Corporate Taxation and the Regulation of Early Twentieth-Century American Business

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Abstract:

In the early twentieth century, the taxation of modern business corporations became increasingly important to the development of American democracy. During that time, governments at all levels began to view business corporations not only as sources of badly needed public revenue, but also as potentially dangerous wielders of concentrated economic power. To combat the growing dominance of corporations, many fiscal reformers sought to use corporate taxation as a mode of regulatory governance. This paper explores the motives and intentions of fiscal reformers during critical junctures in the development of early twentieth-century U.S. corporate taxation. It seeks to explain how changing historical conditions shaped corporate tax law and policy. More specifically, this paper investigates why activists in the first half of the twentieth century turned to taxation in particular as a technique of corporate regulation. By focusing on the pivotal ideas and actions of key political economists, social commentators, and lawmakers, this paper attempts to answer the question: why did reformers see taxation as a viable form of public control over corporate power?

We argue that the corporate tax emerged and developed in the manner it did as a compromise among competing factions and contrasting circumstances. For some, the corporate tax held the potential for controlling, or even reversing, the growth of corporate power. In the wake of corporate scandals, the collection and possible publicity of corporate information by the federal government was seen as one specific way to regulate large-scale industrial corporations. By contrast, others saw the corporate tax as a means to encourage and foster the kind of behavior that would generate much needed economic activity and growth, especially during periods of financial crisis and economic recovery. Still others, mediating between these two extremes, sought to use the corporate tax in a supervisory capacity, while ensuring that it did not “kill the goose that lays the golden eggs.” The corporate tax that emerged by the mid-twentieth century embodied an attempt to strike a delicate balance among these changing demands for penalty, subsidy, and neutrality.
Introduction

Throughout American history there has been a striking ambivalence toward the taxation of business corporations. On the one hand, there has been a long-standing anti-monopoly tradition that has attempted to use tax laws and policies to restrain the growth and power of business corporations. Yet, on the other hand, during particular historical moments, economic experts and government officials have also designed tax laws and policies to encourage the development of business corporations as effective engines of economic growth and prosperity. This tension between a desire to protect democratic values against the rising power of corporate capitalism and an effort to reap the economic benefits of big business has come to define the early twentieth-century history of U.S. corporate tax law and policy.

While business corporations have long been a part of American law, economy, and society, it was during the first half of the twentieth century that the tension between using tax policy to control corporate power or to facilitate its growth became increasingly pronounced. This period witnessed the accelerating rise of large-scale industrial business corporations that threatened to undermine democratic values. As a result, lawmakers during this formative period attempted to use corporate taxation as a means of social control and regulation. But the legal response was not always consistent or coherent. While some policymakers viewed the corporate tax – particularly its collection and possible publicity of information – as a way to limit corporate growth, others believed that the administrative aspects of the levy could be used to manage and harness the power of large-scale corporations. A complex set of mixed motives, in other words, determined the evolution of corporate tax laws and policies.

In this paper, we seek to disentangle the aims and intentions of fiscal reformers during critical junctures in the development of early twentieth-century U.S. corporate taxation. Our central aim is to explain how changing historical conditions have shaped corporate tax laws and policies over time. More specifically, this paper investigates why activists at certain times turned to taxation in particular as a technique of corporate regulation, and why at other times they used tax policy to enable corporate growth. By focusing on the pivotal ideas and actions of key political economists, social commentators, and lawmakers, this paper attempts to explain how and why reformers saw taxation as a viable form of public control over corporate power.
We argue that the corporate tax emerged and developed in the manner it did as a compromise among competing factions and contrasting circumstances. For some, the corporate tax held the potential for controlling, or even reversing, the growth of corporate power. In the wake of corporate scandals, the collection and possible public disclosure of corporate information by the federal government was seen as one specific way to regulate large-scale industrial corporations. By contrast, others saw the corporate tax as a means to encourage and foster the kind of behavior that would generate much needed economic activity and growth, especially during periods of financial crisis and economic recovery. Still others, mediating between these two extremes, sought to use the corporate tax in a supervisory capacity, while ensuring that it did not “kill the goose that lays the golden eggs.”

The corporate tax that emerged by the mid-twentieth century embodied an attempt to strike a delicate balance among these changing demands for penalty, subsidy, and neutrality.

This paper begins in Part I with the 1909 corporate excise tax, a federal levy on the privilege of conducting business in the corporate form. Although there were earlier precedents for national corporate taxes, particularly during the Civil War and the Spanish-American War, the 1909 law was driven by a complex combination of rationales that went beyond the wartime need for revenue. The origins of the 1909 tax, in this sense, reflected the differing logics that would come to define twentieth century U.S. corporate tax law and policy. The act that created the 1909 corporate tax also contained the constitutional resolution that would ultimately lead to the Sixteenth Amendment, empowering Congress to levy an income tax without apportionment.

After exploring the varying motivations for the 1909 corporate tax and the post-Sixteenth Amendment development of corporate income taxation, this paper turns, in Part II, to the World War One tax regime. Though the first corporate income tax was relatively moderate, by the time the United States entered the First World War in 1917, it had established a tax base that would soon become the source of a robust corporate income tax and innovative business taxes like the excess profits tax. Like the levies before them, those enacted as part of the Great War represented the tension in American law and political economy over the desire to promote corporate capitalism without undermining traditional liberal democratic values.

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Part III examines the post-WWI decade to illustrate how changing political currents and a moderate recession led to the early retrenchment of certain parts of the wartime fiscal regime. Although business secured the repeal of the excess profits tax, the reduction of the corporate rate, and a broadening of favorable tax treatment for mergers and acquisitions, many advocates saw these as hollow victories. Congress’s adoption of Treasury Secretary Andrew Mellon’s plan for the pullback of the income tax in lieu of competing proposals to replace it with a national sales tax solidified the place of the corporate income tax in the revenue scheme. This set the stage for the New Deal, which is discussed in Part IV. Not only did the business-friendly policies of the 1920s end when Franklin D. Roosevelt became president, the perception that corporate growth and concentration of economic power contributed to the Crash and ensuing depression led to the embrace of corporate taxation as a regulatory device.

I. The 1909 Levy and the Early Development of Corporate Taxation

Even before lawmakers began considering a corporate tax in 1909, there were several broader forces and seminal events that brought tax reform and corporate regulation to the forefront of national policymaking. First and foremost among these forces was the accelerating growth of corporate capitalism. Indeed, between 1895 and 1904, during what scholars have dubbed “the great merger movement,” U.S. manufacturing firms consolidated at a remarkable pace due to a confluence of historical factors. During that brief period, nearly two thousand companies combined with former rivals to create some of the nation’s largest industrial corporations – many of which continue to exist today. Unlike previous periods of corporate growth, the turn-of-the-century merger movement hastened the institutional convergence of industrial manufacturing and finance capital. Consequently, the ownership of corporate wealth gradually became more dispersed among the American elite, and a spirit of financial speculation and an ideology of “shareholder democracy” began to take shape.

