TAXING BIGNESS

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It is perhaps no coincidence that Louis Brandeis' famous diatribe on the "curse of bigness" was published only a few months after the first modern income tax was signed into law by President Woodrow Wilson in 1913.[1] Throughout its history, the income tax has been used as a weapon against "bigness." In the early years, the entire system of income taxation was focused entirely on the top of the pyramid, with generous exemptions removing most individuals and businesses from the oversight of the income tax altogether.[2] Since then, bigness has remained a focus of tax policy, particularly in corporate income taxation where a relatively small number of very large businesses account for a majority of the tax revenues.[3] In recent years, President Obama has touted small business tax cuts,[4] while complaining that large corporations have not been paying their fair share.[5] Although he has called for a reduction in the top corporate marginal rate

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1 Louis Brandeis, *A Curse of Bigness*, HARPER'S WEEKLY, Jan. 10, 1914, at 18; *Wilson Signs New tariff Law*, N.Y. TIMES, Oct. 4, 1913, at 1.

2 W. ELLIOT BROWNLEE, FEDERAL TAXATION IN AMERICA: A SHORT HISTORY 56-57 (New Ed. 2004); JOHN F. WITTE, THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX 78 (1985) (because of a $3000 exemption for individuals and a $4000 exemption for married couples, "less than 2 percent of the labor force filed returns in the years 1913-1915."); ROBERT STANLEY, DIMENSIONS OF LAW IN THE SERVICE OF ORDER: ORIGINS OF THE FEDERAL INCOME TAX, 1861-1913 227 (1993) ("contemporary estimates indicated that fewer than 4 percent of American families received as much as $3000 in income in 1910.").

3 In 2008, 2,582 corporations with assets of $2.5 billion or more, accounting for approximately 0.04 percent of all corporations and 0.15 percent of all C corporations, earned 68 percent of revenues from all corporations (including S corporations). INTERNAL REVENUE SERVICE, STATISTICS OF INCOME 2008, CORPORATION INCOME TAX RETURNS 2 (2011) (Figure A).

4 Barack Obama, *If We Act Now, The American Jobs Act*, VITAL SPEECHES OF THE DAY, Oct. 2011, at 334, 335 (delivered to a joint session of Congress, Sept. 8, 2011).

5 Id.; Paul Tharp, *Business Howls Over Obama Tax Bites*, NEW YORK POST, Feb. 2, 2010, at 25; Robert J. Samuelson, *Tax Dodge Myths*, WASH. POST, May 11, 2009, at A17.

that would benefit a wide range of corporations,[6] he has also pushed for a variety of reforms in the international tax arena and in the taxation of specific industries like energy and finance that have targeted large, multi-national businesses.[7] In his 2012 Framework for Business Tax Reform, Obama has continued his focus on size as a basis for taxation, proposing tax cuts for small business and "establishing greater parity between large corporations and large non-corporate counterparts," which could include subjecting such large partnerships and other formerly pass-through entities to entity-level corporate taxation.[8] A similar proposal was made by the President's Advisory Panel on Federal Tax Reform in 2005.[9]

The most obvious example of the tax system's focus on bigness is the corporate income tax rate scheme. Since 1935, corporations have been taxed under a graduated marginal rate structure. Much like the scheme applicable to individuals, corporations are subject to different rates depending upon the amount of their net income. The difference, however, is that corporations are not tax-bearing individuals and there is no attempt to calibrate the tax burden to the circumstances of the individuals (whether shareholders or employees) who actually do bear the tax burden of the corporate income tax. Moreover, unlike the individual income tax rates, which rise gradually with a rise in net income, the corporate rates rise unevenly and several phaseouts have led to the creation of "bubble" marginal rates that can cause lower-earning corporations to pay higher taxes than higher-

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[6] Barack Obama, State of the Union, Jan. 25, 2011.
[7] Reuters, *Factbox: Obama Seeks Higher Taxes on Big Business*, REUTERS.COM, Feb. 13, 2012.
[8] The White House and The Department of Treasury, The President's Framework for Business Tax Reform 10 (Feb. 2012); Martin A. Sullivan, *Why Not Tax Large Passthroughs as Corporations?* 131 TAX NOTES 1015 (2011).
[9] The President's Advisory Panel on Federal Tax Reform, Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System 129 (2005).

earning corporations. The result is that corporations are neither strictly taxed according to their ability to pay nor is there much of a redistribution effect as a result of the tax.

The confusing and contradictory nature of the graduated corporate income tax scheme has come under increasing criticism in recent years both inside and outside the beltway. In 2009, George Yin, the former chief of staff of the Joint Committee on Taxation called for the "elimination of all of the graduated corporate tax brackets" as part of his recommendations to Obama's Task Force on Tax Reform.[10] Although the Task Force never took up this issue, Senators Ron Wyden, a Democrat from Oregon, and Dan Coats, a Republican from Indiana, jointly introduced a bipartisan reform proposal in 2011 that included replacing the graduated corporate income tax with a flat rate of 24 percent.[11] Commentators such as Jeffrey Kwall and Martin Sullivan have also supported a move to flat corporate rates, with Kwall calling the graduated corporate rate structure "indefensible as a policy matter,"[12] and Sullivan declaring that "[g]raduated corporate tax rates have no economic justification except as a poorly targeted benefit for small businesses."[13] As Joseph Thorndike observed, "there aren't many people willing to defend [graduated corporate tax rates] these days," noting that "you would have to search

[10] George K. Yin, *Corporate Tax Reform, Finally, After 100 Years*, in TOWARD TAX REFORM: RECOMMENDATIONS FOR PRESIDENT OBAMA'S TASK FORCE 114, 117 (2009).
[11] Bipartisan Tax Reform and Simplification Act of 2011, S 727, 112th Cong., 1st Sess. (2011).
[12] Jeffrey L. Kwall, *The Repeal of Graduated Corporate Tax Rates*, TAX NOTES 1395, 1396 (June 27, 2011).
[13] Martin A. Sullivan, *What the Debt Limit Debacle Teaches Us About Tax Reform*, TAX NOTES 215, 217 (July 18, 2011). *See* Martin A. Sullivan, *Will Rate Changes Transform C Corps into Tax Shelters?*, 134 TAX NOTES 1590, 1593 (2012) ("when considering the subject of discouraging C corporations from being used as tax shelters, it is important to keep in mind the complexity induced by the graduated rate structure and the simplification that would result from eliminating graduated corporate tax rates A flat corporate rate structure would put a stop to many small businesses choosing subchapter C status under current law.").

long and hard for an affirmative defense of the idea."[14] This, however, begs the question Thorndike himself asks: "How did we ever end up with graduated corporate rates?"[15]

The graduated corporate rate structure was publicly promoted as a tax on "bigness" when President Franklin D. Roosevelt first introduced it in 1935.[16] In proposing the graduated rates, Roosevelt explained "[t]he advantages and the protections conferred upon corporations by Government increase in value as the size of the corporation increases . . . it seems only equitable, therefore, to adjust our tax system in accordance with economic capacity, advantage and fact. The smaller corporations should not carry burdens beyond their powers; the vast concentrations of capital should be ready to carry burdens commensurate with their powers and their advantages."[17] Given the relatively modest graduation in the original rates, however, this move is often portrayed as largely a political ploy rather than a serious tax measure. This is part of a larger historical discussion about New Deal tax policy. Mark Leff has called Roosevelt's tax program a "symbolic showpiece."[18] According to Leff, it was "full of sound and fury . . . but it signified almost nothing."[19] Paul Conkin noted that the 1935 tax bill in which the graduated rates were imposed "neither soaked the rich, penalized bigness, nor significantly helped balance the budget."[20] Even at the time its opponents called it a "legislative absurdity" enacted on the "whim" of the President.[21] The conventional wisdom is that the graduated corporate income tax structure was designed to appeal to

[14] Joseph J. Thorndike, *Graduated Corporate Rates: Bad Idea in 1935, Bad Idea Today*, 132 TAX NOTES 1087 (Sept. 12, 2011).
[15] Id.
[16] *At the Tax office, Bear Left*, WALL ST. J., Jun. 21, 1935, at 4.
[17] Franklin D. Roosevelt, Message to Congress on Tax Revision, June 19, 1935, available at http://www.presidency.ucsb.edu/ws/index.php?pid=15088#ixzz1XOF2gdTi (last visited Nov. 14, 2011).
[18] MARK LEFF, THE LIMITS OF SYMBOLIC REFORM: THE NEW DEAL AND TAXATION, 1933-1939 2 (1984).
[19] Id. at 2.
[20] PAUL K. CONKIN, THE NEW DEAL 63 (2d ed. 1975).
[21] RANDOLPH E. PAUL, TAXATION FOR PROSPERITY 45 (1947).

populist voters as part of the "rhetoric and psychological warfare" of New Deal-era politics,[22] but was not designed to actually change the economics of operating businesses through large corporations. To the extent observers attach any substantive policy motive to the origins of the rate scheme, they have characterized it as "an aid to small business."[23]

This Article reviews the origins of the graduated corporate income tax and concludes that it was not intended as either mere populist symbolism or as primarily a small business subsidy. It was intended to permit government to tax large corporations differently. The marginal rate structure adopted in 1935 was admittedly not steep enough to disrupt the economic dominance of big business. Nevertheless, it did allow differentiation among large and small corporations to occur, which was a reversal of prior policy. Although a nominal flat rate had been in existence from the outset of the income tax, it was really a de facto two rate corporate tax because of the existence of a zero rate exemption. In the last revenue act of the Hoover Administration, however, even the exemption was repealed. This meant that between 1932 and 1935 all corporations, regardless of size, were subject to the same flat rate tax during a period in which a relatively large percentage of business was operated in the corporate form.[24] In order to lay the foundation for taxing bigness, Roosevelt had to create a scheme to differentiate among corporations according to the size of their income. This explains why he was more concerned about establishing the principle than the actual rates in his original proposal and why he was willing to accept an even smaller amount of graduation in the rates contained in the final legislation passed by Congress. This focus on being able to

[22] Conkin, supra note xx, at 63.
[23] Kwall, supra note xx, at 1397.
[24] See Figure 1, infra.

target large corporations, rather than providing a subsidy to small corporations, also explains why a graduated rate scheme was more important to Roosevelt than merely restoring the pre-1932 exemption for small corporations.

This ability to differentiate among different-sized corporations, while potentially valuable in an era in which a significant amount of business was done by corporations, has long since out-lived its purpose. From the development of Subchapter S for certain types of less complex corporations in 1958, to the advent of limited liability companies in 1977 and their spread to all states along with the check-the-box regulations in the 1990s, businesses during the second half of the twentieth century have had a variety of means of opting out of the corporate income tax applicable to Subchapter C corporations. Furthermore, Congress has adopted a number of deductions and other special provisions targeted at smaller income businesses of any type. As a result, even if differentiation is justifiable, it no longer needs to occur through the corporate income tax rate structure itself. Removing the graduated marginal rate structure would simplify the tax and potentially would allow for lower rates with the same or even higher revenues due to the broader base.

The Article begins by describing the current graduated marginal rate structure and the features that have engendered the most criticism. In Section II, the Article explores the Revenue Act of 1932, when corporate income became subject to a flat rate of tax on the first dollar, and discusses how it set the stage for the Revenue Act of 1935, which is discussed in Section III. Under the 1935 Act, the decision to impose graduated corporate rates was effectively a decision to reverse the equal treatment sentiment that motivated the Hoover administration and to more explicitly differentiate among corporations based on size. Although this change had little immediate effect, it was hotly contested precisely because of the potential for further differentiation. Section IV examines the change in the business landscape between 1935 and the present, noting that the growth in the availability of non-corporate options that are particularly suitable for smaller businesses has made the original rationale for the graduated rate scheme less relevant. Finally, the Article concludes by examining the potential effects of a single rate corporate tax scheme.

I. The Modern Graduated Corporate Tax Rate System

The modern corporate income tax subjects corporations to a graduated marginal rate system. Under Section 11 of the Internal Revenue Code, as seen in Table 1, corporations are nominally taxed at a 15 percent rate on the first $50,000 of income, a 25 percent rate on income between $50,000 and $75,000, a 34 percent rate on income between $75,000 and $10 million, and a 35 percent rate on income in excess of $10 million.[25]

Table 1 – Statutory Rates

Up to $50,000	15%
Over $50,000, but not over $75,000	25%
Over $75,000, but not over $10 million	34%
Over $10 million	35%

[25] I.R.C. § 11(b)(1).

