Revisiting the (In) sensibility of the Corporate Income Tax

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I. Introduction

Our corporate income tax is a typical "party crasher;" no one knows why it's (still) here, yet most simply accept its presence. This party crasher is also here to stay. It has in fact been with us for as long as our income tax system and preceded our current individual income tax.[1] Not that it has not been noticed – many have criticized it and noted its undesirability,[2] but lately it seems that such opposition, at least among legal academics, has subsided, probably due to acceptance that it is politically impossible to repeal.[3] Moreover, somewhat surprisingly, several acclaimed scholars have concentrated an effort to justify its existence recently.[4]

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[1] The Payne-Aldrich Tariff Act of 1909, Ch. 6, §28, 36 Stat. 92 (repealed 1913). The tax was validated in *Flint v. Stone Tracy Co.,* 220 U.S. 107 (1911). The ratification of the Sixteenth Amendment and the individual income tax followed in 1913. See also BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 1.01 (7th ed., 2000).

[2] The puzzle over the double taxation aspects of the corporate income tax go back many years. See, e.g., ROSWELL MAGIL, THE IMPACT OF FEDERAL TAXES (1943), p. 26-28. (Noting that the double taxation feature was not part of the original conception of the tax and its enactment. Magill further advocates elimination of the double taxation feature no matter what the revenue costs). For more contemporary noteworthy work, see, e.g., CHARLES E. MCLURE, Jr., MUST CORPORATE INCOME BE TAXED TWICE? (1979); Office of Tax Policy, U.S. Treasury, Report of the Department of the Treasury on Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once (1992); Joint Committee on Taxation, U.S. Congress, Background Materials on Business Tax Issues Prepared for the House Committee on Ways and Means Tax Policy Discussion Series, Report JCX-23-02 (April 4, 2002). Joint Econ. Comm., Reforming the U.S. Corporate Tax System to Increase Tax Competitiveness (2005), available at : www.house.gov/jec/CorporateTaxReform.pdf (Evaluating the desirability of corporate income tax repeal); Mihir Desai, *The Degradation of Reported Corporate Profits,* 19(4) J. Econ. Persp. 171 (2005), at 191 (noting that the tax "has long struggled for a rationale.").

[3] The difficulty (beyond the insistent disfavor of the American public of not taxing corporations) was best explained by Jennifer Arlen and Deborah M. Weiss in *A Political Theory of Corporate Taxation* 105 Yale L. J. 325 (1994), who established, correctly I think, that managers do not have enough incentive to push for the outright repeal of the corporate tax.

[4] See, e.g., Reuven S. Avi-Yonah, *Corporations, Society, and the State: A Defense of the Corporate Tax,* 90 Va. L. Rev. 1193 (2004) (supporting the retention of the corporate income tax based on the "real entity" theory, claiming that the tax assists in curbing undesirable power accumulations by corporate management); Mihir A Desai, I.J. Alexander Dyck and Luigi Zingales, *Theft and Taxes*, 84 J. Fin. Econ. 591 (2007) (suggesting, *inter alia*, that the corporate income tax aligns the interests of corporate outsiders (such as minority shareholders) and the IRS,

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This article challenges some of these recent attempts to justify the existence of the corporate income tax, and in light of the analysis suggests, again, that it be repealed. The corporate income tax is not only undesirable – it simply does not make sense.[5] Only limited political advantages to a few privileged members of our society allow it to exist, thereby costing the rest of society.[6] Identifying a superior alternative is, of course, important. I think, however, that some very plausible proposals had been made in the past, and therefore I thought that discussing anew the design of an alternative tax system beyond the endorsement of some of these schemes and clarifications of the reasons for that, which I do in the conclusion, is redundant.[7] To clarify, when I mention the corporate income tax in this article, I refer to our existing corporate income tax; yet, my criticism is equally valid to any tax that increases the overall rate imposed on investments through corporations in comparison to investments using non-incorporated entities, and that is levied at the

