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The Historical Origins of the Debt-Equity Distinction

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THE HISTORICAL ORIGINS OF THE DEBT-EQUITY DISTINCTION

by

Camden Hutchison[*]

ABSTRACT

This Article uses historical evidence to trace the debt-equity distinction's origins, development, and continuing evolution. Citing legislative history, business lobbying efforts, and important changes in the broader historical context, this Article argues that the disparate treatment of debt and equity was never a conscious policy goal, but was rather the unintended outcome of an extended series of short-term political decisions. These political decisions were historically specific—i.e., formulated in response to temporary historical contingencies—but had consequences that have persisted to the present day. The Article concludes by assessing the broader implications of this history for both the current structure of the U.S. tax system and the prospects of future tax reform.

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I. INTRODUCTION

Few aspects of U.S. tax law have received greater criticism—and attracted fewer defenders—than the long-standing distinction between debt and equity.[1] This feature of the tax system allows corporations to deduct interest paid on debt, but not dividends paid to shareholders, from the amount of profits on which federal income tax is calculated. Other things being equal, the effect of this distinction is to reduce the after-tax cost of debt financing relative to equity financing, thus making it less expensive for corporations to borrow money than to issue shares. Many economists believe this policy encourages corporations to substitute debt for equity, distorting the capital structure outcomes that would otherwise obtain in perfect financial markets.[2] Legal scholars have argued that while tax law attempts to draw a bright line between debt and equity, the distinction lacks a compelling theoretical justification, is difficult to draw in practice, and invites tax avoidance strategies.[3] Critics in the financial and popular press have portrayed the debt-

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1. For purposes of this Article, "debt" refers to the usual means by which corporations borrow money, including loans, bonds, and commercial paper, while "equity" refers to capital stock. "Interest" refers to compensation for borrowed money that is typically paid to debtholders, while "dividends" refers to distributions of corporate income that are typically paid to stockholders. As discussed in this Article, the practical and legal distinctions among debt and equity are often problematic.

2. For a review of the relevant economic literature, see John R. Graham, *A Review of Taxes and Corporate Finance*, 1 FOUND. & TRENDS FINANCE 573, 576–600 (2006) [hereinafter Graham, *A Review of Taxes*].

3. For perhaps the most well-known critique of the U.S. tax law's treatment of corporate debt, see William T. Plumb. Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369 (1971) [hereinafter Plumb, *The Federal Income Tax Significance of Corporate Debt*]. For subsequent commentary on the issue, see Ilan Benshalom, *How to Live with a Tax Code with Which You Disagree: Doctrine, Optimal Tax, Common Sense, and the Debt-Equity Distinction*, 88 N.C. L. REV. 1217, 1228–37, 1257–73 (2010) [hereinafter Benshalom, *How to Live with a Tax Code*]; Katherine Pratt, *The Debt-Equity Distinction in a Second-Best World*, 53 VAND. L. REV. 1055, 1055–93 (2000) [hereinafter Pratt, *Second-Best World*]; Adam Emmerich, Comment, *Hybrid Instruments and the Debt-Equity Distinction in Corporate Taxation*, 52 U. CHI. L. REV. 118, 133–42 (1985) [hereinafter Emmerich, *Hybrid Instruments*]. *See also* Joseph Allen, Note, *Seeking True Financial Reform: Ending the Debt-Equity Distinction,* 3 WM. & MARY BUS. L. REV. 243 (2012) [hereinafter Allen, *Seeking True Financial Reform*]. Although the term "debt-equity distinction" did not enter

equity distinction as an aggravating factor in the 2008 financial crisis, claiming that interest deductibility encourages excessive leverage.[4] In light of Republican presidential candidate Mitt Romney's past leadership of Bain Capital, a private equity firm known for engaging in high-leverage acquisition strategies, interest deductibility even emerged as an issue in the 2012 presidential race.[5] Recently, the Obama Administration proposed reducing the tax advantage of debt by limiting the ability of corporations to deduct interest from taxable income.[6] Few observers anticipate significant change, however,

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widespread usage until the late 1960s, earlier scholars recognized the problem, which they often discussed under the rubric of "thin incorporation" or "thin capitalization." *See, e.g.*, Boris I. Bittker, *Thin Capitalization: Some Current Questions*, 34 TAXES 830 (1956); Mortimer Caplin, *The Caloric Count of a Thin Incorporation*, 43 MARQ. L. REV. 31 (1959); William M. Goldstein, *Corporate Indebtedness to Shareholders: "Thin Capitalization" and Related Problems*, 16 TAX L. REV. 1 (1960); Harry K. Mansfield, *Thin Incorporation*, 40 A.B.A. J. 237 (1954); M. R. Schlesinger, *"Thin" Incorporations: Income Tax Advantages and Pitfalls*, 61 HARV. L. REV. 50 (1947); Martin Kurzer, Comment, *Thin Incorporation: A Continuing Problem*, 51 MARQ. L. REV. 158 (1967); Note, *Thin Capitalization and Tax Avoidance*, 55 COLUM. L. REV. 1054 (1955); Note, *Thin Incorporation: The Major Tests of Debt or Equity Financing*, 1959 WASH. U. L. Q. 433 (1959).

4. *See, e.g.*, David Cho, *Look at Macy's: Why Companies Can't Resist: U.S. Tax Code Encourages Them to Rack Up Huge Debt*, WASH. POST, Aug. 8, 2010; Jesse Eisinger, *Distortion in Tax Code Makes Debt More Attractive to Banks*, N.Y. TIMES, Sep. 20, 2012, at B4; Robert C. Pozen, Op-Ed, *A Recipe for Cutting Corporate Taxes*, WASH. POST, Oct. 4, 2012; Felix Salmon, *How to Reduce the Deductibility of Interest Payments*, REUTERS BLOG, Feb. 23, 2012, http://blogs.reuters.com/felix-salmon/2012/02/23/how-to-reduce-the-deductibility-of-interest-payments/; Editorial, *Reform and Corporate Taxes*, N.Y. TIMES, Feb. 23, 2012, at A26 [hereinafter NYT Editorial, *Reform and Corporate Taxes*]. *See also* Allen, *Seeking True Financial Reform*, *supra* note 3.

5. *See* William D. Cohan, *Private Equity's Public Subsidy Is a Tragedy: William D. Cohan*, BLOOMBERGVIEW, Jan. 22 2012, http://www.bloomberg.com/news/2012-01-23/private-equity-s-public-subsidy-is-a-tragedy-william-d-cohan.html; Anthony Luzzatto Gardner, *Romney's Bain Yielded Private Gains, Socialized Losses*, BLOOMBERGVIEW, Jul. 15, 2012, http://www.bloomberg.com/news/2012-07-15/romney-s-bain-yielded-private-gains-socialized-losses.html; James Surowiecki, *Private Inequity*, NEW YORKER, Jan. 30, 2012; *cf.* Josh Barro, *Good Leverage, Bad Leverage and Bain*, BLOOMBERGVIEW Jul. 17, 2012, http://www.bloomberg.com/news/2012-07-17/good-leverage-bad-leverage-and-bain.html.

6. J. REP. BY WHITE HOUSE & DEP'T OF TREASURY, THE PRESIDENT'S FRAMEWORK FOR BUSINESS TAX REFORM 5–6, 9–10 (2012) [hereinafter PRESIDENT'S BUSINESS TAX REFORM]. The House Ways and Means Committee and the Senate Finance Committee have also considered limiting interest deductibility. James Politi, *Congress Weighs Corporate Debt Tax Reform*, FIN. TIMES, Mar. 24, 2013. These

given the well-known difficulty of fundamental tax reform.[7]

This widespread criticism presents a puzzle. If economists, legal scholars, and other tax commentators are in broad agreement that the distinction is unsound, then why does it exist? In other words, how and why did U.S. tax law come to embody a principle that tax policy experts reject?

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proposals follow earlier efforts by the Bush Administration: the capital gains and dividend tax reductions included in the controversial "Bush tax cuts," for example, were intended in part to mitigate the tax advantage of debt. *See* Press Release, White House Office of the Press Secr'y, President Discusses Taking Action to Strengthen America's Economy (Jan. 7, 2003), http://georgewbush-whitehouse.archives.gov/news/releases/2003/01/20030107-5.html. *See also Tax Reform and the Treatment of Debt and Equity: J. Hearing Before the Comm. on Ways & Means and S. Fin. Comm.*, 112th Cong. (2011) (statement of Pamela F. Olson). The Bush-era capital gains and dividend reductions were partially repealed effective January 1, 2013 amidst the federal budget crisis. Under these most recent changes enacted by the Obama Administration, taxation of capital gains and dividends increased from 15 percent to 20 percent for individuals earning more than $400,000 (or married couples earning more than $450,000) annually. American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 101(a)(1)–(3), 126 Stat. 2313, 2315–2316 (2013). In addition, for individuals earning more than $200,000 (or married couples earning more than $250,000) annually, capital gains and dividends are now subject to a 3.8 percent surtax under the Health Care and Education Reconciliation Act raising the maximum rate on investment income to 23.8 percent; this act along with the Patient Protection and Affordable Care Act are popularly referred to as "Obamacare". Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1402, 124 Stat. 1029, 1060–61; *see* Jeff Benjamin, *Deal on Dividend Tax Is Small Victory for Investors*, INVESTMENTNEWS, Jan. 6, 2013, http://www.investmentnews.com/article/20130106/REG/301069988/deal-on-dividend-tax-is-small-victory-for-investors; Tony Nitti, *Obamacare Investment Income: A Downloadable Cheat Sheet*, FORBES, Jan. 6, 2013, http://www.forbes.com/sites/anthonynitti/2012/12/06/cheat-sheets-to-the-obamacare-investment-income-tax-regulations-a-downloadable-pdf/; Hibah Yousuf, *Dividend Tax Hike 'Could Have Been Worse,'* CNNMONEY, Jan. 2, 2013, http://money.cnn.com/2013/01/02/investing/fiscal-cliff-dividend-tax-rate/.
Additionally, the Obama Administration's proposals to directly limit interest deductibility echo the suggestions of several tax commentators. *See generally* Lucas W. Goodman & Robert C. Pozen, *Capping the Deductibility of Corporate Interest Expense*, 137 TAX NOTES 1207 (Dec. 10, 2012); Calvin H. Johnson, *Corporate Meltdowns and the Deduction of Credit-Risk Interest*, 131 TAX NOTES 513 (May 2, 2011); Martin A. Sullivan, *Economic Analysis: Treat Corporate Interest Deductions Like Any Tax Expenditure*, 136 TAX NOTES 631 (Aug. 6, 2012).

7. *See* Ezra Klein, *Tax Reform Is Really, Really Hard*, WASH. POST BLOG, Feb 22, 2012, http://www.washingtonpost.com/blogs/ezra-klein/wp/2012/08/10/tax-reform-is-going-to-be-really-really-hard/; Daniel Shaviro, *How Would the "President's Framework for Corporate Tax Reform" Pay for Cutting the Corporate Rate?* START MAKING SENSE BLOG (Feb. 23, 2012), http://danshaviro.blogspot.com/2012/02/how-would-presidents-framework-for.html; NYT Editorial, *Reform and Corporate Taxes*, *supra* note 4.

Was the favorable treatment of debt a product of the political influence of business and financial interests? Was the unfavorable treatment of equity due to equalitarian efforts to redistribute wealth? Did the distinction necessarily result from any specific political agenda? Is it even possible to pinpoint exactly when and how the distinction first arose?

In general, existing scholarship has not addressed these questions. Although the debt-equity distinction has been the focus of considerable academic attention, few policy-oriented scholars have examined the issue's history.[8] Economists, reflecting their disciplinary training and expertise, tend to evaluate policies as givens, rather than considering their historical contexts. Economic studies of the debt-equity distinction have therefore focused on its effects rather than its causes.[9] Applied policy research produced by the federal government and other nonacademic institutions is particularly ahistorical—many of these sources recommend reform, but provide no insight into why the current system exists.[10] For their part, legal scholars have taken a greater interest in the political aspects of the distinction, but they have generally focused on its contemporary persistence, without accounting for its historical

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8. This is despite recognition that history matters for understanding current policy structures. Ilan Benshalom, for example, has suggested that better appreciation of the origins of tax rules could lead to better contemporary policy analysis. Regarding the debt-equity distinction, he describes the current state of affairs as follows:

> Arbitrary distinctions, such as the debt-equity distinction, have little if any justification for why they should be enforced but for the fact that they are "in the Code." With this type of shaky why, it is no wonder that practitioners devote most of their time to questions of how, while academics find it more attractive to solve abstract problems with intellectually "cleaner" solutions.

Benshalom, *How to Live with a Tax Code*, *supra* note 3.

9. This characterization applies to the vast majority of economic scholarship on the issue, much of which is technical in nature. For a review of the literature, see Graham, *A Review of Taxes*, *supra* note 2.

10. *See, e.g.*, PRESIDENT'S BUSINESS TAX REFORM, *supra* note 6; RUUD A. DE MOOIJ, INTL. MONETARY FUND, TAX BIASES TO DEBT FINANCE: ASSESSING THE PROBLEM, FINDING SOLUTIONS (2011); STAFF OF J. COMM. ON TAX'N, JCX-41-11, PRESENT LAW AND BACKGROUND RELATING TO TAX TREATMENT OF BUSINESS DEBT (2011); DEP'T OF TREASURY, TREASURY CONFERENCE ON BUSINESS TAXATION AND GLOBAL COMPETITIVENESS (2007); ; OFFICE OF TAX POLICY, DEP'T OF TREASURY, APPROACHES TO IMPROVE THE COMPETITIVENESS OF THE U.S. BUSINESS TAX SYSTEM FOR THE 21ST CENTURY (2007); THE PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM (2005); Michael Keen, Alexander Klemm & Victoria Perry, *Tax and the Crisis*, 31 FISC. STUD. 43 (2010).

origins.[11] Such causal explanations as do exist in the literature rely more on reasoned speculation than empirical evidence. Jennifer Arlen and Deborah Weiss, for example, have suggested that lobbying by financial companies may explain the existence of interest deductibility.[12] Barry Adler has written that interest deductibility may be the result of lobbying more generally, with the tacit approval of the taxpaying public.[13] Katherine Pratt has ascribed the debt-equity distinction to a historical, individualistic conception of debtor-creditor relations, under which interest was considered a legitimate business expense, but dividend payments were not.[14] Given their focus on contemporary policy issues, none of these authors support their explanations with primary historical evidence.

This Article takes a different approach. Rather than conducting a normative assessment of the debt-equity distinction as it exists today, it seeks to explain how and why the distinction became law in the first place. Answering this question represents an important contribution to the literature, as no scholar of any discipline has provided an adequate account of the policy's origins. Indeed, if tax scholars are guilty of neglecting history, historians are equally guilty of neglecting taxes—few historians have written on fiscal history, and fewer still have delved into the specific details of tax

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11. See Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 YALE L.J. 325 (1995) [hereinafter Arlen & Weiss, *A Political Theory*] for a commonly cited analysis of the contemporary politics of the debt-equity distinction. *See also* Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 345–46 (1993) [hereinafter Adler, *American Corporate Bankruptcy*]; Benshalom, *How to Live with a Tax Code*, *supra* note 3, at 1238–45; Yariv Brauner, *Integration in an Integrating World*, 2 N.Y.U. J.L. & BUS. 51, 53 n.12 (2005); Michael Doran, *Managers, Shareholders, and the Corporate Double Tax*, 95 VA. L. REV. 517, 528–35 (2009); Anthony P. Polito, *Advancing to Corporate Tax Integration: A Laissez-Faire Approach*, 55 S.C. L. REV. 1, 34–36 (2003). Articles address the debt-equity distinction's history rarely devote more than a few pages to the discussion of its history. *See, e.g.*, Benshalom, *How to Live with a Tax Code*, *supra* note 3, at 1240–43; Curtis Jay Berger, *Simple Interest and Complex Taxes*, 81 COLUM. L. REV. 217, 218–22 (1981) [hereinafter Berger, *Simple Interest*]; Emmerich, *Hybrid Instruments*, *supra* note 3, at 121–28; Jeffrey L. Kwall, *The Uncertain Case Against the Double Taxation of Corporate Income*, 68 N.C. L. REV. 613, 618–20 (1990) [hereinafter Kwall, *The Uncertain Case*]; Pratt, *Second-Best World*, *supra* note 3, at 1094–98; Alvin C. Warren, Jr., *The Corporate Interest Deduction: A Policy Evaluation*, 83 YALE L.J. 1585, 1585–86 (1974) [hereinafter Warren, *The Corporate Interest Deduction*].

12. Arlen & Weiss, *A Political Theory*, *supra* note 11, at 354 n.163.

13. Adler, *American Corporate Bankruptcy*, *supra* note 11, at 346.

14. Pratt, *Second-Best World*, *supra* note 3, at 1065–67.

law.[15] The result of this neglect is that the origins of many long-standing tax principles, including the debt-equity distinction, are poorly understood.

An important exception is the work of Steven Bank, who has written extensively on the history of corporate tax law. Of particular significance is Bank's work on the rise of "double taxation"—the feature of U.S. tax law by which corporate profits are taxed at both the corporate and individual shareholder levels.[16] Since dividend payments, unlike interest, are not deductible by corporations for tax purposes, double taxation can be thought of as the equity side of the debt-equity distinction.[17] Bank's work in this area has been an important influence on my own research, and indeed, this Article supports many of his findings.

My contribution is distinct from Bank's in important respects, however. Most significantly, I redirect attention to the origins of interest deductibility, while Bank's work has emphasized the tax treatment of equity. I also rely somewhat less than Bank on the agency theory framework of corporate governance scholarship. Finally, I pay greater attention to how changes in the historical context, including broad shifts in the American political landscape, transformative economic developments, and unanticipated fiscal crises (such as war, depression, and other exogenous fiscal shocks), imposed a wide array of shifting and often contradictory pressures on U.S. tax policy.

Specifically, this Article argues that the debt-equity distinction is the unintended consequence of an extended series of discrete, reactive, short-term political decisions, rather than the intentional realization of any broader policy goal. Each such decision was influenced by prior decisions, imparting a

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15. Among current historians of taxation, W. Elliot Brownlee and Joseph Thorndike are perhaps the most prominent. While valuable, their work has generally focused on broad policy developments rather than specific legal rules. *See, e.g.*, W. ELLIOT BROWNLEE, FEDERAL TAXATION IN AMERICA: A SHORT HISTORY (2d ed. 2004) [hereinafter BROWNLEE, A SHORT HISTORY]; FUNDING THE MODERN AMERICAN STATE, 1941–1995: THE RISE AND FALL OF THE ERA OF EASY FINANCE, (W. Elliot Brownlee ed., 1996); TAX JUSTICE: THE ONGOING DEBATE, (Joseph J. Thorndike & Dennis J. Ventry eds., 2002); JOSEPH J. THORNDIKE, THEIR FAIR SHARE: TAXING THE RICH IN THE AGE OF FDR (2013).

