ownership had become separated from control. The authors went so far as to conclude that the owners of corporate stock had become subservient to management.[327]

Berle and Means were careful to note that their observations and conclusions did not apply to all corporations. Rather, they only applied to the firms they described as quasi-public corporations. The dynamics of such firms are materially different from the ones that characterize a closely held one. In fact, the mere act of incorporating a closely held firm would not constitute a material change for all practical purposes, according to Berle and Means. In their words, "[i]t has long been possible for an individual to incorporate his business even though it still represents his own investment, his own activities, and his own business transactions; he has in fact merely created a legal *alter ego* by setting up a corporation as the nominal vehicle."[328] In that instance, ownership and control overlap.

By contrast, the separation of ownership and control that distinguishes the quasi-public corporation produces a condition where "the interests of owner and of ultimate manager may, and often do, diverge, and where many of the checks which formerly operated to limit the use of power disappear."[329] Thus, Berle and Means appreciated the fact that their observations about the special dynamics that operate in the modern industrial enterprise do not apply uniformly to all corporations. Rather, it depends on the extent to which the parties who own the firm also control it.

Berle and Means believed that corporations could be roughly classified along a continuum based on the degree and control exercised by their shareholders. They conceptualized control as existing in five different forms:

324. BERLE & MEANS, *supra* note 83.

325. *Transportation: Credit Manager*, TIME, Apr. 24, 1933, at 14.

326. BERLE & MEANS, *supra* note 83, at 6-7.

327. *Id.* at 277.

328. *Id.* at 4.

329. *Id.* at 6.

(1) Control through almost complete ownership,
(2) Majority control,
(3) Control through a legal device without majority ownership,
(4) Minority control,
(5) Management control.[330]

The first form of control exists in what Berle and Means refer to as the private corporation, *i.e.* one that consists of a single individual or a small group of associates owning all or practically all of the outstanding stock of the firm.[331] Majority control referred to cases where the ownership of a majority of the stock by a single individual or small group provided that group with virtually all the legal powers of control, particularly the power to select the company's board of directors.[332] Legal devices of control typically consolidate or concentrate voting power in a single individual or small group. That would be the case when a corporation issues nonvoting stock, effectively leaving all control in the hands of the investors who own the voting stock.[333] Minority control generally exists when a small group holds a sufficient interest to be in a position to dominate a corporation through the voting power represented by their shares of stock.[334] Finally, management control prevails when the stock is so widely held that no individual or small group even has a minority interest large enough to dominate.[335]

It is noteworthy how closely the different categories of control envisioned by Berle and Means seem to be reflected in the personal holding company ownership test and its variations. At their core, those tests focus on concentration of ownership or control. Concentrated ownership is precisely the basis for the first two categories of control articulated by Berle and Means. Their formulations refer to the presence of a small group that owns a certain threshold of shares and the power associated with the block of shares. The personal holding company rules operate on the same premise and translate the idea into the five or fewer test. Concentrated control is also a concept built into the ownership test contained in the foreign personal holding company rules and the controlled foreign corporation provisions

The Berle and Means book may have been a widely read publication,

330. *Id.* at 70.

331. *Id.*; *Id*. at 93. For purposes of their analysis, Berle and Means classified a corporation as private if at least 80 percent of the stock was held by a compact group of individuals.

332. *Id.* at 71; *Id.* at 93. For purposes of their analysis, a firm was majority owned if the public owned less than 50 percent of the stock, but at least 20 percent.

333. *Id.* at 72-80. A similar result would occur when shareholders transfer their shares to a voting trust, leaving the trustee the sole individual authorized to vote the shares. *Id.*

334. *Id.* at 80 (Berle and Means considered this to be the case when the relevant group owns at least 20 percent but less than 50 percent of the stock).