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As these large-scale industrial corporations came to dominate the American economic and political landscape, tax reformers and lawmakers took notice. The growing concentration of corporations in the Northeast industrial sector provided populist tax reformers, particularly those from the agrarian South and West, with an easy target. They pointed to the wealthy shareholders and managers of the new, large-scale industrial firms as the type of individual taxpayers who had the ability and obligation to bear a growing share of the costs of underwriting a modern state. For other progressive reformers, the colossal corporations themselves were seen as sources of tax revenue and as citizens in their own right – citizens that had a social duty under the principles of fiscal citizenship to contribute to the commonwealth. For more pragmatic state-builders, the development of a “corporate-administered” phase of American capitalism provided new “tax handles” with which to assess and collect personal and business incomes.  

As income and economic power became concentrated in large, integrated business corporations, it became easier for government authorities to identify and access sources of tax revenue. Thus, corporate and individual income became more visible and “legible” for taxing authorities.  

In addition to the growing public salience of corporations, the resurgence of the protective tariff and the increasing attention to economic inequality also contributed to bringing tax reform and corporate regulation to the fore. As tariff revenue increased steadily during the first decade of the twentieth century, protectionism was once again associated with an increasing cost of living. Although the annual rate of inflation in the early 1900s was rather moderate (averaging about two percent annually), the perception among many ordinary Americans was that the widening scale and scope of import duties was raising the prices of the “necessaries of life,” and unduly protecting domestic monopolies. Because the tariff affected the price of many

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every day consumption items, including food and clothing, these levies imposed a greater financial burden on the poor than the rich, taking more from those who had less. The regressivity of customs duties also fueled concerns that the growing power of corporations and the existing tax regime were exacerbating disparities in economic wealth and power. These distributional concerns would only multiply as corporations became more powerful and as the tariff continued to be seen as a shield protecting American monopoly power.⁷

If broader structural forces provided the critical background for the origins of the 1909 corporate tax, the triggering event came with the panic of 1907 and the ensuing economic recession. The panic began with the San Francisco earthquake of 1906, which not only devastated the city and its inhabitants, but also set in motion a series of events that dramatically undermined confidence in Northeastern financial institutions. As a result, hundreds of small banks throughout the country failed. Commodity prices plummeted. Imports declined precipitously. And unemployment skyrocketed. Like earlier recessions, the downturn that followed the panic compelled reformers and lawmakers to reconsider the role of the state in the economy.⁸

In the wake of the 1907 panic and subsequent recession, tax reform soon became a pressing issue. With tariff revenues declining due to the downturn, and greater attention focused on growing inequalities, lawmakers began to consider a new income tax that would make up revenue shortfalls and address the distributional impact of the existing tariff regime. Although the movement for a national income tax had been growing throughout the late nineteenth-century, it was initially defeated in 1895 by the U.S. Supreme Court, which struck down the income tax as a violation of the direct tax clause.⁹ Since that time the Court had approved other types of national levies, namely an estate tax and a corporate excise tax used to finance the Spanish-American war, which ultimately encouraged some lawmakers to consider a new income tax that might pass constitutional muster.¹⁰

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Even though the concept of taxing individual income was not new, the idea and process of taxing corporations remained a vexing issue throughout the late nineteenth and early twentieth centuries. Economic experts, social commentators, and lawmakers all debated the differing methods of taxing corporate wealth. “Governments are everywhere confronted by the question of how to reach the taxable capacity of the holders of [corporate] securities or of the associations themselves,” explained Edwin R.A. Seligman, one of the leading tax experts of the time. “Whom shall we tax and how shall we tax them in order to attain a substantial justice? Perhaps no question in the whole domain of financial science has been answered in a more unsatisfactory way.”\(^{11}\) To answer Seligman’s question, some lawmakers believed that corporations could be used as a collection and remittance device to get at the wealth held by the owners or shareholders of large business corporations. From this perspective, corporations were simply an aggregation of individual wills – artificial legal entities created to pursue individual economic interests.

In the spring of 1909, Senators Joseph W. Bailey (D-TX) and Albert Cummins (R-IW) proposed a new comprehensive income tax that included a levy on corporate income – a levy that was premised on the notion of using a corporate income tax to get at shareholder wealth. The Bailey-Cummins bill called for a three percent tax on all individual and corporate income above a $5,000 exemption level. To relieve low-income taxpayers from the corporate tax, the bill permitted shareholders who had income below the $5,000 threshold to apply for a refund of their portion of corporate taxes paid by the business.\(^{12}\) For Cummins, the main objective of the corporate levy was to tax corporate owners. “The corporation is simply the instrumentality for the enrichment of its stockholders,” he informed fellow lawmakers, “and if the instrumentality results in conferring upon its stockholders an income above the minimum fixed by the amendment, then it should be taxed; but if that income is below the minimum, there is no more reason for imposing a tax upon it than there would be if it were derived as a salary or as profit in a real estate transaction or as the profits of a farm.”\(^{13}\) From this perspective, the corporate levy was not intended to be a tax on corporations \textit{qua} corporations. Rather, the goal was to use

\(^{12}\) 44 \textit{Congressional Record} 3137 (1909).
\(^{13}\) 44 \textit{Congressional Record} 1424 (statement of Sen. Cummins).
corporations as a neutral, administrative machine – a remittance vehicle to collect income from wealthy shareholders.  

Although the Bailey-Cummins bill was ultimately tabled, it was not long before the movement for an income tax gained momentum. In a June 1909 message to Congress, President William Howard Taft helped propel the campaign for an income tax by proposing a corporate excise tax along with a constitutional amendment permitting an income tax without apportionment. Earlier Taft had claimed that an income tax might be constitutional, but once he became president he recognized that a direct challenge to the Court could tarnish the integrity of an institution that he revered and would later in his career join.  

In his congressional message, Taft provided a variety of justifications for a new revenue bill. Citing to a “rapidly increasing deficit,” the president called for tariff revision and the adoption of “new kinds of taxation” to help “secure an adequate income” for the growing federal government. This part of his message suggested that Taft was concerned with using the new levy mainly as a source of revenue.

Yet, even in this sense, Taft appeared to believe that both shareholders and corporations – as separate legal entities – could be sources of tax revenue. The tax, Taft explained, imposed “a burden at the source of income at a time when the corporation is well able to pay and when collection is easy.” As scholars have noted, Taft’s words implied two different meanings. On the one hand, the focus on sources of income and collection ease implies that Taft believed the levy could be an effective indirect means to tax shareholder wealth. At the same time, the president’s reference to the corporation’s ability to pay suggests that he also may have believed that the corporation ought to be treated as a separate legal entity with its own taxpaying duties and obligations.

Other parts of Taft’s message were more explicit about the use of taxation as a means of corporate regulation. At the outset, Taft explained that the levy “is an excise tax upon the privilege of doing business as an artificial entity,” and hence “not a direct tax on property.” He

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14 Steven A. Bank, From Sword to Shield: The Transformation of the Corporate Income Tax, 1861 to Present (New York: Oxford University Press, 2010).
15 Buenker Income Tax and the Progressive Era.
16 S. DOC. NO. 61-98, at 1.
17 Id. at 3.
18 Bank, From Sword to Shield.
did this, no doubt, to suggest that the excise tax would not be challenged as a violation of the direct tax clause. Taft maintained that “another merit of this tax is the federal supervision which must be exercised to make the law effective over the annual accounts and business transactions of all corporations.” He was referring to how an effective corporate tax could collect and make public vital information about the operations of large-scale business corporations. Taft acknowledged that the corporate form “has been of the utmost utility in the business world,” but he also reminded Congress that “substantially all of the abuses and all of the evils which have aroused the public to the necessity of reform were made possible by the use of this very faculty.”