16. *See* STEVEN A. BANK, FROM SWORD TO SHIELD: THE TRANSFORMATION OF THE CORPORATE INCOME TAX, 1861 TO PRESENT (2010) [hereinafter BANK, SWORD TO SHIELD]; Steven A. Bank, *The Story of Double Taxation: A Clash Over the Control of Corporate Earnings*, *in* BUSINESS TAX STORIES 153 (Steven A. Bank & Kirk J. Stark eds., 2005) [hereinafter Bank, *The Story of Double Taxation*]; Steven A. Bank, *Corporate Managers, Agency Costs, and the Rise of Double Taxation*, 44 WM. & MARY L. REV. 167 (2002) [hereinafter Bank, *Corporate Managers*].

17. Bank has also addressed the debt side of the distinction in a recent symposium essay. *See* Steven A. Bank, *Historical Perspective on the Corporate Interest Deduction*, 18 CHAP. L. REV. 29 (2014).

distinctly path-dependent character to the process's eventual outcome. Due to the significant inertia of tax policy, decisions made in response to specific historical circumstances became difficult to change—even after the circumstances themselves changed or were no longer relevant. Through an essentially undirected process, the debt-equity distinction became an important feature of U.S. tax law without ever representing a coherent policy objective. As discussed in the conclusion, this process has important implications for our present understanding of the diverse and often contingent forces that have shaped the U.S. tax system.

This Article begins with the Civil War and the enactment of the first U.S. income tax and concludes with the establishment of full double taxation of dividends in the late 1930s. This roughly 80-year period encompasses the debt-equity distinction's origins and early development. Although the distinction has persisted throughout the postwar era, I have limited the scope of my analysis to the distinction's formative years, as its more recent history has already received considerable attention in the legal literature. My focus throughout is on the legislative politics that led to specific statutory developments, as well as the social and economic contexts that shaped the broader legislative agenda.[18]

This Article proceeds as follows: Part II addresses the temporary income taxes enacted in the nineteenth century, prior to the establishment of a permanent federal income tax system. This part focuses in particular on the emerging concept of net income and the attendant deductibility of business expenses. Part III explores statutory developments from 1909 to 1939, the period in which the debt-equity distinction became a permanent feature of U.S. tax law. Spanning World War I and the Great Depression, these were the formative years of U.S. corporate taxation. Part IV concludes, assessing the broader significance of the debt-equity distinction's history to the limits and possibilities of American tax reform.

II. HISTORICAL ANTECEDENTS: THE CIVIL WAR INCOME TAX AND THE INCOME TAX OF 1894

The United States government's first permanent income tax—initially imposed only on corporations—was enacted by Congress in 1909.[19]

18. By and large, this Article does not focus on judicial decisions. Since many of the notable decisions in this area attempted to delineate debt from equity in terms of a preexisting statutory distinction, the scope of this Article is limited to the evolution of the statutes themselves in the interest of concision.

19. An Act to provide revenue, equalize duties and encourage the industries of the United States, and for other purposes, Pub. L. No. 61-5, § 38, 36 Stat. 11, 112–17 (1909) [hereinafter 1909 Act to provide revenue]. Although Congress characterized

Following ratification of the Sixteenth Amendment in 1913,[20] which specifically permitted income taxation without apportionment among the states, Congress expanded the income tax to include personal income as well.[21] Income taxation, both corporate and personal, has been a cornerstone of the U.S. tax system ever since, and many of the Internal Revenue Code's defining features can be traced to the legislation of the early twentieth century.

The first permanent income tax and the Sixteenth Amendment were not the federal government's first efforts at income taxation, however. Congress had enacted income taxes twice before in American history.[22] To help finance the Civil War, Congress enacted an income tax for the first time in 1861,[23] which remained in effect with various modifications until its repeal in 1871.[24] Despite repeated calls for reinstatement, the federal government did without an income tax until 1894, when a broad coalition of equalitarian political interests were able to win its return.[25] This victory was short-lived, however, as the Supreme Court struck down the 1894 tax as unconstitutional within a year of its enactment.[26]

Despite the gaps in time between the nineteenth-century income taxes and the permanent system established in the period between 1909 and 1913, these earlier laws established important precedents for the subsequent tax

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this tax as a special excise tax on corporate profits, it was a corporate income tax for all intents and purposes.

20. U.S. CONST. amend. XVI.

21. An Act to reduce tariff duties and to provide revenue for the Government, and for other purposes, Pub. L. No. 63-16, §§ II.A–F, 38 Stat. 114, 166–71 (1913) [hereinafter 1913 Act to reduce tariff duties and provide revenue].

22. Several states, including North Carolina, Oklahoma, South Carolina, Virginia, and Wisconsin, had also previously experimented with income taxation. As of the enactment of the federal individual income tax in 1913, the only state income tax of any significance was that of Wisconsin, enacted in 1911. EDWIN R. A. SELIGMAN, THE INCOME TAX: A STUDY OF THE HISTORY, THEORY, AND PRACTICE OF INCOME TAXATION AT HOME AND ABROAD 388–429 (1911) [hereinafter SELIGMAN, A STUDY OF THE INCOME TAX]. The Wisconsin income tax, which became a model for income taxes adopted in other states, was enacted as Act of Jul. 15, 1911, ch. 658, 1911 Wisc. Session Laws 984. Surprisingly, the 1911 Wisconsin tax does not appear to have featured in the Congressional debates leading to the 1913 federal tax.

23. An Act to provide increased Revenue from Imports, to pay Interest on the Public Debt, and for other Purposes, § 49, 12 Stat. 292, 309 (1861).

24. An Act to reduce internal Taxes, and for other Purposes, § 6, 16 Stat. 256, 257 (1870) provided that 1871 would be the final year of the income tax.

25. An Act to reduce taxation, to provide revenue for the government, and for other purposes, §§ 27–33, 28 Stat. 509, 553–57 (1894).

26. As discussed *infra*, text at note 130, the Supreme Court struck down the tax on the grounds that it violated the apportionment requirement of U.S. CONT. art. 1, § 2. Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429 (1895).

treatment of debt and equity. Significantly, the nineteenth-century tax laws occasioned Congress's first engagement with what is perhaps the fundamental conceptual problem of income taxation: What, exactly, is "income"? The resolution of this question in the nineteenth century would establish the framework for all future tax laws, conditioning the treatment of interest and dividends under the twentieth-century corporate income tax.

A. The Civil War Revenue Acts and the Meaning of Income

The Civil War gave rise to the federal government's first experiments with income taxation. Prior to the war, the government raised the majority of its revenue through import tariffs.[27] While sufficient to fund the national government's modest peacetime expenditures, tariffs were seen as inadequate to meet the unprecedented cost of war mobilization.[28] In addition, tariff revenue was vulnerable to wartime disruptions to foreign trade, increasing the importance of securing additional sources of government income.[29] Republican legislators, who dominated both houses of the Union Congress, believed a new tax based on individual income could help solve the North's sudden fiscal challenges. Together with tariff increases, excise taxes, and new direct taxes on real property (apportioned among the states), the country's first income tax was adopted August 5, 1861.[30]

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27. *See* F. W. TAUSSIG, THE TARIFF HISTORY OF THE UNITED STATES 63–133 (5th ed. 2010).

28. In the century and a half following the Civil War, federal spending as a percentage of the U.S. economy has increased significantly. Federal spending as a percentage of GDP was approximately 1.7 percent in 1859; the same figure was approximately 20.8 percent in 2013. John Joseph Wallis, *Federal Government Finances—Revenue, Expenditure, and Debt: 1789–1939, table Ea584–587 in* HISTORICAL STATISTICS OF THE UNITED STATES, EARLIEST TIMES TO THE PRESENT: MILLENNIAL EDITION (Susan B. Carter et al. eds., 2006); Office of Mgmt. & Budget, *Table 15.3—Total Government Expenditures as Percentages of GDP: 1948–2013*, https://www.whitehouse.gov/sites/default/files/omb/budget/fy2015/assets/hist15z3.xls (last visited Oct. 5, 2015). *See also* BROWNLEE, A SHORT HISTORY, *supra* note 15, at 31.

29. BANK, SWORD TO SHIELD, *supra* note16, at 12; ROY G. BLAKEY & GLADYS C. BLAKEY, THE FEDERAL INCOME TAX 2 (1940) [hereinafter BLAKEY & BLAKEY, THE FEDERAL INCOME TAX]; SELIGMAN, A STUDY OF THE INCOME TAX, *supra* note 22, at 430–34; JOHN WITTE, THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX 67 (1985) [hereinafter WITTE, POLITICS AND DEVELOPMENT].

30. The revised tariffs, excise taxes, direct taxes, and income tax were all included within 1861 Act to increase Revenue, *supra* note 23. As discussed *infra* Part I.A, the 1861 income tax was never collected, being superseded by replacement legislation in 1862. The Confederacy, facing a similar fiscal crisis, adopted its own income tax in 1863. William D. Samson, *The Nineteenth Century Income Tax in the South*, 12 ACCOUNT. HIST. J., Spring 1985, at 37, 44–48.

Unlike today, the Civil War income tax applied only to the income of individuals, not the profits of corporations. Under the 1861 Act, the tax was to be levied as 3 percent of the annual income, in excess of $800, of "every person residing in the United States."[31] Corporations and other business entities were not obligated to pay taxes on profits).[32] Beginning in 1862, the government levied a withholding tax equal to the individual income tax on interest and dividends paid by businesses in certain industries. The income targeted by this withholding tax was the income of individuals, not the profits of corporations as entities separate from their investors.[33] Corporations and other businesses subject to the withholding tax merely served as collection points. At the time, the perceived injustice of double taxation—taxing income at the corporate level and then again at the individual level—was a sensitive political issue, which Congress sought to avoid by allowing individual taxpayers to deduct interest and dividends subject to the withholding tax from their personal

31. 1861 Act to increase Revenue, *supra* note 23, at § 49, 12 Stat. 292, 309. In subsequent years, the 3 percent rate would increase and the $800 exemption would decrease. For comparison, the relative value of $800 in 1861 would be $21,800 in 2013, based on changes in the consumer price index (CPI). *Seven Ways to Compute the Relative Value of a U.S. Dollar Amount - 1774 to Present*, MEASURINGWORTH.COM, http://www.measuringworth.com/uscompare/ (last visited Nov. 26, 2014) [hereinafter *Seven Ways to Compute U.S. Dollar Amount*]

32. For a summary of the 1861 Act's key provisions, see *infra* Appendix row 1.

33. An Act to provide Internal Revenue to support the Government and to pay Interest on the Public Debt, §§ 81–82, 12 Stat. 432, 469–70 (1862) [hereinafter 1862 Act to provide Internal Revenue to support the Government] imposed a 3 percent withholding tax on interest and dividends paid by transportation companies, as well as on dividends (but not interest) paid by financial and insurance companies. An Act to provide Internal Revenue to support the Government, pay Interest on the Public Debt, and for other Purposes, §§ 117, 120–22, 13 Stat. 223, 281–82, 283–85 (1864) [hereinafter 1864 Act to support the Government and pay Interest on Public Debt] allowed individual taxpayers to deduct interest and dividends subject to withholding tax from their personal income, imposed individual income tax on certain business profits, whether divided or otherwise, imposed a 5 percent withholding tax on interest and dividends paid by transportation companies, and imposed a 5 percent withholding tax on dividends (but not interest) paid by financial and insurance companies. *See* BLAKEY & BLAKEY, THE FEDERAL INCOME TAX, *supra* note 29, at 5; SELIGMAN, A STUDY OF THE INCOME TAX, *supra* note 22, at 444; Reuven S. Avi-Yonah, *Corporations, Society, and the State: A Defense of the Corporate Tax*, 90 VA. L. REV. 1193, 1219–20 (2004) [hereinafter Avi-Yonah, *A Defense of the Corporate Tax*]; *cf.* BANK, SWORD TO SHIELD, *supra* note 16, at 5 (arguing that although Congress purposefully avoided double taxation, the Civil War tax laws planted the seeds of a separate corporate income tax).

income.[34] This deduction was meant to ensure that taxes withheld from interest and dividend payments were not duplicated when individual investors filed their personal tax returns.[35]

Despite the absence of a separate corporate income tax, the Civil War revenue acts had important consequences for the subsequent tax treatment of corporate debt and equity. Congress's experience with these early income tax laws first gave rise to the concept of net income, inspiring the deduction system familiar to us today. Since the tax distinction between debt and equity is predicated on the existence of interest deductibility, the emergence of a net conception of income was central to the distinction's later development.

When the income tax was first enacted, the precise meaning of "income" was unclear. Under the 1861 Act, the 3 percent tax applied to "the annual income of every person residing in the United States, whether such income is derived from any kind of property, or from any profession, trade, employment, or vocation carried on in the United States or elsewhere[.]"[36] The word "income" was not defined in the statute, however, and national, state, and local taxes were the only specified deductions.[37] This left considerable ambiguity as to whether the law's purpose was to tax gross income (all revenue received by the taxpayer) or net income (revenue received by the taxpayer, minus associated costs and expenses).

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34. 1862 Act to provide Internal Revenue to support the Government, *supra* note 33, at § 91, 12 Stat. 432, 473–74; 1864 Act to support the Government and pay Interest on Public Debt, *supra* note 33, at § 117, 13 Stat. 223, 281–82.

35. Integration of the withholding and individual-level taxes was imperfect, however, in that the withholding tax was set at a flat rate that did not take into account the standard personal exemption. This inconsistency was likely due to limitations in the design and administration of the tax laws, rather than specific Congressional intent. BANK, SWORD TO SHIELD, *supra* note 16, at 7–8. To illustrate the relative scale of these taxes, in fiscal year 1864, the withholding tax on interest and dividends amounted to $5,277,141.07, approximately 24 percent of all income tax revenues and nearly 5 percent of internal revenue from all sources. In fiscal year 1865, withholding tax on interest and dividends increased to $8,070,367.53, nearly 26 percent of all income tax revenues and approximately 4 percent of internal revenue from all sources. Withholding tax on interest and dividends represented a much larger percentage of income tax revenues in fiscal year 1863—approximately 62 percent—as the administrative infrastructure for collecting income tax directly from individuals was not yet fully in place. *See* TREASURY DEP'T, REPORT OF THE COMMISSIONER OF INTERNAL REVENUE ON THE OPERATIONS OF THE INTERNAL REVENUE SYSTEM FOR THE YEAR ENDING JUNE 30, 1865 (1865); TREASURY DEP'T, REPORT OF THE COMMISSIONER OF INTERNAL REVENUE ON THE OPERATIONS OF THE INTERNAL REVENUE SYSTEM FOR THE YEAR ENDING JUNE 30, 1864 (1864); TREASURY DEP'T, REPORT OF THE COMMISSIONER OF INTERNAL REVENUE ON THE OPERATIONS OF THE INTERNAL REVENUE SYSTEM FOR THE YEAR ENDING JUNE 30, 1863 (1863).

36. 1861 Act to increase Revenue, *supra* note 23, at § 49, 12 Stat. 292, 309.

37. *Id*

The 1861 Congressional debates leading to the tax's enactment suggest that although certain deductions were implied, the exact scope of allowable deductions was intentionally left unclear. Senator James Simmons, a Republican from Rhode Island who introduced the tax bill in the Senate, warned against what he considered the disadvantages of specifying deductions. When questioned as to whether "income" meant gross or net income for purposes of the tax bill, Simmons responded that "income" was intended to mean "net profits," but that specific determinations as to exactly which expenses were or were not deductible were best left to the Treasury Department, which was charged with the tax's enforcement.[38] According to Simmons, express use of the term "net income" within the language of the statute would open the door for taxpayers to claim spurious deductions.[39] Referring to a hypothetical storehouse owner, Simmons explained:

> If I put in the word "net" income, he would try to have all the repairs, and so on, deducted, and would make them amount to as much as the income. That would be the trouble. When a man repairs his buildings, he will have less income that year, because he spends it in repairing. I thought of putting this word "net" in; but I could see so many ways of evading it that I thought it better to let the Secretary of the Treasury prescribe his rules, and let the bill cover all incomes.[40]

Other Senators disagreed, feeling the meaning of the law should be as clear as possible. For example, Senator Daniel Clark, a Republican from New Hampshire, submitted an amendment to insert the word "net" before the word "income," but his proposal was voted down 18-10 in floor debate.[41] Ultimately, Senator Simmons's preference for ambiguity prevailed, as reflected in the final language of the law. The meaning of income under the 1861 Act was never subjected to practical interpretation, however. In the first of many revisions to the Civil War tax laws, a superseding revenue act was signed July 1, 1862, before the 1861 Act was put in force.[42]

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38. CONG. GLOBE, 37th Cong., 1st Sess. 315 (1861).
39. *Id.*
40. *Id.*
41. *Id.*
42. The 1861 tax was to be payable June 30, 1862, but the Secretary of the Treasury, Salmon Chase, advised that enforcement of the tax be deferred, as "numerous questions will certainly perplex its assessment and collection." SELIGMAN, A STUDY OF THE INCOME TAX, *supra* note 22, at 435–36. The superseding 1862 tax was enacted as 1862 Act to provide Internal Revenue to support the Government, *supra* note 33.

Under the 1862 Act, the income tax continued to apply to individuals—"every person residing in the United States"—and was now imposed at 3 percent of income exceeding $600 (unless the taxpayer's income exceeded $10,000, in which case the rate increased to 5 percent of income exceeding $600).[43] Presumably, the Act's reference to "every person residing in the United States" limited its application to individuals, although a separate section of the act confused the matter by defining "person" to include "partnerships, firms, associations, or corporations."[44] The Commissioner of Internal Revenue, charged with enforcing the tax, resolved this ambiguity by determining that the income tax applied to individuals only.[45] Although the tax was not applied to corporations or other business entities as such, under the 1862 Act, certain corporate interest and dividend payments became subject to a 3 percent withholding tax.[46] To avoid double taxation, these payments were correspondingly deductible from the taxable income of individual investors.[47]

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43. 1862 Act to provide Internal Revenue to support the Government, *supra* note 33, at § 90, 12 Stat. 432. For comparison, based on changes in the CPI, the relative value of $600 in 1862 would be $14,300 in 2013, while the relative value of $10,000 would be $239,000. *Seven Ways to Compute U.S. Dollar Amount*, *supra* note 31. Unlike the 1861 Act, which explicitly referred to an "income tax," the corresponding section of the 1862 Act referred instead to an income "duty." Why Congress chose to use the word "duty" in the 1862 version is unclear, but "duty" was changed back to "tax" in 1867. An Act to amend existing Laws relating to Internal Revenue, and for other Purposes, § 13, 14 Stat. 471, 481–82 (1867) [hereinafter 1867 Act to amend Laws relating to Internal Revenue].