335. *Id.* at 84.

but it was not the first to offer some of the observations that it described. The separation of ownership and control in the modern corporation had been understood by scholars for years.[336] It was even expressly acknowledged that management could not be relied on to pursue the interests of absentee owners.[337] Indeed, the separation of ownership and control was essential to the very structure of the corporate form. That is what made it uniquely suited to accommodate large scale commercial enterprises, fueling the growth of industrial firms requiring enormous commitments of capital.[338]

The earlier studies did not explicitly acknowledge how observations about the separation of ownership and control did not apply to closely held firms. Yet this distinction was implicit in those studies because they limited their examination to the large-scale industrial enterprise. Thus, Berle and Means were explicit about drawing a distinction that was widely understood to exist, including by the members of Congress responsible for drafting anti-tax avoidance legislation. At the very least, those tax law writers intuitively appreciated that closely held corporations behaved more like traditional partnerships and unlike the publicly traded firms that began to dominate the economic landscape. That became evident during the deliberations on various aspects of the bills under consideration during the formative years of the modern income tax. It is also evident from the content of some the laws enacted during the period.

It may not be possible to directly connect the personal holding company ownership test to insights offered by Berle and Means or anyone else. Still, it seems more than coincidental that the ownership test tracks so closely some key concepts that had been developed by the contemporary scholars in the field. At the very least, these insights might help explain why the ownership test proved to be so noncontroversial, durable, and effective.

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336. *E.g.*, ROBERT BROOKINGS, INDUSTRIAL OWNERSHIP: ITS ECONOMIC AND SOCIAL SIGNIFICANCE 1-24 (1925) (describing the separation of ownership from management and illustrating how the large scale industrial firms that came to dominate the economy had owners who ceased to exercise their right to select the managers, allowing the managers to effectively select themselves); THORSTEIN VEBLEN, ABSENTEE OWNERSHIP AND BUSINESS ENTERPRISE IN RECENT TIMES 82-100 (1923) (describing the separation of ownership and emphasizing how owners in the modern industrialized firm have been reduced to mere suppliers of capital whose principal concern is a return on their investment, while management furnishes specialized skills in the service of a complex commercial institution); THOMAS NIXON CARVER, THE PRESENT ECONOMIC REVOLUTION IN THE UNITED STATES 90-122 (1925) (describing how laborers were accounting for a growing share of industrial securities, helping to displace the dominant position of the rich and making the ownership of such firms more and more diffuse); I. MAURICE WORMSER, FRANKENSTEIN, INCORPORATED 87-160 (1931) (describing how managers of industrial firms frequently own no shares in the companies they manage, while the owners of its shares might not have any voting power).

337. BROOKINGS, *supra*, note 336, at 23.

338. *Id.*

B. Modern Economic Theories of the Firm

Modern economic theories of the firm continue to recognize the fundamental insight that a firm's concentration of ownership will determine the way it behaves. Economic theories of the firm try to explain the boundaries of the firm. More specifically, they try to explain why some transactions occur within firms and others occur in the marketplace. In 1937, Ronald Coase was the first to offer a theory.[339] Since then, economists have worked to refine his theories.[340] The most recent strand of literature is called the property rights theory of the firm.[341] According to that theory, firms arise when parties are engaged in long term relationships and make relationship-specific investments.[342] The terms of the relationship are generally spelled out in a contract. However, that document does not anticipate every possible issue that may arise over the course of the relationship. One mechanism for addressing an incomplete contract is for one party to simply acquire ownership of the other party. This way, the acquiring party can dictate a resolution of matters that the parties did not anticipate.

The property rights theory posits that the owner of an asset (such as a firm) has the power to fill any gaps in an incomplete contract because ownership of the asset comes with residual rights of control over it. Thus, the owner can dictate all uses of an asset not specified in a contract. More importantly, ownership affects substantive economic outcomes because the owner of an asset is the party with the strongest incentives to invest in it. If ownership of the asset changes, the incentive shifts from one party to another.