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the combination of which could result in increased monitoring of management theft and tax evasion, and better corporate governance). Another notable recent defense of the tax is Herwig Schlunk's *How I Learned To Stop Worrying and Love Double Taxation,* 79 Notre Dame L. Rev. 127 (2003), that supports the tax relying on benefit theory rationale. I do not respond to this article here because it does not refer to our corporate income tax, and therefore is beyond my scope. Similarly, I do not respond to Terrence R. Chorvat, *Apologia for the Double Taxation of Corporate Income,* 38 Wake Forest L. Rev. 239 (2003) (arguing that because a properly structured income tax encourages investment in risky assets, a separate tax on corporations could be an efficient way of raising revenue and may improve economic productivity. Chorvat adds a prescription for design of such a tax). Additionally, I do not discuss Steven A. Bank's, *A Capital Lock-In Theory of the Corporate Income Tax,* 94 Geo. L. J. 889 (2006), who proposes a positive account of the stability of the corporate income tax, relying on the unique ability of corporations to shield locked-in capital from shareholders and their creditors. This unique feature grants special power to corporate management on the one hand and explains why management is reluctant to accept look-through type taxation of corporations on the other hand, so it gives a unique basis to tax corporations separately and explains (at least partly) why management has not resisted the tax enough. This is primarily a positive account that is beyond the scope of this article. It may support a benefit based normative justification for the tax, yet there is not enough basis for reference and analysis of its potential costs and benefits for a meaningful discussion in the context of this article at the present.

[5] See, e.g., Richard Bird, Why Tax Corporations - A Working Paper Prepared for Finance Canada, Working Paper 96-2 (Dec. 31, 1996): *"although economists recognize that it is often convenient to utilize corporations as agents to collect taxes from customers (sales taxes), employees (payroll and personal income taxes) and owners (dividend and withholding taxes), they often see no good reason why corporations as such should pay any taxes, particularly since corporation income (and capital) taxes may impose significant economic costs on society."*

[6] See, e.g., Arlen & Weiss, *supra* note 3, at 368.

[7] See, *infra* note 171.

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corporate level, without being merely a collection, or withholding mechanism for the individual income tax that is imposed on the corporate shareholders.[8]

The most recent support of the corporate income tax is founded on certain positive externalities attributed to the tax. Put simply, their fairness-based idea is that the tax is desirable because it curbs the power or wealth accumulation by corporate management, majority corporate shareholders or other "rich" stakeholders in corporations.[9] It is desirable, so go the arguments, because it directly promotes corporate governance or assists in redistribution (or at least negates redistribution from the poor to the rich).[10] These arguments essentially follow the false, but very strong intuition that the corporate income tax is "progressive," because the better-off are more likely to have stakes in corporations than the less well-off.[11]

The power of some of these recent arguments is in the fact that they attempt to justify our current corporate income tax rather than a utopian system never truly expected to be in place that has sometimes been promoted supposedly in support of the corporate tax.[12] Furthermore, they avoid the general tax policy criticism of the tax, and even acknowledge its soundness.[13] This line of argument is also the most recent and therefore the least exposed to critical analysis. I demonstrate that these arguments do not prove that the corporate income

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[8] The basic message of this article is that the unjustifiable separate tax on corporate earnings should be eliminated. This does not mean that entity level taxation that is a true proxy for the taxation of corporate shareholders could not be used. It should be used, however, only as a collection mechanism. This means, for example, that shareholders that are subject to a personal income tax rate lower than the entity-level tax rate (that should be equal to the top personal marginal rate), should be refunded the difference between the tax collected at the entity level and the tax due based on their personal (lower) rate.

[9] Avi-Yonah, *supra* note 4.

[10] See, e.g., Id.

[11] Part III**,** *infra,* directly confronts this intuition

[12] A primary example for this is another line of defense of the corporate income tax, which focuses on what is commonly called the benefit theory in income tax policy analysis. The benefit theory justifications of the corporate tax basically argue that corporations enjoy certain exclusive benefits from being such, and these benefits are the result of the special status the state (and therefore the law) grants them. These benefits could not be captured by the income tax system effectively unless corporate earnings will be separately taxed as such; hence the corporate income tax is justified. For a recent primary example see, e.g., Schlunk, *supra* note 4.

[13] Avi-Yonah, *supra* note 4, at 1210-1211.

tax is fairness promoting or a desirable corporate governance device. Moreover, I note that even if it resulted in some benefits to society on these grounds it is not necessarily desirable overall because the social costs of having it have not been evaluated against these potential benefits. These costs most likely overwhelm such possible benefits. The arguments in support of the corporate income tax and my critique follow this introduction in part II.