44. 1862 Act to provide Internal Revenue to support the Government, *supra* note 33, at § 68, 12 Stat. 432, 459–60. Although a literal reading of this section might suggest that every reference to "person" in the 1862 Act included "partnerships, firms, associations, or corporations," the broader statutory framework would have made such an interpretation difficult to sustain.

45. The Commissioner of Internal Revenue issued the following decision in the spring of 1863: "The income tax is assessed upon the actual income of individuals. Firms, as such, will not make returns." Comm'r of Internal Revenue, No. 110, Relative to the assessment of the income tax (May 1863) *reprinted in* GEORGE SEWALL BOUTWELL, A MANUAL OF THE DIRECT AND EXCISE TAX SYSTEM OF THE UNITED STATES 275 (1863) [hereinafter BOUTWELL, A MANUAL].

46. 1862 Act to provide Internal Revenue to support the Government, *supra* note 33, at §§ 81–82, 12 Stat. 432, 469–70.

47. 1862 Act to provide Internal Revenue to support the Government, *supra* note 33, at § 91, 12 Stat. 432, 473–74; *see infra* Appendix *row* 2. The salaries of federal employees (including elected officials) also became subject to a 3 percent withholding tax on amounts in excess of $600 and were fully deductible from such employees' personal tax returns. 1862 Act to provide Internal Revenue to support the Government, *supra* note 33, at § 86, 12 Stat. 432, 472.

For the most part, the phraseology of the 1861 Act was carried over to the 1862 Act, with one significant difference: the 1862 Act replaced the term "income" with the broader phrase "gains, profits, or income."[48] Although this broader language more strongly suggested a net income concept, ambiguity persisted, as reflected in the disagreement that characterized the 1862 legislative debates. Some members of Congress believed the meaning of "gains, profits, or income" was self-evident, and that further elaboration would only dilute the statute.[49] Others argued that the meaning of "gains, profits, or income" was ambiguous, and that express use of the words "net income" was a necessary clarification.[50] Although opponents of the term "net income" claimed to agree, in principle, that taxpayers should be allowed to deduct expenses from taxable income, such claims may have been disingenuous, as opposition to the term seems to have been motivated largely by a desire to limit deductions and thereby maximize revenue.[51] For example, despite having earlier acknowledged that "gains, profits, or income" meant net income, Representative Justin Morrill, a Republican from Vermont, specifically opposed the deductibility of mortgage interest.[52]

This issue of mortgage interest received particularly close attention from Congress. By the 1860s, the westward expansion of American agriculture was creating unprecedented growth in mortgage lending, as more and more farmers purchased farmland with loans secured by the underlying property.[53] Mortgage loans were fast becoming one of the most common forms of personal debt, and it is therefore unsurprising they featured prominently in Congressional debates. Tellingly, some of the same lawmakers who advocated a less precise definition of income also argued that mortgage payments should not be allowable as deductions.[54] As was often the case in nineteenth-century tax politics, there appears to have been a regional cast to these debates, with western agricultural states favoring interest deductibility and wealthier northeastern states opposing it.[55] In an exchange in the House

48. 1862 Act to provide Internal Revenue to support the Government, *supra* note 33, at § 90, 12 Stat. 432, 473.

49. *See* CONG. GLOBE, 37th Cong., 2nd Sess. 1531–32 (1862).

50. *Id*.

51. *Id*. at 1531–32, 2486–87.

52. *See id.* at 1531–32.

53. For discussion of the nineteenth-century rise of the national mortgage market, see Jonathan Levy, *The Mortgage Worked the Hardest*, *in* CAPITALISM TAKES COMMAND: THE SOCIAL TRANSFORMATION OF NINETEENTH-CENTURY AMERICA 39 (Gary J. Kornblith & Michael Zakim eds., 2010).

54. *See* CONG. GLOBE, 37th Cong., 2nd Sess. 1531–32 (1862).

55. *See* BLAKEY & BLAKEY, THE FEDERAL INCOME TAX, *supra* note 29, at 4; BROWNLEE, A SHORT HISTORY, *supra* note 15, at 46–47; SELIGMAN, A STUDY OF THE INCOME TAX, *supra* note 22, at 506–08, 520–21.

of Representatives, Representative Owen Lovejoy of Illinois and Representative Steven White of Indiana proposed an amendment specifying that "income" meant "net income." Representatives Justin Morrill of Vermont and Thaddeus Stevens of Pennsylvania opposed the measure. Illustrating the tensions between the western and northeastern states, Stevens criticized the proposal in the following terms:

> I oppose the amendment of the gentleman from Indiana. The income tax, as a general rule, will be almost exclusively collected from the large cities. The country, and especially the western country, will not pay a millionth part of it. If the present amendment prevails, they will not pay any part of it.[56]

In addition to revealing regional frictions, these debates suggest that, from the income tax's earliest beginnings, some lawmakers were already concerned with the use of deductions as an avoidance measure.

Other lawmakers also opposed inclusion of a specific mortgage interest deduction, but for essentially the opposite reason—they believed the phrase "gains, profits, or income" clearly entailed the deduction of mortgage interest and feared specifying particular deductions might imply the disallowance of others.[57] Following a rather confused debate, the "gains, profits, or income" phraseology (without the word "net") prevailed in the House, but not all representatives agreed that the final language was sufficiently precise. Upon assurances from colleagues that "gains, profits, or income" meant net income, an unsatisfied Lovejoy responded: "All I have to say is, that some of the best lawyers in the House understand income to be the gross income."[58]

These disagreements notwithstanding, most members of Congress probably did understand "gains, profits, or income" to mean net income, as this was the meaning most often articulated in the official record. According to Senator John Sherman, future Treasury Secretary and original sponsor of the Sherman Antitrust Act, the word "income" was widely understood to mean net income, both as a practical and legal matter. Conceding that the word "income" had not yet received definitive construction in American law, Sherman argued that the term had a well-established meaning in commercial practice and under the law of England, and that in both contexts, expenses—

56. CONG. GLOBE, 37th Cong., 2nd Sess. 1531 (1862). Representatives Lovejoy, White, Morrill, and Stevens were all Republicans. Given the dominance of the Republican Party, regional differences were often of greater political significance than party differences.

57. *Id.* at 1531–32, 2486–87.

58. *Id.* at 1532.

including interest—were always deducted to arrive at income.[59] A contemporary analysis of the 1862 Act in the Daily National Intelligencer supported the "net income" interpretation. Citing dictionary definitions of the words "gains," "profits," and "income," the article concluded that while the term "income" could be construed literally to mean all revenue that "comes in," the addition of the narrower terms "gains" and "profits" to form the phrase "gains, profits, or income" weighed in favor of a net concept.[60]

Similar to the question of the meaning of the term "person," the ambiguity of "gains, profits, or income" was ultimately resolved at the administrative level when the income tax was assessed and collected by the newly formed Bureau of Internal Revenue. Faced with the practical problem of how to measure taxable income, the Bureau chose to assess the tax on a net basis. Its standard income tax return form, published and distributed for use by taxpayers, explicitly provided for the deduction of business expenses, maintenance expenses, insurance expenses, mortgage interest, and rent.[61] Letter rulings issued by the Bureau in 1863 emphasized that "income tax is laid upon the net gains, after the expenses of conducting the business are deducted[,]"[62] and that the rate of taxation was to be determined "after those deductions are made, which are in actual diminution of income, such as rents, taxes, repairs, losses, &c."[63] Moreover, an 1863 administrative decision of the Bureau ruled that "[i]nterest on borrowed capital used in business" was also deductible.[64] Given the Bureau's decisive construction of the law, the ambiguity of the statute had little practical significance.

When Congress amended the income tax again in 1864, it followed the Bureau's lead by addressing deductions explicitly and providing that labor costs, rent, and interest on mortgages were all deductible from taxable income.[65] Taxpayers could also deduct interest on general, unsecured debt, but only up to the amount of interest they had received during the tax year.[66] In addition, the 1864 amendments increased the income tax to a graduated rate of 5–10 percent and increased the withholding tax on corporate interest and

59. *Id.* at. 2487.

60. *The Income Tax*, DAILY NAT'L INTELLIGENCER, Aug. 27, 1862, at 2.

61. Form 24, *reprinted in* BOUTWELL, A MANUAL, *supra* note 45, at 155–56.

62. Ruling 23, *reprinted in* BOUTWELL, A MANUAL, *supra* note 45, at 304.

63. Ruling 36, *reprinted in* BOUTWELL, A MANUAL, *supra* note 45, at 306.

64. Decision 110, *reprinted in* BOUTWELL, A MANUAL, *supra* note 45, at 275.

65. 1864 Act to support the Government and pay Interest on Public Debt, *supra* note 33, at § 117, 13 Stat. 223, 281–82.

66. *Id*.

dividends to 5 percent.[67] Regarding deductions from income, it is not entirely clear why—having avoided the issue in previous versions of the tax—Congress chose to address deductions explicitly in 1864. The labor, rent, and interest deductions were included in the 1864 House bill without comment and were never amended (and apparently never discussed) as the bill moved through Congress on its way to enactment.[68] It seems likely that Congress was simply conforming the law to the collection practice established by the Bureau, but given the lack of legislative discussion, the exact reasons remain unknown. Whatever the impetus, expense deductibility had now become an explicit feature of statutory tax law.

The income tax remained in place following the conclusion of the Civil War, and its structural details continued to evolve at both the statutory and administrative levels. In 1867, Congress abandoned rate graduation and changed the tax to a flat 5 percent rate on income exceeding $1,000.[69] More importantly, the interest deduction provision was substantially rewritten. Under the 1867 amendments, general, unsecured business interest became fully deductible, while the deductibility of non-business mortgage interest was repealed.[70] In effect, interest deductibility now depended on whether the underlying debt was business-related, rather than on whether it was secured by a lien. Following this amendment, the Bureau ceased its former practice of allowing taxpayers to deduct interest on home mortgages.[71]

At the time, most interest-bearing debt in the American economy was, in fact, business-related. Mortgage loans were issued primarily for the purchase of farmland, which generated business income for tax purposes.

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67. 1864 Act to support the Government and pay Interest on Public Debt, *supra* note 33, at §§ 116, 120, 122, 13 Stat. 223, 281, 283–84, 285–85; *see infra* Appendix row 3.

68. H.R. 405, 38th Cong. (1864). The revenue bill passed the House by a vote of 103-33 and the Senate by a vote of 28-3. The deduction provisions do not appear to have been controversial, as I have found no discussion of them in Congressional debates or contemporary news coverage. For vote count information, see *The Vote on the Tax Bill*, BOSTON DAILY ADVERTISER, Apr. 30, 1864, at 2.

69. 1867 Act to amend Laws relating to Internal Revenue, at § 13, 14 Stat. 471, 477–80. For comparison, the relative value of $1,000 in 1867 would be $16,200 in 2013, based on changes in the CPI. *Seven Ways to Compute U.S. Dollar Amount*, *supra* note 31.

70. 1867 Act to amend Laws relating to Internal Revenue, at § 13, 14 Stat. 471, 477–80.

71. OFFICE OF INTERNAL REVENUE, INSTRUCTIONS TO UNITED STATES ASSESSORS: CONCERNING THE ASSESSMENT OF INCOMES AND SPECIAL TAXES FOR THE YEAR 1868, at 7 (1868); *Mr. Delano on Taxation of Homestead Income*, N.Y. TIMES, March 28, 1870, at 1.

Personal non-business lending was mainly limited to store credit.[72] Nevertheless, homestead mortgage lending—mortgage lending secured by a home, rather than farmland—which did not generate business income and was therefore no longer deductible under the Bureau's collection practices, had become sufficiently widespread that the Bureau's actions led to strong public criticism.[73] Editorials in major newspapers and periodicals condemned "the weak and oppressive effort of the Internal Revenue Bureau to prohibit the deduction of interest paid on mortgages,"[74] castigated the Bureau's policies as lacking "justice or common sense,"[75] and forewarned that "we are rapidly drifting toward a despotism in this matter of the income tax."[76]

Perhaps in response, Congressional amendments to the tax laws in 1870 eliminated any distinction between business and non-business interest, allowing taxpayers to deduct "the amount of interest paid during the year" without qualification.[77] Strangely, the Bureau continued its practice of limiting full interest deductibility to business debt. According to Bureau regulations, interest on home mortgages and other non-business obligations was only deductible up to the amount of interest income received, which for most taxpayers meant not at all.[78] This discrepancy between the statutory law and its administrative enforcement highlights the confusion and ambiguity that characterized the early income tax. It also illustrates the early conception of interest as a business expense, an association that would continue to influence later corporate tax policy.

In addition to addressing the treatment of interest, the 1870 amendments also provided for the income tax's (temporary) repeal, limiting the tax's effectiveness to the year 1871 "and no longer."[79] In the years following the conclusion of the war, the federal government's fiscal situation had begun to improve, budget deficits had turned to surpluses, and the income

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72. *See* LOUIS HYMAN, BORROW: THE AMERICAN WAY OF DEBT 17–40 (2012).

73. *See Income Tax Exemptions*, INDEPENDENT, Mar. 24, 1870, at 8 [hereinafter *Income Tax Exemptions*]; *Mortgagors and the Income Tax*, N.Y. TIMES, Mar. 11, 1870 at 2; *Reducing Taxes*, MERCHS.' MAG. & COMMERCIAL REV., Jan.–June 1870, at 420 [hereinafter *Reducing Taxes*]; *The Income Tax*, N.Y. TIMES, Mar. 20, 1870, at 3 [hereinafter *The Income Tax*]; *The Income Tax and Interest on Mortgages*, N.Y. TIMES, March 15, 1870, at 2.

74. *Reducing Taxes*, *supra* note 73.

75. *The Income Tax*, *supra* note 73.

76. *Income Tax Exemptions*, *supra* note 73.

77. 1870 Act to reduce Taxes, *supra* note 24, at § 9, 16 Stat. 256, 258.

78. 7 I.R.R. 59, 11 I.R.R. 89, 11 I.R.R. 97, *reprinted in* ORLANDO F. BUMP, INTERNAL REVENUE LAWS. INTERNAL REVENUE STATUTES NOW IN FORCE; WITH NOTES REFERRING TO ALL DECISIONS OF THE COURT AND DEPARTMENTAL RULINGS, CIRCULARS, AND INSTRUCTIONS, REPORTED TO OCTOBER 1, 1870, at 295–96 (1870).

79. 1870 Act to reduce Taxes, *supra* note 24, at § 6, 16 Stat. 256, 257.

tax—always unpopular—was no longer considered necessary.[80] So ended the federal government's first experiment with income taxation, a revenue source that would remain dormant until the Populist movement of the 1890s. Although brief in duration, the Civil War income tax was of major importance to subsequent tax law. Two of its developments in particular—the establishment of a tax base grounded in the concept of net income and the designation of interest as a deductible business expense—would eventually become permanent features of the American tax system.

B. The Income Tax of 1894 and the Advent of the Corporate Interest Deduction

Following the Civil War, the government returned to its previous reliance on import tariffs. Popular discontent with the tariff system would soon emerge as a major political issue, however. The postwar nineteenth century was a period of rapid economic development, but also of damaging financial panics, growing labor unrest, and increasingly salient income inequality.[81] Amidst these sweeping economic changes, the politically dominant Republican Party's tariff-centered fiscal policies drew increasing criticism. Many voters perceived high tariffs on manufactured and other imported goods as favoring northeastern industrial interests at the expense of American consumers. Although indirect taxes such as tariffs are generally less visible than direct taxes on income, U.S. tariffs were too high and too pervasive to escape public notice. Since tariffs increased the prices of imported goods, including basic necessities, and since the poor spent a greater proportion of income on consumption than the wealthy, the postwar tax system was highly regressive.[82] Even consumers who avoided imported goods were effectively

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80. SELIGMAN, A STUDY OF THE INCOME TAX, *supra* note 22, at 456–68.

81. RICHARD FRANKLIN BENSEL, THE POLITICAL ECONOMY OF AMERICAN INDUSTRIALIZATION, 1877–1900, at 206–17 (2000) [hereinafter BENSEL, THE POLITICAL ECONOMY]; EDWARD C. KIRKLAND, INDUSTRY COMES OF AGE: BUSINESS, LABOR, AND PUBLIC POLICY, 1860–1897, at 1–12, 163–94, 356–81, 399–409 (1961); GLENN PORTER, THE RISE OF BIG BUSINESS, 1860–1920 82–84 (3rd ed., 2006). For recent work on nineteenth-century labor unrest, see generally THERESA A. CASE, THE GREAT SOUTHWEST RAILROAD STRIKE AND FREE LABOR (2010); THE PULLMAN STRIKE AND THE CRISIS OF THE 1890S: ESSAYS ON LABOR AND POLITICS (Nick Salvatore et al. eds., 1999); THE GREAT STRIKES OF 1877 (David Omar Stowell ed., 2008).

82. In modern economic parlance, a regressive tax system is one in which a given taxpayer's effective tax rate is inversely related to their ability to pay. In other words, poor taxpayers face higher effective rates than wealthy taxpayers. At the time, the tariff system was widely criticized as favoring the wealthy and disproportionately burdening the poor. SELIGMAN, A STUDY OF THE INCOME TAX, *supra* note 22, at 454–55. During the political debates leading to the 1894 income tax, Representative Benton

taxed when they purchased competing domestic goods, the high prices of which were supported by tariffs. In addition to taxing imports, Republican fiscal policy also imposed high excise taxes on "sinful," though highly popular, consumer goods such as alcohol and tobacco.[83] Serving as the cornerstone of the Republican Party's protectionist trade policy, these import and consumption taxes effected a substantial wealth transfer from consumers to producers.[84]

Popular dissatisfaction with tariff policy helped energize an increasingly competitive Democratic party, which rose to challenge Republican dominance in the 1880s and 1890s. Calls to reduce tariffs and reinstate a progressive income tax converged with populist demands for trade liberalization, restrictions on trusts, and an inflationary "free silver" monetary policy—all spurred by economic disaffection and increasingly visible concentrated wealth.[85] Tax reform was a central plank of the Democratic Party Platform of 1892, which cast Republican tariff policy as "the culminating atrocity of class legislation."[86] The tariff issue helped Democrats win both houses of Congress in the elections of 1892.[87] Following the Democrats' victory, any remaining political resistance to a new income tax was undermined by the financial panic of 1893, which precipitated the worst depression the United States had experienced to date.[88] Amidst a climate of

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McMillin of Tennessee summarized this view by stating that under the tariff system "want, not wealth, pays the tax" and that an income tax would "put more tax upon what men have, less on what they need." *Id.* at 497.