With American society still reeling from a financial panic linked to abuses in the banking industry and an earlier series of corporate scandals in the insurance industry, Taft’s address underscored the regulatory potential of a corporate tax. Indeed, the president spelled out how the tax in a “perfectly legitimate and effective” way could help the government, stockholders, and the greater public gain “knowledge of the real business transactions and the gains and profits of every corporation in the country.” By making the inner dealings of big businesses more transparent, the corporate tax, Taft insisted, would be a “long step toward that supervisory control of corporations which may prevent a further abuse of power.” Taft’s many references to the public disclosure aspects of the law suggested that he believed the tax could be used to do much more than just raise revenue from wealthy shareholders.

In its final form, the 1909 law contained a tax on the legal privilege of doing business in corporate form. In particular, the law required “every corporation, joint stock company or association, organized for profit and having a capital stock represented by shares” to pay a “special excise tax with respect to the carrying on of doing business.” The tax was set at an annual flat rate of one percent on net income above $5,000, and even applied to all foreign corporations engaged in business in the United States. The law also contained the controversial public disclosure feature that Taft had recommended. This provision directed that

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20 S. DOC. NO. 61-98, at 3.
22 S. DOC. NO. 61-98, at 3.
23 Kornhauser, “Corporate Regulation and the Origin of the Corporate Income Tax.”
25 The law excluded “amounts received by [corporations] as dividends upon stock of other corporations.” *Id.*
all corporate tax returns “shall be filed in the office of the Commissioner of Internal Revenue and shall constitute public records and be open to inspection as such.” For some progressive lawmakers, like Cummins, this provision did not go far enough in encouraging corporate transparency. For others, like Senator Elihu Root (R-NY), the publicity provision was “exceedingly drastic and injurious.” Ultimately, sustained business criticism of the publicity feature led Congress to restrict, and within two years eliminate, public access to corporate returns. 

While the publicity feature of the 1909 law was an innovative, albeit short-lived, feature of corporate taxation, the idea of taxing business corporations was hardly new. Indeed, throughout the nineteenth century, states and localities regularly taxed property held by corporations. And during the Civil War and the Spanish-American War, the national government experimented with several temporary corporate levies. Yet none of these early measures seemed specifically designed to capture the taxpaying ability of corporations qua corporations. The Civil War income tax, for example, applied to business profits, but mainly as an indirect means to tax individual shareholders. The 1898 excise tax on sugar and oil producing industries, by contrast, was a tax on the privilege of doing business and hence was a model for the 1909 law.

Yet, even the 1898 excise tax was enacted for differing reasons. On the one hand, the statute’s legislative history and its general application to all sugar and oil refinery businesses, not just corporations, suggest that lawmakers were not singling out corporations as regulatory targets, but rather that they were using the excise levy as a proxy to tax the owners of sugar and oil companies, and hence generate the revenue necessary to prosecute a war. On the other hand, if the ultimate targets of the tax were specifically Standard Oil and American Sugar, two of the largest and most powerful industrial corporations in America at the time, then perhaps the 1898 excise tax was a forerunner of the legislative attempt to control the increasing wealth and

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26 Tariff Act of 1909, Ch. 6, § 38(6), 36 Stat. 11, 116.
29 Bank, From Sword to Shield
30 In 1897, Standard Oil was the largest industrial corporation in the country, with over $256 million in total assets, and American Sugar was the third largest with $116 million in total assets. Bunting, Rise of Large American Corporations, 149.
power of corporate capital. Furthermore, since the 1898 law did not contain disclosure requirements, lawmakers seemed less concerned about transparency as a form of public control, and more interested in using the levy to curb the growing profits of specific corporations.31

Unlike the earlier corporate taxes, which were temporary measures in response to wartime emergencies, the 1909 levy paved the way for a more permanent corporate tax. In fact, after the Sixteenth Amendment was ratified in 1913 and a comprehensive income tax enacted in that same year, the corporate excise tax was replaced with a direct tax on corporate incomes. This new corporate income tax acted as a complement to the individual income tax. The new law provided a “normal” tax of one percent on all individual and corporate income above certain exemption levels. It also enacted a graduated set of “surtaxes” on individual income that ranged from one to six percent on income above $20,000. Because shareholders were exempt from paying the normal tax rate on dividends, the normal rate on their corporate income was merely applied at the corporate rather than the individual level. With this system in place, only truly wealthy shareholders paid a graduated surtax on corporate dividends.32

The adoption of progressive rates, however, complicated the taxation of corporate income. With higher individual surtax rates, there was an incentive for corporations to retain earnings rather than distribute them as dividends to individual shareholders. This meant that the corporate form could be used to avoid graduated individual income taxes. To combat this, lawmakers enacted a highly subjective penalty provision: shareholders of a corporation that retained earnings for the purpose of avoiding the shareholder-level surtax on dividends would be subject to surtaxes on their pro rata share of the earnings as if they had been distributed. In effect, this provision provided partnership-like, pass-through tax treatment for those corporations that were deemed to be tax avoidance vehicles. Thus, because of its progressive rate structure, the 1913 Act was arguably the beginning of the modern American corporate tax.33

Indeed, it is no surprise that during this time the corporation was targeted as a separate legal entity, with its own tax paying capacity. Not only were American legal theorists incorporating the ideas of continental scholars who viewed colossal business corporations as real and separate legal entities capable of paying taxes, policymakers were similarly making the

32 Section II(A), subdivision (2), Underwood Tariff Act of October 3, 1913, 38 Stat. 166.
33 Ibid. [cite to specific sections].
claim that business corporations had a unique ability to pay. 34 As the U.S. Bureau of Corporations explained, corporations provided “a place where the theoretically perfect test – ability to earn – can be applied in practice as a means of ascertaining the proper amount of taxes to be paid.”35 At the same time, economic experts and social commentators were also linking the growing inequality created by modern industrialism to the rise of large-scale corporations. “The greatest force in the last three decades making for income concentration has been the successful organization of monster corporations,” wrote statistician and political economist Willford I. King in 1915. “The promoters and manipulators of these concerns have received, as their share of the spoils, permanent income claims, in the shape of securities, large enough to make Croesus appear like a pauper.”36

Thus, from its origins in the 1909 excise tax to its development as part of a more comprehensive income tax, the corporate tax was marked by dueling, perhaps even contradictory, rationales. For those who feared that “monster corporations” were separate legal persons that could threaten American democracy, certain elements of the new corporate tax were seen as a means toward limiting the growing power and influence of these economic and legal entities. Meanwhile, for those who viewed the corporation as simply an aggregation of individuals, the corporate tax was merely an effective administrative device, a tool for collecting and remitting taxes on wealthy shareholders. In this sense, the multiple goals of tax policy were not necessarily antithetical to each other. Just as bootleggers and Baptists could come together to support Prohibition, anti-corporate regulators and administrative revenue reformers could agree, at least in principle, on the need for a corporate tax, even if their motivations differed.