In addition to these nominal statutory rates, however, there are two surtax rates. At net incomes exceeding $100,000, corporations are required to pay the lesser of an additional 5 percent on the excess and $11,750. Similarly, at net incomes exceeding $15 million, corporations are required to pay the lesser of 3 percent on the excess or $100,000.[26]

This scheme has a number of flaws if it is designed to serve as a progressive levy on corporate income, even if we allow for the notion of progressivity determined at the entity-level alone. First, the stated, or nominal, rate before the application of the surtax rates rises very sharply at quite low income levels and then levels off almost completely at the higher end. The one percentage point differential between the top rate of 35 percent and the second rate of 34 percent seems merely symbolic. This suggests it is more properly characterized as a graduated rate tax at the lower brackets, but a flat tax for most large corporations.[27]

Second, the surtax rates disrupt the progression of graduation. The surtax of 5 percent or $11,750 is designed to ensure that the reduced rates on lower incomes phase out for wealthier companies. It does so by phasing in a tax in lieu of the lower taxed income at the first two brackets. A flat 34 percent rate on the first $75,000 of income would be $25,500, while the current 15 percent tax on the first $50,000 and a 25 percent rate on the next $25,000 results in a combined tax of $13,750, which is a difference of $11,750. Thus, the 5 percent surtax and the ceiling is equal to the difference between a 34 percent flat rate and the current graduated rate, effectively recapturing the income tax lost from the presence of the lower 15 and 25 percent rates from all but the very smallest of companies. Similarly, the 3 percent surtax up to a maximum of $100,000 on incomes

[26] I.R.C. § 11(b)(1). One exception to this graduated rate scheme is for personal service corporations, which are taxed at a flat 35 percent rate on all of its income. I.R.C. § 11(b)(2).
[27] Martin A. Sullivan, CORPORATE TAX REFORM: TAXING PROFITS IN THE 21ST CENTURY 68 (2011).

in excess of $15 million operates to phase-in a tax in lieu of the application of the 35 percent rate to the first $10 million of income ($3.5 million) as opposed to a 34 percent flat rate on that income ($3.4 million).

Not only do the surtax rates negate the progressive nature of the corporate income tax, but they turn it upside down. That is because each of the surtax rates effectively operates as a "bubble rate" for corporations on incomes earned in that marginal bracket. As shown in Table 2, the 5 percent surtax combined with the ceiling on the amount paid creates a de facto 39 percent marginal rate on corporations earning an income of between $100,000 and $335,000, dropping back down to a 34 percent rate on income over $335,000. Similarly, the 3 percent surtax on corporations with incomes over $15 million, up to a maximum of $100,000, effectively creates a 38 percent tax at this bracket, which drops back to a 35% rate on income earned over $18,333,333. So, as seen in Table 2, There are two bubble rates that makes the scheme regressive at those brackets.

Table 2 – Statutory Rates with Surtaxes

Up to $50,000	15%
Over $50,000, but not over $75,000	25%
Over $75,000, but not over $100,000	34%
Over $100,000, but not over $335,000	39%
Over $335,000, but not over $10 million	34%
Over $10 million, but not over $15 million	35%
Over $15 million, but not over $18,333,333	38%
Over $18,333,333	35%

Moreover, even if the graduated corporate rate structure nominally introduces a measure of progressivity into the system, many of the companies benefitting the most from the system are large rather than small or medium-sized. According to the Congressional Budget Office, this is because "large corporations can reduce their taxable income for certain years by sheltering some of it or by controlling when they earn income and incur expenses."[28] The result is that corporations that may be large as measured by asset size may not necessarily be as large measured by income.

Finally, the fact that small and medium-sized corporations can be owned by high income individuals and large corporations can be owned by lower-income individuals further undercuts the ultimate progressivity of the graduated rate scheme.[29] Economist Martin Sullivan has called the lower rates "a simple and clear giveaway to one privileged class of businesses."[30] "They may do little or nothing to promote progressivity," Sullivan continued, "as many rich people own small corporations and many lower-income families own stock in Fortune 500 companies."[31]

The convoluted and confusing nature of the current rate scheme begs the question of why graduated corporate rates exist in the first place. If there is a kernel of value lying beneath the illogic of the current rate structure, then the rates could be reformed without repealing the system altogether. Thus, it makes sense to examine the origins of graduated corporate income tax rates. Although Congress did not adopt an explicitly graduated corporate tax rate structure until 1935, the move toward this system has its roots in a

[28] CONGRESSIONAL BUDGET OFFICE, REDUCING THE DEFICIT: SPENDING AND REVENUE OPTIONS 175 (2011).
[29] Kwall, supra note xx, at 1396; Sullivan, Corporate Tax Reform, supra note XX, at 68 .
[30] Sullivan, Corporate Tax Reform, supra note xx, at 68.
[31] Id.

decision in 1932 during the waning days of the administration of President Herbert Hoover.

II. Hoover and the Pre-New Deal Origins of the Graduated Rate Scheme

At the origins of the income tax in 1913, corporations were subject to a separate rate structure and it was a "true" flat tax.[32] This rate structure was actually separate in substance rather than form because the corporate tax was defined to be merely an application of the individual normal tax:

> the normal tax hereinbefore imposed upon individuals likewise shall be levied, assessed, and paid annually upon the entire net income arising or accruing from all sources during the preceding calendar year to every corporation, joint-stock company or association . . .[33]

Nevertheless, the significance of the statute was that the corporate rate of 1 percent was by definition identical to the individual normal rate of 1 percent, except in one respect: corporations were not eligible for the $3,000 exemption applicable to unmarried individuals ($4,000 for married couples) under the individual income tax.[34] The explanation for this omission appeared to be largely grounded on a view that trying to determine whether individual investors would be eligible for the exemption on their allocable share of corporate income would be too difficult administratively,[35] although some suggested that it was the price investors paid for receiving the benefit of investing through a corporation.[36] Corporate income distributed to individual shareholders was still potentially subject to the graduated marginal rate surtax up to a maximum of 6 percent,

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[32] *See* Steven A. Bank, *Origins of a Flat Tax*, 73 DENV. U. L. REV. 329, 335-36 (1996) (discussing terminology).
[33] Tariff Act of 1913, ch. 16, § II(G)(a), 38 Stat. 114, 172.
[34] Id. at § II (C), 38 Stat. at 168.
[35] 50 CONG. REC. 3848 (1913) (colloquy between Sen. John Sharp Williams-D and Sen. Albert Cummins-R).
[36] Id. at 509 (statement of Rep. Cordell Hull).

but only if the distribution qualified as a dividend and if the shareholder's overall income made them liable for the surtax rates.[37] Thus, given the absence of an exemption or graduated marginal rates at the entity level, the corporate income tax rate was truly flat.

The existence of the flat corporate income tax was short-lived. In the Revenue Act of 1918, adopted at the conclusion of World War I, Congress exempted the first $2,000 of a corporation's income from tax.[38] This matched the exemption available to married couples under the individual income tax.[39] The decision to permit corporations to exempt a certain amount of income appears to be part of a larger move in the Act "to prevent undue hardship" in view of the doubling of the rates from 6 percent in 1917 to 12 percent in 1918.[40] The result was that, although corporations were not subject to the same graduated marginal rates as individuals, they were taxed under two rates – a zero rate on income up to $2,000 and a 12 percent rate on income above that amount. This $2,000 exemption for corporate income remained in place for the next decade. Notwithstanding the exemption, this two rate system was still generally considered a de facto flat tax because there was only one rate beyond the exemption.

Congress did not consider adopting a true graduated corporate income tax rate structure until 1927, when it did so as part of a general push to reduce the corporate tax burden and reduce the post-war tax surpluses that had accumulated.[41] The corporate income tax rate had risen in 1921 when the excess profits tax was repealed.[42] In light of the surpluses, there was pressure to return to the pre-1921 rate. Thus, Representative

[37] Id. at § II(A)(2).
[38] Revenue Act of 1918, ch. 18, §§ 230(a), 236(c), 40 Stat. 1058, XX (1919).
[39] Id. at § 216(c).
[40] Roy G. Blakey & Gladys C. Blakey, *The Revenue Act of 1918*, 9 AM. ECON. REV. 214, 223 (1919).
[41] Roy G. Blakey, *The Revenue Act of 1928*, 18 AM. ECON. REV. 429, 430-31 (1928).
[42] Id. at 433.

John Nance Garner of Texas, the top Democrat on the House Ways and Means Committee, proposed reducing the general corporate income tax rate from its then-current level of 13.5 percent, but he proposed to do so as part of a graduated rate system that many members of his party favored.[43] Under Garner's plan, income of less than $7,000 would be taxed at a 5 percent rate, income between $7,000 and $12,000 would be taxed at a 7 percent rate, income between $12,000 and $15,000 would be taxed at a 9 percent rate, and income beyond that would be subject to an 11.5% rate.[44]

Garner's graduated corporate income tax proposal met immediate opposition. The *Wall Street Journal* called it "a direct challenge to the 'Big Business' savoring of the old 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.[45] Republicans favored other means of reducing the burden on smaller corporations, including a proposal by Treasury Secretary Andrew Mellon to allow small corporations to file as partnerships.[46] Although the House approved the Garner plan, it was later rejected in the Senate under the Revenue Act of 1928 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

[43] Barbara Deckard Sinclair, *Party Realignment and the Transformation of the Political Agenda: The House of Representatives, 1925-1938*, 71 AM. POL. REV. 940, 943 (1977).
[44] *Senate to Decide Fate of Tax Bill*, WALL ST. J., Dec. 21, 1927, at 18. Garner had originally proposed a 10 percent rate, which would have matched the recommendation of Professor T.S. Adams on behalf of the U.S. Chamber of Commerce, but this was too great a reduction of revenue and it did not survive the Ways and Means review. Blakey, *The Revenue Act of 1928, supra* note xx, at 433-34.
[45] Id.
[46] *House Cuts Taxes $24,000,000 More*, N.Y. TIMES, Dec. 13, 1927, at 1; Blakey, *The Revenue Act of 1928*, supra note xx, at 431-32.

with incomes of $25,000 or less.[47] Thus, the two-rate system for taxing corporate income remained.