83. In the late nineteenth century, these excise taxes became a major component of the U.S. tax system, often generating as much as one-third to one-half of federal tax revenue. BROWNLEE, A SHORT HISTORY, *supra* note 15, at 37–38.

84. For discussion of the tax politics of the late nineteenth century, see *id.* at 31–57. *See also* BENSEL, THE POLITICAL ECONOMY, *supra* note 811, at 457–509.

85. For discussion of the role of political populism in late nineteenth century financial and monetary debates, see CHARLES POSTEL, THE POPULIST VISION 137–73 (2007); GRETCHEN RITTER, GOLDBUGS AND GREENBACKS: THE ANTI-MONOPOLY TRADITION AND THE POLITICS OF FINANCE IN AMERICA, 1865–1896, at 1–61, 152–207 (1999). In the politics of the day, the tax, trust, and trade issues were closely interconnected. No less than Henry Havemeyer, president of the notorious "sugar trust," believed that "[t]he mother of all trusts is the Customs Tariff Bill." *Facts About the Trusts*, N.Y. TIMES, Jun. 19, 1899.

86. Democratic Party Platform (June 21, 1892) *reprinted in Democratic Party Platforms: Democratic Party Platform of 1892, June 21, 1892*, THE AMERICAN PRESIDENCY PROJECT, http://www.presidency.ucsb.edu/ws/index.php?pid=29585 (Gerhard Peters & John T. Wooley eds.) (last visited Mar. 16, 2013).

87. BROWNLEE, A SHORT HISTORY, *supra* note 15, at 46–47; SELIGMAN, A STUDY OF THE INCOME TAX, *supra* note 22, at 493–99.

88. DOUGLAS W. STEEPLES & DAVID O. WHITTEN, DEMOCRACY IN DESPERATION: THE DEPRESSION OF 1893, at 27–65 (1998).

crisis and resentment, a broad coalition of Democrats and Progressives won passage of a new income tax in 1894.[89] To its many supporters, the income tax was more than simply a revenue measure—its passage was also a symbolic victory over economic privilege and inequality.[90]

Initially, the income tax had been introduced in the House in January 1894 by Representative Benton McMillin, as an amendment to the already pending 1894 revenue bill.[91] As originally drafted, the tax generally followed its Civil War predecessor, with certain important structural differences. Unlike the Civil War tax, which had applied to personal income only, the 1894 Act taxed corporate profits separately from the income of individuals. Specifically, in addition to a 2 percent tax on the annual "gains, profits, and income" in excess of $4,000 of "every citizen of the United States," it also imposed a 2 percent tax on the annual "net profits or income above actual operating and business expenses" of all "corporations, companies, or associations," excluding partnerships.[92] To avoid double taxation, Congress allowed individuals to exclude dividends from taxable income.[93] This shift to taxing corporations separately from individuals reflected the increasing significance of corporations in the American economy, as the prevalence of the corporate form had surged in the second half of the nineteenth century. Since more and more businesses were being organized as corporations, there were increasing practical advantages to taxing corporations directly.[94]

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89. BROWNLEE, A SHORT HISTORY, *supra* note 15, at 46–47; SELIGMAN, A STUDY OF THE INCOME TAX, *supra* note 22, at 493–99.

90. BROWNLEE, A SHORT HISTORY, *supra* note 15, at 47; SELIGMAN, A STUDY OF THE INCOME TAX, *supra* note 22, at 507.

91. 26 CONG. REC. 1,594–97 (1894).

92. 1894 Act to reduce taxation, *supra* note 25, at §§ 27, 32, 28 Stat. 509, 553, 556–57. Like today, partnership income was attributable to individual partners. Note that while individual income was taxable only to the extent it exceeded $4,000, corporate income received no comparable exemption. For comparison, the relative value of $4,000 in 1894 would be $112,000 in 2013, based on changes in the CPI. *Seven Ways to Compute U.S. Dollar Amount*, *supra* note 31.

93. 1894 Act to reduce taxation, *supra* note 25, at § 28, 28 Stat. 509, 553–54; *see infra* Appendix row 4.

94. During the mid- to late-nineteenth century, rapid economic development, together with the spread of general or free state incorporation laws that allowed firms to incorporate by following a simple administrative procedure without the need of specific legislative approval, led to increasing numbers of corporations. Robert E. Wright, *Capitalism and the Rise of the Corporation Nation*, *in* CAPITALISM TAKES COMMAND: THE SOCIAL TRANSFORMATION OF NINETEENTH-CENTURY AMERICA 145 (Gary J. Kornblith & Michael Zakim eds., 2012). Growth in the number, size, and economic importance of corporations was also driven by institutional changes that occurred during the Civil War, including an increased reliance on corporations to coordinate the extractive, manufacturing, and transportation sectors of

Although the 1894 Act income tax seemed to entail an additional layer of taxation by taxing corporations directly, in substance it closely followed the Civil War system, which had imposed a withholding tax on dividend payments while exempting dividends from individual tax returns. Under both systems, corporate profits were generally taxed only once.[95] Indeed, some scholars have argued that the 1894 corporate income tax actually targeted individual investors rather than corporations qua corporations, and was therefore merely a variation of taxation "at the source" (i.e., taxation paid at the entity level on behalf of diffuse taxpayers).[96] This view—suggesting significant continuity between the Civil War withholding provisions and the 1894 corporate income tax—is supported by the statements of Democratic Senator George Vest of Missouri, a member of the Committee on Finance and one of the key architects of the 1894 Act:

> Instead of making the corporation a collector simply for the Government, we have endeavored to simplify the bill and, in my judgment, we have strengthened it, by putting the tax directly upon the corporation and then allowing the corporation to adjust its relations with its own stockholders as it sees proper.[97]

Viewed in this light, the decision to tax corporations directly was a matter of administrative convenience, and did not reflect a conception of corporations as economically distinct from their investors.

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the economy. Sean Patrick Adams, *Soulless Monsters and Iron Horses: The Civil War, Institutional Change, and American Capitalism*, *in* CAPITALISM TAKES COMMAND: THE SOCIAL TRANSFORMATION OF NINETEENTH-CENTURY AMERICA 249 (Gary J. Kornblith & Michael Zakim eds., 2012).

95. The practical similarity of the two systems was accentuated by the high dividend payout ratios common in the late nineteenth century. Unlike in later decades, many corporations in the 1890s distributed most of their profits as dividends. STEVEN A. BANK, ANGLO-AMERICAN CORPORATE TAXATION: TRACING THE COMMON ROOTS OF DIVERGENT APPROACHES 107–20 (2011); JONATHAN BARRON BASKIN & PAUL J. MIRANTI, JR., A HISTORY OF CORPORATE FINANCE 189–97 (1999) [hereinafter BASKIN & MIRANTI, A HISTORY OF CORPORATE FINANCE]; ROBERT SOBEL, THE GREAT BULL MARKET: WALL STREET IN THE 1920S, at 32 (1968); BANK, SWORD TO SHIELD, *supra* note 16, at 6–7; Steven A. Bank, *Is Double Taxation a Scapegoat for Declining Dividends? Evidence from History*, 56 TAX L. REV. 463, 467–74 (2003).

96. *See* Avi-Yonah, *A Defense of the Corporate Tax*, *supra* note 33, at 1214–15; Steven A. Bank, *Entity Theory as Myth in the Origins of the Corporate Income Tax*, 43 WM. & MARY L. REV. 447, 504–37 (2001). Any reader who has had income or payroll taxes withheld from their regular paycheck will be familiar with "at the source" taxation.

97. 26 CONG. REC. 6,866 (1894).

The finer details of the 1894 Act were shaped by the Congressional debates leading to its enactment. The taxation of corporate interest payments received particular attention from lawmakers. As originally drafted, the legislation provided no deductions from corporate income.[98] An amendment supported by Vest, however, proposed that the corporate tax be calculated based on net earnings "above ordinary working or operating expenses."[99] While clarifying that the tax was to be calculated based on net income, this amendment also seemed to disallow the deduction of interest, which was generally considered a fixed expense rather than an operating expense.[100] Members of Congress opposed to the income tax's reintroduction seized on Vest's amendment as one of several flaws warranting the tax's rejection. Senator David Hill, a Democrat from New York and one of the income tax's staunchest opponents, assailed the lack of corporate interest deductibility during a lengthy floor speech against the tax.[101] According to Hill, disallowing the deduction of fixed charges such as interest was an injustice unprecedented in the history of taxation, amounting to "robbery under the form of law."[102] Invoking the recent financial crisis and the depressed state of the national economy, Hill warned that disallowing corporate interest deductions would "cripple, embarrass, and throw into receiverships hundreds of corporations now struggling for existence."[103]

The day after Hill's speech, Vest modified his proposal, offering language permitting corporations to deduct interest on "bonded indebtedness."[104] The reasons behind Vest's shift are not entirely clear. While it may have been an effort to placate critics such as Hill, it also had the effect of angering the tax's most fervent supporters. Many observers assumed the new language was a concession to the railroad industry, which was facing dire economic conditions in the wake of the financial panic.[105] American railroad corporations were heavily reliant on bond financing, and high leverage led to

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98. *Id.* at 1,594–97.

99. *Id.* at 6,621.

100. *Id*.

101. Senator Hill—representing New York, one of the nation's wealthiest and most highly industrialized state economies—was one of the few Democrats in Congress to oppose the 1894 income tax. Hill's role in these debates again illustrates that regional differences were often more important than party affiliations in nineteenth-century tax politics.

102. 26 CONG. REC. 6,621 (1894).

103. *Id*.

104. *Id.* at. 6,690.

105. *Hill's War Paint On*, BOSTON DAILY ADVERTISER, Jun. 23, 1894, at 1; *Very Near the End*, MORNING OREGONIAN, Jun. 23, 1894, at 1.

high rates of insolvency as revenues plunged and credit evaporated.[106] Given the power and influence of the railroads, critics of Vest's revision were quick to ascribe it to industry lobbying. Claiming that "a large assembly of railroad people" had visited Washington immediately prior to Vest's proposal, Senator Eugene Hale, a Republican from Maine, characterized the amendment as "the surrender to the railroad corporations."[107] Populist Senator William Allen of Nebraska went further, alleging that a "certain railroad magnate" (he declined to specify who) had been invited to the Capitol Building and dictated tax policy directly to the Senate Finance Committee.[108] For his part, Vest denied the accusations in full:

> I know nothing of any railroad people being assembled here. I have not seen any of them, except as I have seen people here every day for the last four months; but this amendment has not been made at the instigation of any corporation. I am under the influence of no corporation, and have no connection with any corporation; but we are endeavoring to make this bill upon just and equitable principles, and this was the result of consultation amongst the members of the committee.[109]

Since Vest's discussions with the Finance Committee were never publicly reported, the true reasons for the revision—and the extent of railroad industry influence—remain unknown. Given the precarious financial environment and the massive debt overhang facing American business, however, it seems plausible that the solvency of large corporations (such as railroads) was an important consideration in the Finance Committee's decision making. Indeed, before Vest's revised language was even put to vote, Connecticut Republican Senator Oliver Platt suggested expanding the deduction from "bonded indebtedness" to cover all corporate debt, of whatever form.[110] This change was quickly accepted, and deductibility of all interest on "bonded or other indebtedness" was incorporated into the final law.[111]

Deductibility of dividends was also a sensitive issue. As drafted, the 1894 bill provided that individual income was taxable only to the extent it

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106. By 1897, more than 25 percent of the railroad industry's total capitalization (and more than 40 percent of track mileage) would fall into receivership. BASKIN & MIRANTI, A HISTORY OF CORPORATE FINANCE, *supra* note 95, at 150–51.

107. 26 CONG. REC. 6,690 (1894). The exchanges between Senators Hale and Vest were widely reported in the nation's newspapers.

108. *Id.* at 6,709.

109. *Id.* at 6,690.

110. *Id.* at 6,773.

111. 1894 Act to reduce taxation, *supra* note 25, at § 32, 28 Stat. 509, 556–57; 26 CONG. REC. 6,777 (1894).

exceeded $4,000 annually. Corporate income, however, enjoyed no corresponding exemption.[112] This meant that while interest paid by corporations to individuals with incomes less than $4,000 was essentially tax free (being deductible at the corporate level and untaxed at the individual level), the payment of dividends to such "low income" investors remained subject to the corporate-level income tax. During the debates over the tax bill, many lawmakers sought to eliminate this disparity by allowing corporations to deduct a portion of their dividends.

Discussion of this issue was strongly influenced by differing perceptions of bondholders and shareholders. In the early 1890s, large corporations in need of outside financing typically issued bonds, which enjoyed a longer-established, deeper, and more liquid market than equity securities.[113] Perhaps for this reason, ownership of bonds and other forms of debt was commonly associated with the capitalist elite, while ownership of shares was more often associated with small investors and dependent beneficiaries, including the proverbial widows and orphans. Given these stereotypical notions of bondholders and shareholders, the less favorable treatment of equity under the tax bill was controversial: In the House, Ohio Democrat Tom Johnson argued that, as drafted, the corporate tax would punish the most disadvantaged members of society, including "widows or orphans or aged people."[114] Senator Hill of New York lamented that:

> this injustice is upon those people who have incomes of less than $4,000, the poor people of the country, the widows and orphans, and the men of infirm health, who rely upon the little accumulations which have been given to them or which they have worked for and laid up.[115]

Although a supporter of the income tax, Senator James Smith, a Democrat from New Jersey, also warned that the provisions concerning corporations risked "discriminating against the widow, the orphan, and the man of moderate means."[116]

To address these concerns, Smith introduced an amendment in the Senate allowing corporations to deduct "any dividends paid to a single

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112. *See* 26 CONG. REC. 1,594–97 (1894).

113. VINCENT P. CAROSSO, INVESTMENT BANKING IN AMERICA: A HISTORY 30 (1970) [hereinafter CAROSSO, INVESTMENT BANKING]. The dominance of bonds over stock in the financing of large corporations would not begin to wane until the "great merger movement" of 1895 through1904. BASKIN & MIRANTI, A HISTORY OF CORPORATE FINANCE, *supra* note 95, at 194.

114. 26 CONG. REC. 1,652 (1894).

115. *Id.* at 6,865.

116. *Id.* at 6,871.

stockholder not exceeding $4,000 annually."[117] Smith argued this deduction was necessary to protect not only vulnerable dependents such as widows and orphans, but also owners of small businesses and members of agricultural cooperatives.[118] Smith's proposal was criticized on the grounds that it would be impracticable to administer—according to Vest, the deduction provision "would be almost impossible of execution."[119] These criticisms were apparently effective, as Smith's amendment was tabled by a 31–24 vote.[120] Immediately following the vote on Smith's amendment, Hill proposed a substantially similar amendment—the only difference being that it provided a $3,000 per shareholder deduction, rather than $4,000.[121] Explaining the purpose of his amendment, Hill stated that his goal was not to benefit corporations, but rather to protect individual investors. Again characterizing the income tax as fundamentally flawed, he claimed its operation would constitute an injustice against the poor: "I am not complaining because it affects corporations," he stated, "I am simply complaining that you make a discrimination against the poor man."[122] Hill's rhetorical appeals notwithstanding, his amendment fared no better than Smith's, being rejected by a vote of 33–20.[123] Then, in a striking display of either dogged determination or political posturing (probably the latter), Hill proposed substantially similar amendments twice more—first with a deduction of $2,000 and finally with a deduction of $1,000.[124] These too were rejected.[125] Ultimately, no deductions of dividends would be included in the final law.

Congress finally passed the 1894 Act in late August.[126] As enacted, it retained the 2 percent tax on individual income exceeding $4,000[127] as well as the 2 percent tax on all corporate income.[128] Interest payments, but not dividends, were fully deductible by corporations.[129] The corporate interest deduction was born.

These developments were short-lived, however. The following year, in the *Pollock v. Farmers' Loan & Trust Co.* decision, the Supreme Court

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117. *Id.* at 6,867.
118. *Id.* at 6,871–72.
119. *Id.* at 6,867.
120. *Id.* at 6,872.
121. *Id.*
122. *Id.* at 6,873.
123. *Id.* at 6,875.
124. *Id.* at 6,875–78.
125. *Id.*
126. *See* 1894 Act to reduce taxation, *supra* note 25.
127. 1894 Act to reduce taxation, *supra* note 25, at § 27, 28 Stat. 509, 553.
128. 1894 Act to reduce taxation, *supra* note 25, at § 32, 28 Stat. 509, 556–57.
129. *Id.*

struck down the new tax before it was ever collected.[130] In a controversial five to four ruling, the Court held that the income tax violated the Constitution's requirement that direct taxes be apportioned on a population basis among the states.[131] The Court's decision came as a staggering defeat for the tax's supporters, who had spent years fighting for income taxation in the national political arena.

Like the Civil War income tax before it, however, the 1894 tax's influence would extend far beyond its abbreviated lifespan. In removing interest—but not dividends—from the corporate income tax base, the 1894 Act established a precedent followed by the income tax laws passed between 1909 and 1913. Under the 1894 Act, interest was deductible from corporate income and subject to taxation when received by investors, while dividends were not deductible from corporate income and not subject to taxation when received by investors. Since interest and dividends were each subject to a single level of taxation (interest being taxed at the investor level and dividends being taxed at the corporate level), and since the individual and corporate tax rates were both 2 percent, the respective tax burdens on debt and equity were similar for investor income above $4,000.[132] This same basic structure—interest being taxed at the investor level and dividends being taxed at the corporate level—was recreated by the tax legislation of the early twentieth century. As detailed in Part III, it was during the decades of 1909 to 1939, under the pressures of war, depression, and a massively expanding federal budget, that preferential treatment of debt financing emerged as a permanent feature of American tax law.