Part III provides some observations on the motivations behind some of the recent attempts to justify the corporate income tax. I believe that most of this support stems from the perception mentioned above that the corporate income tax has some positive redistributive effects (it is "fair" or "progressive").[14] I explain why it is so difficult to evaluate the fairness of the corporate income tax, focusing on our inability to identify who bears its economic burden. I further discuss the difficulty of making any of these arguments without an analysis of the cost of the tax. Any tax professional is well aware of the huge resources devoted to corporate tax planning, and the devotions of the bulk of high level tax professionals to this line of work.[15] This is so when the revenue collected is small, dwarfed in comparison to the other less costly components of the system that draw much less

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[14] These sentiments were explored by Arlen and Weiss, *supra* note 3, who concluded, however, that they were not the reason for the resilience of the corporate tax

[15] For obvious reasons it is difficult to assess the full costs of corporate tax planning, but we do have some studies on the costs of corporate tax compliance. These studies focused to date on the large corporations, but a recent study extended the analysis to mid-size businesses. Joel Slemrod & Varsha Venkatesh, *The Income Tax Compliance Cost of Large and Mid-Size Businesses*, Report to the Internal Revenue Service Large and Mid-Size Business Division (September 2002). Chapter 2 of this study summarizes former research. For example, one estimation found the average corporate tax compliance costs for the largest corporate taxpayers (<1500) to be close to $2m in 1996. For another review of the costs, see table 3 in United States Government Accountability Office, *Tax Policy - Summary of Estimates of the Costs of the Federal Tax System* (August 2005), available at: http://www.gao.gov/new.items/d05878.pdf. In his recent presentation to the President's advisory panel on federal tax reform, Professor Slemrod estimated just the collection costs of the corporate income tax to be 13.5% of the revenue collected, and increasing over the last few years. There are many difficulties with any number presented in this context, but one conclusion is indisputable: the number is large and the corporate tax is very costly. Available at: http://www.taxreformpanel.gov/meetings/docs/slemrod_03032005.ppt#1. See also Joel B. Slemrod, *The Economics of Corporate Tax Selfishness*, 57 Nat'l Tax J. 877, notes 65-67 and accompanying text (2004) (explaining estimates of corporate tax compliance costs and the losses to society resulting from the corporate income tax).

attention.[16] This is anecdotal, but very telling about the costs of this tax and the problem of analyzing it without taking such costs into account. Cost analysis has not been made and I am skeptical whether it can even be made effectively at the present. The lack of data[17] and the difficulty of analysis of the corporate income tax incidence make this analysis impractical.

Part IV concludes this article with a rough proposal to repeal the corporate income tax system in an acceptable fashion. This proposal is not the focus of this article and reiterates the work of others,[18] but I thought it would be useful to demonstrate not only that the corporate income tax should be repealed but also that it could be repealed in a satisfactory manner.

It is important for me to emphasize that the critical policy decision is whether a separate tax should be imposed on corporate earnings. Most of the past discussion of the corporate income tax and its undesirable effects took place in the context of what is commonly called integration proposals (integration of the tax on corporate earnings and the taxation of corporate distributions (dividends)).[19] The problem with most of this discussion is that it focused on identifying the most desirable (in most cases – the most efficient) and, at the same time, politically acceptable integration method. This meant that the existence of the

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[16] Corporate tax revenues declined in the U.S. and the rest of the wealthy world (with the exception of Japan) to between 5% and 10% (and for a while even below that) of total revenue. See, e.g., United States Government Accountability Office, *Tax Compliance - Challenges to Corporate Tax Enforcement and Options to Improve Securities Basis Reporting*, Statement of David M. Walker (Comptroller General of the United States) of June 13, 2006 (as amended on July 7, 2006), available at: http://www.gao.gov/new.items/d06851t.pdf. For the most recent data that includes other OECD countries, see Kimberly A. Clausing, *Corporate Tax Revenues in OECD Countries*, 14 Int'l. Tax Pub. Fin. 115 (2007).

[17] Despite the original understanding about publicity as a key feature of the corporate income tax upon its enactment. This was demonstrated originally by Marjorie Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 Ind. L. J. 53 (1990). For the lack of data, see "Douglas Shackelford on the Future of the Corporate Income Tax and the Effect of Taxes on the Stock Market," interview for the Tax Foundation (with Andrew Chamberlain), at 6-7, transcript available at: http://www.taxfoundation.org/podcasts/transcript14.pdf

[18] Primarily Michael S. Knoll, *An Accretion Corporate Income Tax,* 49 Stanford L. Rev. 1 (1996); and Joseph M. Dodge, *A Combined Mark-to-Market and Pass-Through Corporate-Shareholder Integration Proposal,* 50 Tax L. Rev. 265 (1995).