II. The World War One Corporate Tax Regime

If the 1913 income tax initiated the development of modern corporate taxation, the World War One tax regime, with its dramatically higher tax rates and innovative business levies, certainly accelerated the process. Yet like its earlier versions, the wartime corporate taxes were riddled by a variety of complex justifications. As the costs of conducting a global war increased, the need for new and sustained revenues pushed Congress to enact steeply progressive income tax rates. At the same time, the robust demand for wartime goods and material provided an opportunity for some industrial corporations to benefit enormously from the war effort. To prevent unreasonable war profiteering, lawmakers enacted several innovative profits taxes. Although these levies were intended to act as constraints on “unreasonable” corporate profits, they frequently had unanticipated consequences. In fact, by the end of the war the steeply progressive rates and the new profits taxes led some experts to wonder whether the tax regime was unnecessarily hindering the development of corporate capital.

Even before the U.S. officially entered the war in April 1917, the need for war preparedness led lawmakers to transform the federal tax system. The Revenue Act of 1916, in fact, initiated a series of wartime tax measures that significantly shifted the national tax system away from its traditional reliance on indirect and regressive consumption taxes to the modern system of direct and progressive taxation. The 1916 law increased individual and corporate rates, adopted a federal estate tax, as well as a net receipts tax on munitions makers. The revenue acts that followed not only transformed the American fiscal system, they also ushered in a revolution in administrative capacity, as the power and personnel of the U.S. Treasury Department increased dramatically. By focusing the new national tax powers on the wealthiest Americans, and rejecting a broad-based mass income or sales tax, the Woodrow Wilson administration and its congressional allies set a clear tone: the World War One tax regime would be focused on “soaking the rich.”

There was, to be sure, some resistance to the new “soak-the-rich” wartime tax regime. Most business interests limited their opposition to private correspondence with policymakers because they were profiting tremendously from the war, and because they feared that their protests would be interpreted as anti-patriotic. Still, politically conservative interests preferred to

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finance the war with a mix of consumption taxes and bonds rather than steeply progressive income or munitions levies. Populist lawmakers, by contrast, initially used the threat of highly progressive taxation to try to blunt the war effort. On the eve of the war, Claude Kitchin (D-N.C.), the House majority leader and powerful chair of the House Ways and Means Committee, did not hide his sectional bias. When wealthy New York citizens, he wrote, “are thoroughly convinced that the income tax will have to pay for the increase in the army and navy, they will not be one-half so frightened over the future invasion of Germany and preparedness will not be so popular with them as it now is.” Only later did populists like Kitchin see the war as an opportunity use tax policy as type of anti-monopoly tool.

One of the Wilson administration’s greatest achievements was its ability to build a fragile political coalition of populist Democrats and progressive Republicans in support of the new wartime tax regime. Led by Treasury Secretary William G. McAdoo, who was also Wilson’s son-in-law, the administration together with its congressional allies was able to dramatically raise individual tax rates and lower exemption levels. Although the WWI revenue laws did not usher in a mass-based tax, they did increase the scope and scale of taxes on America’s wealthiest citizens. During the war, the top marginal individual income tax rate soared to 77 percent, and in fiscal year 1919 nearly 17 percent of the labor force filed individual income tax returns. Accordingly, the effective tax rate of the nation’s wealthiest one percent of households climbed from roughly three percent in 1916 to 15 percent within two years. Although the corporate income tax rate also increased, it did not do so at the same pace and hence the spread between individual and corporate rates widened significantly, providing further incentives for wealthy shareholders to use corporations as tax avoidance vehicles.

The war’s most challenging revenue provisions came with the increasing taxation of corporate profits. In 1917, once the United States had officially entered the war, Congress not only increased the tax rate on corporate incomes to six percent, it also introduced a novel excess-profits tax. Whereas the 1916 munitions tax levied a flat 12.5 percent tax on the profits of all

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armament producers, the newly created excess-profits tax applied to profits “over a reasonable return on invested capital” and affected all businesses, not just those in the munitions industry.40

A tax on excess profits reflected the belief that the broader public, operating through the powers of the state, had a legitimate stake in collecting excess private gains generated by war profiteering. Although other nations were already using excess profits taxes as a funding source for the war, the unprecedented turn to this levy by the United States signaled the Wilson administration’s desire to alter the concept and meaning of business profits – at least during the war. The term “excess” implied that there was some reasonable level of earnings that a business was entitled to, but that any surplus amount above that level was “unreasonable” or “abnormal.” Such surpluses generated by the war were deemed to be windfall gains that exceeded a legitimate amount of financial profit. At a time when ordinary Americans were sacrificing life and limb, the enactment of an excess profits tax expressed a growing indignation with war profiteering and a demand for shared sacrifice that was at the heart of the Wilson administration’s sense of fiscal citizenship.41

Indeed, social concerns over excessive and unscrupulous war profiteering drove the demands for an excess-profits tax. As early as 1917, calls for the “conscription of wealth” to match the conscription of men began to fill the editorial pages of the country’s leading publications.42 Similarly, the popular journal The Outlook documented “the extraordinary increase in profits” among the leading industrial concerns. Comparing the profits of over one hundred companies from 1914 to 1916, the editors calculated that the aggregate profits of these corporations “exceed the profits of the year in which the war began by over a billion dollars.” From this statistical evidence, The Outlook joined other leading popular periodicals in supporting an excess-profits tax to make “the war-brides pay up.”43

40 Eight percent was established as the “reasonable rate of return,” and all profits above that level were taxed at graduated rates ranging from eight percent to a maximum of 60 percent on corporate profits that were in excess of 32 percent of invested capital. Revenue Act of 1917, 40 Stat. 300 (1917). For an elementary and useful example of how excess profits were calculated, see Rockoff, America’s Economic Way of War, 116.


From the start, though, many economic and legal experts questioned the efficiency, administrability, and even constitutionality of a tax on all “excess” profits beyond a “normal level.” The main point of contention seemed to rest with the idea of using “invested capital” as a baseline from which excess profits could be determined. The economist Edwin Seligman summarized the hostility toward the notion of “invested capital” when he wrote that “what constitutes capital is so elusive as to be virtually impossible of precise calculation.” Members of the business and legal communities echoed Seligman’s concerns. *The Commercial and Financial Chronicle* – that bastion of orthodox business thinking – attacked the “Excessive Taxation of ‘Excess’ Profits” as “governmental confiscation of wealth.” While most business leaders were cautious about publicly complaining about the excess profits tax, privately they seethed. Jacob Schiff, a senior partner in the investment banking firm of Kuhn, Loeb & Co., wrote a letter to Treasury Secretary McAdoo in 1917 complaining that the high wartime rates would “curb the push and ambition which is at the bottom of all material progress and development.” Similarly, the automobile manufacturer Cleveland Dodge wrote to McAdoo warning that the excess profits tax schemes “would kill the goose which lays the golden egg.”