In 1932, President Herbert Hoover revisited the corporate income tax rate structure. The surplus that had motivated corporate tax reduction in 1928 had turned into an enormous deficit as a result of the stock market crash and ensuring depression.[48] According to Treasury Secretary Andrew Mellon's 1931 Annual Report, the country's deficit was estimated to be more than $2.3 billion in 1932 and $1.4 billion in 1933, with the aggregate increase in the public debt over the three year period from 1931-1933 being approximately $3.25 billion.[49] Mellon concluded that "[s]uch a financial situation calls for immediate remedy, notwithstanding the fact that the rapid retirement of our public debt throughout a decade of plenty may be considered to have created something in the nature of a reserve upon which we are justified in drawing during lean years."[50] Not surprisingly, at least as part of the remedy for the situation, Mellon called for "a very substantial increase in the revenues through taxation."[51] As the *New York Times* reported in September of 1931, "[f]or the first time since the war the American public faces the possibility of higher taxes."[52]

Hoover's tax plan, the precise details of which were first outlined in Mellon's Annual Report, was more about of expanding the base than raising the rates on existing

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[47] *See Senate Tax Cut Near $300,000,000*, N.Y. TIMES, May 23, 1928, at 6; Blakey, *The Revenue Act of 1928*, *supra* note xx, at 435.
[48] Charles Merz, *Our Rising Deficit: A Problem for Congress*, N.Y. TIMES, Sept. 20, 1931, at XX1.
[49] ANNUAL REPORT OF THE SECRETARY OF THE TREASURY ON THE STATE OF THE FINANCES FOR THE FISCAL YEAR ENDED ON JUNE 30, 1931 27 (1932).
[50] Id.
[51] Id.
[52] Charles Merz, *Our Rising Deficit: A Problem for Congress*, N.Y. TIMES, Sept. 20, 1931, at XX1.

taxpayers and goods.[53] As Mellon later explained in his statement on national finances delivered to the House Ways and Means Committee, "the weakness in our revenue system is . . . the narrowness of the base on which it rests . . . the needed to our revenue cannot be obtained without the broadening of that base. We cannot simply increase the taxes of the present group of taxpayers."[54] Under the individual income tax aspects of the plan, the normal and surtax rates would increase and the individual exemption would drop from $3,500 for a married couple to its 1924 level of $2,500.[55] This would be paired with the adoption of a variety of regressive miscellaneous taxes, including increased sales taxes, stamp taxes, and postage rates, as well as a very controversial manufacturer's excise tax.[56] Mellon took pains to point out that the increased burden would mostly be felt by the wealthy, noting that three-fifths of the added taxes would come from taxpayers with incomes of $100,000 or more and four-fifths would come from taxpayers with incomes of $10,000 or more.[57] Nevertheless, this still was premised on taxing more people, with the number of individuals obligated to pay taxes expected to increase by approximately 1.7 million under the plan.[58] In large part, this expansion consisted of taxing people who had previously been subject to tax under the 1924 Act before the exemption was raised.[59] The *Los Angeles Times* approvingly noted that "[t]his

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[53] WALTER LAMBERT, NEW DEAL REVENUE ACTS: THE POLITICS OF TAXATION 20-21 (Ph.D. diss., University of Texas, 1970).
[54] *Text of Mellon's Statement on National Finances to the Ways and Means Committee*, N.Y. TIMES, Jan. 14, 1932, at 10.
[55] Arthur Sears Henning, *Fight Looms on Hoover Plan to Increase Taxes*, CHI. TRIB., Dec. 10, 1931, at 1.
[56] Id.; RANDOLPH E. PAUL, TAXATION FOR PROSPERITY 36-37 (1947).
[57] Annual Report of the Secretary for 1931, supra note xx, at 29.
[58] Id.
[59] Arthur Sears Henning, *Fight Looms on Hoover Plan to Increase Taxes*, CHI. TRIB., Dec. 10, 1931, at 1.

spread of the burden of government over a greater number of citizens is in line with sound economics."[60]

As part of this proposal for what the *New York Times* described as "drastic taxation,"[61] Mellon recommended eliminating the existing $3,000 exemption for domestic corporations with net incomes below $25,000.[62] According to the Secretary's Annual Report, it was estimated that this change would raise about $27 million in additional corporate income tax receipts during the latter half of fiscal year 1932 and $60 million in additional receipts over 1933.[63] Although not trivial, observers recognized that, even when combined with a rise in the corporate tax rate of a half percentage point, this was hardly much of a revenue raiser as compared with the miscellaneous taxes.[64] The rise in sales taxes and stamp taxes was expected to bring in $514 million in 1933 alone, while the increase in the postage rate was scheduled to bring in $150 million. The predicted rise in individual income tax revenues of $185 million was more than triple the increased amount expected from the corporate tax changes.[65] Columbia economist and former Treasury Advisor E.R.A. Seligman called the corporate tax proposal "so insignificant as scarcely to evoke much discussion."[66]

The repeal of the corporate exemption was overshadowed even in the business arena by much more controversial corporate proposals to eliminate the provision for filing consolidated returns and to remove the exemption from the normal tax for

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[60] *The National Budget*, L.A. TIMES, Dec. 10, 1931, at A4.
[61] *To Meet the Deficit*, N.Y. TIMES, Dec. 10, 1931, at 22.
[62] ANNUAL REPORT OF THE SECRETARY OF THE TREASURY ON THE STATE OF THE FINANCES FOR THE FISCAL YEAR ENDED ON JUNE 30, 1931 30 (1932).
[63] Id.
[64] LAMBERT, *supra* note xx, at 102-03.
[65] Lawrence Sullivan, *President Wants Drastic Reduction in Federal Operations Cost*, N.Y. TIMES, Dec. 10, 1931, at 1.
[66] E.R.A. Seligman, *Seligman Critical of Large Tax Rise,* N.Y. TIMES, Dec. 10, 1931, at 18.

dividends,[67] but there was still opposition. Some objected to the burden the repeal imposed on the smaller corporations. New Jersey Representative Isaac Bacharach, a Republican member of the House Ways and Means Committee, complained that "[e]ven the 1924 act allowed a deduction of $2,000 to such corporations. When we consider that out of 498,110 corporations which filed income tax returns for the taxable year 1930, only 242,412, or 43 per cent showed a profit, it seems obvious that we ought to encourage the little corporation by allowing it to make at least $2,000 before it is taxed."[68] Others went in the opposite direction, proposing a more explicit graduated corporate income tax rate structure so as to reach the truly wealthy corporations. The American Farm Bureau Federation, for example, recommended in its testimony before the Senate Finance Committee that it adopt rates ranging from 10 percent on corporate incomes below $2,000 to 16 percent on incomes of $1 million and above.[69]

Notwithstanding this opposition, there were advantages to including the repeal of the corporate exemption as part of the tax proposal. As a general matter, corporate taxes were popular. As President Hoover later recalled, a tax increase on corporate income was convenient precisely because the American public had trouble grasping the concept of incidence:

> Taxes on the profits of corporations are a favorite with the public, who have little understanding that the larger corporations in the end always pass their taxes on in the price of goods and services, or that they undertake unjustified risks because when they lose then they deduct the losses from their profits.[70]

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[67] Roy G. Blakey and Gladys C. Blakey, *The Revenue Act of 1932*, 22 AM. ECON. REV. 620, 625 (1932) (noting that the consolidated return and dividend tax issues were some of "the hardest fought contests" in Congress).

[68] *Forecasts Action on Tax-Loss Sales*, N.Y. TIMES, Dec. 14, 1931, at 5 (quoting Rep. Bacharach).

[69] *Statement of the American Farm Bureau Federation*, submitted to the Senate Finance Committee, in Revenue Act of 1932, Hearings before the Committee on Finance, U.S. Senate on H.R. 10236 at 123 (April 6, 1932).

[70] THE MEMOIRS OF HERBERT HOOVER: THE GREAT DEPRESSION 1929-1941 137 n. 1 (1952).

More specifically, the repeal of the corporate exemption served as a counterbalance to those who might claim that the significant reduction in the individual exemptions amounted to a targeted tax on the average person instead of the truly wealthy. The Administration had gone to great lengths to dispute this perception,[71] but it was not clear that their rebuttal was getting much traction.

Initially, the Ways and Means Committee struck a compromise. In early reports, it maintained a $2,000 exemption for companies with income of $10,000 or below and only eliminated the exemption when a corporation's income rose above $10,000.[72] Later, it replaced that proposal with a $1,000 exemption.[73] In the Senate Finance Committee, though, new Treasury Secretary Ogden Mills successfully pushed once again to eliminate the corporate tax exemption completely, in part to find a revenue neutral means of lowering the high surtax rates in the House Bill.[74]

As enacted, the Revenue Act of 1932 therefore created a truly flat tax for corporations. Corporations with incomes of $25,000 or less, which had previously been exempt from their first $3,000 of income, were taxed from first dollar. All business operating in the corporate form – regardless of the size of their income – were taxed at the same rate of 13.75 percent. As it happens, Congress adopted this reform, which has been characterized as dealing "a severe blow to many small firms," at a critical juncture in America's thinking about corporations and their taxation.[75]

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[71] *Tax Plan Held Easy on Small Incomes*, N.Y. TIMES, Dec. 25, 1931 at 18.
[72] 75 CONG. REC. 5691 (March 10, 1932) (statement of Representative Crisp).
[73] *Revised Tax Proposals of House Committee Which Seeks to Balance the National Budget*, N.Y. TIMES, Mar. 30, 1932, at 1.
[74] Arthur Sears Henning, *Mills Offers New Plan to Raise Billion*, CHI. DAILY TRIB., Apr. 19, 1932, at 1; *Tax Bill Completed; Revised Throughout on Mills's Pattern*, N.Y. TIMES, May 7, 1932, at 1. Mills, the former Undersecretary of the Treasury under Mellon, was promoted when Mellon resigned on February 3, 1932. Blakey and Blakey, *The Revenue Act of 1932, supra* note xx, at 626, n. 3.
[75] Leff, supra note xx, at 53.

III. Graduated Corporate Taxation in the New Deal

A. Growing concern about large corporations

In the first term of new President Franklin Delano Roosevelt's presidency, there was an increasing concern about the growth in corporate power and its role in the stock market crash and ensuing depression. Some of this was just a rhetorical shift as a result of the change in Administrations and the elevation to power of the Democrats and their populist platform, but it was also a function of the rise in the large corporation and the perception that size had enabled them to receive certain advantages.

To some extent, this concern was a natural outgrowth of the corporation's dominance in the economy during a period when there was high scrutiny of the economy. As seen in Figure 1, a relatively large percentage of businesses were operated in corporate form during this period:

Table 3: Corporations as a Percentage of all Businesses, 1932-1935[76]

Year	Corporations	All Businesses	% Corporate
1932	451,884	714,143	63%
1933	446,842	719,433	62%
1934	469,804	775,402	61%
1935	477,113	800,473	60%

Moreover, not only were most businesses operated in corporate form, but corporations accounted for the majority of the country's income. According to a Twentieth Century

[76] Historical Statistics of the United States: Millenial Edition Online (Naomi Lamoreaux, ed.) (Table Ch1-18 - Active proprietorships, partnerships, and corporations–entities, receipts, and Profit: 1916–1998**)**

Fund study, corporations produced 57 percent of the nation's income in 1929.[77] The impact was greater in certain industries, with corporations producing 86 percent of the income in the transportation and public utilities sector, 92 percent of the income in the manufacturing sector, and 96 percent of the income in mining and quarrying.[78]

The emphasis on the danger of the large corporation and its role in the stock market crash and ensuing Great Depression began during the presidential campaign. It was clear that Roosevelt and the Democrats sought to portray the election at least partly as a referendum on large corporations and where to target relief efforts. In a speech in Columbus, Ohio in August of 1932, Roosevelt noted that "[e]ven before the election of Mr. Hoover a terrible race began between the rising tide of bubble fortunes in the stock market and the rising tide of unemployment. . . . Despite huge profits in a handful of large corporations, more than half the corporations of the country were reporting no net income."[79] This echoed comments made during the House debates over the Revenue Act of 1932, such as when Representative Clarence Cannon, a Democrat from Missouri, pointed out that "5 per cent of the corporations of the country making tax returns . . . receive 90 per cent of the total gross income paid to all the corporations of the United States."[80] According to Roosevelt, this phenomenon was exacerbated under Hoover, with the result that "[w]e find two-thirds of American industry concentrated in a few hundred corporations, and actually managed by not more than 5,000 men . . . In other words, we find concentrated economic power in a few hands, the premise opposite of the

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[77] ALFRED L. BERNHEIM, BIG BUSINESS: ITS GROWTH AND ITS PLACE 1, 17, tbl. 3 (1937).
[78] Id.
[79] *Text of Gov. Roosevelt's Speech Made in Columbus*, WASH. POST, Aug. 21, 1932, at 1, 2.
[80] 75 Cong. Rec. 7127 (Mar. 30, 1932) (statement of Rep. Cannon).

individualism of which the President speaks."[81] In a speech the following month in San Francisco, Roosevelt once again railed against what he considered to be the threat of "economic oligarchy," citing "a recent survey which he said showed that 600 large corporations control two-thirds of American industry and that 10,000,000 small business men control the other third."[82] Roosevelt predicted that "if the process of concentration goes on at the same rate, at the end of another century we shall have all American industry controlled by a dozen corporations and run by perhaps 100 men."[83]

The Democrats had successfully reframed the debate as being about the treatment of bigness and the Republicans were on their heels. Hoover and his supporters desperately tried to counter all such claims. The *Los Angeles Times* dismissed as "ridiculous" Roosevelt's "charge that the present administration has done everything for the banks and large corporations and nothing for the farmer and small homeowner," calling it "a mild form of demagoguery."[84] The newspaper later noted that President Hoover "traced in detail how the economic reconstruction program sponsored by the administration benefits everybody, and showed that, instead of being merely helpful to the 'big corporations,' as his opponent charged, the Reconstruction Finance Corporation has prevented the loss of the savings of 25,000,000 American families."[85] Then-Governor Roosevelt had contended that the RFC program had only seen "to it that a favored few are helped," with the administration, according to Roosevelt, hoping that"