[19] See, e.g., Dodge, Id.; Mclure, supra note 2; "Colloquium on Corporate Integration," 47 Tax L. Rev. 427 (1992); and Michael J. Graetz & Alvin C. Warren Jr., Integration of the U.S. Corporate and Individual Income Taxes: The Treasury Department and American Law Institute Reports (Tax Analysts, 1998) [New compilation of the early 1990s integration proposals of the Treasury department and the ALI].

corporate income tax as we know it today was axiomatically taken for granted. Often, this discussion led to support of partial integration methods that left at least part of the separate corporate tax intact and therefore at best just ameliorated its undesirable effects, leaving most of its costs, and exposing it further to political meddling. This discourse should end. Rather than trying to ameliorate the distortions of the corporate income tax, we ought to acknowledge its insensibility and work on improving alternative schemes. We can then concentrate on designing our (single) tax system more transparently and in the shape of our social and political consensus.

II. The Corporate Power Structure and the Corporate Income Tax

The most original line of argument in support of the corporate income tax is that it promotes goals, such as improvement of corporate governance and restraint of undesirable power accumulation, that are external to our income tax system and the traditional analysis of its (un)desirable effects on our society. This line of argumentation is effective since it avoids the overwhelming criticism of the tax in the traditional literature. It is smart because it accepts that the tax does not make much sense as a "tax," or a conventional component of our income tax system.[20] Yet, it seems that it stems primarily from the same fundamental intuition that the tax is fair because it results in desirable redistribution or in positive corporate governance benefits.[21] Even if the alleged benefits were factual, this justification of the corporate income tax could hold only if they outweigh the costs of having the tax, especially if such benefits could not be captured by other (less costly) means. None of the recent literature that covers these possible justifications of the corporate income tax includes

[20] See, e.g., Avi-Yonah, *supra* note 4, at 1210.
[21] See, e.g., Desai, Dyck & Zingales, *supra* note 4 (noting the possible desirability of the tax in the context of the agency problem between "inside" and "outside" shareholders).

an analysis of the costs' aspects or alternative measures to capture the alleged benefits of the tax. Nonetheless, these arguments are powerful because they attempt to justify "our" corporate income tax, not a theoretical, never to be implemented corporate tax scheme,[22] and because it proposes a basis for taxation that is indeed unique to corporations and therefore may justify a separate tax on them.[23]

Not only is it potentially convincing, but also, as already mentioned, it is the most recent line of argumentation in support of the corporate income tax, and one that is yet to be properly refuted by corporate income tax opponents. Therefore, it deserves special attention if one is to argue for the repeal of the corporate income tax as I do in this article.

An interesting aspect of the new literature is that it is supported by historical analysis (which I generally accept) that concludes that the argument and the so-called "real entity" view of the corporation were central to the original political decision to enact the tax in 1909.[24] This, however, is just an anecdote – not true support for the argument – since the circumstances have dramatically changed[25] and since, of course, the argument was used as a veil for a mere political compromise.[26] Nonetheless, I think that it is useful to start with a review of the historical background in order to understand how we got this tax in the first place; the contemporary argument in its support and my response follow.

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[22] In that it is superior to other potential justifications of the corporate income tax – see Avi-Yonah, *supra* note 4, at 1205-1208, 1210-1212. Moreover, The original and most comprehensive articulation of this argument, by Professor Reuven Avi-Yonah (preceded only by Hideki Kanda & Saul Levmore's, *Taxes, Agency Costs, and the Price of Incorporation*, 77 Va. L. Rev. 211 (1991), where the authors promoted thinking similar to Avi-Yonah's but did not articulate this part of their normative argument as explicitly in support of the retention of our current corporate income tax), a clear proponent of the tax, explicitly acknowledges the failing of all other arguments in its support. Avi-Yonah, *supra* note 4, at 1210-1211.

[23] This is in contrast, for instance, to the traditional benefit theory based justifications that rely on limited liability. The simplistic notion that a corporation has a separate legal personality and therefore must be taxed similarly to other persons is a non-starter, of course. Corporations are not taxed similarly to other persons anyway, and it is well understood that corporations do not bear the burden of the corporate income tax; people (flesh and blood) do.

[24] Id., part II, at 1212. I do, however, challenge its relevance to the contemporary debate over the desirability of the corporate income tax. See, *infra* section II.A.

[25] And, most importantly, no publicity.

[26] See, e.g., Avi-Yonah, *supra* note 4, at 1217.