As many experts predicted, the excess-profits tax did not always operate as intended. Treasury Department economist, Thomas S. Adams, conducted a study of the excess profits tax in the summer of 1918 that documented how the levy was having perverse implications. The existing law, with its use of “invested capital” as the baseline for determining “excess profits,” was adversely affecting small businesses more than the large corporations it was designed to attack. Larger corporations, Adams concluded, were able to manipulate the law to reduce their tax liability. By increasing their invested capital, either by issuing more equity or by increasing their investments in intangible assets or through other accounting maneuvers, they could inflate the base from which their rates of return and profits were calculated, thereby placing their net profits in a lower tax bracket. By contrast, smaller enterprises, especially those that relied

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mainly on personal services such as family businesses, did not have high levels of capital to begin with, nor did they have the slack or flexibility to adjust their capital levels or annual investments. Thus, they were hardest hit by the excess profits tax.\textsuperscript{46}

Despite the uncertain effect of the excess profits tax, there were some lawmakers and experts who believed a revised profits levy could be used as a permanent measure to combat monopoly power. Eventually, the Treasury Department was able to convince lawmakers that a hybrid excess profits and war profits tax could be used to fund the remaining war effort. By hinging the calculation of “war profits” to a pre-war level of acceptable profits, the new hybrid levy was reframed as a temporary measure, one that could be – and was – easily dismantled after the war. Indeed, when the war officially ended in the spring of 1919, the excess profits tax was one of the first targets of the fiscal conservatives who swept into office.

Although excess profits taxation was quickly eliminated, the overall thrust of the new income tax regime did not wither away after the conflict. The ultimate success of the income and profits tax regime demonstrated the federal government’s ability to underwrite a global war with a robust tax system. This success convinced reformers, lawmakers, and tax administrators that a direct and progressive tax system – especially one with a strong corporate income and profits tax component – could be used both to collect badly needed revenue and to discipline corporate war profiteering.

\textbf{III. The 1920s and the Mellon Plan}

The aftershocks of World War I continued to reverberate at the outset of the 1920s. The dislocation occasioned by the war’s end and a sharp drop in prices ushered in a significant recession between 1920 and 1922.\textsuperscript{47} Furthermore, the heavy wartime taxes remained after armistice as the country strained to cover the war bill. The top combined individual normal and surtax rate, which had been seven percent in 1913, had more than doubled to 15 percent in 1916

and rose to a whopping 77 percent at war’s end, with commentators calling it “the greatest burden that had ever been laid upon the American people.”

In the post-war recessionary environment, the voices of those who had sought to use corporate taxation to regulate and discipline big business during the war were drowned out by those seeking to use corporate tax reform as a means to subsidize or facilitate business activity and economic growth. In his 1920 Annual Report, Treasury Secretary David Houston’s prescriptions for tax reform reflected this gradual shift in attitude. “While it is vitally important that saving and reinvestment effected through the medium of the corporation should not be dealt with more leniently than similar savings made by the partnership or individual,” Houston noted, “it is equally important that the methods of taxation employed should in all cases penalize saving and investment as little as possible.”

By 1921, a consensus was forming about the need for business tax relief. In his inaugural address that year, President Warren G. Harding remarked that the “business world reflects the disturbance of war’s reaction.” Other lawmakers agreed that steeply progressive taxes were undermining the postwar recovery. A House Ways and Means Committee Report observed that “the exacting of the present excessive sums of taxes from the country contributes in no small degree to the depressing influences under which business and industry in general are staggering as an aftermath of the World War . . . The reduction of the tax burden is essential to business recovery.”

One particular target of business tax reformers was the excess profits tax. As they had during the war, critics of the levy noted its contradictory implications. The National Association of Manufacturers contended that the public equated “excess” with “illegal” profits, and the levy incentivized corporations to undertake inefficient projects on deductible expenses, thereby artificially depressing investor returns. Not only was the tax viewed as problematic in concept, it was also considered complex in operation, requiring significant audits, frequent appeals, and lengthy process before liability could be established. Indeed, the uncertainty the tax generated

49 David F. Houston, Annual Report of the Secretary of the Treasury (1920): 34.
was itself considered a threat to business. Treasury economist T.S. Adams wrote that “[t]housands of business concerns, particularly corporations, must some day be confronted with large additional tax bills for the war period. These ‘heavy but indefinite future obligations’ . . . hang like a suspended avalanche over American business.”53

There was some sentiment in favor of simply replacing the excess profits tax with an undistributed profits tax to get at earnings retained within the corporation, but the economic downturn helped squash this idea. Partly, this was because the issue of retained earnings was less important when corporate earnings were already down. Senator Reed Smoot (R – UT) noted “[d]uring war times . . . there may have been some reason for taxing undistributed earnings, but just as surely as we stand here to-day there is not much danger of undistributed earnings for the year 1921, and, I think, for a number of years to come.”54

More importantly, many observers believed that it was important to shield corporations and corporate savings from the high taxes enacted during the war. Whereas retained earnings had been viewed as a tax avoidance maneuver prior to the war, they came to be seen as an important engine for the economy through corporate reinvestment. Adams, who had advocated for undistributed profits taxation in 1918, changed his tune by 1923:

The proposal [to tax undistributed profits] has been rejected because Congress and the people will not face the prospect of applying fifty per cent surtaxes to the great volume of savings effected every year by the corporations of this country. . . . We want corporations to save, to reinvest, to plow back their profits into the business. We admit that it would be undesirable to apply the high surtaxes to the savings made by corporations. Saving, reinvesting is beneficent; it is a renewal of the lifeblood of business; and that part of the business income of the country [that is retained] cannot stand surtaxes rising to fifty per cent.”55

Secretary of State Charles Evan Hughes sounded a similar theme in a speech before the National Institute of Social Sciences in May of 1924, saying “[w]e must have a surplus and it must be used to develop enterprise. How fatuous to dry up this essential source of prosperity by plans of

taxation which discourage enterprise and yet are stridently proclaimed as being in the interest of the people!”

The pro-business shift in corporate taxation also was evident in the move to further liberalize the tax treatment of mergers, consolidations, and other corporate reorganizations. In 1918, Congress adopted a provision to permit the nonrecognition, or tax deferral, of gains and losses on exchanges of stock or securities in such transactions, but it was considered too vague and restrictive to permit much activity. This legal ambiguity had proven problematic as businesses made the transition from wartime to peacetime production. The slow-down in merger activity during the recession from 1920 to 1922 was blamed at least in part on the defects of the 1918 law. T.S. Adams testified before the Senate Finance Committee that “where any heavy tax is involved the reorganization is held up. They do not do it. All kinds of business readjustments have been stopped. . . . The principal defect of the present law is in blocking desirable business readjustments.” In the 1921 Act, Congress expanded and clarified the reorganization provision to remove it as an obstacle. As the Senate Finance Committee report on the Act emphasized, the amendments “will, by removing a source of grave uncertainty . . . permit business to go forward with the readjustments required by existing conditions.”