According to property rights theory, the economic boundaries of a firm will include all assets that are under common or unified control; formalistic or legalistic boundaries are irrelevant. Thus, if one corporation is wholly owned by another, the property rights theory would not view the two legal entities as two separate economic entities. Instead, the two would constitute one single firm. Berle and Means would have

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339. Ronald H. Coase, *The Nature of the Firm,* 4 ECONOMICA 386 (1937)

340. *E.g.*, Oliver E. Williamson, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS (1975); Oliver E. Williamson, THE ECONOMIC INSTITUTIONS OF CAPITALISM (1985); Benjamin Klein, Robert G. Crawford & Armen A. Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process,* 21 J. L. AND ECON. 297 (1978);

341. This theory is developed and discussed in detail in Sanford J. Grossman & Oliver Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691 (1986); Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. POL. ECON. 1119 (1990); OLIVER HART, FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE (1995); and Oliver Hart, *An Economist's Perspective on the Theory of the Firm*, 89 COLUM. L. REV. 1757 (1989).

342. The basic elements of the property rights theory of the firm were cogently synthesized by T. Christopher Borek, et al., *Tax Shelters or Efficient Tax Planning? A Theory of the Firm Perspective on the Economic Substance Doctrine,* 57 J. L. & ECON. 975, 978-981 (2014).

drawn the same conclusion. In other words, ownership of a firm continues to play a central role in economic theories that explain the boundaries of the firm. That crucial insight explains why the concentration of ownership principle offers a fundamentally sound basis for determining whether a firm should be treated by the tax system as an extension of its owners or as a freestanding taxpaying unit that is separate and distinct from them.

C. Agency Theory

The insights of agency theory may also help explain the durability and power of concentration of ownership as an organizing principle for distinguishing firms for tax purposes.[343] An agency relationship arises whenever one or more parties (the principal(s)) engage another party (the agent) to perform on their behalf some service that requires the agent to exercise delegated decision-making authority.[344] Agency theory is based on the fundamental observation that the agent will not always act in the best interests of the principal because the two parties may have divergent interests in certain situations.[345] Within a corporation, the relationship between the shareholders and management is one example of an agency relationship, with the shareholders acting as the principal and management serving as their agents. As general agency theory makes clear, one should not expect the agent (management) to always act in ways that serve the best interests of the principals (shareholders), particularly when those interests conflict.

Several scholars have already described how common issues arising in a corporation's business affairs can reveal the conflicting interests of shareholders and managers.[346] Generally, shareholders must monitor management to guard against decisions that will result in higher management compensation and prestige without a corresponding benefit to shareholders. This tension became apparent during the formative years of the income tax. Management at publicly owned firms fought the adoption of a tax on undistributed corporate profits, viewing it as a threat to their unrestricted power to set dividend policy.[347] In order to repel

343. For a general discussion of agency theory and the agency cost problem in the economics and finance literature, *see* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650 (1984); and Eugene Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980).

344. Jensen & Meckling, *supra*, note 343, at 308.

345. *Id.*

346. *See e.g.,* BERLE & MEANS, *supra* note 83.

347. Steven A. Bank, *Corporate Managers, Agency Costs, and the Rise of Double Taxation*, 44 WM. & MARY L. REV. 167, 171 note 18 (2002) (citing Kevin J. Murphy, *Corporate Performance and*

Congressional efforts to impose such a tax, they aligned themselves with the forces fighting for a shareholder tax on dividends, even though that would burden the firm's shareholders with a double tax on the dividends they received.[348]

Agency theory also explains the various ways that firms responded when Congress cut the tax on corporate dividends in 2003. Prior to the legislation, corporate dividends were taxed at the same rate as other types of income. Afterwards, most dividends were taxed at a substantially lower rate, creating a potential incentive for corporations to distribute their earnings. Indeed, dividends rose sharply and quickly after the law took effect. However, the response was more dramatic and pronounced in firms whose executives owned a larger fraction of outstanding shares and in firms with large shareholders who occupied seats on the board of directors.[349] Ordinarily, managers would prefer to retain earnings to fund pet projects. However, for managers who also owned large blocks of stock, a cut in the dividend tax changed the calculus. For those managers, the tax cut suddenly made it more attractive for them to have a dividend in their pocket than to have the power to spend the firm's earnings.[350] Along the same lines, the large shareholders who occupied board seats simply used their power and influence to pressure the board to declare dividends.[351] If ownership was too dispersed to allow any individual shareholders to occupy a seat on the board, a cut in the dividend tax would not have affected the decision about whether it was in the company's best interest to declare a dividend.