A. A Short History of the Corporate Income Tax[27]

The corporate income tax was enacted by Congress in 1909.[28] In the half-century prior to that, the U.S. had income taxes for certain periods of time, but these had not taxed corporations. The first income tax was used during the Civil War, for its limited purposes, and expired with the end of Reconstruction in 1872.[29] A 1894 income tax, which was struck down as unconstitutional in 1895 by the Supreme Court,[30] expanded the original Civil War tax and taxed both distributed and undistributed corporate profits, but was still viewed primarily as a device to tax shareholders.[31] Therefore, at least throughout the nineteenth century, income tax schemes were consistent with the general so-called "aggregate" view of the corporation (that focuses on the stakeholders rather than the "separate" fictional entity that we call a corporation) prevalent at the time.[32]

The aggregate view of the corporation gave place to the so-called "real entity" view of the corporation (that focuses on the unique properties of the entity itself, as if it were a real person) with the turn of the century and Roosevelt's presidency – so goes the argument.[33] The corporate income tax was originally proposed by the subsequent administration as an excise tax measured on corporate income. The proposal also included work towards a constitutional amendment that would make a general income tax constitutional. This came as a compromise between competing factions in the President's

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[27] This short description draws from several studies that exposed the origins of the tax. By no means does it pretend to be comprehensive – it is a concise summery intended to serve as a reference point for my argument that it is irrelevant to the question of normative justification for the corporate income tax that is at the core of this article. For a more detailed study of the subject see: Avi-Yonah, Id., part II; Kornhauser, *supra* note 17; Steven Bank, Entity Theory as Myth in the Origins of the Corporate Income Tax, 43 Wm. & Mary L. Rev. 447 (2001).

[28] *Supra* note 1.

[29] Avi-Yonah, *supra*, note 4, at 1213, note 82.

[30] As an unconstitutional direct tax without apportionment. *Pollock* v. *Farmers' Loan & Trust Co.*, 157 U.S. 429 (1895), aff'd on reh'g, 158 U.S. 601 (1895).

[31] Bank, *supra* note 27. See also Avi-Yonah, *supra* note 4, at 1214-1215, agreeing with Bank's conclusions.

[32] Id., at 1213, note 80, referring to Morton J. Horwitz, *Santa Clara Revisited: The Development of Corporate Theory*, 88 W. Va. L. Rev. 173, 183-186 (1985).

[33] Avi-Yonah, *supra* note 4, at 1225-1229.

party, and in response to increasing pressure on the President by income tax proponents.[34] Being a compromise, one of the reasons for enacting the tax was to defeat the enactment of a general income tax.[35] The tax was not repealed, however, later when the general income tax was eventually enacted. This has nothing to do, of course, with the retention of the corporate tax in the 21st. century.

The stated justifications of the corporate income tax enactment included:[36] a benefits' theory argument, viewing the tax as imposed on the distinct privilege of doing business in the special corporate form (limiting the liability of shareholders, etc); administrative convenience – the ease of collection at the "source" of income and from a "person" that is able (at that time) to pay the tax; and the administration's desire to regulate corporations at the federal level.[37] An important aspect of this desire was the understanding that corporate tax returns will be public.[38]

These justifications cannot support today a corporate tax, i.e., a tax that imposes a higher rate overall on earnings on investments done through corporations in comparison to non-incorporated entities. The focus of benefit theories on the limited liability feature lost their power over the years as it became easier for non-publicly traded business entities to maintain limited liability for shareholders without subjection to the corporate income tax – through a limited liability corporation ("LLC"), for instance. The administrative convenience argument was never serious because collection at the entity level does not require additional

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[34] Kornhauser, *supra* note 17, at 53. The other component of the compromise was keeping Tariffs at their high levels, which benefited domestic industry and the rich.
[35] As was explicitly stated by Senator Aldrich, one of the sponsors of the (Tariff) Bill. See Avi-Yonah, *supra* note 4, at 1217, note 111, referring to 44 Cong. Rec. 3929 (1909) (statement of Sen. Aldrich).
[36] Id., at 1217-1220.
[37] Kornhauser, *supra,* note 17, at 53.
[38] Id. This understanding has not materialized to full disclosure, and today corporate tax returns are essentially all confidential. The latter reason was in line with Roosevelt's focus on increasing the power of the Federal government vis-à-vis the large corporations. Avi-Yonah, *supra* note 4, at 1215-1216.

levels of taxation.[39] Finally, the federal government regulates corporations extensively anyway, and since corporate tax returns are generally confidential, the publicity aspect that was central to this argument, maybe turned the situation on its head and resulted in less rather than more transparence. Next, I tackle what is left from this argument, as revived by Professor Avi-Yonah.