III. THE STATUTORY DEVELOPMENT OF THE DEBT-EQUITY DISTINCTION

Income taxation returned to the U.S. in the early twentieth century—this time permanently. Due to the constitutional constraints on direct taxation imposed by the *Pollock* decision, corporate and individual income taxes were reintroduced in two separate phases. First, a "special excise tax" on corporate profits—a corporate income tax in all but name—was enacted in 1909. This corporate tax was joined by a personal income tax in 1913, following ratification of the Sixteenth Amendment. Although the rates of these taxes were initially low (only 1 percent on corporate profits and 1 percent to 7 percent on personal income), they would increase significantly within a few years of their enactment. The extraordinary cost of World War I would prompt the expansion of the income tax, transforming it into the U.S. government's

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

131. *Id.*; *see also* U.S. CONT. art. 1, § 2.

132. If an investor earned less than $4,000 annually, interest went untaxed. *See supra* text accompanying note 112.

single largest source of revenue. Tax rates decreased after the conclusion of the war and remained stable during the prosperity of the 1920s, but the back-to-back crises of the Great Depression and World War II brought further dramatic changes to the tax system.

Throughout this period, a variety of policy concerns pulled Congress in conflicting directions regarding the tax treatment of corporate debt and equity. On the one hand, many lawmakers feared that allowing corporations to deduct interest would encourage them to take on excess debt in order to reduce their taxes. On the other hand, lawmakers were also concerned that disallowing interest deduction would increase the tax burden on shareholders. Many in Congress assumed that any taxation of funds allocable to interest payments would be passed on to shareholders in the form of reduced dividends. The tax treatment of dividends themselves was also a complex issue. Politicians were vocal in their opposition to double taxation, but as we shall see, this opposition could waver in the face of political expediency. Finally, organized business became increasingly involved in tax policy during this period, injecting further complications into Congressional decision making. Spurred into action by World War I's elevated tax rates—by far the highest to that point in American history—business exerted significant influence at several key junctures in the income tax's evolution. During the three decades preceding World War II, these various factors converged together to shape the contemporary debt-equity distinction.

A. The Corporation Tax of 1909

In the years following the *Pollock* decision of 1895, political pressure to reestablish income taxation continued to mount, despite the constitutional hurdles imposed by the Supreme Court.[133] An unprecedented wave of business consolidations occurring from 1895 to 1904 increased popular concern over the economic power of large corporations. In a rapid burst of merger activity, approximately 1,800 firms disappeared into larger enterprises, mainly by way of horizontal consolidations.[134] Sudden, dramatic increases in the market share of America's largest corporations fueled public resentment toward concentrated wealth, leading even Republican President Theodore Roosevelt to advocate graduated estate and income taxes in 1906.[135] Pressure to reduce tariffs had not abated in the years following the *Pollock* decision, and with even Republican opposition softening, some form of major tax reform began

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133. BLAKEY & BLAKEY, THE FEDERAL INCOME TAX, *supra* note 29, at 22–23; BROWNLEE, A SHORT HISTORY, *supra* note 15, at 47–53.

134. NAOMI R. LAMOREAUX, THE GREAT MERGER MOVEMENT IN AMERICAN BUSINESS, 1895–1904, at 1–13 (1988).

135. BLAKEY & BLAKEY, THE FEDERAL INCOME TAX, *supra* note 29, at 21.

to seem inevitable.[136] As the tax issue built to a head in 1909, newly-elected Republican President William Howard Taft brokered a tax reform compromise between Congressional conservatives (who opposed income taxation) and progressives (who supported it): Under Taft's plan, a small tax on corporate profits would be enacted immediately, while the question of an individual income tax would be submitted to the states as a proposed constitutional amendment.[137] Rather than describing the new corporation tax as an income tax, the measure was labeled a special excise tax pegged to corporate profits, a transparent (and ultimately successful) bid to circumvent the *Pollock* holding.[138] Labels aside, the 1909 corporation tax was an income tax both in design and effect.

The treatment of corporate debt was an important question in drafting the new tax law. As part of the political compromise to which it owed its existence, the corporation tax was initially drafted by members of the Taft Administration, and the choice of whether to tax interest on bonds was a major issue in the Administration's internal decision making.[139] As in prior decades, corporate bonds remained closely associated with the nation's wealthy in the public consciousness, and the Administration was reluctant to be seen as

136. *Id.* at 22–24.

137. From a procedural standpoint, the 1909 corporation tax was an unusual piece of tax legislation. It was first proposed by the presidential administration and then introduced by the Senate Finance Committee as an amendment to a revenue bill that had already passed the House. This process was arguably inconsistent with the constitutional requirement that all revenue bills originate in the House. Indeed, the corporation tax would be unsuccessfully challenged on these grounds in federal court. *See infra* note 138. The Taft Administration's support of a corporation tax may have been an effort to forestall an individual income tax, as this was clearly the goal of conservative Republicans in Congress. Avi-Yonah, *A Defense of the Corporate Tax*, *supra* note 33, at 1217. *See also* MORTON KELLER, REGULATING A NEW ECONOMY: PUBLIC POLICY AND ECONOMIC CHANGE IN AMERICA, 1900–1933, at 215–18 (1990). Republican Senator Nelson Aldrich, chairman of the Senate Finance Committee and long-time opponent of income taxation, explained his support for the Administration's proposal as follows: "I shall vote for a corporation tax as a means to defeat the income tax." 44 CONG. REC. 3,929 (1909).

138. Soon after its enactment, the corporation tax was challenged in federal court on the same grounds as the 1894 income tax—that it violated the Constitution's prohibition on unapportioned direct taxation. In the same case, it was also challenged on the separate grounds that its introduction by the Senate Finance Committee violated the constitutional requirement that all revenue bills originate in the House. The Supreme Court upheld the tax on the theory that it was an excise tax, not a direct tax, despite its similarities to the tax of 1894. Flint v. Stone Tracy Co., 220 U.S. 107, 173–77 (1911).

139. BLAKEY & BLAKEY, THE FEDERAL INCOME TAX, *supra* note 29, at 40–47.

allowing wealthy bondholders to avoid taxation.[140] According to New York Republican Senator Elihu Root, a close ally of the Taft Administration and one of the corporation tax's primary authors, the treatment of corporate bonds "was the subject of repeated discussion in which the President, the Attorney-General, and other members of the Cabinet and members of the Committee on Finance of the Senate took part."[141] Despite initial reluctance, the Taft Administration ultimately decided to allow corporations to deduct interest on bonds, the tax's authors fearing that to do otherwise would subject shareholders to double taxation. In Root's words:

> [t]he final conclusion was that the imposition of this tax on the entire income, including the income assignable to the payment of interest on bonds, would result not in the taxation of bondholders, but in imposing a double tax on the stockholders, and it was not thought advisable to do it.[142]

In other words, Root and others believed taxation of any revenues allocable to interest payments would be passed on to equity holders. The Taft Administration also considered taxing interest payments directly upon receipt by bondholders, but this approach was deemed infeasible in light of the *Pollock* decision.[143]

When the Taft Administration's proposals were first presented to the Senate Finance Committee in June of 1909, many committee members were opposed to interest deductibility, fearing that corporations would exchange bonds for stock in order to avoid the tax.[144] Compounding this fear was the widespread corporate practice of selling watered stock—stock issued at prices exceeding a corporation's book value, to the benefit of promoters and other corporate insiders. A specific concern regarding interest deductibility was that it would encourage corporations to issue discounted stock to insiders and then exchange that stock for debt (at full face value), so as to "water" (or dilute) the stock of outside investors while simultaneously sheltering income.[145]

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140. *Insurgents' Fight Will Hold Congress: Eight Senators at Least Are to Oppose Taft's Tax Measure*, N.Y. TIMES, Jun. 28, 1909, at 2; *Is Corporate Taxation Just, and Will It Aid the Revenues? Opportunities Presented for Diverting the Earnings before Reaching Form to Be Made Taxable*, WALL ST. J., Jun. 26, 1909, at 6; *Taft's Corporation Tax Framed to Reach the Rich*, N.Y. WORLD, Jun. 18, 1909.

141. 44 CONG. REC. 4,007 (1909).

142. *Id.*

143. *Id.*

144. BLAKEY & BLAKEY, THE FEDERAL INCOME TAX, *supra* note 29, at 46–47; *Senate to Accept Taft's Plan*, WASH. HERALD, Jun. 22, 1909, at 4 [hereinafter *Senate to Accept Taft's Plan*].

145. *See* BANK, SWORD TO SHIELD, *supra* note 16, at 14–15.

Representative Cordell Hull, a Democrat from Tennessee and a key figure in the drafting of the legislation, recalled the issue in 1916: "I think the original theory of the matter was that corporations could issue quite a lot of watered stock, transfer that into bonds, mortgage their property, and incur interest, and make a great many shifts in many ways that would result in avoiding the real purpose of the law."[146]

Despite these concerns, a majority of the Senate Finance Committee eventually agreed that at least some measure of interest deductibility was necessary, for two reasons. First, as noted above, many lawmakers believed that disallowing interest deductibility would indirectly increase the tax burden on shareholders.[147] Since the payment terms of outstanding corporate bonds were fixed—and since bond investors were generally thought to enjoy greater bargaining power than shareholders—lawmakers feared that taxing amounts paid as interest would simply reduce the residual funds available for dividends.[148] Second, given that the corporation tax was designed to avoid the *Pollock* holding, some lawmakers feared that taxing revenue allocable to bondholders (or taxing bondholders directly) would be a step too far in the direction of an undisguised income tax, inviting constitutional challenge.[149] Faced with these conflicting concerns, the committee settled on a middle position proposed by Senator Root: corporations would be permitted to deduct interest, but only on an amount of debt not exceeding their paid-up capital stock.[150]

When the corporation tax advanced from the Senate Finance Committee to the wider Senate, many Senators had misgivings over allowing even limited interest deductibility. In the July session, Senator Augustus

146. 53 CONG. REC. 10,656 (1916).

147. BLAKEY & BLAKEY, THE FEDERAL INCOME TAX, *supra* note 29, at 46–47; *Rush of Objections to Taft Tax Plan*, N. Y. TIMES, Jun. 22, 1909, at 1 [hereinafter *Rush of Objections to Taft Tax Plan*]; *Taft is to Fix Tax*, WASH. POST, Jun. 22, 1909, at 1 [hereinafter *Taft is to Fix Tax*].

148. BLAKEY & BLAKEY, THE FEDERAL INCOME TAX, *supra* note 29 at 46–47; *Doubling up the Burdens on the Stockholders*, WASH. TIMES, Jun. 19, 1909, at 6; *Rush of Objections to Taft Tax Plan*, *supra* note 147; *Senate to Accept Taft's Plan*, *supra* note 144; *Taft is to Fix Tax*, *supra* note 147; *Tariff Revision Before All Else*, CHI. DAILY TRIBUNE, Mar. 18, 1913, at 9.

149. 44 CONG. REC. 4,007 (1909); BLAKEY & BLAKEY, THE FEDERAL INCOME TAX, *supra* note 29, 46–47. The tax would be unsuccessfully challenged in any event. *See supra* note 138.

150. BLAKEY & BLAKEY, THE FEDERAL INCOME TAX, *supra* note 29, 46–47. According to Root, "paid-up capital stock" meant corporate stock for which full value had been paid. 44 CONG. REC. 4,008 (1909). To illustrate the working of this provision (which would ultimately be included in the final law), a hypothetical corporation capitalized with $1,000 of debt and $500 of paid-up capital stock would be allowed to deduct interest on only $500 of debt.

Bacon, a Democrat from Georgia, argued that no portion of a corporation's interest payments should be exempt from taxation, repeating the familiar warning that corporations would avoid the tax by converting stock to bonds.[151] Referring to popular attitudes toward bondholders, Bacon asserted that "[t]he desire to reach the bonded interests of the country would be very much more generally shared by the people at large than the desire to reach simply the stocks of corporations."[152] Based on this reading of the popular will, Bacon introduced an amendment to tax interest payments directly at a rate of 2 percent, requiring corporations to withhold and pay the tax on behalf of bondholders.[153] On motion of Senator Aldrich, Bacon's amendment was tabled by a 41–34 vote, and no such withholding provision was included in the Senate's version of the bill.[154]

Similar concerns were raised in the House, however. Representative William Cox, a Democrat from Indiana, protested that accumulated wealth in the form of bond holdings would not be adequately taxed under the Senate bill. Since interest payments were deductible from corporate income, but were not taxed when received by individual investors (there being no individual income tax), a significant portion of corporate profits would escape taxation altogether. According to Cox, "[t]he railroads alone, being bonded for upward of $6,000,000,000, and the trusts for at least an equal sum, these sums representing one-ninth of the total wealth of the country, under this system of taxation all this immense wealth will escape the burden."[155] Highlighting the connections—both actual and perceived—between corporate debt and the nation's wealthiest citizens, Cox argued that bond holdings such as the Andrew Carnegie and Jay Gould fortunes would avoid "their just and proportionate share of taxation."[156] "The idea that men like Carnegie," he stated, "now the holder of more than $300,000,000 worth of the bonds of the United States steel trust, escape federal taxation is indeed absurd."[157] Despite these criticisms, Cox ultimately agreed to support the tax bill, a reflection of Congress's limited taxation options following the *Pollock* ruling. From the perspective of Cox and other Democrats, if taxing individual investors was off the table, the proposed corporation tax, however flawed, was better than nothing.[158]

The Senate Finance Committee's limitation of interest deductibility to debt not exceeding paid-up capital stock was agreed to by the Conference

151. 44 CONG. REC. 4,007–08 (1909).
152. *Id.* at 4,062.
153. *Id.*
154. *Id.* at. 4,062–63.
155. *Id.* at 4,422.
156. *Id.* at. 4,424.
157. *Id.*
158. *Id.* at 4421–44 (1909).

Committee and included in the final law, signed in August 1909, imposing a 1 percent tax on corporate profits in excess of $5,000.[159] Since the corporation tax was not accompanied by an individual income tax, corporate income paid as interest to individual debtholders went untaxed, subject to the paid-up capital limitation. Profits paid as dividends, on the other hand, were taxed at the corporate level.[160] This disparity bestowed a tax advantage on debt financing, as corporations were able to offset interest payments against taxable income. With a corporate tax rate of only 1 percent, however, this advantage was so small that it likely had little effect on corporate financing decisions. It was not until after the return of individual income taxation that the tax advantage of debt would become economically significant.

B. The Return of Individual Income Taxation

The return of individual income taxation in 1913 occurred at the height of the Progressive Era. Progressive Democrat Woodrow Wilson won the 1912 presidential election, and the year 1913 witnessed several major developments in Progressive legal and regulatory reform. These included the Pujo Committee's influential report on the "money trust" of Wall Street banking firms, the creation of the Federal Reserve System, the establishment of separate U.S. Departments of Commerce and Labor, and the ratification of the Sixteenth and Seventeenth Amendments to the Constitution.[161]

The tax-related developments of 1913 were particularly significant. Following the ratification of the Sixteenth Amendment—which allowed Congress to levy an unapportioned income tax, effectively overturning *Pollock*—the 1913 Act reinstituted individual income taxation while simultaneously reducing tariffs. This Act marked the beginning of a longer-term policy shift by which the income tax would ultimately replace tariffs as the government's primary source of revenue.[162] The tax system evolved rapidly in the years following 1913, especially during the crises of the world wars and the Great Depression. Although the most dramatic of these changes came in the form of higher income tax rates, structural features of the tax system, such as the treatment of debt and equity, saw important changes as

159. 1909 Act to provide revenue, *supra* note 19, at § 38, 36 Stat. 11, 112–17.

160. *See infra* Appendix row 5.

161. CAROSSO, INVESTMENT BANKING, *supra* note 113, at 137–55; JAMES LIVINGSTON, ORIGINS OF THE FEDERAL RESERVE SYSTEM: MONEY, CLASS, AND CORPORATE CAPITALISM, 1890–1913, at 215–34 (1986); SAMUEL P. HAYS, THE RESPONSE TO INDUSTRIALISM, 1885–1914, at 90–91 (1995); Jay S. Bybee, *Ulysses at the Mast: Democracy, Federalism, and the Sirens' Song of the Seventeenth Amendment*, 91 NW. U.L. REV. 500, 536–47 (1996).

162. BROWNLEE, A SHORT HISTORY, *supra* note 15, at 55.

well. The tax burden on debt and equity was similar under the 1913 Act, but by the late 1930s debt enjoyed a significant structural advantage over equity, a feature of U.S. tax law that has persisted to the present day.

As enacted, the details of the 1913 Act were more elaborate than those of its predecessors. The Act imposed a "normal income tax" of 1 percent on individual income exceeding $3,000 ($4,000 for married couples), plus an "additional tax" increasing in graduated brackets to a maximum of 6 percent on income exceeding $500,000.[163] As under the 1909 Act, business corporations were subject to a flat income tax of 1 percent (though now without the $5,000 exemption).[164] Interest payments remained deductible, and the statutory deduction limit was relaxed: a corporation could now deduct interest on an amount of debt equal to one-half the sum of its paid-up capital and outstanding debt.[165] Interest received by investors was taxed as ordinary income, subject to both the normal and additional taxes.[166] Unlike interest, dividends were not deductible at the corporate level.[167] At the individual level, however, dividends received a partial tax break: they were excluded from income for purposes of the normal tax, while being included for purposes of the graduated additional tax.[168]

The combined effect of these rules was that corporate revenues were subject to similar amounts of taxation regardless of whether they were paid as interest or distributed as dividends. To illustrate, profits distributed as dividends were subject to (a) the 1 percent corporate tax and (b) the individual additional tax (depending on the investor's total income); whereas, interest payments were subject to (a) the 1 percent individual normal tax and (b) the individual additional tax (depending on the investor's total income). If a corporation was managed with the goal of minimizing the tax burden on its

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163. 1913 Act to reduce tariff duties and provide revenue, *supra* note 20, at § II.A, 38 Stat. 114, 166–67. Based on changes in the CPI, the relative value of $3,000 in 1913 would be $72,800 in 2013, while the relative value of $500,000 would be $12,100,000. *Seven Ways to Compute U.S. Dollar Amount*, *supra* note 31. Given the national income distribution, this was a highly progressive tax—in its first years, only about 2 percent of American households paid any income tax at all. BROWNLEE, A SHORT HISTORY, *supra* note 15, at 57.

164. 1913 Act to reduce tariff duties and provide revenue, *supra* note 20, at § II.G(a), 38 Stat. 114, 172.

165. 1913 Act to reduce tariff duties and provide revenue, *supra* note 20, at § II.B, 38 Stat. 114, 167–68.