[81] *Text of Gov. Roosevelt's Speech Made in Columbus*, WASH. POST, Aug. 21, 1932, at 1, 2.
[82] James A. Hagerty, *Nominee Gets Ovation*, N.Y. TIMES, Sept. 24, 1932, at 1.
[83] Id.
[84] Editorial, *Still Pussyfooting*, L.A. TIMES, Apr. 11, 1932, at A4.
[85] *What Hoover Didn't Say*, L.A. TIMES, Aug. 21, 1932, at A4.

some of their prosperity will leak through, sift through to labor, to the farmer, to the small business man."[86]

Academic researchers helped to fuel and reinforce Roosevelt's focus on the power of large corporations. Adolf Berle and Gardiner Means' famous book, *The Modern Corporation and Private Property*, was published in 1932.[87] Berle -- a member of Roosevelt's famed "Brain Trust" – had just completed the book when he was recruited to help Roosevelt develop his economic policies during the presidential campaign.[88] The book, which had described "a shift in corporate ownership . . . of almost revolutionary proportions from owner-managers to absentee investors," also focused significantly on the growing concentration of economic power in the hands of few.[89] According to Berle and Means, the 200 largest corporations controlled almost half of all corporate wealth and 38 percent of all business wealth."[90] During the campaign, Berle contributed a section of a briefing memorandum to Roosevelt in which he wrote that "the administrators of the great corporations lost sight of the many small investors whose savings were persuaded into securities."[91] According to Berle, instead of distributing those accumulated profits as dividends, the managers of these "great corporations" used them "to satisfy unrestrained ambitions for expansion."[92] As Berle and Means had explained, "[i]t would take only forty years at the 1909-1929 rates or only thirty years at the 1924-1929 rates for all

[86] Id.
[87] ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).
[88] DANIEL R. FUSFELD, THE ECONOMIC THOUGHT OF FRANKLIN D. ROOSEVELT AND THE ORIGINS OF THE NEW DEAL 207-08, 213 (1954).
[89] Berle & Means, supra note xx, at 62.
[90] Id. at 31.
[91] 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.
[92] Id.

corporate activity and practically all industrial activity to be absorbed by two hundred giant companies."[93]

Not only were large corporations increasing in size and importance, but contemporary research appeared to demonstrate that this size gave them an advantage over small corporations in their rate of return. In a 1934 study, Professor William Crum of the Harvard Business School examined the Bureau of Internal Revenue's *Statistics of Income* to determine whether a relationship existed between the size of a corporation and its performance.[94] According to Crum, "[t]he most striking finding . . . is the fairly general tendency for larger corporations to have a higher average return on their gross business than smaller corporations."[95] This followed from a 1933 study by Crum in which he found "significant differences in earning power between consolidated enterprise and non-affiliated enterprise."[96] The 1934 study's conclusion was highlighted in all of the major newspapers, with the *New York Times* trumpeting that "Advantage Shown for Big Companies," the *Wall Street Journal* proclaiming that "Large Companies Make Better Profit," and the *Washington Post* reporting that "Big Companies Lead Nation in Making Profits."[97]

In this environment, it became common to consider large and small corporations to be different entities altogether, rather than different sizes on the same continuum. This

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[93] Berle & Means, supra note xx, at 40-41.
[94] WILLIAM LEONARD CRUM, THE EFFECT OF SIZE ON CORPORATE EARNINGS AND CONDITION: AN ANALYSIS OF 1931 INCOME TAX STATISTICS 1 (1934). Notwithstanding the seeming alliance of views, Crum had criticized Berle and Means' conclusions primarily because of their failure to separate out concentration by industry to reveal the importance of public utilities in driving their data. *See* W.L. Crum, *On the Alleged Concentration of Economic Power*, 24 AM. ECON. REV. 69, 70-71 (1934).
[95] CRUM, THE EFFECT OF SIZE ON CORPORATE EARNINGS AND CONDITION, *supra* note XX, at
[96] W.L. Crum, *Large-Scale Enterprise in the Light of Income Tax Returns*, 47 Q. J. ECON. 414, 447-48 (1933).
[97] *Advantage Shown for Big Companies*, N.Y. TIMES, July 9, 1934, at 23; *Large Companies Make Better Profit*, WALL ST. J., July 9, 1934, at 14; *Big Companies Lead Nation in Making Profits*, WASH. POST, July 12, 1934, at 19.

perception had support in the data. According to one Twentieth Century Fund Study, of the more than half a million corporations in existence in the U.S. in 1933, 594 – constituting one-tenth of 1 percent of all corporations – owned more than half of all corporate assets.[98] With "large corporations" defined as those in control of at least $50 million in assets or earning a net income of at least $5 million a year, the difference between large and small or medium-sized corporations was so great that the Twentieth Century Fund grouped small and medium-sized corporations with partnerships and sole proprietorships for purposes of its study, rather than dividing between incorporated and unincorporated entities.[99]

Not everyone agreed that large corporations were a concern that required governmental involvement. One businessman, E.R. Hoyt, the co-founder of Hoyt Metal Co., a corporation which itself had helped in the formation of a large lead trust,[100] wrote a letter to the editor of the *New York Times* complaining that "the law to limit the growth of a corporation must be psychological and not a government interference. The limit should be in the 'thought' of the management, and the question will it pay to go on growing?"[101] According to Hoyt, the small business man . . . is protected by the unwritten law which limits profitable growth in the body of the individual or in the corporation."[102]

To the extent such arguments had traction, they broke down in the midst of the revelations that came from Hearings before the Senate Committee on Banking and

[98] TWENTIETH CENTURY FUND, CORPORATIONS SURVEY COMMITTEE, BIG BUSINESS: ITS GROWTH AND ITS PLACE 99 (Alfred L. Bernheim, ed., 1937).
[99] Id. at 10.
[100] *Lead Trust Organizing*, N.Y. TIMES, Sept. 30, 1902, at 10.
[101] E.R. Hoyt, Letter to the Editor, *Governing Growth of Business*, N.Y. TIMES, Jan. 24, 1932, at E2.
[102] Id.

Currency that were held in 1933.[103] The "Pecora Hearings," as they came to be known because of the Committee's "unrelenting" lead counsel, Ferdinand Pecora,[104] investigated the causes of the stock market crash and the allegations of misconduct on the part of investment bankers and corporate managers that may have played a role in the crash and ensuring depression. At least part of the testimony focused on the abuses of large corporations and the way that they amassed power. For example, an investment banker testified about the Pennsylvania Railroad's use of "voting trust certificates" to enable its holding company to acquire several smaller railroad lines without being subject to stockholder oversight, noting that these devices were "inventions of the devil."[105] Similarly, some of the most explosive moments during the hearings occurred in connection with the investigation of J.P. Morgan & Co, which witnesses established had used its control of heavily discounted option warrants in the United Corporation to consolidate holdings of firms representing 22 percent of the country's gas and electric industry.[106] In addition to the use of devices to increase their market size and power, it was revealed to the Committee that corporations used their power in a way that destabilized the market. According to testimony before the Committee, twenty large corporations were heavily involved in more than $20 billion dollars worth of "call loans" during 1929, which helped fuel the excessive market speculation and the subsequent Crash when the funds were quickly recalled by the corporate lenders.[107]

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[103] *Stock Exchange Practices: Hearings Before the Sen. Comm. On Banking and Currency on S. Res. 84*, 73d Cong. 2319-25 (1933).

[104] Leff, *supra* note xx, at 58-59; *The Man Who Will Question Morgan*, N.Y. TIMES, May 21, 1933, sec. 8, at 2.

[105] FERDINAND PECORA, WALL STREET UNDER OATH 58-59 (1939) (quoting Otto Kahn of Kuhn, Loeb and Company).

[106] *Morgan Inquiry in Furor as Glass Raps Pecora*, L.A. TIMES, May 27, 1933, at 1.

[107] *20 Companies Lent 20 Billions in 1929 in Call Loan Boom*, N.Y. TIMES, Feb. 24, 1934, at 1.

B. Revenue Act of 1935

Against the backdrop of this focus on the perils of corporate "bigness" and the contributions of large corporations to the Crash and Great Depression, Roosevelt delivered a Tax Message to Congress on June 29, 1935. According to Roosevelt "[o]ur revenue laws have operated in many ways to the unfair advantage of the few, and they have done little to prevent an unjust concentration of wealth and economic power."[108] In light of his concern about this situation, Roosevelt proposed adopting number of tax reforms, including an inheritance tax and a more steeply graduated individual rate schedule.

Perhaps the most novel of Roosevelt's proposals, albeit the one that "occasioned the severest contest,"[109] was for a graduated rate corporate income tax structure. Roosevelt explained that "[w]e have established the principle of graduated taxation in respect to personal incomes, gifts, and estates. We should apply the same principle to corporations. Today the smallest corporation pays the same rate on its net profits as the corporation which is a thousand times its size."[110] He offered at least two arguments in favor of differentiating between large and small corporations in taxation. First, Roosevelt claimed that "[t]he advantages and the protection conferred upon corporations by Government increase in value as the size of the corporation increases." While he acknowledged that many of these advantages were conferred upon the corporation by the State rather than the Federal government, Roosevelt contended that "the most important

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[108] Franklin D. Roosevelt, *Message to Congress on Tax Revision*, June 19, 1935, in Gerhard Peters and John T. Woolley, eds., THE AMERICAN PRESIDENCY PROJECT, located at http:www.presidency.ucsb.edu/ws/?pid=15088 (last visited August 21, 2012).

[109] Roy G. Blakey & Gladys C. Blakey, *The Revenue Act of 1935*, 25 AM. ECON. REV. 673, 680 (1935).

[110] Franklin D. Roosevelt, *Message to Congress on Tax Revision*, June 19, 1935, in Gerhard Peters and John T. Woolley, eds., THE AMERICAN PRESIDENCY PROJECT, located at http:www.presidency.ucsb.edu/ws/?pid=15088 (last visited August 21, 2012).

advantages, such as the carrying on of business between two or more States, are derived through the Federal Government."[111] Second, Roosevelt argued that small businesses were in particular need of a tax break in these economic circumstances. He asserted that "the drain of a depression upon the reserves of business puts a disproportionate strain upon the modestly capitalized small enterprise. Without such small enterprises our competitive economic society would cease. Size begets monopoly. . . . Today our small corporations are fighting not only for their own local well-being but for that fairly distributed national prosperity which makes large-scale enterprise possible."[112]

In widely-reported subsequent Congressional testimony in support of the President's proposal, Robert H. Jackson, Special Counsel to the Internal Revenue Bureau, underlined the degree to which the graduated corporate income tax proposal was about taxing bigness and differentiating between large and small corporations.[113] Jackson cited the previously mentioned study by Professor William Crum,[114] as well as a 1934 National Bureau of Economic Research paper, to the effect that large corporations have a higher rate of return.[115] According to the latter, out of a total of 381,000 corporations studied, only the 632 corporations with assets in excess of $50 million earned an aggregate net profit in 1931.[116] Jackson also noted that "the Bureau called attention to the fact that there was an impressive relationship between size of corporations and relatively smallness of losses – the group of smallest corporations experiencing the greatest

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111 Id.
112 Id.
113 Jackson's testimony was reprinted as *The Big Corporations Rule*, THE NEW REPUBLIC, Sept. 4, 1935, at 99. *See also* W.R. Huff, *Barrage of Statistics Laid Down by Jackson, Defending Tax Bill*, WALL ST. J., Aug. 8, 1935, at 2.
114 See supra, text accompanying notes xx.
115 *Revenue Act of 1935*, Hearings before the Committee on Finance, U.S. Senate, 74th Cong., 1st Sess. on H.R. 8974 212 (July 30, 1935) ("1935 Senate Hearings").
116 Id. (citing Solomon Fabricant, Recent Corporate Profits in the United States, v.50, Nat'l Bur. Econ. Res., April 18, 1934).