Avi-Yonah analyzes the legislation process in support of the argument that over the turn of the century the "real entity" view of the corporation replaced the previously prevalent "aggregate" view of the corporation, and was a principal catalyst for the enactment of the corporate income tax. He reasons that this change occurred due to changes in the nature of corporations and particularly the rise of the large American corporations (the "great trusts") in the same period.[40] Together with the legislative history, however, his analysis demonstrates that both the opponents and proponents of the corporate tax consisted of various distinguishable groups that took their respective positions for a variety of reasons, and did not join forces behind the legislation in acceptance of one logical goal or another. The compromise property of the tax is very strong. This weakens an argument in support of the corporate income tax based on the original justifications for its enactment. Such an argument is not very strong anyway, as acknowledged by Avi-Yonah himself, who admits that a contemporary normative justification is required for our current tax.[41]

The "real entity" view of the corporation, however, is important to the contemporary debate over the desirability of the corporate income tax, since I view it as an

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[39] See, e.g., the conclusion to this article where I describe options for replacing the corporate tax with a collection mechanism at the entity level that does not result in higher taxation of investment done through corporate rather than non-incorporated entities.
[40] Avi-Yonah, *supra* note 4, at 1227-1231.
[41] Id. at 1231.

articulation of the intuition that large corporations[42] are independent of their owners the shareholders.[43] The story is that they have powers that could be exercised independently of the interests of corporate shareholders (or other stakeholders), and these powers are usually vested with the managers, who may abuse them. This potential abuse of power is practically beyond the control of others in this game, namely the shareholders, which leaves the state as the sole player that could stop such abuse, and tax is one way for the state to do that. Next, I present the argument in support of the corporate income tax that grew out of this intuition.

B. The Core Management Power Argument[44]

The fundamental formulation of the management power argument in support of the corporate income tax is that the tax is imposed on, and therefore reduces, corporate earnings, in turn reducing the economic, social and political power of individual corporate managers who derive such powers from their control over the economic resources of corporations (including income). And, of course, such power curbing is desirable.[45] This is quite simple. The sophisticated part of the argument is in the observation that corporate management power is accumulated for most purposes independently of the economic incidence of the corporate income tax. The argument against such accumulation of power is

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[42] In effect, the entity theory may apply, if at all, only to publicly traded corporations, who fit this description.

[43] For a primarily historical review of the development of this view, see Reuven S. Avi-Yonah, *The Cyclical Transformations of the Corporate Form: A Historical Perspective on Corporate Social Responsibility,* 30 Del. J. Corp. L. 767 (2005). For different aspects and critique, see PHILLIP I. BLUMBERG, THE MULTINATIONAL CHALLENGE TO CORPORATION LAW: THE SEARCH FOR A NEW CORPORATE PERSONALITY (1993). Note that the argument depends on the view of the corporation as "owned" by shareholders, while "controlled" by management. There are, of course competing views of corporations, such as the contractarian theory that describes the corporation as merely a nexus of (incomplete) contracts, not a thing to be owned and therefore is not compatible with the real entity view. For more on the competing views of the corporation, see STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS (2002), Ch. 1.

[44] Basically, Professor Avi-Yonah's argument, *supra* note 4, at 1210-1212.

[45] For several reasons mentioned below

therefore allegedly free of the significant doubts that shadow the incidence analysis that cause much of the difficulty in the economic analysis of the corporate income tax.[46] Avi-Yonah asserts that the more "immediate" burden that the tax imposes on management simply falls on management.[47] If that is the case, and if curbing the power of management is desirable, then, goes the argument, the corporate income tax that performs this function is desirable.[48]

One could argue that this unique power of corporate management should be taxed by an income tax under normal principles. The first problem she would face is that corporate income just isn't the income of the managers as normally defined under our federal income tax law. The well-known Schanz-Haig-Simmons definition of income[49] may assist here if this power translated to either consumption or to increase in wealth of these managers. Conventional wisdom is that the first prong of the definition (consumption) is not relevant because managers do not simply consume corporate resources. When they do, they are supposed to be taxed under the current income tax system anyway. The second prong of the definition (increase in net wealth) isn't more helpful because wealth increases are not taxed under our federal income tax system until realized. Therefore, accumulation of power

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[46] For the difficulties in establishing an acceptable methodology for assessment of the corporate tax incidence see, *infra* Part III. Note that this argument is not truly free of the analysis of the incidence of the tax, because even assuming that the tax reduces the amount of cash available to management is not so simple. It is possible that repeal of the tax will be followed by relevant responses, such as labor demanding wage increase, and shareholders tightening control of management and pressing for higher dividends, resulting in less cash in the hands of management. I elaborate on this further in section II, but, for now, I accept Avi-Yonah's argument as it is, and rebut on other grounds.