Agency theory would seem to offer a similar explanation for the enduring power of the ownership test in the personal holding company rules. The test only captures firms whose shares are owned in blocks large enough to represent an influential voice in the firm's affairs, even if the holder does not actually sit on the board or occupy a position in management. In some cases, there may be one individual who owns a block large enough to dictate company policy. In others, there will be more than one person with such power. However, the number will be a finite one that is small enough for any problems normally associated with collective action to be minimized.[352] Therefore, even when there is no

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Managerial Renumeration: An Empirical Analysis, 7 J. ACC. & ECON. 11, 11-12 (1985); James R. Repetti, *The Misuse of Tax Incentives to Align Management-Shareholder Interests*, 19 CARDOZO L. REV. 697, 698-699 (1997)).

348. *Id.* at 217-223.

349. Raz Chetty & Emmanuel Saez, *An Agency Theory of Dividend Taxation*, 1-2 (Nat'l Bureau of Econ. Research, Working Paper No. 13538, 2007).

350. *Id.* at 3.

351. *Id.*

352. Those difficulties include rational apathy and the temptation of individual shareholders to take a free ride. Robert Charles Clark, CORPORATE LAW 389-94 (Francis A. Allen et al. Eds., 1986).

single person who can dictate policy, management is unlikely to pursue its interests at the expense of the controlling group of shareholders.

VIII. A PROPOSAL FOR CLASSIFYING FIRMS FOR TAX PURPOSES

A. The Basic Elements

This Article has argued that the tax system should use concentration of ownership as the basis for classifying business firms for all purposes. It has also suggested that the test for classifying business firms could be modeled after the personal holding company ownership test, a test that asks whether five or fewer individuals own over half the value of a corporation for the last six months of the year.[353] If such a test were to be applied to classify firms for all income tax purposes, it would require that five or fewer taxpayers (individuals or firms classified as separate entities under test) own over half the value of any firm during some relevant window of time.[354] Whenever the test is met, the firm would not constitute a taxable entity. That would cause the profits of the firm to be taxed under the default rules that now apply to a partnership if there are multiple owners. The firm would be entirely disregarded if there is only one owner, leaving the activities of the firm attributed to the owner as if it were a sole proprietorship. In cases where the firm did not possess the necessary concentration of ownership, it would be treated as a corporation for tax purposes, causing the firm's profits to be taxed at both the entity and shareholder levels.

In order to function properly, the concentration of ownership test should be supplemented with attribution rules similar to the ones currently used within the personal holding company context.[355] Those rules accomplish two things. First, some of the rules cause individuals (and entities) to be treated as the constructive owners of stock that is actually owned by certain related persons. So, for example, if two spouses each own stock in Company A, one spouse would be considered the

353. I.R.C. § 542(a)(2).

354. There is reason to believe that the five or fewer formulation fairly estimates the concentration necessary to cause a firm to behave like an extension of its owners. A 2006 government analysis of S corporations examined the incidence of firms whose officers received no compensation for the services they performed, suggesting that the firm substituted dividends for such compensation. Such a strategy gives the officers access to the firm's earnings without triggering any employment tax liability. The study found that of the firms engaging in this technique, 87 percent had no more than 2 shareholders and 93 percent had no more than 3. Firms with up to 10 shareholders accounted for 99 percent of the total cases. NATIONAL TAXPAYER ADVOCATE, 2007 ANNUAL REPORT TO CONGRESS – VOLUME 1, 314 (2008). In a transaction involving two unrelated persons, the officer would have insisted on receiving compensation for the work, and the firm would have paid a market rate.