Supporters of the Act tried to pump it up as a pro-business measure. “The present Federal tax law is distinctly more favorable to business than any since the war,” declared New York City tax lawyer and former Treasury official Arthur Ballantine in the winter of 1922. “An individual or partnership may incorporate the business without tax liability by reason of the transfer to the corporation. The exchanges of securities in the course of corporate reorganizations may be effected without tax liability.” Ballantine and other members of the nascent corporate tax bar conferred that the new reorganization provisions were a step in the right direction toward making the tax system more responsive to changing economic conditions.

Notwithstanding the positive reviews of the 1921 Act, many pro-business Republicans were dissatisfied. Postmaster William H. Hays, the former chairman of the National Republican Party, wrote a letter to newly appointed Treasury Secretary Andrew W. Mellon urging him to

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58 Hearings on H.R. 8245 Before the Senate Comm. On Fin., 67th Cong. 29 (1921) (“1921 Senate Hearings”).
59 Id. at 12.
move more quickly to scale back the wartime tax regime, complaining that the 1921 Act did not go far enough in aiding business and investors.\footnote{Mellon to Hays, November 17, 1921, Record Group 56, General Records of the Department of Treasury, Correspondence of the Office of the Secretary of the Treasury, Central Files of the Office of the Secretary of the Treasury, 1917-32, Box 187, Folder “Tax – Exchanges of Property, 1921-1932,” National Archives and Record Administration, College Park, Md.} These critics viewed the repeal of the excess profits tax as a start, but the amendments to the income tax only served to lessen the negative impact of a tax that had outlived its usefulness with the passing of the exigencies of war.

The problem was that the business community itself could not agree on a suitable alternative to the excess profits tax. A national sales tax was the most promising proposal, but business split on whether to support it. Many business trade groups supported a sales tax, ranging from the Business Men’s National Tax Committee to the New York Board of Trade.\footnote{See K. M. Williamson, “The Literature on the Sales Tax,” \textit{Quarterly Journal of Economics} 35 (Aug. 1921), pp. 618-33; Randolph E. Paul, \textit{Taxation in the United States} (1954), p. 128; Roy G. Blakey & Gladys C. Blakey, \textit{The Federal Income Tax} (1940), p. 190.} Other organizations, though, such as the National Industrial Conference Board, the National Association of Credit Men, the National Association of Retail Grocers, and the Committee of Manufacturers and Merchants of Chicago all opposed the various sales tax proposals. Their concern was that the tax would effectively act as a gross receipts tax and if business could not easily shift the cost to consumers, it could be particularly damaging to businesses with higher costs and lower margins.\footnote{Mehrotra, \textit{Making the Modern American Fiscal State}, 379. 1921 Senate Hearings, supra note XX, at 360.}

The resulting compromise – the Mellon Plan – was both a rejection of a complete retreat from the pre-war era and a continuation of the more business friendly tax policies enacted in 1921. Under the Mellon Plan, a steep reduction of the top combined personal income tax rates from 77 percent at the end of the war to 25 percent by 1927 was coupled with a modest increase in the corporate rate from 10 percent to 13.5 percent over the same period. This was more pro-business than it might at first appear. The corporate rate increases were viewed as a substitute for the revenues from the excess profits tax in 1921 and the capital stock tax in 1924,\footnote{Blakey & Blakey, \textit{Federal Income Tax}, at 221, 241.} both of which most businesses viewed to be more odious than the corporate income tax.

Moreover, the drop in the top individual rates was considered necessary to spur business investment. In his 1924 book written to garner popular support for the plan, Mellon wrote,
The high rates inevitably put pressure upon the taxpayer to withdraw his capital from productive business and invest it in tax-exempt securities or to find other lawful methods of avoiding the realization of taxable income. The result is that the sources of taxation are drying up; wealth is failing to carry its share of the tax burden; and capital is being diverted into channels which yield neither revenue to the Government nor profit to the people.65

Mellon particularly highlighted the example of the railroad industry, noting that “[i]t is estimated that the railroads will require a billion dollars a year of new capital in order satisfactorily to provide the facilities and equipment requisite to handle the traffic presented and to reduce the cost of transportation.” The existing tax rules, Mellon contended, were impeding the proper flow of capital. “If the railroads are to be furnished with capital, much of it must come from the sale of stock and to permit any sale surtaxes must be reduced as to attract the large investor to that type of security.”66

Throughout the 1920s, Progressives and their allies continued to beat the drum for using tax as a tool for corporate regulation, but any victories were small and short-lived. For example, they repeatedly attempted to revive the publicity requirement originally enacted in 1909 for corporate tax returns, but now they sought to apply it to all returns. After a public inspection requirement was defeated in 1921, Congress finally adopted a provision in 1924 requiring public inspection of both the names of corporate and individual taxpayers and the amount of taxes they paid. During deliberations over this requirement, then-Secretary of Commerce Herbert Hoover had warned that publicity would particularly harm businesses, arguing that the publicity of returns during Reconstruction was partly responsible for the economic difficulties of the time.67 By 1926, the anti-publicity movement got the upper hand and the amount of tax paid was no longer made public.68

Similarly, as part of the deliberations over the Revenue Act of 1928, Congress considered a graduated corporate income tax that would for the first time tax the “bigness” that Louis Brandeis had decried more than a decade earlier.69 Business immediately assailed the proposal. The Wall Street Journal called it “a direct challenge to the ‘Big Business’ savoring of the old

66 Id. at 104, 105-06.
67 Blakey & Blakey, Federal Income Tax, at 245, n. 95. (NYT May 17, 1924)
trust busting days,” complaining that it would “penalize the stockholders of the large corporations, such as the railroads” and that it was “essentially an excess profits tax” without the use of the more equitable invested capital standard. Although the House approved the proposal, it was later rejected in the Senate in favor of a one percentage point reduction of the single corporate rate and an increase in the exemption from $2,000 to $3,000 for corporations with incomes of $25,000 or less. For at least a little while longer, business concerns still trumped in the tax arena.

IV. The 1930s and the New Deal on Corporate Taxation

The stock market crash of 1929 and the onset of the Great Depression forced a re-examination of many governmental policies, most notably in the corporate arena. This time, however, the prescription for the economic situation was decidedly less business friendly than it had been a decade earlier. Whereas corporations were seen as part of the solution in 1921, and therefore to be protected from or encouraged by taxation, after the Crash corporations were seen as part of the problem and tax reform was viewed as part of the solution.

One of the most significant changes in the intervening decade was the continued rise of large corporations and the dominance of large corporate groups and their owners in the economy. As policymakers began to investigate the causes of the economic downturn, the growth of big business was identified as a contributing factor. Supreme Court Justice Louis Brandeis effectively captured the prevailing sentiment in this new era, writing that “coincident with the growth of these giant corporations, there has occurred a marked concentration of individual wealth, and . . . the resulting disparity in incomes is a major cause of the existing depression. Such is the Frankenstein monster which states have created by their corporation laws.” In addition to the race to the bottom in state corporate laws that Brandeis referenced, there was a growing concern that the pro-business tax policies of the 1920s had contributed to the dangerous concentration of corporate power.