[47] Avi-Yonah, *supra* note 4, at 1244-1245, in particular note 235.

[48] Therefore, it is arguably hardly surprising that corporate managers have been the strongest supporters of its repeal. Avi-Yonah, *supra* note 4, at 1212. I am not so sure about the validity of this argument. Even this alleged observation should be put in context. For instance, do managers support the repeal of the corporate income tax if the alternative is a tax on undistributed corporate earnings? Of course not – this choice is the one that led to the enactment of the tax in the first place…

[49] Income = consumption + change in net wealth ($C + \Delta W$). Georg von Schanz, Der Einkommensbegriff und die Einkommensteuergesetze 13 FinArc 1 (1896); Robert M. Haig, The Federal Income Tax (New York, 1921); Henry C. Simons, Personal Income Taxation (Chicago, 1938).

(whatever that means) by itself is not a taxable event.[50] Increases in ability to pay or other increases in earning potential are not taxable as such either, much in the same way that original earning potential is not taxed. [51] We only tax realized income,[52] and so far as managers are concerned once they realize their power into money or other perks they are taxed or at least should be taxed – by the regular income tax, not the corporate tax. One may argue that this is not right, but the realization principle has been such a fundamental principle of income tax systems everywhere that challenging it would be a true uphill battle far beyond the scope of this article.[53]

Avi-Yonah does not pick up this battle, but his argument carries some of its flavor when he criticizes Professor Dan Shaviro's explanation that wealth (or the equivalent power in our context) is nothing but the opportunity to consume (later).[54] He implies that management's power to control the corporation's resources extends beyond current and future consumption and that management's primary advantage is in their ability to invest,

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[50] Note that if one argues that it should be taxed, she would be making a very different argument, since it would no longer be justification of the current system.

[51] DAVID F. BRADFORD, UNTANGLING THE INCOME TAX (1986), at 24-25, 154-156. The debate over endowment taxation provides probably the best context to understand these features of our tax system. See, e.g., Lawrence Zelenak, *Taxing Endowment,* 55 Duke L. J. 1145 (2006).

[52] For a detailed analysis of the principle and review of most of the relevant literature, see" David M. Schizer, *Realization as Subsidy,* 73 N.Y.U. L. Rev. 1549 (1998); Deborah H. Schenk, *A Positive Account of the Realization Rule*, 57 Tax L. Rev. 355 (2004); and Deborah H. Schenk, *An Efficiency Approach to Reforming a Realization-Based Tax,* 57 Tax L. Rev. 503 (2004). For a recent interesting defence of the princuiple see Terrence Chorvat, *Perception and Income: The Behavioral Economics of the Realization Doctrine,* 36 Conn. L. Rev. 75 (2003) (arguing that requiring a realization event is generally the best way to measure taxable income because it is consistent with how individuals actually perceive income).

[53] Of course, many scholars have criticized the reliance of our income tax system on realization in the context of a comprehensive tax reform. See, e.g., Schenk, Id.; Noel B. Cunningham & Deborah H. Schenk, *Taxation Without Realization: A "Revolutionary" Approach to Ownership,* 47 Tax L. Rev. 725 (1992); and David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation,* 134 U. Pa. L. Rev. 1111 (1986) Moreover, it is difficult to imagine an argument that supports deviation from the realization principle in the case of management power accumulation as a special case. The most often quoted reasons for the realization requirements are hardship of valuation (of the income) and liquidity concerns. If one believes these are serious, then they apply quite strongly in our case – power accumulation does not result in direct and immediate increased liquidity and is obviously quite difficult to valuate.

[54] Daniel N. Shaviro, *Replacing the Income Tax With a Progressive Consumption Tax* 103 Tax Notes 91, 106 (Apr. 5, 2004), in Avi-Yonah, *supra* note 4, footnote 206 and accompanying text.

not consume.[55] One initial response to that is embedded in Shaviro's explanation – that investment itself is meaningless (at least from our income tax perspective) if one (or one's heirs) cannot enjoy (consume) its fruits; that enjoyment does not have to be monetary.[56] That still leaves the opportunity (for savers/investors) to defer consumption, and maybe more importantly an alleged advantageous investment opportunities. It may be the case that wealthy people have better investment opportunities due to their status as wealthy (or as managers), but, again, our tax system does not tax opportunities – just realized income. One may believe that such opportunities or advantages justify a more progressive tax system, but this is a ground for an argument to increase progressivity throughout the system, not only in this limited context.[57] Moreover, it is difficult to see why corporate managers are in a better position in comparison to the other "investment privileged" rich.