166. 1913 Act to reduce tariff duties and provide revenue, *supra* note 20, at § II.B, 38 Stat. 114, 167–68.

167. 1913 Act to reduce tariff duties and provide revenue, *supra* note 20, at § II.G(b), 38 Stat. 114, 172–74.

168. 1913 Act to reduce tariff duties and provide revenue, *supra* note 20, at § II.B, 38 Stat. 114, 167–68 (1913); *see infra* Appendix row 6.

investors, it would have been indifferent between issuing debt or equity with the same pre-tax return.[169]

There were exceptions to this general parity, however. Dividends paid to other corporations (e.g., dividends paid by a subsidiary to a holding company) were not excluded from the receiving corporation's income. Under the 1909 Act, such intercompany dividends had not been taxable.[170] Under the 1913 Act, corporations were subject to the 1 percent corporate tax, even though the paying corporation was also taxed on the underlying profits.[171] Despite rhetorical opposition to double taxation, many lawmakers considered it politically necessary that the income tax reach unpopular trusts and holding companies. Lawmakers feared that exempting distributions from subsidiaries to holding companies would create the appearance of letting the nation's largest corporations off the hook. [172] Since profits were taxed at both the subsidiary and holding company levels, the 1913 Act disadvantaged equity as a means of effecting intercompany transfers. A holding company that wished to avoid the double tax could instead structure its interest in a subsidiary as a loan.

As for the treatment of debt, the 1913 Act's relaxation of the interest deduction limit was the first in a series of steps that would eventually culminate in the limit's repeal. As originally reported by the Ways and Means Committee in April of 1913, the revenue bill followed the 1909 Act in limiting interest deductibility to debt not exceeding paid-up capital.[173] After the bill passed the House, however, the Senate Finance Committee relaxed the limit. Under the committee's version, corporations were allowed to deduct interest on debt not exceeding one-half the sum of outstanding debt and paid-up capital, a change accepted by the House in conference.[174] During the committee's hearings on the bill, several business lobbyists had requested that the deduction limit be increased, characterizing it as unfair to highly-leveraged companies and unnecessary given the new individual income tax.[175] Although

169. In reality, corporate managers may have found debt financing more attractive, as the tax on interest was payable by investors rather than by the corporation itself. Again, since the corporate tax rate was only 1 percent, any such preference was likely minor.

170. 1909 Act to provide revenue, supra note 19, at § 38, 36 Stat. 11, 112–17.

171. BLAKEY & BLAKEY, THE FEDERAL INCOME TAX, *supra* note 29, at 100.

172. *Big Trusts Face a Twofold Tax*, CHI. DAILY TRIBUNE, Oct. 31, 1913, at 17.

173. H.R. 3321, 63rd Cong. § 2.G (1913).

174. S. REP. NO. 63-80, at 26 (1913). H.R. REP. NO. 63-86 (1913). To illustrate, a hypothetical corporation capitalized with $1,000 of debt and $500 of paid-up capital stock would be allowed to deduct interest on only $750 of debt.

175. BANK, SWORD TO SHIELD, *supra* note 16, at 15–17.

neither the Senate Finance Committee's amendment nor its acceptance by the House were specifically explained in the legislative record, it seems likely these appeals on the part of the business community were influential in Congress's decision-making.

The deduction limit was increased again in 1916—this time to debt not exceeding the sum of paid-up capital and one-half of outstanding debt.[176] Unlike in 1913, this increase was accompanied by specific legislative discussion. During House debate of the 1916 bill, Representative Joseph Sherley, a Democrat from Kentucky, suggested that the deduction limit be removed entirely. Sherley questioned the limit's fundamental rationale, given that interest was now taxed when received by individual debtholders. He also argued that the limit was unfair to corporations, since sole proprietorships, partnerships, and other unincorporated businesses—taxed under the individual income tax rules—were allowed to deduct interest in full. Finally, he pointed to problems with the limit's application by the Bureau, arguing that "the provision has resulted in endless confusion in the department, conflicting rulings, and more trouble than almost any other single paragraph in the income-tax law."[177] Responding to Sherley's criticisms, Representative Hull reiterated the limit's primary purpose—to reduce the incentive for corporations to exchange stock for bonds. Although Hull supported maintaining the limit, his comments suggest he was not unsympathetic to the complaints being raised by the business community. Describing the 1909 version of the limit as "somewhat drastic," Hull remarked that subsequent increases were intended to moderate the limit's effect.[178] Ultimately, the deduction limit remained in place, though it was pegged at increasingly higher debt levels.[179] This trend toward greater leniency would continue into World

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176. An Act to increase the revenue, and for other purposes, Pub. L. No. 64-271, § 12(a), 39 Stat. 756, 767–69 (1916) [hereinafter 1916 Act to increase revenue]; *see infra* Appendix row 7. To illustrate, a hypothetical corporation capitalized with $1,000 of debt and $500 of paid-up capital stock would be allowed to deduct interest on all $1,000 of debt. However, particularly highly-leveraged corporations were not able to deduct interest on all of their debt. For example, a corporation capitalized with $1,400 of debt and $100 of paid-up capital stock would be allowed to deduct interest on only $800 of debt.

177. 53 CONG. REC. 10,656 (1916). There had been considerable confusion surrounding the Treasury Department's application of the 1913 limit. The Treasury Department had initially interpreted the limit as one-half of the sum of outstanding debt and paid-up capital, but later revised its interpretation to the sum of paid-up capital and one-half of outstanding debt. BANK, SWORD TO SHIELD, *supra* note 16, at 17–18.

178. 53 CONG. REC. 10,656 (1916).

179. In Representative Hull's words, "[t]he original provision was modified, but it was not thrown wide open." 53 CONG. REC. 10,656 (1916).

War I, during which major developments in business taxation would lead to the limit's complete repeal.

C. World War I and Unlimited Interest Deductibility

American entry into World War I brought major changes to the new income tax. Like the Civil War before it, World War I demanded extraordinary spending while simultaneously disrupting foreign trade and tariff revenues. Congress relied on the income tax to help finance mobilization, raising tax rates to levels unimaginable before the war. Ironically, while the war led to substantially higher tax rates, it would also lead to the permanent repeal of the limit on corporate interest deductibility.

During the war, higher corporate income tax rates, together with the introduction of supplemental excess-profits and war-profits taxes, significantly increased the tax burden on American businesses.[180] The excess-profits tax was particularly heavy, accounting for approximately two-thirds of all tax revenues during the war.[181] In 1917, the standard corporate income tax increased to a total rate of 6 percent.[182] For the 1918 tax year, the 1919 Act increased the corporate tax rate again to 12 percent.[183] These figures were dwarfed by the excess-profits tax, which reached as high as 80 percent for the 1918 tax year.[184]

With American soldiers fighting overseas, business leaders were reluctant to directly criticize higher taxes. Rather than lobbying for the reduction of nominal tax rates, businesses instead focused on the tax laws' more technical provisions.[185] The interest deduction limit is a case in point. Higher marginal tax rates increased the value of deductions—all the more so because the amount of the excess-profits tax was calculated based on net income under the standard corporate income tax.[186] As the value of deductions

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180. The "war-profits tax" was the statutory designation for the highest bracket of the excess-profits tax. An Act to provide revenue, and for other purposes, Pub. L. No. 65-254, § 301(a), 40 Stat. 1057, 1088 (1919) [hereinafter 1919 Act to provide revenue].

181. BROWNLEE, A SHORT HISTORY, *supra* note 15, at 64–65.

182. An Act to provide revenue to defray war expenses, and for other purposes, Pub. L. No. 65-50, § 4, 40 Stat. 300, 302 (1917) [hereinafter 1917 Act to defray war expenses].

183. 1919 Act to provide revenue, *supra* note 180, at § 230(a)(1), 40 Stat. 1057, 1075–76.

184. 1919 Act to provide revenue, *supra* note 180, at § 301(a), 40 Stat. 1057, 1088.

185. BLAKEY & BLAKEY, THE FEDERAL INCOME TAX, *supra* note 29 at 127–28, 141.

186. *Id.* at 185–88.

increased, a broad array of businesses, trade groups, and conservative editorial boards began to call for the complete repeal of the interest deduction limit.[187]

Perhaps strategically, criticisms of the interest deduction limit often emphasized abstract notions of tax fairness, rather than focusing on the dollar amounts that businesses would save (and the Treasury would lose) if the limit were repealed. A common criticism was that overlap of the excess-profits tax and the interest deduction limit unfairly penalized debt financing, an argument based on the technical operation of the excess-profits tax. First enacted under the 1917 Act, the excess-profits tax (which applied to all businesses, not just corporations) was levied in addition to the standard income tax and was intended to capture the excess profits derived from war contracts. The tax was implemented in two different versions: the original version was enacted in the fall of 1917[188] and a revised version applicable to the 1918 tax year was enacted in early 1919.[189] Under the 1917 Act, the tax was calculated as a graduated percentage of a company's net income, ranging from 0 percent to 60 percent, which increased along with the ratio of the company's net income to its statutorily-defined "invested capital." In other words, the greater a company's net income divided by its invested capital, the higher the rate of the excess-profits tax.[190] Under the 1919 Act, the tax was calculated as a graduated percentage of net income, ranging from 0 percent to 65 percent, which, again, increased along with the ratio of the company's net income to its invested capital.[191] The 1919 Act also added a war-profits bracket of 80 percent, subject to a deduction based on the company's pre-war financial performance.[192] Under both the 1917 and 1919 versions, the greater a company's invested capital (other things being equal), the less its excess-profits tax liability. Critically, invested capital was defined to include equity

187. *See, e.g.*, *Revenue to Defray War Expenses: Hearings and Briefs Before the S. Comm. on Finance on H.R. 4280*, 65th Cong. 14–23 (1917) (statement of A. E. Holcomb); *To Provide Revenue for War Purposes: Hearings Before the S. Comm. on Finance*, 65th Cong. 104–19 (1918) (statement of Robert E. Reed); *Federal Treatment of Borrowed Capital*, N.Y. TIMES, April 5, 1918, at 14.

188. 1917 Act to defray war expenses, *supra* note 182, at § 200–14, 40 Stat. 300, 302–08.

189. 1919 Act to provide revenue, *supra* note 180, at § 300–37, 40 Stat. 1057, 1088–96.

190. 1917 Act to defray war expenses, *supra* note 182, at § 201–03, 40 Stat. 300, 302–08. This is a necessarily simplified description of the tax.

191. 1919 Act to provide revenue, *supra* note 180, at § 301(a), 40 Stat. 1057, 1088. This is a necessarily simplified description of the tax.

192. An Act to provide revenue, and for other purposes, Pub. L. No. 65-50, §§ 301(a), 311, 40 Stat. 300, 1088, 1090–91 (1917). Again, this is a necessarily simplified description.

and undistributed profits, but not to include most forms of debt.[193] Since debt financing did not contribute to invested capital, the excess-profits tax weighed heavier on highly leveraged firms. Critics argued that this penalty on debt financing more than offset the benefit of interest deductibility, and that as long as the excess-profits tax remained in effect, the interest deduction limit should be removed.

Examples of this argument can be found in Congressional hearings on the war revenue acts, where business representatives—often present at Republican invitation—submitted their views on pending tax legislation. In a statement to the Senate Finance Committee in 1917, A. E. Holcomb, the Assistant Secretary of AT&T, argued that the deduction limit had become a "peculiar" and "arbitrary" anachronism.[194] At the same hearing, representatives of the Interborough Rapid Transit Co. termed the limit "unjust," arguing that it was particularly inequitable in conjunction with the excess-profits tax.[195] At another Senate Finance Committee hearing, Benson Watson, Secretary of the National Association of Credit Men (a major trade group representing credit professionals), argued that since debt was excluded from invested capital under the excess-profits tax, "the business entity should have the privilege of charging, as a business expense, the total amount of interest paid."[196] W. E. Humphrey, a lobbyist representing northwestern mortgage lenders, testified that because of the deduction limit, highly indebted firms could accrue tax liabilities even when operating at a loss, an outcome with "no justice to it."[197] This injustice was compounded by the operation of the excess-profits tax, he argued, which penalized borrowing even further.[198] Addressing the deduction limit's original policy rationale, Humphrey summarized his critique as follows:

> I never knew of but one reason why it was inserted in the present law, and that reason was, probably, to keep a corporation from decreasing its capital stock and increasing

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193. 1917 Act to defray war expenses, *supra* note 182, at § 207, 40 Stat. 300, 306; 1919 Act to provide revenue, *supra* note 180, at § 325, 40 Stat. 1057, 1091–93.

194. *Revenue to Defray War Expenses: Hearings and Briefs Before the S. Comm. on Finance on H.R. 4280*, 65th Congress 21–22 (1917) (statement of A. E. Holcomb).

195. *Revenue to Defray War Expenses: Hearings and Briefs Before the S. Comm. on Finance on H.R. 4280*, 65th Congress 27 (1917) (memorandum submitted on behalf of the Interborough Rapid Transit Co. of New York City).

196. *To Provide Revenue for War Purposes: Hearings Before the S. Comm. on Finance*, 65th Congress 287 (1918) (statement of Benson Watson).

197. *To Provide Revenue for War Purposes: Hearings Before the S. Comm. on Finance*, 65th Congress 627 (1918) (statement of W. E. Humphrey).

198. *Id.* at 626–29.

> its bonded indebtedness. But if that was the reason, that is the only reason I can imagine why it ever did get into law; and that reason has disappeared under the excess-profits tax, because if they reduce their capital stock and increase their bonded indebtedness they would have to pay more.[199]

According to Humphrey, the excess-profits tax negated the deduction limit's reason for existence.

Perhaps responding to these criticisms, the Treasury Department issued regulations in early 1918 that broadened the definition of invested capital under the excess-profits tax. Under the Treasury Department's regulations, corporations were permitted to include debt in invested capital, but only to the extent that interest thereon was not deductible from taxable income (i.e., to the extent it exceeded the statutory deduction limit).[200] By reducing the excess-profits tax's penalty on debt financing, this regulatory action seemed to address the business community's primary grievance.

Nevertheless, lobbying against the deduction limit continued. In what appears to have been a particularly influential step, a large coalition of banks and trust companies petitioned the Ways and Means Committee in June of 1918.[201] In written testimony cosigned by 36 financial companies (including powerful Wall Street institutions such as Chase National Bank, Goldman, Sachs & Co., and the Guaranty Trust Company), the coalition put forward several tax reform recommendations, including complete elimination of the interest deduction limit.[202] Many of these companies stood to benefit from the limit's repeal, not only because they themselves used considerable amounts of debt financing, but also because a large portion of their business was underwriting bonds issued by their clients.

The Ways and Means Committee was receptive to the coalition's arguments. "The suggestions are most valuable," Democratic Chairman Claude Kitchin remarked, "and I am sure that the Committee will take them under serious consideration."[203] Indeed, several of the group's proposals—including its suggestion to eliminate the interest deduction limit—were incorporated by the Ways and Means Committee into the revenue bill reported

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199. *Id.* at 627.

200. U.S. DEPT. OF THE TREASURY, REGULATIONS NO. 41, RELATIVE TO THE WAR EXCESS PROFITS TAX IMPOSED BY THE WAR REVENUE ACT, APPROVED OCTOBER 3, 1917, 18 (1918).

201. *Present Revenue Tax Reforms*, N.Y. TIMES, June 25, 1918, at 7 [hereinafter *Present Revenue Tax Reforms*].

202. One of the petition's primary drafters, Morris F. Frey of the Guaranty Trust Company, had publically called for the limit's repeal earlier in the year. *Plea for Revision of Income Tax Law*, N.Y. TIMES, May 29, 1918, at 17.

203. *Present Revenue Tax Reforms, supra* note 201.

in September.[204] In its report, the Ways and Means Committee explained (in language echoing that of corporate lobbyists) that since borrowed money was not included in "invested capital" under the excess-profits tax, it was "only fair" to allow the deduction of all interest from taxable income.[205] Strangely, the Ways and Means Committee made no mention of the fact that the Treasury Department had already addressed this issue earlier in the year.[206] In any case, the Ways and Means Committee's change—lauded in the business press—was included in the final law enacted February 1919.[207]

As this sequence of events makes clear, Congress's primary rationale for repealing the interest deduction limit was the manner in which it overlapped with the excess-profits tax. However, when the excess-profits tax was itself repealed in 1921, unlimited interest deductibility remained in place, without any explanation in the legislative history.[208] Although previously a recurrent subject of vigorous debate, in just a few short years, interest deductibility appears to have become a fait accompli among lawmakers. The sole discussion of interest deductibility in the legislative history of the Revenue Act of 1921 concerned whether taxpayers could deduct interest on debt incurred to purchase tax-exempt securities.[209] At no point in these discussions did lawmakers express any doubt as to whether interest should be fully deductible by corporations in ordinary circumstances.[210]

By repealing the excess-profits tax without restoring the interest deduction limit, the Revenue Act of 1921 began the era of unlimited interest deductibility. Interest has remained fully deductible by corporations ever since, subject to specific and relatively narrow exceptions. During the 1920s, the tax advantage conferred on debt financing by interest deductibility was relatively small, as interest received was taxable to individuals, while

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204. *See* H.R. REP. NO. 65-767 (1918). This bill became law as 1919 Act to provide revenue, *supra* note 180. In addition to calling for repeal of the interest deduction limit, the group also proposed that all corporate debt be included within the definition of "invested capital" under the excess-profits tax. *Present Revenue Tax Reforms*, *supra* note 201. This latter proposal was not adopted by the Ways and Means Committee.

205. H.R. REP. NO. 65-767, at 12–13 (1918).

206. *See supra* note 200 and accompanying text.

207. BANK, SWORD TO SHIELD, *supra* note 16, at 22–23; *see infra* Appendix row 8.

208. Revenue Act of 1921, Pub. L. No. 98, §§ 300–38, 42 Stat. 227, 271–77 (1921) provided that 1921 would be the final year of the excess-profits tax. Warren, *The Corporate Interest Deduction*, *supra* note 11, at 1586; *see infra* Appendix row 9.

209. Under the Revenue Act of 1921, Congress prohibited taxpayers from deducting interest on debt incurred to purchase tax-exempt securities (such as municipal, state, and certain federal bonds) because of the potential for such transactions to serve as abusive tax shelters.

210. See, for example, the exchange at 61 CONG. REC. 7,231 (1921).

dividends remained partially exempt.[211] As discussed below, the advent of full double taxation in the 1930s would disturb this balance, providing corporate debt a more economically potent advantage over equity.