70 “Senate to Decide Fate of Tax Bill,” Wall St. J., Dec. 21, 1927, at 18.
As Roosevelt took office, he and his allies in Congress sought not merely to reverse the pro-business tax policies of the 1920s, but to use the corporate tax as one of the tools to achieve his vision for the federal oversight of corporations. Indeed, the movement to use the corporate tax as a regulatory device was not just a political or reactionary movement driven by the economic events in 1929. Rather it was one of the main pillars of New Deal policy, fueled by academic research and the powerful personalities in Roosevelt’s so-called “Brain Trust” of close advisors.

This movement began on the campaign trail. In a May 1932 memorandum, Raymond Moley and other Brain Trusters outlined a national program for recovery.73 One of the key prongs was to address the problem of corporate “hoarding,” or retaining earnings to pay for expansion or to hold as a private “war chest” rather than distributing them as dividends. Adolf Berle, a Columbia law professor who was responsible for this section of the memo, wrote that “this attempt of corporations to provide for a rainy day was really the thing which itself brought on the rainy day. The expansion doubly upset the balance of production and consumption.”74 Berle had just completed his work with economist Gardiner Means on their seminal book, *The Modern Corporation in Private Property*, before being recruited to help develop Roosevelt’s economic platform.75 Based on the insights gleaned from that research and fellow Columbia professor Rex Tugwell’s research on the misallocation of capital resources in the corporate economy,76 Berle advised that “we should carefully consider a modification of taxes on corporate income, aimed at discouraging undue accumulation of corporate reserves, and stimulating distribution of such reserves to the millions of small investors who are their rightful owners.”77

At the same time, Berle was advocating “a tax on undistributed surplus income of corporations” as a check against corporate managers who had “lost sight” of the small investors and acted like corporate profits were “private funds.”78 Soon thereafter in 1932, the United State

73 Memorandum of May 19, 1932 of Raymond Moley and others for Franklin Delano Roosevelt, outlining a National Program for Recovery, available in Box 282, Folder 3, of the Hoover Institution Archives, Stanford University (“Memorandum of May 19, 1932”).
74 Id. at 2.
77 Memorandum of May 19, 1932, 3.
78 Id. at 4.
Committee on Banking and Currency authorized an inquiry to investigate the causes of the stock market crash. The subsequent hearings, known as the Pecora hearings after Ferdinand Pecora, the aggressive lead counsel for the Committee, contained substantial revelations of corporate abuses, including rampant tax avoidance through largely legal maneuvers.

The Pecora Hearings only fanned the flames for those seeking to use corporate tax reform as a means of regulating corporations. In 1933, the House authorized a study of the internal revenue system to investigate some of the sensational revelations from Pecora’s investigation. The resulting House Subcommittee Report targeted a variety of corporate tax provisions. It specifically named the expansion of the tax-free reorganization provisions in 1921 and 1924 as one of the culprits for business failure, proposing to repeal nonrecognition treatment altogether for such transactions. “[T]he present provisions,” the Report observed, “have encouraged the injection into business structure of an unsavory stimulus, such as the organization of large holding companies and the overcapitalization of business.” The Report also recommended eliminating the ability of a group of affiliated corporations to file a consolidated return, which was characterized as an attempt “to strike at the holding company system.”

In the Revenue Act of 1934, both of the subcommittee recommendations were scaled back, but nevertheless they were adopted in a way that suggested a momentum shift in corporate taxation. Rather than proposing to repeal the reorganization provisions, which Treasury Secretary Henry Morgenthau pointed out would actually cost revenue because it would permit stockholders to claim their post-Crash losses, the eligibility for reorganization treatment was

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81 One outgrowth of the Pecora Hearings was the adoption of a proposal for publicizing tax returns by requiring disclosure of the pink slip containing basic summary information that each taxpayer had to submit with his return. Unlike in 1909, this publicity was required for both corporations and individuals and was focused more on the revelations of widespread tax avoidance among wealthy individuals than it was on corporate regulation. See Marjorie E. Kornhauser, “Shaping Public Opinion and the Law: How a “Common Man” Campaign Ended a Rich Man’s Law,” Law and Contemporary Problems 73 (2010): 123.
“restricted..., to conform more closely to the general requirements of corporation law.” The U.S. Chamber of Commerce tried to invoke 1920s-style arguments, warning that the new provision “will discourage mergers which, in the view of recent economic conditions should be made in the interests of good business policies,” but this argument failed to dislodge the proposal the way it might have a decade earlier. Some amendments were made, but contemporary commentators still complained that the provision as enacted “sharply modified” the tax-free reorganization.

The foundation for the proposal to repeal the consolidated return was laid even before Roosevelt assumed office and the subcommittee issued its report. It was based on the growing concern about holding companies, which first appeared at the turn-of-the-century as states relaxed their restrictions on corporations holding stock in other corporations, and in particular about the use of pyramidal structures that enabled investors at the top of the pyramid to leverage a relatively small investment in one corporation into control over a vast empire. The consolidated return appeared to “penalize[] David and assist Goliath.” The fear was that consolidated returns had enabled these corporate groups to drive out competition through predatory pricing while at the same time avoiding taxation on monopoly profits, all by using the losses from one subsidiary to offset the gains from another. As Missouri Democrat Charles Cannon explained,

An electric company or telephone branch or transportation company pays little attention to the cost of installing new services. A railroad company can run a bus line at a loss, a streetcar company can operate a line of taxicabs, or a power company can preempt a new community at a loss. Through the benevolent provisions of this law they charge these losses against their profits elsewhere and reduce their taxes while destroying competition and monopolizing the market.

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89 75 Cong. Rec. 7125 (1932) (statement of Representative Charles Cannon, D-Mo).
90 Id.
Congress rejected Cannon’s proposal to repeal the consolidated return in the Revenue Act of 1932, but it did subject corporate groups to a penalty tax that rose to as much as one percent for the privilege of filing a consolidated return. House Speaker John Nance Garner (D-TX) described how the penalty tax served as a compromise between those seeking to use taxation to battle corporate abuse and those worried that the tax reform would kill the golden goose: “[i]f it is advantageous to them to file such returns they will pay the penalty. If there is no advantage in consolidated and affiliated returns, they will submit separate returns.”

As a result of the Subcommittee Report in 1933, corporate tax reformers reintroduced the proposal to repeal the consolidated return. In the Revenue Act of 1934, they were ultimately successful in securing repeal, but not without railroads obtaining an exemption after Ben Dey, general counsel of the Southern Pacific railroad, testified that “it is impossible to put the railroads under this proposal without committing a terrific public crime. They simply cannot stand it.” Railroads still had to pay the penalty tax in existence prior to 1934, but the ability to continue filing consolidated returns robbed the repeal of much of its impact.

By 1935, the movement away from a pro-business approach was largely complete. In his tax message to Congress in June of 1935, Roosevelt openly embraced regulatory taxation. He justified measures such as a graduated corporate tax rate and an intercorporate dividends tax much in the way President Taft had justified a corporate tax in 1909 – as the price for the privileges afforded to it by the government – though the focus was more on the abuses of those privileges than on the price for them. Roosevelt proclaimed that “we should seek through taxation the simplification of our corporate structures through the elimination of unnecessary holding companies in all lines of business.”