percentage of deficit."[117] This differential rate of return helped provide a more stable revenue source, according to Jackson,[118] but it would also help address concentration of wealth among a few corporations, which Jackson called "startling."[119]

Jackson also identified several benefits that large corporations uniquely enjoyed:

> (1) As buyers of commodities and services, the large volume of their purchases gives the larger corporations a bargaining power that often results in price concessions which smaller concerns do not share.
> (2) Through widely distributed branch plants and warehouses they are able to effect important savings in transportation costs and to sell in a Nation-wide market.
> (3) Their large resources enable them to buy up important patents, often to pool these patents with those obtained by other large enterprises, and to carry on research programs, the fruits of which, while of public as well as private benefit, accentuate their competitive advantages over their smaller rivals.
> (4) In many cases large concerns have become of such dominating size that they are able to control the markets for their products, enabling them to maintain prices that protect their profit margins.
> (5) Large corporations possess distinct advantages over their smaller competitors in the facility and cost o financing, for they are able to tap the large reservoirs of capital that are made available through the organized financial markets.[120]

He did not contend that these benefits were provided by the federal or even state governments. Rather, he suggested that "these advantages are reasons why size provides a useful measure of ability to contribute to the cost of government."[121]

Notwithstanding the rhetoric and evidence in support of taxing bigness, Roosevelt's actual proposal was admittedly not very drastic. He suggested replacing the existing rate of 13.75 percent with a rate of 10.75 percent for small corporations up to 16.75 percent for larger corporations, although he left to Congress the task of defining

[117] 1935 Senate Hearings, supra note xx, at 212.
[118] Id. at 231.
[119] Id. At 213.
[120] Id. at 217.
[121] Id.

where to draw the lines between large and small firms.[122] Additionally, Roosevelt recommended adopting an intercorporate dividends tax "to prevent evasion of such graduated tax on corporate incomes through the device of numerous subsidiaries or affiliates, each of which might technically qualify as a small concern even though all were in fact operated as a single organization," although there is evidence that this was independently justified as a disincentive for holding company structures.[123]

The concept of a graduated tax on corporations as a way to control or penalize "bigness" may have been novel, but it was not unprecedented in American politics. Even before the Garner proposal in 1927, discussed in Section II,[124] a similar proposal was considered on a narrower base at the origins of the modern income tax in 1913. At that time, Attorney General James Clark McReynolds, proposed to curb the growth of the firms remaining from the disbanded Tobacco Trust by subjecting them to a graduated tax measured by the amount of their production.[125] Called a "drastic proposition," this was justified on the grounds that "this is an emergency situation, which calls for radical treatment, and that in no other way can speedy relief be obtained from the conditions resulting from the dissolution of the Tobacco Trust."[126] The proposal was eventually introduced in Congress by Senator Gilbert Hitchcock of Nebraska, who explained that "[m]y amendment is not only to raise revenue by a high tax on the great corporations, but it is a regulatory measure which will enable the independent manufacturer to live."[127]

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[122] Franklin D. Roosevelt, *Message to Congress on Tax Revision*, June 19, 1935, in Gerhard Peters and John T. Woolley, eds., THE AMERICAN PRESIDENCY PROJECT, located at http:www.presidency.ucsb.edu/ws/?pid=15088 (last visited August 21, 2012).

[123] Id.; Steven A. Bank and Brian R. Cheffins, *The Corporate Pyramid Fable*, 84 BUS. HIST. REV. 435, 439-40 (2010).

[124] See supra text accompany notes xx-xx.

[125] *To Hit Tobacco Trust by Taxing*, N.Y. TIMES, June 4, 1913, at 1.

[126] Id.

[127] *Tobacco Tax Aimed at a Few Big Firms*, N.Y. TIMES, June 6, 1913, at 1.

The *New York Times* called the amendment "monstrous" and "oppressive," noting that "[n]o crime against bigness is charged."[128]

Moreover, Roosevelt's message was largely an endorsement of a similar graduated corporate tax bill that was currently under consideration in Congress. Senator Burton Wheeler, a Democrat from Montana, had introduced a bill in February of the same year in which he proposed what the *Wall Street Journal* described as "a net capital return tax graduated according to the 'bigness' of corporations."[129] Under Wheeler's proposal, corporations would be taxed at rates ranging from 2 percent on net capital returns in excess of $3 million to 25 percent on net capital returns in excess of $50 million.[130] There was no attempt to hide his principal motivation. Wheeler reportedly characterized it as "a Federal tax on bigness, i.e., a tax on corporations based on their size."[131]

Not surprisingly, business reaction to Roosevelt's tax message was decidedly negative. As the *Washington Post* predicted, "[t]he corporation tax proposal is the one that will raise the greatest storm," with over 3,700 corporations expected to have a higher tax bill as a result of the graduated rates.[132] According to Mark Leff, the Post's prediction proved true: "When business lobbyists descended on Washington . . . the proposal to introduce a graduation feature into the corporation income tax excited the most intense opposition."[133] Soon after the President's tax message was delivered, the National Industrial Conference Board issued a detailed and widely reported analysis of

[128] *Taxing to Destroy*, N.Y. TIMES, June 7, 1913, at 10.
[129] *Congress Gets Two Tax Suggestions Directed at 'Bigness' of Business*, WALL ST. J., Feb. 20, 1935, at 1; 79 CONG. REC. 2199 (Feb. 19, 1935).
[130] Id.
[131] Philip H. Gadsen, *Against the Bill, in The Holding Company Bill: A Debate*, 93 FORUM AND CENTURY 259 (1935) (quoting Wheeler).
[132] Peter Kihss, *Aims to Foster Small Business Enterprises*, WASH. POST, June 30, 1935, at B3.
[133] Leff, supra note xx, at 160.

the proposed new tax program, calling the graduated corporate income tax proposal "a new and radical departure in federal income tax legislation" and concluding that "the effect" of it was "primarily to tax or penalize size or bigness, wherever and in whatever form it may be found."[134] The United States Chamber of Commerce called the recommendations "of a destructive nature," noting that "[t]hey are based solely on the idea that the large enterprise . . . can and should be taxed heavily, merely because it is large, without sufficient attention to utility or economic value of aggregations of capital."[135] Benjamin Anderson, an economist for the Chase National Bank, called the graduated corporate income tax proposal a "very dangerous principle."[136] Several corporations organized letter writing campaigns to stockholders, including General Motors, Curtis Publishing, and Johns-Manville Corp., collectively contacting more than 370,000 individuals.[137] Alfred Sloan, president of General Motors, wrote in his letter to stockholders that the graduated corporate income tax was "an attempt to control and limit, or perhaps even destroy, 'business bigness.'"[138] Walter Fuller, president of Curtis Publishing, a much smaller corporation than General Motors, but one with almost 12,000 stockholders, explained to his shareholders that "[w]e are paying for you from earnings

[134] *New Federal Tax Proposals*, NATIONAL INDUSTRIAL CONFERENCE BOARD INFORMATION SERVICE: DOMESTIC AFFAIRS SERIES NO. 43 11(1935); Franklyn Waltman, Jr., *National Industrial Group Holds Levies "Impracticable*," WASH. POST, July 22, 1935, at 1; *New Deal Tax Plan Seen Move to Hit "Bigness,"* CHI. DAILY TRIB., July 22, 1935, at 19; *Roosevelt Taxes Held Unfair Move for Social Reform,* N.Y. TIMES, July 22, 1935, at 1..

[135] U.S. CHAMBER OF COMMERCE, REPORT OF THE COMMITTEE ON FEDERAL FINANCES, FEDERAL TAXATION: THE SUGGESTIONS IN THE PRESIDENT'S TAX MESSAGE 7 (July 1935).

[136] *Proposed Taxes Threat to Our Economic Life, Says Chase Economist*, WALL ST. J., Aug. 6, 1935, at 11.

[137] *Three Corporations Appeal to 370,000 Holders to Protest "Share-Wealth" Tax Plans*, WALL ST. J., July 12, 1935, at 1. *See also Graduate Corporate Tax Protest*, WALL ST. J., July 29, 1935, at 2 (United Engineering & Foundry Co.); *Tax Opposition Grows in Industrial and Banking Quarters*, WALL ST. J., July 1, 1935, at 2 (U.S. Rubber Co. and National City Bank); *Oil Executive Hits Tax*, N.Y. TIMES, Aug. 6, 1935, at 38.

[138] *Three Corporations Appeal to 370,000 Holders to Protest "Share-Wealth" Tax Plans*, WALL ST. J., July 12, 1935, at 1.

that would otherwise go to stockholders a tax that is now 13¾ cents on each dollar and which soon may be 17 cents."[139]

Outside of the business interests themselves, many observers in the media derided Roosevelt's attempt to penalize "bigness" through the tax system. The *Wall Street Journal* observed that "[o]bviously Mr. Roosevelt regards bigness as a form of injustice, to be redressed through taxation."[140] The *Philadelphia Inquirer* wrote that "[p]enalizing industrial bigness by taxation is an effective method of hampering re-employment, preventing wage increases and delaying recovery."[141] In a more balanced, but nonetheless critical take, the *Washington Post* noted that "before employing the right to tax . . . to penalize large corporations merely because of their size, it would be well to ask whether the large corporation is efficient, whether it deals fairly with labor, whether it has rendered positive services to the community. The assumption that bigness as such is anti-social; that taxation should be punitive is the main theme of the President's message."[142]

Even among progressive or bipartisan sources the graduated income tax proposal was looked at with skepticism. Both *the Nation* and the *New Republic* thought it was not radical enough. According to the latter, the proposal was "contrary to the opinion both of its opponents and of many of its supporters, a conservative measure in the literal sense of the word."[143] Because of the modest level of graduation, 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."[144] *The Nation* was less concerned about actually breaking

[139] *Sloan Scores Tax Curbing "Bigness,"* N.Y. TIMES, July 12, 1935, at 8.
[140] *At the Tax Office, Bear Left*, WALL ST. J., June 21, 1935, at 4.
[141] *With Other Editors: The President's Tax Program*, WASH. POST, June 30, 1935, at B7 (quoting from the *Philadelphia Inquirer*).
[142] *It's a Long Trail*, WASH. POST, June 21, 1935, at 8.
[143] *A Conservative Tax Program*, 83 NEW REPUBLIC 208 (1935).
[144] Id. At 209.

up large corporations, noting that while "[t]he menace in bigness in finance and industry is the political and economic power that goes with it," there are "indubitable benefits."[145] The magazine suggested that the preferred solution for the growth of big corporations is "social control of industry" rather than disincentivizing it through punitive taxation.[146] Finally, the American Liberty League, a short-lived and ostensibly bipartisan political group with a large representation from business leaders, issued a statement objecting that "[g]raduated taxes on corporation incomes are designed to hit bigness, but in reality would penalize many small stockholders."[147]

This barrage of criticism led some in Congress to look for alternatives. "Prompted . . . by a strong sentiment in the committee against the graduated corporation income tax," the House Ways and Means Committee considered an excess profits tax, with the tax rate based on earnings per dollar invested, rather than earnings alone.[148] The supposed advantage of this proposal was that it would take into account the relationship between income and the investment return of stockholders.[149] The Senate Finance Committee was similarly concerned with the president's proposal, with some Democratic members described as "openly hostile."[150] Meanwhile, Senator Wheeler continued to press his graduated tax on net capital returns, proposing it as an amendment to the

[145] *Wanted: A Philosophy of Taxation*, 141 THE NATION 4 (1935).
[146] Id.
[147] *Roosevelt Maps his Tax Bill Drive with House Chiefs*, N.Y. TIMES, July 5, 1935, at 1, 2.
[148] *House Committee Studies Substitute for 'Bigness' Tax*," WALL ST. J., July 19, 1935, at 1.
[149] Jules T. Bogen, *The New Tax Program*, WASH. POST, July 30, 1935, at 9; *Toward Tax Logic*, N.Y. HERALD TRIBUNE, republished in *Editorial of the Day*, CHI. DAILY TRIB. July 21, 1935, at 12.
[150] Franklyn Waltman, Jr., *Bill is Crudely Drawn, Hard to Administer, Business Men Say*, WASH. POST, Aug. 8, 1935, at 1.

original bill.[151] The tax bill reported out of the House, however remained on income, or "bigness," rather than being limited to rate of return.[152]

Notwithstanding the continued focus on taxing bigness, the degree of graduation in the rates was reduced from even Roosevelt's modest proposal. Senate Finance Committee Chair Harrison characterized the House bill's proposal as a mere "gesture toward complying with the President's suggestion with reference to a graduated tax on corporations. They made the tax 13¼ percent up to $15,000 profit, and over that it was 14¼ percent. In other words, they made a graduation of only 1 percent, dropping it one-half percent from the present law of 13¾ percent in the case of profits under $15,000, and increasing it one-half percent over the present law where the profits were more than $15,000."[153] When Democrat Charles Truax of Ohio proposed an amendment to the bill that would have raised the top rate to 16½ percent, he was immediately shot down. Representative Jere Cooper of Tennessee explained

> The Committee on Ways and Means gave perhaps more extensive consideration to this provision of the bill that to any other provision in it. We worked it out on the very best basis possible. It recognizes the principle of a graduated corporation tax, but it does not go so far as is sought by the amendment offered by the gentlemen from Ohio [Truax]. It is felt by the committee that the provision as it now stands in the bill is far preferable to the provision contained in this amendment, and the committee asks that the amendment be voted down.[154]

In part, this reaction was because the proposed amendment only raised the top rate and did not also lower the bottom rate, but there was little support for moving the rate in either direction.