355. *See* I.R.C. § 318 (2005).

constructive owner of any stock actually owned by the other, and vice versa.[356] This rule prevents an individual from bypassing the concentration of ownership test by transferring stock to a related person to disguise the true ownership. Second, the attribution rules can also treat stock owned by certain entities as being constructively owned by the entity's owners. Under one such rule, any stock owned by a partnership is treated as proportionally owned by its partners.[357] Thus, if a partnership owned 100 shares of stock in Company A, a partner who owned a 60 percent interest in the partnership would constructively own 60 shares of Company A stock.

A few hypotheticals will illustrate how this combination of rules would apply to determine the tax classification of business firms. Consider the case of a firm consisting of a group of ten investors. If each investor owned an equal share of the firm, each would own a ten percent interest in the firm. Under the five or fewer test, the firm would be classified as a corporation because five of the investors would not own over half the value of the firm—they would own exactly half. It is conceivable that one of the investors could transfer a fractional interest to another investor so that the firm could be classified as a partnership. This type of tax planning is theoretically possible. However, because control is the defining characteristic of ownership, there are very significant practical reasons why it would not occur.[358] Parties will be extremely reluctant to shift ownership solely to achieve a particular tax outcome unless they are also willing to accept the change in power dynamics that comes with the new allocation of ownership interests.[359]

In the hypothetical involving the ten investors, under an even allocation of ownership interests, it would take six investors working in concert to authorize any action by the firm. If ownership interests are not evenly allocated, it would take fewer investors to do so. The smaller the control group, the more likely the firm will be used to serve the interests of the individuals comprising that group. As the size of the control group grows, it becomes more difficult for the firm to be used to accomplish the interests of any particular investor or group of investors. Among other things, each additional member of the control group adds to the diversity of interests, making it difficult for them to use the firm to optimize the tax consequences for all of them.[360] Thus, any adjustment in ownership will affect the allocation of control.

One might imagine that tax planners would try to manipulate the

356. I.R.C. § 318(a)(1)(A)(i) (2005).

357. I.R.C. § 318(a)(2)(A) (2005).

358. Borek, *supra* note 342, at 996.

359. *Id.* at 999.

360. Hamill, *supra* note 24, at 426 (1996).

classification of a firm by using a tiered ownership structure. Consider the case of an operating company with widely dispersed ownership, including some owners who are classified as corporations. The concentration of ownership test would treat the company as a corporation for tax purposes. A tiered ownership structure would not change that result. In a tiered structure, the operating company could be owned by five first-tier firms. Each first-tier firm would be owned by five second-tier firms. Each second-tier firm would be owned by five third-tier firms, and so on. The attribution rules would disregard the intermediate firms, causing the individuals and corporations owning interests in the top-tier firms to be treated as the owners of the operating company.[361] In the final analysis, the company would be treated as having the same number of owners as it did without the intermediate tiers of firms. Thus, it would not be possible for a company with diluted ownership to successfully use a tiered structure to transform itself from a corporation to a nontaxable entity.

One could also imagine that tax planners might consider ways to structure an investment so that the income of a U.S. corporation could be shifted to a low- or no-tax foreign jurisdiction. However, existing international provisions of the Internal Revenue Code would seem to prevent such a strategy from achieving that objective. Consider a U.S. corporation that is directly owned by members of the public. Under current rules, the firm is a corporation because it is incorporated under state law. For that reason, the firm is subject to U.S. tax on any income it derives, while its shareholders are subject to U.S. tax on amounts they receive from the firm as a dividend. A tiered structure utilizing a foreign entity would produce the same result. The basic strategy might be to interpose a foreign corporation in between the shareholders and the existing operating company, resulting in the U.S. operating company becoming the wholly owned subsidiary of a foreign company that is publicly traded. Because it would have one owner, the operating company would be disregarded under the concentration of ownership principle, while that upper tier foreign company would be a corporation under the same principle. Considering solely the proposed rule for classifying business entities, that would appear to make the foreign parent solely liable for tax on the earnings derived by the U.S. operating company. If the foreign parent is domiciled in a jurisdiction that imposes no tax on corporate earnings (*e.g.*, the Cayman Islands), then the income would effectively be insulated from any tax (U.S. or foreign) until the foreign parent pays a dividend to the shareholders.