These measures against “bigness,” which were both adopted in the Revenue Act of 1935, hardly imposed the kind of rates or penalties one would need to truly reshape the corporate landscape by force. Roosevelt’s original proposal for graduated corporate rates suggested

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92 75 Cong. Rec. 7127 (1932).
93 1934 House Hearings, supra note xx, at 486. The railroads argued that the 1920 Transportation Act limited their ability to consolidate their lines in a single corporation. Id. at 503-04 (statement of Jacob Aronson of the New York Central Lines).
replacing a flat rate of 13.75 percent with a scheme rising from 10.75 percent to 16.75 percent. 96 The final Act imposed a 12.5 percent rate on income below $2,000 up to a 15 percent rate on income above $40,000. 97 Neither was likely to make bigness unprofitable. Similarly, the intercorporate dividends tax was actually just a reduction of the 100 percent exemption for dividends received by a corporate shareholder to a 90 percent exemption, amounting to an effective tax of 1.5 percent on intercorporate dividends. 98

Even progressive sources were dubious about the measures. The New Republic claimed that “it will scarcely break up the big industrial units, nor will it restore enough competition to make any visible difference.” 99 This has led modern observers to deride the 1935 Act and indeed the entire New Deal corporate tax program as a “symbolic showpiece . . . full of sound and fury,” but signifying “almost nothing.” 100 Historian Paul Conkin observed that the provisions enacted in 1935 “neither soaked the rich, penalized bigness, nor significantly helped balance the budget.” 101

Such pronouncements ignore the extent to which the New Deal corporate tax program was largely about establishing the principle of differentiation between large and small corporations so that businesses could be taxed based upon size. 102 It was called “the camel’s head inside the tent.” 103 Indeed, the intensity of business reaction reflected this concern. Edward G. Seubert, the President of Standard Oil Company of Indiana, wrote in a letter to stockholders that “[t]he danger in present proposals is not so much in their immediate effect as in adoption of the principle of discriminating against a corporation merely because it is big and successful.” 104 A representative of the Armstrong Cork Company testified the reduction in the top rates in the House bill did not give much comfort: “Experience teaches that once the opening wedge is driven, the field covered by a new tax tends to expand steadily.” 105

96 Roosevelt, Message to Congress.
100 Leff, Limits of Symbolic Reform, 2.
102 Bank, Taxing Bigness, (noting that between 1932 and 1935, all corporations were subject to the same flat rate tax, which prevented raising corporate rates without harming small business).
105 1935 Senate Hearings at 120 (statement of H.W. Prentis, Armstrong Cork Co.).
Roosevelt’s corporate tax policy in his second term in office only served to confirm business fears about the expanding regulatory ambitions. In 1936, Roosevelt proposed perhaps the most disturbing of all corporate tax reforms from the perspective of business – an undistributed profits tax. Although his advisers had urged such a policy as a tool against corporate surplus as far back as the Berle memorandum in 1932, Roosevelt had resisted because of the fear that business opposition would derail his other New Deal policies. His electoral landslide in 1936, coupled with a budgetary crisis, prompted him to move forward. In a supplemental budget message delivered on March 3, Roosevelt proposed replacing the corporate tax and the exemption of dividends from the individual tax with a penalty tax on excessive retained earnings.

Although Roosevelt and his supporters expected that business would oppose the penalty tax, they may have underestimated the degree of opposition. Alfred Buehler reported that “[t]he business world . . . was aghast at the proposal and shuddered at the consequences if it was adopted.” The New York Times argued that the penalty tax would substitute “the blanket judgment of Congress and the Treasury Department, based on a general theory” for the “individual judgment of business managers, based on their direct knowledge of the needs of their particular company.” One of the biggest concerns was that it would drive a wedge between corporate managers and stockholders. The U.S. Chamber of Commerce predicted that the tax “would engender such uncertainties concerning the sound course to pursue as to subject management to grave difficulties with shareholders and creditors.”

When defeating the proposal became unlikely, business leaders pushed to neutralize its distributive force. They favored retaining the tax on dividends so that the penalty for a distribution would cancel out the penalty for retaining earnings. The goal was to realign managers and shareholders on the question of dividend policy, at the price of effectively introducing double taxation of corporate income. As enacted in the Revenue Act of 1936, the

111 Bank, From Sword to Shield, 164-83.
The top rate of 27 percent on undistributed profits was identical to the lowest surtax rate for incomes in excess of $44,000.\footnote{Revenue Act of 1936, §101, 49 Stat. 1014 (1936).}

The demise of the undistributed profits tax, and indeed the regulatory movement in corporate taxation generally, began in the summer of 1937. Much like in the early 1920s, when reformers cited the post-war recession as a justification for business friendly corporate tax policy, one of the swiftest economic slowdowns in history created a window of opportunity for business groups.\footnote{“Testimony before the Senate Special Committee to Investigate Unemployment Relief, January 4, 1938,” in Economic Balance and a Balanced Budget: Papers of Marriner S. Eccles (Rudolph L. Weissman ed., 1940): 89, 91; Leff, supra note xx, at 209.} Critics blamed the undistributed profits tax for a myriad of economic problems, ranging from rising unemployment and growing stock market volatility to strikes by capital and declining business confidence.\footnote{Bank, From Sword to Shield, 184-85.} In 1939, Congressional leaders and Treasury and Administration officials jointly negotiated a business tax aid program that (1) eliminated the undistributed profits tax, (2) liberalized the capital stock tax, (3) eliminated the limit on capital loss deductions for corporations, and (4) permitted corporations to carryforward losses for two or three years.\footnote{Bank, From Sword to Shield, 188-89; “Leaders to Push Business Tax Aid at Present Session,” Wall Street Journal, May 16, 1939, at 1.} By 1942, the ban on consolidated returns was also lifted.\footnote{Bank, “When We Taxed the Pyramids,” supra note xx.}

Toward the end of World War II, it was clear that the shift away from a regulatory approach to corporate taxation was complete. J. Keith Butters and John Lintner of the Harvard Business School had published a number of influential and well-publicized studies in the spring of 1944 documenting the extent to which the post-war recovery could be harmed by the corporate tax burden.\footnote{J. Keith Butters and John Lintner, Effect of Federal Taxes on Growing Enterprises, Study No. 1: The Lockheed Aircraft Corporation (1944); J. Keith Butters and John Lintner, Effect of Federal Taxes on Growing Enterprises, Study No. 2: Polaroid Corporation (1944).} This started a flurry of corporate tax reform proposals. During the summer, three high-profile corporate tax reform proposals designed to aid business in the transition to the post-war economy were released within weeks of each other.\footnote{Bank, From Sword to Shield, 191-201.} Many groups soon followed with their own plans, leading to almost sixty proposals being in circulation at one
point. Although budgetary concerns deferred radical reform, a “five point program” which was “designed to improve the cash position of business” was signed into law in 1945.120

[remainder to be written]

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