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[151] *Senator Wheeler to Propose Graduated Tax on Large Corporations' "Capital Return,"* WALL ST. J., July 20, 1935, at 1.
[152] George B. Bryant, Jr., *Principle of Taxing "Bigness" Retained in House Tax Bill*, WALL ST. J., July 27, 1935, at 9.
[153] 79 CONG. REC. 13042 (Aug. 14, 1935).
[154] Id. at 12420 (Aug. 3, 1935).

According to some Congressional insiders, even this scaled down bill was a concession to Roosevelt, with a Republican member of the Ways and Means Committee, Thomas Jenkins of Ohio, reporting that "[t]he President's special recommendation for a graduated corporation tax was treated very shabbily by the Democratic members of the committee, but in order to save the President's face, the committee, after days of secret sessions, finally, by a close vote, decided to reduce the rate on corporations" rather than reject the graduated rates completely.[155] Jenkins opined that the Democrats "placated the President with one slight step of graduation."[156] Eventually, the range of graduated rates was broadened in the Senate to 12.5 percent on income below $2,000 up to 15 percent on income above $40,000.[157] Nevertheless, this still fell short of the President's original proposal.

C. What was the point?

Given all of the political opposition from both sides and the narrow measure of graduation that was enacted, one can fairly ask why Roosevelt was so persistent in his pursuit of it. The minimal rate differential and lack of ambition led some observers to conclude that the graduated corporate income tax proposal was merely symbolic.[158] The *Wall Street Journal* said it "is not a serious revenue measure but is a serious political gesture."[159] The Twentieth Century Fund condemned the final result as being neither fish nor fowl: "The present degree of graduation in corporation taxes in the United States represents an indecisive policy that has but slight merit and works considerable

[155] Id. at 12314 (Aug. 2, 1935).
[156] Id.
[157] Revenue Act of 1935, 49 Stat. 1014, 1015 §102 (1935).
[158] *See supra* text accompanying notes 16-20.
[159] *Aimed at Moderate Success*, WALL ST. J., Aug. 1, 1935, at 4.

injustice."[160] The rate was not high enough to actually punish bigness in any real way, but it was sufficiently high to put corporations with similar rates of return, but different amounts of income, on unequal footing.

This was not a situation where an ambitious bill was drastically scaled back through the legislative process and the president sought to keep it to preserve the appearance of a political victory. From the outset, the proposed rate differential was fairly small and the goals were fairly modest. Mark Leff has suggested that the final Act did stray far from its origins as an anti-bigness measure when it imposed the top rate on a relatively small amount of income,[161] but this is a bit speculative. Roosevelt himself had never actually proposed a particular schedule of thresholds for the graduated rates. It is true that Senate Finance Committee chair Harrison had submitted a draft that imposed the top rate of 17½ percent only on corporations with incomes in excess of $20 million, which is quite a bit different from the $40,000 threshold for the imposition of the top rate in the final Act.[162] Nevertheless, it is not clear how committed Roosevelt was to that higher threshold. Leff asserted that Roosevelt signed onto the rates in Harrison's proposed draft, but he may have merely approved of it as an opening bid in the negotiations.[163] As Roosevelt later described it, his proposal was meant to strike a balance: "The graduated tax need not be so high as to make bigness impracticable, but might be high enough to make bigness demonstrate its alleged superior efficiency."[164]

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[160] Committee on Taxation of the Twentieth Century Fund, FACING THE TAX PROBLEM 397 (1937).
[161] Leff, supra note xx, at 163.
[162] Id.
[163] Id. at 143.
[164] Franklin Delano Roosevelt, *Message to Congress on Curbing Monopolies*, April 29, 1938, located at The American Presidency Project http://www.presidency.ucsb.edu/ws/index.php?pid=15637 (last visited July 25, 2012).

Moreover, there is little evidence that the graduated rates actually did much to influence the size of corporations. A Twentieth Century Fund study published in 1937 did identify thirty large corporate groups that dismantled or downsized during this period,[165] but there is little evidence that graduated income tax rates had much to do with this. There is some support for the effect of the associated intercorporate dividends tax,[166] which purportedly was enacted to enforce the graduated rates, but most companies were silent as to their motives or cited other factors.[167] Indeed, of the thirty corporate groups that underwent some form of restructuring, only four had publicly complained about the graduated corporate tax in newspaper stories or their annual shareholder reports and three more criticized the Revenue Act of 1935 or recent tax legislation more generally.[168] Furthermore, many of the corporate groups started restructuring prior to 1935 or were public utilities forced to restructure under the Public Utility Holding Company Act.[169] None of them specifically mentioned the tax rates as grounds for their downsizing plans.

For example, of the companies studied by the Twentieth Century Fund that cited the graduated corporate rates specifically, Diamond Match was one of the most vocal. In its Annual Report to Shareholders for the year 1935, which was released in the spring of

[165] TWENTIETH CENTURY FUND, COMMITTEE ON TAXATION, FACING THE TAX PROBLEM 547 n. 1 (1937).

[166] *See, e.g.*, *Bethlehem Steel's Unification Plans are Approved*, WALL ST. J., Feb. 27, 1936, at 8 (citing "new law enacted . . . by which dividend payments to a parent organization were made taxable" as one justification for the merger plan); *du Pont Merges Unit to Cut Levy Under Tax Bill*, WALL ST. J., July 2, 1936, at 1 (citing intercorporate dividends tax as the justification for the dissolution of a subsidiary).

[167] See Bank & Cheffins, supra note xx, at 441-42.

[168] For those complaining about the graduated corporate tax, see DIAMOND MATCH CO., REPORT TO STOCKHOLDERS OF THE DIAMOND MATCH COMPANY FOR THE YEAR 1934 105 (April 25, 1935) (Diamond Match Company); *General Foods Protests High Corporate Tax*, WASH. POST, Aug. 14, 1935, at 20 (General Foods); *17% Tax on Corporations Seen as Damper on Business*, WASH. POST, June 30, 1935, at R17 (McKesson & Robbins, Inc.); *Tax Opposition Grows in Industrial and Banking Quarters*, WALL ST. J., July 1, 1935, at 2 and *Share Wealth Protested by U.S. Rubber*, HARTFORD COURANT, July 1, 1935, at 10 (U.S. Rubber).

[169] Bank & Cheffins, supra note xx, at 442.

1936 after the graduated corporate income tax rates had been implemented, the company stated "the primary object of a graduated corporation income tax (which is grossly inequitable because the rate of taxation bears no relation to the rate of return on invested capital) is not revenue, but an attempt to control and limit, and later to destroy, what is falsely called 'big business' and, concurrently, to effect what is equally erroneously described as 'a broader distribution of wealth' or a 'redistribution of wealth and income.'"[170] Nevertheless, the company later discussed only the intercorporate dividends tax and the repeal of the consolidated return as grounds for its restructuring and in subsequent years added the undistributed profits tax to its list of complaints. The graduated corporate income tax rates that were ultimately enacted in 1935 were never mentioned.[171]

Notwithstanding all of this evidence that the graduated rates did not and could not have had much immediate impact on large corporations, they did provide a boost to small corporations. The repeal of the exemption in 1932 disadvantaged small corporations vis-à-vis partnerships and large corporations. During the Senate Finance Committee hearings on the Revenue Act of 1935, this effect was specifically discussed. Senator Peter Gerry, a Democrat from Rhode Island, asked whether he was correct in recalling that the $3,000 exemption had been "put in originally in order to even it up with the copartnership."[172] L.H. Parker, Chief of Staff of the Joint Committee on Taxation responded by testifying that "under certain conditions . . . the small corporation is at a disadvantage with the

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[170] REPORT TO STOCKHOLDERS OF THE DIAMOND MATCH COMPANY FOR THE YEAR 1935 105 (April 23, 1936).

[171] Id. at 177; REPORT TO STOCKHOLDERS OF THE DIAMOND MATCH COMPANY FOR THE YEAR 1936 154-55 (April 22, 1937); REPORT TO STOCKHOLDERS OF THE DIAMOND MATCH COMPANY FOR THE YEAR 1937 171-73 (April 28, 1938).

[172] *Revenue Act of 1935*, Hearings before the Committee on Finance, U.S. Senate, 74th Cong., 1st Sess. on H.R. 8974 13 (July 30, 1935) ("1935 Senate Hearings").

partnership" in the absence of the exemption.[173] Parker explained that "if we should go into partnership and make $5,000, we would both take up $2,500 on our income-tax return, and if that was all the income that we had, neither of us would pay any tax; if we were both married, our $2,500 exemption would take us out, whereas the corporation that made $5,000 would pay 13¾ percent on that amount."[174]

Graduated rates were expected to help those same small corporations in the short-run. As Parker testified, "[t]he graduation in the bill gives a certain small amount of relief to the corporation with a small net income which . . . is at some disadvantage with the partnership. This is one justification for the proposal."[175] Robert Jackson offered support for this proposition in his testimony, noting that "182,000 corporations, or 95 percent of all of those expected to report net incomes for this year, would pay a smaller tax under such a schedule than under the flat rate now in effect."[176] Only 3,000 or so of the wealthiest corporations were expected to experience any increase in taxes at all.[177] This probably explains why there was what Mark Leff called "an undercurrent of dissent" in favor of the graduated rate scheme in a U.S. Chamber of Commerce referendum on the bill.[178] Nevertheless, there was only a benefit when compared to the post-1932 tax situation. Small corporations still did not regain a benefit equivalent to the $3,000 exemption they had enjoyed prior to 1932.[179]

[173] Id.
[174] Id. Parker acknowledged, however, that the corporation could avoid that effect if the stockholders were also employees of the corporation and took out that amount in salary rather than dividends.
[175] Id. at 15.
[176] Id. at 210.
[177] *Proposed Taxation of Individual and Corporate Incomes, Inheritances, and Gifts*, Hearings before the Committee on Ways and Means, U.S. House of Representatives, 74th Cong., 1st Sess. 317 (July 13, 1935).
[178] Leff, supra note xx, at 160 n. 274.
[179] Leff, supra note xx, at 143.