However, under current tax rules, any foreign corporation is subject to U.S. tax on its taxable income that is effectively connected with a trade

361. I.R.C. § 318(a)(2)(A) (2005).

or business in the United States.[362] In the case of a wholly owned subsidiary, the subsidiary's separate existence would be disregarded, causing its activities to be attributed to the parent.[363] Thus, if the U.S. operating company derives all of its income from conducting business in the U.S., the tax bill of the foreign parent would be identical to the tax bill of the U.S. operating company in the absence of a tiered structure.

B. Possible Concerns and Considerations

Berle and Means suggested that concentration of ownership would not be the only factor affecting the dynamics of a corporation. Devices that realign power within a firm might produce the same result. For example, in the case of a corporation, the firm could issue both voting stock and nonvoting stock. If the voting stock were held by a sufficiently small number of shareholders, that group would be in a position to dictate the firm's policies, no matter how dispersed the nonvoting shares are actually held. Different classes of stock could be used to produce the same result if one class of stock gave shareholders the right to fill a controlling number of board seats, leaving the other class with token membership on the board.

These possibilities might lead one to consider adjusting the proposed entity classification rule so that it accounts for concentration of voting power, not just concentration of ownership. Indeed, concentration of voting power appears often in the rules surveyed in Part VI, but it plays a very inconsistent role. It is not a factor in the personal holding company rules. Nor was it a factor in the foreign personal company rules when they were first adopted in 1937. Fifty years later, a firm met the ownership test if a concentration of *either* voting power or value was present. Concentration of voting power was the *only* factor used in the controlled foreign corporation provisions when they were first adopted in 1962. Today, the ownership test would be met if a concentration of *either* voting power or value was present. The common controlled corporation rules also consider the concentration of *either* voting power or value. The passive activity rules refer to the ownership test in the personal holding company rules, where concentration of voting power is irrelevant. Under the limitation on benefits provision, a firm must have *both* a concentration of voting power and value.

These anti-abuse rules must be considered in light of the purpose they are designed to serve. Each one is targeted at a specific abuse of the corporate form to disguise one's identity in order to avoid tax. Using

362. I.R.C. § 882(a) (2017).

363. A parallel rule applies when there are multiple owners operating in partnership. *See* I.R.C. § 875(1) (1966).

voting power as an alternative way to classify all firms (not just incorporated firms) for all purposes could be problematic because it might open the door to a specific tax planning opportunity. Firms whose interests are sufficiently dispersed to qualify as a corporation could deliberately concentrate power solely to qualify as a partnership. On the other hand, basing a firm's classification solely on the concentration of ownership presents the risk that a firm whose ownership is dispersed would be treated as a corporation even though power might be sufficiently concentrated to make the firm an extension of the individuals belonging to the control group. It is difficult to determine the magnitude of these two risks; in fact, they may cancel each other out. However, given the objective to design a mandatory rule that is not subject to manipulation, the most sensible approach may be for the entity classification rules to focus solely on concentration of ownership.

Indeed, the overall objective of this Article is to determine when firms can be expected to function as extensions of their owners. This will be the case only when the owners also manage the firm; the interests of the owners will diverge from those of its managers when there is an actual separation of ownership and control. Therefore, the more sensible choice would be to distinguish firms solely by considering concentration of ownership.