D. Double Taxation

Despite Congress's oft-voiced concern for avoiding double taxation, corporate profits were in fact regularly double taxed, even prior to the 1930s. Under the 1913 Act, corporate profits were taxed at the entity level. When the same profits were distributed to shareholders as dividends, they were excluded from income for purposes of the modest "normal income tax," but included in income for purposes of the graduated "additional tax."[212] This meant that dividend income received by shareholders who were subject to the additional tax (i.e., wealthy shareholders) was actually taxed twice: once when recognized by the corporation and again when received by the individual investor.

At first, this limited form of double taxation was of little economic significance, as at 1 percent, the corporate rate was not only extremely low (by today's standards), but also identical to the individual normal rate.[213] Parity between the corporate rate and the individual normal rate (from which dividends were exempt) meant that interest and dividends were generally subject to the same amount of taxation, regardless of the individual taxpayer's income. Profits distributed as dividends were subject to (a) the 1 percent corporate tax plus (b) the applicable amount (if any) of the individual additional tax, while revenues paid as interest were subject to (a) the 1 percent individual tax plus (b) the applicable amount (if any) of the individual additional tax. An exception, of course, was interest paid by corporations in excess of the interest deduction limit. These amounts were subject to the corporate tax, the individual normal tax, and the individual additional tax.[214] As discussed above, the interest deduction limit was repealed by the 1919 Act, which applied to the 1918 tax year.

Beginning in 1917, corporate and individual rates began to diverge, with the corporate rate surpassing the individual normal rate.[215] Although a

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211. *See supra* text accompanying Part III.

212. 1913 Act to reduce tariff duties and provide revenue, *supra* note 20, at § II.B, 38 Stat. 114, 167–68; *see supra* text accompanying notes 1633– 173.

213. Under the 1913 Act, the corporate rate and the individual normal rate were both 1 percent. 1913 Act to reduce tariff duties and provide revenue, *supra* note 20, at §§ II.A, II.G(a), 38 Stat. 114, 166, 172.

214. 1919 Act to provide revenue, *supra* note 180, at § 234(a)(2), 40 Stat. 1057, 1077.

215. In 1916, the individual normal rate was 2 percent (with a $3,000 standard deduction) and the corporate rate was 2 percent (with no standard deduction).

higher corporate tax rate would have tended to disadvantage equity relative to debt (since dividends were not deductible from corporate income), the operation of the excess-profits tax from 1917 to 1921 dominated this effect by significantly penalizing debt. Given the higher corporate tax rate and the elimination of the interest deduction limit, this disadvantage was reversed when the excess-profits tax was repealed, and the total tax burden on dividends (i.e., corporate plus individual taxes) was greater than that on interest for the remainder of the decade.

The tax disadvantage of equity financing increased during the New Deal, when a series of legislative developments led to full double taxation of dividends. During President Franklin D. Roosevelt's first term, amidst the depths of the Great Depression, several of Roosevelt's advisers recommended policies intended to deter corporations from hoarding profits in the form of retained earnings.[216] These advisers, including Adolf Berle, Raymond Moley, and Rexford Tugwell (each Columbia University professors and members of Roosevelt's "brain trust" of academic advisers), believed excessive earnings retention had contributed to the depression and was impeding economic recovery.[217] They argued that encouraging corporations to increase dividend payments would stimulate the economy by putting money back in the hands of investors.[218] This macroeconomic argument was joined by a concern that retained earnings were being undertaxed, as income retained at the corporate level and not distributed as dividends escaped the graduated surtax otherwise payable by wealthy investors—as had been the case since 1913, individual income remained subject to a graduated additional tax, now called a "surtax,"

1916 Act to increase revenue, *supra* note 176, Pub. L. No. 64-271, §§ 1(a), 7(a), 39 Stat. 756, 756, 761. In 1917, the individual normal rate increased to a total of 4 percent (with a $1,000 standard exemption), while the corporate rate increased to a total of 6 percent (with no standard deduction). 1917 Act to defray war expenses, *supra* note 182, at §§ 1, 3, 4, 40 Stat. 300, 300–02. For the 1918 tax year, the individual normal rate increased to 6 percent on income between $1,000 and $5,000, and 12 percent on income above $5,000, while the corporate rate increased to 12 percent on all income. 1919 Act to provide revenue, *supra* note 180, at §§ 210(a), 216, 230(a)(1), 40 Stat. 1057, 1062, 1069, 1076. In subsequent years, the corporate rate was generally higher than the individual normal rate.

216. Bank, *Corporate Managers*, *supra* note 16, at 184–88. Retained earnings are profits held or reinvested by a corporation, rather than distributed to shareholders.

217. *Id.* at 198–203.

218. *Id.*

at high income levels.[219] In order to address both issues, Roosevelt's advisers proposed levying a special tax on retained earnings.[220]

Following this recommendation, Roosevelt proposed major changes to corporate taxation in a special budget message delivered to Congress in early 1936.[221] Under the President's proposal, (a) earnings retained by corporations would be subject to a new undistributed-profits tax, (b) corporations would be permitted to deduct dividend payments from taxable income, and (c) dividend payments received by investors would be fully taxed at the individual level (under both the normal income tax and the surtax).[222] The combined effect of this proposal was that corporate income would be taxed once at the corporate level if retained under the undistributed-profits tax or once at the individual level if distributed as dividends under applicable individual taxes. Corporate income would be subject to double taxation only if it were retained in one tax year and then distributed to shareholders in a subsequent tax year. Describing a need to plug "leaks" in the U.S. tax system, President Roosevelt argued for his proposal in the following terms:

> The accumulation of surplus in corporations controlled by taxpayers with large incomes is encouraged by the present freedom of undistributed corporate income from surtaxes. Since stockholders are the beneficial owners of both distributed and undistributed corporate income, the aim, as a matter of fundamental equity, should be to seek equality of tax burden on all corporate income whether distributed or withheld from the beneficial owners. As the law now stands our corporate taxes dip too deeply into the shares of corporate earnings going to stockholders who need the disbursement of dividends; while the shares of stockholders who can afford to

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219. Kwall, *The Uncertain Case*, *supra* note 11, at 619–20. Accumulation of undistributed earnings by a corporation for the purpose of avoiding the individual additional tax was prohibited by law beginning with the revenue act of 1913. Due to difficulties in establishing the necessary intent, however, enforcement of this prohibition was nearly impossible. BLAKEY & BLAKEY, THE FEDERAL INCOME TAX, *supra* note 29, at 404–06.

220. *Id.*

221. President Franklin D. Roosevelt, Supplemental Budget Message to Congress (Mar. 3, 1936), *reprinted in Franklin D. Roosevelt, Supplemental Budget Message to Congress*, THE AMERICAN PRESIDENCY PROJECT, http://www.presidency.ucsb.edu/ws/?pid=15255 (Gerhard Peters & John T. Wooley eds.) [hereinafter Roosevelt, 1936 Supplemental Budget Message to Congress]; BLAKEY & BLAKEY, THE FEDERAL INCOME TAX, *supra* note 29, 401–03.

222. Roosevelt, 1936 Supplemental Budget Message to Congress, *supra* note 221.

> leave earnings undistributed escape current surtaxes altogether.[223]

In other words, Roosevelt advocated direct taxation of corporate surpluses in order to reach the beneficial (if unrealized) income of individual shareholders.

Roosevelt's proposal drew strong criticism from the business community. The primary objection was not that Roosevelt's proposal entailed higher taxes, but rather that the government was attempting to use the tax system to substitute its own business judgment for that of corporate managers.[224] Many business leaders feared that an undistributed-profits tax would incite shareholders to demand higher dividends, reducing management prerogative over the allocation of corporate funds.[225] For Roosevelt Administration advisers such as Adolf Berle, who believed that managers hoarded earnings to entrench their own economic power, this was exactly the point.[226]

The controversy over the undistributed-profits tax reflected two major developments in American business history: first, the growth of public stock ownership during the early twentieth century, and second, the corresponding increase in managers' independence from investors. The growth of public shareholding, beginning in the 1890s and accelerating rapidly in the 1920s, meant that large corporations were increasingly owned by diffuse, anonymous public shareholders.[227] Reflecting this trend, the total annual trading volume on the New York Stock Exchange increased dramatically during this period, growing from 159 million in 1900 to a pre-crash peak of 1.1 billion in 1929.[228] Broad public shareholding contributed to the separation of ownership and control identified by Berle. As corporate ownership became more and more

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223. *Id.*

224. Bank, *Corporate Managers*, *supra* note 16, at 198–203.

225. *Id.*

226. Berle's views were expressed in his seminal work on corporate governance (written with Gardiner Means), *The Modern Corporation and Private Property*. ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932) [hereinafter BERLE & MEANS, THE MODERN CORPORATION].

227. The rise of public stock ownership was initially driven by the great merger movement of 1895 through1904, in which a sweeping wave of industrial consolidations was financed in large part by floating public stock. BASKIN & MIRANTI, A HISTORY OF CORPORATE FINANCE, *supra* note 95, at 193–97.

228. *Id.* at 167. This increase in trading volume was accompanied by rising stock values: The Dow Jones Industrial Average increased from a low of 52.96 in 1900 to a pre-crash peak of 381.17 in 1929. *Historical Chart Gallery: Dow Jones Industrial Average (1900-present, monthly)*, STOCKCHARTS.COM, http://stockcharts.com/free charts/historical/djia1900.html (last visited Mar. 13, 2014).

dispersed, professional managers (often holding only small equity stakes) became increasingly autonomous from unorganized investors.[229]

Despite this separation of ownership and control, at the time of Roosevelt's proposal, the interests of management and affluent shareholders were actually aligned for tax purposes. Wealthy shareholders benefited if earnings were retained at the corporate level due to the high individual surtax that would otherwise be triggered by dividend payments. As of 1935, this surtax ranged as high as 75 percent, while the maximum corporate rate was only 15.75 percent.[230] As Roosevelt had alluded in his budget message to Congress, many shareholders preferred that earnings not be distributed as dividends, a preference which was reinforced by favorable tax treatment of capital gains.[231] At the time, up to 70 percent of long-term capital gains could be excluded from individual income, meaning that if an investor held corporate stock long enough prior to sale (the maximum exclusion was achieved if stock was held 10 years or more), appreciation was taxed at a maximum rate of only 23.7 percent.[232] Wealthy shareholders therefore paid less taxes if corporate earnings were "locked in" at the corporate level and realized as capital gains in later years. Roosevelt's proposal to replace the corporate income tax with a heavy undistributed-profits tax threatened to reverse this calculus. By taxing the "accumulation of surplus in corporations," the undistributed-profits tax was intended to drive a wedge between managers' and shareholders' preferences regarding dividend policy.[233]

Notwithstanding staunch opposition from business groups, the Roosevelt Administration's proposals—including an undistributed-profits tax ranging as high as 42.5 percent—were included in a revenue bill passed by the

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229. *See* BERLE & MEANS, THE MODERN CORPORATION, *supra* note 226, *see also* ALFRED D. CHANDLER, JR., THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS (1977); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983); MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (1994). For an examination of the historical developments in American corporate law that contributed to the disempowerment of small investors, see Colleen Dunlavy, *From Citizens to Plutocrats: Nineteenth-Century Shareholder Voting Rights and Theories of the Corporation*, *in* CONSTRUCTING CORPORATE AMERICA 66–93 (Kenneth Lipartito & David Sicilia eds., 2004).

230. Revenue Act of 1935, Pub. L. No. 74-407, §§ 101–02, 49 Stat. 1014, 1014–17 (1935); *see infra* Appendix row 10.

231. Roosevelt, 1936 Supplemental Budget Message to Congress, *supra* note 221.

232. Revenue Act of 1934, Pub. L. No. 73-216, § 117(a), 48 Stat. 680, 714 (1934).

233. Roosevelt, 1936 Supplemental Budget Message to Congress, *supra* note 221.

House in April 1936, by an overwhelming 267–93 margin.[234] When the bill reached the more conservative Senate Finance Committee later that month, however, business was able to successfully intervene. The U.S. Chamber of Commerce (the nation's largest business group), a number of smaller trade organizations, and a host of individual companies invested significant effort into influencing the committee's handling of the bill. These efforts were not enough to block the undistributed-profits tax entirely, but the version of the tax that emerged from the committee was significantly weaker than the Roosevelt Administration's original proposal.

In the course of its deliberations, the Senate Finance Committee heard testimony from approximately 100 outside witnesses, most of whom spoke on behalf of business interests.[235] Reflecting the growing presence of business organizations in national politics, the range of industry groups at the hearings was extremely broad, including not only the U.S. Chamber of Commerce, but also the American Association of Railroads, the American Bankers' Association, the American Management Association, the American Mining Congress, the National Association of Credit Men, the National Association of Manufacturers, and many others. Over the preceding decades, national business associations had grown in number, size, and influence, often with active support from the U.S. Department of Commerce. Perhaps ironically, the involvement of these associations in federal lawmaking processes had actually increased under the cooperative system of industry cartelization administered by Roosevelt's National Recovery Administration.[236] In Washington, these associations were collectively represented by the U.S. Chamber of Commerce, itself originally created at the behest of the Taft Administration.[237] These groups, lobbying on behalf of their members, overwhelmingly opposed the undistributed-profits tax.[238]

For the most part, business associations generally represented the outlook and policy preferences of professional managers. However, it is important to note that the undistributed-profits tax was also opposed by at least some shareholders. In a particularly interesting case of shareholder opposition,

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234. Turner Catledge, *House Gets New Tax Bill, but Yield is Still in Doubt; Quick Passage is Forecast*, N.Y. TIMES, Apr. 22, 1936, at 1; *$803,000,000 Tax Bill Wins by Vote of 267-93 in House; Business Attacks New Deal*, N.Y. TIMES, Apr. 30, 1936, at 1.

235. BLAKEY & BLAKEY, THE FEDERAL INCOME TAX, *supra* note 29, at 414–17.

236. ROBERT HIGGS, CRISIS AND LEVIATHAN: CRITICAL EPISODES IN THE GROWTH OF AMERICAN GOVERNMENT 159–95 (1987).

237. Richard Hume Werking, *Bureaucrats, Businessmen, and Foreign Trade: The Origins of the United States Chamber of Commerce*, 52 BUS. HIST. REV. 321 (1978).

238. BLAKEY & BLAKEY, THE FEDERAL INCOME TAX, *supra* note 29, at 414–17.

Catherine Curtis, director of Women Investors in America (claiming to represent between one-third and one-half, by number, of all shareholders in large public corporations), testified to the Senate Finance Committee that the likely result of the "unsound," "revolutionary," "confiscatory" undistributed-profits tax was that "small businesses are destroyed, recovery is retarded, investments are impaired."[239] Of particular concern to Women Investors in America was that the undistributed-profits tax would prevent corporations from building financial reserves to protect against business downturns. This was precisely the same argument made by many corporate managers. The extent to which Women Investors in America's position was representative of other shareholder groups is unclear, but—perhaps tellingly—I have found no evidence of any shareholder groups supporting the undistributed-profits tax.

Following its hearings, the Senate Finance Committee significantly modified Roosevelt's bill. The U.S. Chamber of Commerce was particularly influential in this process—not only did it participate in the committee's hearings, it was also directly involved in drafting the committee's amendments.[240] The committee's most important changes were to reduce the maximum undistributed-profits tax from 42.5 percent to 7 percent, while at the same time restoring the standard corporate income tax.[241] Although business interests would have preferred to reduce *all* corporate taxation as much as possible (including eliminating the standard corporate income tax), a looming federal budget deficit barred major reductions to tax revenue.[242] A compromise solution acceptable to business was to maintain the existing corporate income tax, while significantly reducing the undistributed-profits tax.[243]

In early June, the Senate Finance Committee's amendments were accepted by the wider Senate, meaning the Conference Committee was faced with conflicting versions of the same bill.[244] Following protracted negotiations, House and Senate conferees eventually reached an elaborate compromise. The undistributed-profits tax was set at graduated rates of 7 percent to 27 percent (based on the percentage of the corporation's net income

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239. *Revenue Act, 1936: Hearings Before the S. Comm. on Finance*, 74th Cong. 820 (1936) (statement of Catherine Curtis).

240. Bank, *Corporate Managers*, *supra* note 16, at 218.

241. *Id.* at 218–22.

242. BANK, SWORD TO SHIELD, *supra* note 16, at 171–81. Although the government had anticipated a balanced budget for fiscal year 1937, the Supreme Court's invalidation of processing taxes under the Agricultural Adjustment Act and Congress's acceleration of World War I veterans' bonus payments created an unexpected deficit.

243. *Id.* at 213–26.

244. BLAKEY & BLAKEY, THE FEDERAL INCOME TAX, *supra* note 29, at 421–25; Bank, *Corporate Managers*, *supra* note 16, at 226.

that remained undistributed in a given tax year), a range which was lower than the House version, but higher than the Senate version.[245] The standard corporate income tax was preserved at graduated rates ranging from 8 percent to 15 percent.[246] Finally and significantly, dividends received were no longer exempt for purposes of the individual normal tax.[247] Thus, under the final legislation enacted in late June under the Revenue Act of 1936, corporate earnings were subject to full double taxation: profits were taxed at the corporate level when recognized by the corporation, then taxed again at the individual level if distributed to shareholders or again at the corporate level if retained as undistributed profits.[248]

The passage of the undistributed-profits tax, even in diluted form, did not bring an end to business's campaign against the measure. Upon its enactment, the U.S. Chamber of Commerce issued a statement condemning the new tax, and urged businesses to press for its repeal in the next congressional session.[249] A year later, in 1937, reversal of the burgeoning economic recovery stoked further hostility to the tax. As the nation was finally recovering from the Great Depression, the U.S. economy entered a severe double-dip recession in 1937, the Dow Jones Industrial Average losing nearly half its value between 1937 and 1938. Corporate leaders were quick to blame the undistributed-profits tax, claiming it had shattered business confidence.[250] Unsurprisingly, this argument was embraced by congressional Republicans, but as the Roosevelt Administration failed to produce an effective response to

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245. BLAKEY & BLAKEY, THE FEDERAL INCOME TAX, *supra* note 29, at 422–27; Bank, *Corporate Managers*, *supra* note 16, at 226–28.

246. *Id.*

247. The dividend exemption was removed from § 25 of the Revenue Act of 1936. *See* Revenue Act of 1936, Pub. L. No. 74-740, § 25, 49 Stat. 1648, 1662–63 (1936); *see also infra* Appendix row 11.

248. Revenue Act of 1936, Pub. L. No. 74-740, 49 Stat. 1648 (1936). Key provisions of the Revenue Act of 1936 are summarized in Blakey & Blakey's *The Federal Income Tax*, *supra* note 29 at 424–28.