But there was a larger purpose to the graduated rates than just restoring some of the modest benefit the exemption had previously provided to small corporations. Since 1932, because of the flat rate, there had been no ability to ratchet up the income tax on large corporations without subjecting small corporations to a higher rate as well. Indeed, in a 1934 Office of Tax Analysis study prepared under the direction of Carl Shoup for the Secretary of the Treasury, the study participants all agreed that "[t]he corporation income tax is not, on the whole, so desirable a subject for increased revenues as is the personal income tax, because of its proportional rate."[180]

A corporate excess profits tax had been enacted in 1933,[181] but it could not accomplish the same objectives as a graduated rate in terms of treating large and small corporations differently. It was effectively focused upon a corporation's rate of return rather than the size of its income.[182] In fact, excess profits taxation was considered potentially worse for small businesses than even a flat rate corporate income tax. In a 1934 Treasury memorandum on the revival of excess profits taxation, economist Malcolm Bryan wrote that [f]rom the point of view of organizational units, again, it has been urged that an excess profits tax is regressive. Small businesses, the contention is, are likely to have a higher rate of earning on their capital than larger organizations; and in support of this reasoning, the Treasury in 1918 presented figures to show that the bulk of

[180] Carl Shoup, The Federal Revenue System: Forward and Summary of Recommendations (Sept. 20, 1934), locate at Box 62; Tax Reform Programs and Studies; Records of the Office of Tax Analysis/Division of Tax Research; General Records of the Department of the Treasury, Record Group 56; National Archives, College Park, MD. ("Federal Revenue System")

[181] It was largely enacted as a backstop for the capital stock tax. Corporations would have been motivated to declare a low value for their capital stock, but for the fact that it would hurt them on the excess profits tax. See Alfred G. Buehler, *The Taxation of Corporate Excess Profits in Peace and War Times*, 7 L. & CONTEMP. PROBS 291, 297 (1940).

[182] See Shoup, Federal Revenue System supra (describing the lack of consensus over the practicality and ease of administration of an excess profits tax). The 1934 enactment imposed a 6-12 percent tax on profits in excess of between 10-15 percent of the declared value of capital stock. Buehler, supra note xx, at 296.

collections under the United States' previous excess profits tax came from other than the largest companies."[183]

Establishing graduated rates therefore didn't merely set forth the principle of taxing bigness; it decoupled the rates for large and small corporations and thereby offered a mechanism to tax bigness in a targeted manner. Although taking this step in 1935 may have had some meaningful political advantages, including fending off pressure from "Share Our Wealth" social change advocates such as Senator Huey Long of Louisiana and Reverend Charles Coughlin and helping Roosevelt to win the support of Republican Progressives in the 1936 election,[184] the strategic advantage was that it set the table for a tax strategy that could treat corporations differently going forward. Indeed, the graduated rate approach was always considered a part of a longer term agenda. In late 1934, Treasury Secretary Henry Morgenthau submitted a variety of tax reform proposals to the President, including a recommendation for "scaling the tax on corporations according to their size," but he classified it as a "long run" proposal.[185]

This explains why neither the size of the rate differential nor the threshold at which the top rate was set were as important as establishing the very existence of such distinctions. Edgar Goodrich, a former member of the U.S. Board of Tax Appeals, wrote that it was this principle of differentiation, and not the actual revenue, that was most important:

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[183] Malcolm H. Bryan, *The Federal Revenue System: The Excess Profits Tax*, located at Box 62; Tax Reform Programs and Studies; Records of the Office of Tax Analysis/Division of Tax Research; General Records of the Department of the Treasury, Record Group 56; National Archives, College Park, MD.

[184] Arlene Lazarowitz, *Hiram W. Johnson: The Old Progressive and New Deal Taxation*, 69 CAL. HIST. 342, 349-51 (1990/91); Leff, supra note xx, at 123, 135, 147; ROY G. BLAKEY & GLADYS C. BLAKEY, THE FEDERAL INCOME TAX 366-67 (1940); ELLIS W. HAWLEY, THE NEW DEAL AND THE PROBLEM OF MONOPOLY 344-45 (1966)..

[185] JOHN MORTON BLUM, FROM THE MORGENTHAU DIARIES: YEARS OF CRISIS, 1928-1938 299 (1959).

> As a revenue raiser this bill is not important. The additional taxes it would glean would be practically unnoticed in the annual Treasury harvest. But the fundamental significance of the new proposals cannot be overstated. The bill evidences the formulation of a principle new to our American system: the use of the taxing power to destroy "bigness" wherever found and disapproved.[186]

Similarly, Representative Samuel B. Hill, a Democrat from Washington, sounded this theme when introducing the bill on behalf of the Ways and Means Committee: "Although we make but a very slight graduation we recognize the principle and we tax according to size of the income."[187]

Perhaps the truest test of the importance of the graduated rate provision is that opponents continued their campaign against it even while the rate differential was being narrowed. Establishing even the mere principle was called "the camel's head inside the tent."[188] M.L. Seidman of the New York Board of Trade testified that "[w]hile the proposed differential is now very small as compared to the differential recommended by the President, the principle involved is wrong."[189] Similarly, 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."[190] As a consequence, critics were not satisfied when the House passed a bill with a more modest degree of graduation. A representative of the American Mining Congress noted that "merely narrowing the range of the proposed graduation does not alter the principle involved . . . this principle should not be incorporated in our tax

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[186] Edgar J. Goodrich, *House Bill Applies New Taxation Principles*, N.Y. TIMES, Aug. 4, 1935, at E3.
[187] 79 CONG. REC. 12301 (Aug. 2, 1935) (statement of Rep. Hill).
[188] Harley L. Lutz, *The Federal Revenue Act of 1935*, 26 AM. ECON. REV. 161, 167 (1936).
[189] 1935 Senate Hearings, supra note XX, at 73.
[190] Howard Wood, *Standard Oil Chief Assails New Tax Plan*, CHI. DAILY TRIB., Aug. 6, 1935, at 23.

structure."[191] A representative of the Armstrong Cork Company agreed, testifying that "[t]he fact that the graduation proposed in the House bill is confined to the narrow limit of 1 percent does not alter the fact that it introduces a new principle into the taxation of corporations – a principle that seems to me to be unfair and unsound. Experience teaches that once the opening wedge is driven, the field covered by a new tax tends to expand steadily."[192]

This concern was exacerbated by what business likely speculated would be the political effect of separating out large and small corporations. One modern observer has noted that "with the masses of corporations separated from the six hundred or so high income corporations earning the bulk of the income, raising the rates on the big fellows (or Rockefellers), while leaving the little fellows alone, would be easier politically."[193] This helps explain one of the reasons why businesses had sought to expand their stockholder base to middle class investors and why businesses cited the presence of small stockholders in large corporations as an important reason to reject a graduated corporate tax. As Representative Samuel B. Hill remarked in response to business claims that the graduated rates would hurt the small stockholders, "the big corporation does not care anything about the little stockholder except to get the use of his money and democratize the stockholdings so that they can curry popular favor when legislation arises affecting corporations. This is the use they make of the little stockholder.[194]

IV. The Declining Significance of Graduated Rates as a Decoupling Device

[191] Id. at 168 (statement of Julian D. Conover, American Mining Congress).
[192] Id. at 120 (statement of H.W. Prentis, Armstrong Cork Co.).
[193] John W. Lee, A Populist *Political Perspective of the Business Tax Entities Universe: "Hey the Stars Might Lie But the Numbers Never Do,"* 78 TEX. L. REV. 887, 964 (2000).
[194] 79 CONG. REC. 12422 (August 3, 1935) (Statement of Rep. Samuel B. Hill).

In many respects, business fears about the ratcheting up of the rates on larger corporations were realized. Within a few years of the adoption of graduated marginal corporate income tax rates, the top rate rose from 15 percent in 1935 to 19 percent in 1938. By 1942, when World War II ramped up the need for revenues, the rate soared to a high of 40 percent and the differential spread between the bottom and top rates more than doubled from 7 percentage points in 1935 to 15 percentage points in 1942.[195] From 1952 through 1963, the top corporate rate reached a peak of 52 percent and the differential between the top and bottom rates was 22 percentage points.[196]

On the other hand, this dramatic increase in corporate rates and in the spread of the graduated rates seemed to represent a shift to a focus on smallness rather than bigness. Mark Leff has described the original result in 1935 as a transformation "from a penalty against bigness to a rebate for smallness."[197] Whether this was true in describing the 1935 Act, it was certainly true about the treatment of graduated rates in subsequent years. Rather than imposing very high rates on the most successful large corporations, the graduated rate scheme mostly operated to protect the smallest corporations from the high rates. This was because the threshold at which the top rate was levied dropped from $40,000 in 1935 to $25,000 in 1938.[198] While it rose somewhat in the intervening years, it dropped back to $25,000 and stayed there for almost a quarter of a century from 1950 through 1974.[199] Not only did this scheme fail to treat very large corporations much differently than other corporations, it gave them a largely meaningless tax break on the

[195] *See Corporation Income Tax Brackets and Rates, 1909-2002, available at* http://www.irs.gov/pub/irs-soi/02corate.pdf (last visited Sept. 24, 2012) ("*Corporation Income Tax Brackets and Rates*"). There was also a bubble rate of 53 percent on income between $25,000 and $50,000. Id.
[196] Id.
[197] Leff, supra note xx, at 163.
[198] *Corporation Income Tax Brackets and Rates, supra* note xx.
[199] Id.

first $25,000 of their income. Consequently, the evolving graduated rate scheme served little purpose in taxing bigness other than to protect the smallest corporations from bearing the brunt of the highest rate.

Not surprisingly, in the latter half of the twentieth century, the government's official posture towards the graduated corporate rate structure has been that it is a subsidy for small businesses. In 1985, when Treasury proposed eliminating the graduated corporate rate scheme and replacing it with a flat 33 percent rate,[200] Senator Max Baucus, now the chairman of the Senate Finance Committee, introduced a resolution in Congress in opposition to the proposal on the grounds that "the retention of graduated corporate rates is essential to the continued viability of the small business community."[201] This is also how it is classified in the Joint Committee on Taxation Staff's 2012 annual estimate of federal tax expenditures, or provisions offering reductions in individual or corporate tax liabilities that are targeted to a particular set of taxpayers:

> The corporate income tax includes a graduated tax rate schedule. The lower tax rates in the schedule are classified by the Joint Committee staff as a tax expenditure (as opposed to normal income tax law) because they are intended to provide tax benefits to small business and, unlike the graduated individual income tax rates, are unrelated directly to concerns about ability of individuals to pay taxes.[202]

Thus suggests that if the graduated rate scheme is to survive at all, it would be because of its need to protect small corporations from the effects of across-the-board rate increases.

The need for this kind of small business entity subsidy and for decoupling the treatment of large and small businesses more generally under the corporate income tax

[200] See Staff of the Joint Committee on Taxation, Analysis of Proposals Relating to Comprehensive Tax Reform 40 (Appendix) (Feb. 26, 1985).
[201] 131 Cong. Rec. S 4416 (1985).
[202] STAFF OF THE JT. COMMITTEE ON TAX'N, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2011-2015 9 (Jan. 17, 2012).

rate scheme has become less meaningful as alternative vehicles have emerged for small businesses. The Subchapter S in 1958, in particular, and its antecedent Subchapters R enacted in 1954, allowed small business corporations – or corporations with 10 or fewer stockholders – to opt out completely from entity-level taxation.[203] Similarly, the development of the limited liability company and the adoption of the check-the-box treasury regulation in 1996 permitted businesses to form the limited liability company, which had many of the features of a corporation, but still enjoyed pass-through partnership taxation.[204] For small businesses in particular, the C corporation has become anachronistic since the top individual income tax rate was slashed dramatically during the 1980s and brought below the top corporate rate at least for a brief time in 1986.[205]

As a result of this proliferation of alternative business forms, the vast majority of small businesses can and do easily avoid subchapter C completely. Whereas more than 60 percent of all business operated as C corporations between 1932 and 1935 when the graduated corporate income tax was enacted,[206] Table 4 shows that a mere 20% of all corporations organized as C corporations by the mid-1990s when the check-the-box regulations were adopted:

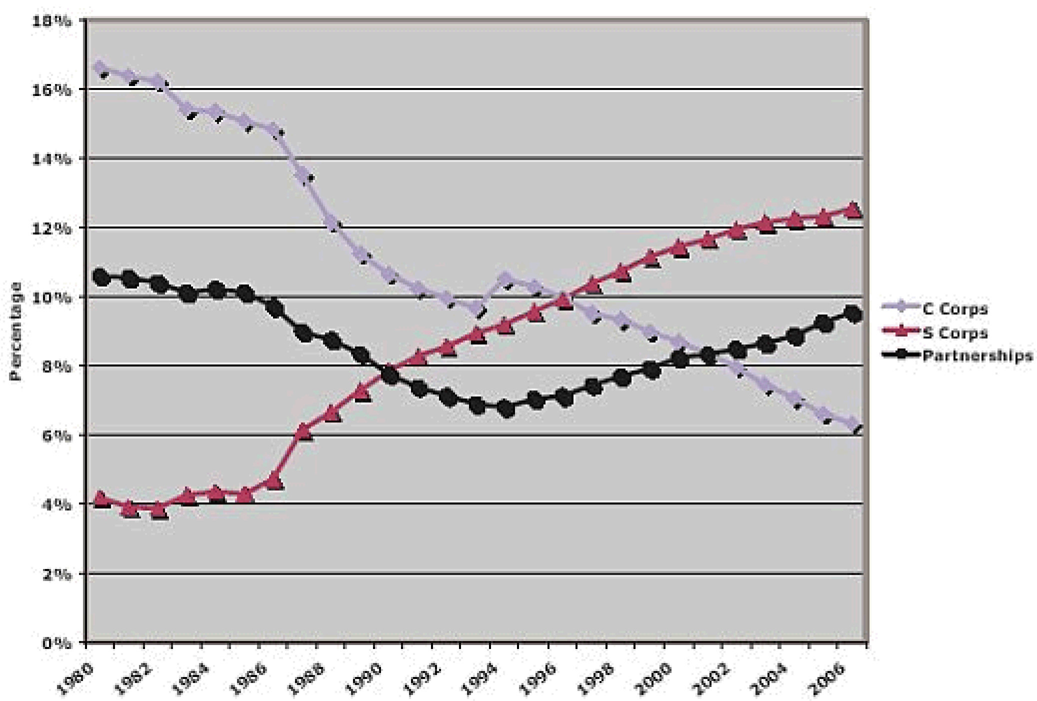
Table 4: Corporations as a Percentage of all Businesses, 1994-1997[207]

[203] Under Subchapter R as enacted, unincorporated businesses could elect to be taxed as corporations, but not the reverse. The original bill permitted small corporations to elect their tax status as well, but this was struck in Conference Committee and then later revived in Subchapter S. For a history of this development, see Mirit Eyal-Cohen, *When American Small Business Hit the Jackpot: Taxes, Politics and the History of Organizational Choice in the 1950s*, 6 PITT. TAX REV. 1, 20, 33 (2008).
[204] Susan Pace Hamill, *The Story of LLCs: Combining the Best Features of a Flawed Business Tax Structure*, in BUSINESS TAX STORIES 295, 303 (Steven A. Bank & Kirk J. Stark, eds., 2005).
[205] Martin A. Sullivan, *Passthroughs Shrink the Corporate Tax by $140 Billion*, 130 TAX NOTES 987, 988 (2011).
[206] See Table 3, supra.
[207] Historical Statistics of the United States: Millenial Edition Online (Naomi Lamoreaux, ed.) (Table Ch1-18 - Active proprietorships, partnerships, and corporations–entities, receipts, and Profit: 1916–1998**)**

Year	Corporations	All Businesses	% Corporate
1994	4,342,368	21,990,202	20%
1995	4,474,167	22,478,939	20%
1996	4,631,370	23,240,649	20%
1997	4,710,083	23,645,197	20%

The decline in the percentage of C corporations is due in significant part to the overall growth of S corporations and partnerships (including limited liability companies) in the last three decades, as seen in Figure 1:

Figure 1: Distribution of C corporations, S corporations, and Partnerships, 1980-2006

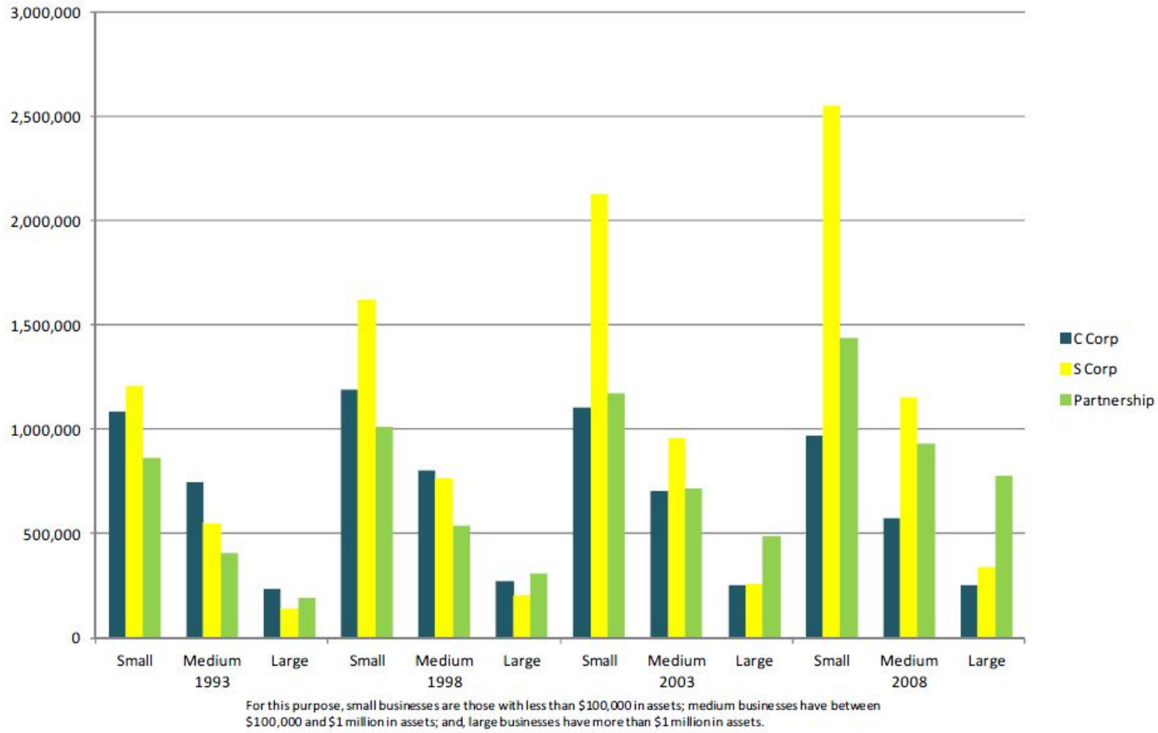


Source: Congressional Research Service, Business Organizational Choices: Taxation and Responses to Legislative Changes (August 6, 2009): 14.

Moreover, the latest evidence indicates that small businesses have been to a large degree responsible for this rise in the use of the S corporation and the partnership. As depicted in Figure 2, a recent Joint Committee of Taxation study found that the number of small business entities electing to use the C corporation form has declined modestly between 1993 and 2008, while the number using S corporations and partnerships increased dramatically.[208] More specifically, the number of small C corporations, defined as those with assets less than $100,000, dropped by approximately 110,000 between 1993 and 2008, while during the same period the number of small S corporations grew by more than 1.3 million.[209] Thus, to the extent that the graduated corporate rate scheme, although not a tax on bigness, still operates to offer some form of tax relief for small businesses, it is a form of relief that is no longer of much use to many small businesses.

Figure 2: The Number of Small, Medium, and Large Business Entities by Type of Legal Entity, 1993, 1998, 2003, and 2008

[208] Staff of the Joint Committee on Taxation, Selected Issues Relating to Choice of Business Entity 8 (July 27, 2012) (Figure 3).
[209] Id. at 7-8.



Source: Joint Committee on Taxation calculations on SOI data.

The real question is why small businesses are still using the C corporation at all. Path dependence surely explains much of it, but one theory is that some of it is due to tax avoidance. There are a few legitimate tax reduction provisions targeted at small corporations,[210] but it is not clear that they are incentives to incorporate. Some small businesses may incorporate at least in part to take advantage of the lower corporate rates on small incomes as compared to their own personal rate.[211] The theory is that a small business owner with a 35 percent top individual marginal rate might be induced to incorporate so as to shift part of her income to the lower 15 percent corporate rate on the first $50,000 of income, especially if she was not seeking to distribute those earnings. It

[210] See, e.g., Eric Toder, *Does the Federal Income Tax Favor Small Business? National Tax Association*, PROCEEDINGS OF THE 100[TH] ANNUAL CONFERENCE, 2007, available at http://www.urban.org/UploadedPDF/411606_income_tax_favor.pdf (last visited October 5, 2012) (identifying provisions).

[211] See Lee, A Populist Perspective of the Business Tax Entities Universe, supra note xx, at 979, 982-83.

is not clear how often corporations are currently used in this way,[212] particularly in light of the availability of 15 percent rates on dividends and capital gains under the 2003 tax relief program, but Jane Gravelle and Thomas Hungerford of the Congressional Research Service reported that "[t]here are over 600,000 corporations with earnings less than $50,000, according to Internal Revenue Service statistics, suggesting some shifting occurs."[213] In other words, not only is the graduated corporate tax rate not a tax on bigness, but it is not really a subsidy for small business per se. Instead, it has become a subsidy for small businesses to elect the corporate form rather than operate as S corporations or partnerships

V. Conclusion

The graduated corporate income tax rate structure was not enacted with rates sufficient to match the rhetoric of taxing bigness when it was enacted in 1935, but that does not mean it was merely symbolic or that it was only a subsidy for small businesses. It emerged in the context of a period in which there was great attention paid to the abuses of large corporations. One strategy for addressing such abuses could have been to subject large corporations to a higher tax rate than smaller corporations, but this was not possible under the flat corporate rate system enacted at the end of the Hoover administration in 1932. Adopting a graduated marginal rate scheme therefore permitted the tax treatment of large and small corporations to be decoupled. Although the rate differential was never

[212] See Kwall, supra note 11, at 1396 ("few individuals are likely to incorporate for the sole reason of exploiting the lower marginal rates).″

[213] JANE G. GRAVELLE AND THOMAS L. HUNGERFORD, CORPORATE TAX REFORM: ISSUES FOR CONGRESS 5 (Dec. 16, 2011).

wide enough to "make bigness demonstrate its alleged superior efficiency,"[214] it did provide the mechanism for doing so when the political climate made that more feasible.

Circumstances have changed significantly since the corporate tax was restructured so it could target bigness. Given the availability of non-corporate vehicles and the possibility that at least some of the remaining small business C corporations are engaged in tax avoidance, it makes sense to consider moving to a flat corporate rate. Taxing bigness, to the extent that is a goal, no longer requires a means for decoupling small businesses from large ones, while a repeal of the graduated rate structure might have positive efficiency consequences by reducing the tax incentive to use the corporate form in the small business context. As Martin Sullivan predicts, "when considering the subject of discouraging C corporations from being used as tax shelters, it is important to keep in mind the complexity induced by the graduated corporate rate structure and the simplification that would result from eliminating graduated corporate tax rates. A flat corporate rate structure would put a stop to many small businesses choosing subchapter C status under current law."[215]

A flat corporate rate also might raise a non-trivial amount of revenue. The Staff of the Joint Committee on Taxation estimated that the annual cost of the reduced rate provided to small corporations was approximately $3.2 billion in 2012.[216] Over the past several years, the Congressional Budget Office has repeatedly identified the repeal of the graduated corporate tax rates on its annual list of possible revenue raisers, estimating that

[214] Franklin Delano Roosevelt, *Message to Congress on Curbing Monopolies*, April 29, 1938, located at The American Presidency Project http://www.presidency.ucsb.edu/ws/index.php?pid=15637 (last visited July 25, 2012).
[215] Martin A. Sullivan, *Will Rate Changes Transform C Corps into Tax Shelters?* 134 TAX NOTES 1590, 1593 (2012).
[216] STAFF OF THE JT. COMMITTEE ON TAX'N, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2011-2015 41, tbl. 1 (Jan. 17, 2012).

it would raise as much as $2.8 billion in additional revenue in 2013 and $24.4 billion over the next decade or so.[217] At a time when the President is seeking a revenue-neutral way to reduce the top corporate income tax rates, ending the graduated marginal rate scheme's ineffective small subsidy may be a logical first step.

[217] Congressional Budget Office, REDUCING THE DEFICIT: SPENDING AND REVENUE OPTIONS (March 2011).