C. The Benefits of a Mandatory Entity Classification Rule

If concentration of ownership became the basis for classifying business firms, there would little justification for the Internal Revenue Code to contain more than one version of the partnership model for taxing business profits. Thus, the S corporation rules could become obsolete.[364] It may also be necessary to reconsider the rationale for many anti-abuse rules that now litter the Internal Revenue Code. The most obvious candidates for reexamination would be the personal holding company rules and the other provisions discussed in Part VI, all of which now use some version of the concentration of ownership test. In addition, the classification rules could potentially serve as a substitute for defining a consolidated group of corporations.

The most significant benefit, however, may be that this alternative system for classifying business firms would foreclose a variety of tax

364. The idea of unifying the partnership and S corporation rules has been proposed elsewhere. *See* Willard Taylor, *Does One Size Fit All? Should There Be a Single Set of Federal Income Tax Rules for S Corporations and Partnerships?* 8 OHIO STATE ENTREPREN. BUS. L. J. 327 (2013) (evaluating a proposal considered in WAYS & MEANS COMM., TECHNICAL EXPLANATION OF THE WAYS AND MEANS COMMITTEE DISCUSSION DRAFT PROVISIONS TO REFORM THE TAXATION OF SMALL BUSINESSES AND PASSTHROUGH ENTITIES (2013)).

avoidance techniques that now depend on a firm's tax classification. Consider, for example, a very common tax avoidance technique that is currently available when a closely held firm is classified as a corporation. If the owners also work for the firm and want to access the firm's profits, they typically have two options for doing so. They could either receive a dividend on their stock or compensation for their work. If the payout is structured as compensation, the shareholder-employee would have to pay both income and employment tax, while the firm could deduct the payment itself and any payroll taxes that would apply. By contrast, if the payment took the form of a dividend, the payment would not lead to a reduction in the firm's tax liability, while causing the recipient to incur income (but not employment) tax on the amount received. Individual circumstances would dictate which choice would trigger the lowest combined tax, but the larger point is that the option itself is available solely because the employee-owners control the firm and chose to classify it as a corporation.

This particular tax planning option would not exist under the proposed mandatory classification system. If the firm's ownership is sufficiently concentrated, the firm would be classified as a partnership, and, under current rules, the owner would be taxed on his entire share of the earnings, no matter what. By contrast, if the firm's ownership is sufficiently dispersed, the firm will be acting in its own self-interest, not in the service of any individual owner or group of owners. As a result, market factors, not tax considerations, will drive decisions about the amount and structure of any payout to an owner.

IX. CONCLUSION

The tax system would not need a way to classify business firms if it contained only one method for taxing business profits. However, because the U.S. has two distinctively different ways to tax business profits, it is imperative to have a rational way to determine when one method prevails over the other. Throughout the existence of the modern income tax, the method for taxing a firm's profits has always depended on a firm's tax classification. However, there has never been a satisfactory way to establish that classification because there has never been a satisfactory way to distinguish firms. The formalistic and legalistic factors that used to matter were inadequate because taxpayers could simply manipulate the factors to achieve their tax objectives without compromising economic outcomes. That experience revealed the need to develop a more substantive basis for distinguishing firms for tax purposes. In short, we need a tax theory of the firm.

This Article offers a tax theory of the firm whose organizing principle is concentration of ownership. That principle explains the very reason why the U.S. initially adopted the corporate tax as an alternative to the traditional way of taxing firms as if they were extension of their owners. The principle is supported by longstanding economic theories that explain the behavior of firms. The principle lies at the heart of a wide range of anti-abuse rules that effectively treat a firm as a partnership when it is classified as a corporation. And each of those rules adopts a similar formula to translate the concentration of ownership principle into an objective test to determine whether a firm should be respected as such or not: whether five or fewer individuals own over half the value of the firm.

The concentration of ownership principle, as expressed by this formula, represents a viable and defensible way to distinguish firms for tax purposes. It deserves to serve as the organizing principle for a comprehensive tax theory of the firm that can dictate the way a firm is classified for tax purposes. Until the government adopts such a unifying theory of the firm, the tax system will fail to tax business profits in an equitable way.