249. *Text of Four Reports Adverse to the Compromise Tax Bill*, N.Y, TIMES, Jun. 20, 1936, at 6.

250. Bank, *Corporate Managers*, *supra* note 16, at 234–39. As a matter of economic history, claims that the undistributed-profits tax caused the 1937 recession are dubious. Most economists who have studied the recession have laid the blame on reductions in federal spending and/or an ill-advised contraction of the money supply by the Federal Reserve. *See, e.g.*, MILTON FRIEDMAN & ANNA SCHWARTZ, A MONETARY HISTORY OF THE UNITED STATES, 1867–1960, at 493–545 (1963); Christina Romer, *The Lessons of 1937*, THE ECONOMIST, June 18, 2009, at 73. In one major study of the recession, the economist Kenneth Roose did assign the undistributed-profits tax a contributory role, however. KENNETH ROOSE, THE ECONOMICS OF RECESSION AND REVIVAL; AN INTERPRETATION OF 1937–1938, at 239 (1954).

the economic downturn, hostility toward the tax began to spread to conservative and then moderate Democrats as well.[251] By 1938, bipartisan dissatisfaction with the undistributed-profits tax had reached a point at which congressional intervention seemed all but certain.[252] Indeed, "in an effort to encourage and stimulate business" and to promote "a freer flow of capital into productive enterprises," the Revenue Act of 1938 reduced the undistributed-profits tax to only 2.5 percent.[253] The next year, the Revenue Act of 1939 allowed the tax to completely expire.[254]

While effectively killing the undistributed-profits tax, the Revenue Act of 1938 did not restore the exclusion of dividends from the individual normal tax—an incongruous outcome given the pro-investment rhetoric surrounding the act's passage. Why was the dividend exclusion not restored? An important reason may be that during the political run-up to the Revenue Act of 1938, the undistributed-profits tax was the overriding concern of business groups, and—whether by strategy or oversight—they focused little attention on the tax treatment of dividends paid to investors.[255] After all, corporate managers had only limited incentives to lobby for tax rules that would primarily benefit shareholders. Another reason may be that shareholders themselves were far less politically organized than the management-centered business lobby. The legislative record provides abundant evidence of the influence of business associations, but with rare exceptions (such as the 1936 testimony of Women Investors in America), shareholders are most notable for their absence. A final reason may be that since the individual normal tax was only 4 percent, the issue was simply not very salient in the context of much higher surtax rates.[256] Whatever the reasons, the result of preserving the corporate income tax without restoring the individual dividend exclusion was that dividends paid to individual shareholders remained subject to full double taxation. Given decades' worth of impassioned denouncements of double taxation by both parties in Congress, this outcome is probably best understood as an ironic byproduct of the political

251. Bank, *Corporate Managers*, *supra* note 16 at 234–39.

252. *Id.* at 234–39.

253. S. REP. NO. 75-1576, at 1 (1938). Under the Revenue Act of 1938, the undistributed-profits tax took the form of a maximum 2.5 percentage point reduction in the corporate income tax rate. Revenue Act of 1938, Pub. L. No. 75-554, § 13(c)(2)(B), 52 Stat. 447, 355 (1938); *see infra* Appendix row 12.

254. Revenue Act of 1939, Pub. L. No. 76-155, 53 Stat. 862 (1939).

255. For a detailed discussion of the legislative history of the Revenue Act of 1938 as it relates to double taxation, see Bank, *Corporate Managers*, *supra* note 16, at 239–55.

256. Revenue Act of 1938, Pub. L. No. 75-554, §§ 11, 12, 52 Stat. 447, 452–55 (1938).

bargaining process. There is nothing to suggest that either Republicans or Democrats considered double taxation a policy goal.

The irony of this result is magnified by the fact that double taxation—a product of business lobbying—would later become the target of intense criticism from business groups. Arguing that double taxation burdens capital investment, business groups today, including the U.S. Chamber of Commerce, regularly call for its elimination.[257] During the New Deal era, business groups were willing to accept this burden if it meant avoiding the undistributed-profits tax.[258] Indeed, it was not until after the undistributed-profits tax had been scheduled to expire that business leaders began to publically criticize double taxation. Even then, lobbying against double taxation was a low priority for corporate managers—especially compared to business-level tax cuts that more directly affected the resources under their control.[259]

According to Steven Bank, managers' willingness to trade double taxation against the undistributed-profits tax is yet another example of the agency problem well known in corporate governance scholarship.[260] For the most part, I agree with this explanation. What must be added to Bank's account, however, are the sweeping changes in American political economy—the emergence of the corporation as the nation's dominant economic institution, the increasingly decentralized ownership of corporations by diffuse public shareholders, and the growing political power of the national business lobby—which in combination allowed the policy preferences of corporate managers to triumph in Washington, even during years in which Democrats controlled the White House and both chambers of Congress. At a more detailed level, what must also be emphasized is that the shift from partial double taxation to full double taxation in 1936 resulted in only a 4 percentage point increase in the total taxation of dividends, at a time when surtax rates, which had always been applicable to dividends, ranged as high as 75 percent. From this perspective, the marginal difference between dividend taxation

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257. For examples of business criticism of double taxation, see BUS. ROUNDTABLE, EFFECTIVE LEADERSHIP ON THE WORLD STAGE (2011), http://businessroundtable.org/sites/default/filesFullBinder.pdf; Nat'l Ass'n of Mfrs., *Tax Policy* (2012), http://old.nam.org/Issues/Official-Policy-Positions/Tax-Technology-Domestic-Economic-Policy/TTDEP-01-Tax-Policy.aspx; U.S. Chamber of Commerce, *Chamber Pushes Broadest Tax Relief for All* (2003), http://www.uschamber.com/press/releases/2003/may/chamber-pushes-broadest-tax-relief-all; U.S. Chamber of Commerce, "*State of American Business 2003*" (2003), http://www.uschamber.com/press/speeches/2003/january-15.

258. Bank, *Corporate Managers*, *supra* note 16, at 222–23.

259. Bank, *Corporate Managers*, *supra* note 16, at 256–57.

260. For a more economically rigorous analysis of the agency costs surrounding the undistributed-profits tax, see William G. Christie & Vikram Nanda, *Free Cash Flow, Shareholder Value, and the Undistributed Profits Tax of 1936 and 1937*, 49 J. FIN. 1727 (1994).

before and after 1936 was simply not very significant. It was not until the normal income tax and the surtax were consolidated into a single graduated income tax after World War II that double taxation of dividends became a mobilizing issue. During the 1950s, marginal rates that ranged as high as 91 percent prompted growing criticism of double taxation, leading to a number of proposals to integrate the corporate and individual income taxes.[261] High rates also encouraged the postwar proliferation of hybrid securities—custom investment instruments designed to provide the economic characteristics of equity securities, while qualifying as debt securities for tax purposes and thus allowing the deduction, as interest, of payments to investors. As corporations sought to avoid the heavy taxation of equity capital, they became more and more creative in the design and use of hybrid securities. Indeed, it was precisely these practices—made possible by the law's binary treatment of debt and equity—that drew increasing critical attention to the debt-equity distinction in the legal literature.[262]

Although the U.S. tax system continued to evolve through the postwar era and beyond, the debt-equity distinction had become relatively fixed by the beginning of World War II. Following the Revenue Act of 1938, interest was fully deductible at the corporate level and fully taxable at the individual level, while profits were fully taxable at the corporate level and taxable again when received as dividends. Despite widespread criticism and calls for reform, this same basic framework remains in place today.[263]

IV. CONCLUSION

The history of the debt-equity distinction reveals little in the way of forethought or design. Rather than advancing any conscious policy goal, each major step in the distinction's evolution was an ad hoc response to the immediate historical context. Thus, the permanent institution of corporate interest deductibility in 1894 was shaped by temporary economic conditions following the panic of 1893. Similarly, the permanent repeal of the interest

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261. *See, e.g.*, *Stock Exchange Heads Urge Senate to Ease Double Tax on Dividends*, WALL ST. J., Apr. 13, 1954, at 24. This criticism helped contribute to the statutory provision of the S corporation, a type of corporation immune from entity-level taxation (similar to a partnership), but only available to small businesses. 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 (2008). Double taxation would remain in effect for public corporations through the end of the century. BANK, SWORD TO SHIELD, *supra* note 16, at 191–236.

262. *See, e.g.*, Emmerich, *Hybrid Instruments*, *supra* note 3; Plumb, *The Federal Income Tax Significance of Corporate Debt*, *supra* note 3.

263. Congress has recently taken partial steps toward integration. Dividend income (and capital gains) is today subject to a preferred rate of 23.8 percent, compared to the maximum rate of 39.6 percent for ordinary income. *See supra* note 6.

deduction limit during World War I was premised on the temporary operation of the excess-profits tax. Finally, the rise of permanent full double taxation in the 1930s was a byproduct of the political battle over the temporary undistributed-profits tax. Intended to address short-term political issues, the consequences of these decisions have outlived their historical origins.

Beyond the specific issue of the debt-equity distinction, what can this history tell us regarding the broader development of the U.S. tax system? Based on my research, I would propose two general insights. First, tax policy outcomes are not the result of rational technocratic processes, but neither are they sufficiently explained in simple terms of special-interest politics. Rather, tax policy is often the result of reactive, context-driven decision making, by which short-term political issues come to dictate long-term policy outcomes. Path dependence, a common feature of institutional evolution, may be particularly significant in the tax policy context. The economic and political benefits of stable, predictable tax rules create a strong bias against reform—even in situations where existing rules are merely the legacy of historical circumstances. Robert C. Clark has written that the structure of the corporate tax system derives from political choices made at its inception, the system's "major traits determined by a set of genes fixed in its infancy."[264] Clark may overstate the point, but his argument is suggestive of the longevity of tax policy choices.[265]

The second insight (in some tension with the first) is that the policy preferences of corporate managers, as represented by the national business lobby, have played a major role in the development of corporate tax law. Business interests were an important factor in each of the key junctures in the debt-equity distinction's evolution: the decision to allow corporations to deduct interest on debt in 1894, the relaxation and eventual repeal of the interest deduction limit from the years 1913 through 1921, and the advent of full double taxation of dividends in the 1930s. The national business lobby's increasing role in tax policy reflected broader developments in the relative political power of corporate managers and investors. Just as the rise of interest deductibility and the defeat of the undistributed-profits tax reflected the political influence of corporate managers, the establishment of full double taxation reflected the lack of influence of unorganized shareholders. Again, however, lest the ability of managers to dictate their preferred vision of tax

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264. Robert C. Clark, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 YALE L J. 90, 90–92 (1977).

265. Clark's primary concern in "The Morphogenesis of Subchapter C" is the growing complexity of tax law over time, a process which he argues has occurred in a "cumulative, evolutionary way." *Id.* at 92. For another account of tax law's increasing complexity, *see* Berger, *Simple Interest*, *supra* note 11. For an analysis of the income tax's historical development framed in the political theory of incrementalism, see WITTE, POLITICS AND DEVELOPMENT, *supra* note 29.

policy be overstated, it should be emphasized that double taxation—a byproduct of business opposition to the undistributed-profits tax—is today the subject of persistent criticism from the business community itself.[266] This ironic turn of events suggests that the priorities of special interest groups may be subject to the same short-term biases as those of legislators.

Ultimately, the history of the debt-equity distinction supports the arguments of its present-day critics. Lacking a consistent policy basis and shaped by ad hoc responses to shifting external pressures, it is hardly surprising that the distinction appears arbitrary from a contemporary perspective. The history of the distinction may also offer tangible lessons regarding tax reform. Three such lessons spring immediately to mind: First, major features of the tax system can (and do) emerge in the absence of intentional policy design. Second, there is no reason to expect such features to be optimal from any theoretical standpoint. Finally, tax policy decisions possess significant inertia, and become difficult to reverse once made. These lessons suggest that serious reform proposals regarding the tax treatment of debt and equity *should* be based on deliberate, theoretically-informed policy design that Congress's past legislative decisions on the matter should be afforded little deference, and that better tax policy may be possible if the system were reconsidered from the ground up. Unfortunately, they also suggest that fundamental tax reform is extraordinarily difficult, and that smaller changes at the margin may be the only realistic course available. In the end, from the perspective of achieving simple, elegant, and economically efficient tax policy, the lessons of the debt-equity distinction may be less than encouraging.

266. *See supra* note 257.

APPENDIX: SELECTED DEVELOPMENTS IN THE TAX TREATMENT OF CORPORATE DEBT AND EQUITY, 1861–1938

This table summarizes certain legislative developments discussed in the accompanying article. The goal is to show major structural changes in the taxation of corporate revenues (both at the corporate level and upon distribution to investors). This table represents a partial summary only—many tax law developments are not included.

LEGISLATION	DEBT		EQUITY	
	Tax Treatment of Interest Paid by Corporations	**Tax Treatment of Interest Received by Individuals**	**Tax Treatment of Corporate Profits**	**Tax Treatment of Dividends Received by Individuals**
1. 1861 Act (income tax was enacted but not collected)	No corporate-level income taxation	Subject to income tax of 3% on income in excess of $800	No corporate-level income taxation	Subject to income tax of 3% on income in excess of $800
2. 1862 Act	No corporate-level income taxation. Withholding tax of 3% applicable to interest paid by certain transportation companies	Subject to income tax of 3% on income exceeding $600 (5% if the taxpayer's income exceeded $10,000). Interest payments subject to corporate withholding tax deductible from individual income	No corporate-level income taxation. Withholding tax of 3% applicable to dividends paid by certain financial and transportation companies	Subject to income tax of 3% on income exceeding $600 (5% if the taxpayer's income exceeded $10,000). Dividends subject to corporate withholding tax deductible from individual income
3. 1864 Act	No corporate-level income taxation. Withholding tax of 5% applicable to interest paid by certain transportation companies	Subject to graduated income tax ranging from 5%-10%. Interest payments subject to corporate withholding tax deductible from individual income	No corporate-level income taxation. Withholding tax of 5% applicable to dividends paid by certain financial and transportation companies	Subject to graduated income tax ranging from 5%-10%. Dividends subject to corporate withholding tax deductible from individual income
4. 1894 Act (income tax was enacted but not collected)	Deductible from taxable corporate income	Subject to income tax of 2% on income in excess of $4,000	Subject to corporate-level income tax of 2%	Excluded from individual income taxation
5. 1909 Act	Deductible from taxable corporate income, but only on debt not exceeding paid-up capital stock	No individual income taxation	Subject to tax of 1% on profits in excess of $5,000	No individual income taxation
6. 1913 Act	Deductible from taxable corporate income, but only on debt not exceeding one-half the sum of debt and paid-up capital stock	Subject to normal income tax of 1% on income in excess of $3,000. Also subject to graduated additional tax ranging from 1%-6% on income in excess of $20,000	Subject to corporate income tax of 1%	Exempt for purposes of the normal income tax Subject to graduated additional tax ranging from 1%-6% on income in excess of $20,000

LEGISLATION	DEBT		EQUITY	
	Tax Treatment of Interest Paid by Corporations	**Tax Treatment of Interest Received by Individuals**	**Tax Treatment of Corporate Profits**	**Tax Treatment of Dividends Received by Individuals**
7. 1916 Act	Deductible from taxable corporate income, but only on debt not exceeding the sum of paid-up capital stock and one-half of outstanding debt	Subject to normal income tax of 2% on income in excess of $3,000. Also subject to graduated additional tax ranging from 1%-13% on income in excess of $20,000	Subject to corporate income tax of 2%	Exempt for purposes of the normal income tax. Subject to graduated additional tax ranging from 1%-13% on income in excess of $20,000
8. 1919 Act (enacted February 24, 1919)	Fully deductible for purposes of the corporate income tax and excess-profits tax	Subject to normal income tax of 6% on income up to $4,000 and 12% on income in excess of $4,000. Also subject to graduated surtax ranging from 1%-65% on income in excess of $5,000	Subject to corporate income tax of 12%. Also subject to graduated excess-profits/war-profits tax ranging from 0%-80%	Exempt for purposes of the normal income tax. Subject to graduated surtax ranging from 1%-65% on income in excess of $5,000
9. Revenue Act of 1921[267]	Fully deductible from taxable corporate income	Subject to normal income tax of 6% on income up to $4,000 and 8% on income in excess of $4,000. Also subject to graduated surtax ranging from 1%-65% on income in excess of $5,000	Subject to corporate income tax of 12.5%	Exempt for purposes of the normal income tax. Subject to graduated surtax ranging from 1%-65% on income in excess of $5,000
10. Revenue Act of 1935	Fully deductible from taxable corporate income	Subject to normal income tax of 4%. Also subject to graduated surtax ranging from 4%-75% on income in excess of $4,000	Subject to graduated corporate income tax ranging from 12.5%-15.75%[268]	Exempt for purposes of the normal income tax. Subject to graduated surtax ranging from 4%-75% on income in excess of $4,000
11. Revenue Act of 1936	Fully deductible from taxable corporate income	Subject to normal income tax of 4%. Also subject to graduated surtax ranging from 4%-75% on income in excess of $4,000	Subject to graduated corporate income tax ranging from 8%-15%[269]	Subject to normal income tax of 4%. Also subject to graduated surtax ranging from 4%-75% on income in excess of $4,000

267. Pursuant to the Revenue Act of 1921, the excess-profits tax was repealed as of January 1, 1922.

268. Corporations were allowed to deduct 90 percent of dividends received from other corporations.

269. Corporations were allowed to deduct 85 percent of dividends received from other corporations. Corporate profits that were not distributed to investors were subject to a graduated undistributed-profits tax ranging from 7 percent to 27 percent.

LEGISLATION	**DEBT**		**EQUITY**	
	Tax Treatment of Interest Paid by Corporations	**Tax Treatment of Interest Received by Individuals**	**Tax Treatment of Corporate Profits**	**Tax Treatment of Dividends Received by Individuals**
12. Revenue Act of 1938	Fully deductible from taxable corporate income	Subject to normal income tax of 4%. Also subject to graduated surtax ranging from 4%-75% on income in excess of $4,000	Corporations with profits in excess of $25,000 subject to corporate income tax of 19%[270]	Subject to normal income tax of 4%. Also subject to graduated surtax ranging from 4%-75% on income in excess of $4,000

270. Corporations received a tax credit equal to approximately 14 percent of dividends received from other corporations. An available dividends-paid credit (the last vestige of the undistributed-profits tax) could reduce the corporate income tax rate from 19 percent to 16.5 percent.