Avi-Yonah's real argument, however, is different: it is that the corporate income tax is desirable because it simply reduces management's power, which is (a la Avi-Yonah) desirable on fairness grounds. For him, therefore, it is irrelevant that the tax is not coherent with the rest of the income tax or that it cannot be easily explained by normal tax principles.

Based on sociological literature, Avi-Yonah mentions three aspects of corporate management power that worry him – political,[58] economic[59] and market powers.[60] He argues that these excessive concentrations of power should be discouraged, and tax is one way of doing that.[61] Avi-Yonah calls this a democracy argument since private accumulation of

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[55] Avi-Yonah, *supra* note 4, footnote 206.
[56] Shaviro comments that the confusion over non direct or monetary consumption may be one source for the misunderstanding of this point. See Shaviro, *supra* note 54, at 106.
[57] Note that this argument does not stand even if we accept that the corporate tax has desirable distributive effects. I do not accept this, and elaborate on this in section III, *infra*.
[58] Lobbying is the obvious example for this assertion of power..
[59] Power over employees in those aspects that are not simply or effectively covered by the contractual employment relationship
[60] Power over consumers
[61] moreover, it is a traditional American way of doing that. Avi-Yonah, *supra* note 4, at 1238-1239.

powers (by managers) is not accountable to the people as all powers should ultimately be in a democracy.[62] Another argument that he raises is a liberal, equality-based argument, in Michael Waltzer's tradition, that accumulations of money, as a dominant good in our society, should be curbed by redistribution, including by redistributive taxation. Otherwise, dominance in one (economic) "sphere" will convert to dominance in other spheres, such as the political sphere, and that is bad because it would unduly constrain the lives of others (employees, etc).[63]

Avi-Yonah acknowledges that wanting to curb accumulations of power or money by corporate managers does not necessarily mean that a corporate tax is required, or that a corporate tax is necessarily an automatically desirable means of achieving this end. He argues, however, that alternative, direct ways of curbing corporate managers' powers are ineffective, concluding that this task is therefore left to (government) regulation of corporate activities. He further notes that traditional regulation (environmental, labor, etc) deals only with negative externalities and does not interfere with ordinary accumulation of corporate power through straight forward money-making business. He argues that only tax can do that.

Next, I respond to this argument. I chose to isolate it because it is the only comprehensive argument in support of our current corporate income tax. Later sections will deal with related arguments.

C. My Response

Next, I claim that the above arguments cannot stand critical analysis, and anyway, they do not support the preservation of the corporate income tax.

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[62] Id.

[63] Id., at 1240-1241.

1. The Proper Benchmark for the Evaluation of the Management Power Argument

The core argument is that the corporate income tax reduces the power of corporate management because it reduces the capital (or money) under its authority. In other words, because the corporate tax reduces the money left in the hands of managers "to play with," they are more limited in their ability to "play" in comparison to a world in which no tax would be imposed at the corporate level. In order to evaluate this argument I will first ignore the costs of the tax - administration, compliance and enforcement costs. These costs reduce the capital of corporations but they are generally under management's control, so I assume for now that they do not invalidate the argument.

To evaluate this argument one must first establish an appropriate benchmark for comparison – what would be that other world (without a corporate tax) in comparison to which our world (with a corporate tax) is better in terms of limitation of corporate management powers? The most immediate benchmark system that comes to mind is an income tax system that is identical to ours, but with no corporate income tax and with some individual income tax rate increase to compensate for the revenue loss from the absence of the corporate income tax.[64] In such a system all tax items should be attributable to shareholders proportionately to their stake in the corporation.[65] In comparison to this world managers may indeed find themselves with more cash at hand in the short term since they (the corporation) do not have to nominally pay the tax to the government – the replacement rate increase affects the shareholders' pockets directly. To stop here is, however, very naïve. It is easy to see that in such a case there would be more pressure by shareholders (on management) for increased transparence and distributions of the business' earnings, at least

[64] John Whalley, *The Incidence of the Corporate Tax Revisited*, Technical Committee on Business Taxation Working Paper 1997-7 (October 1997), available at: http://www.fin.gc.ca/taxstudy/wp97-7e.pdf.
[65] Or at least most of them – similarly to the way we tax partners.

to cover the additional tax that they need to pay. These distributions may eventually be smaller than the decrease in cash due to corporate tax payment, but they clearly decrease the desirability of the tax as a management power-curbing device. Shareholders' pressure for increased transparence[66] may be even less desirable for corporate management: they may need to provide more extensive calculations of tax items attributed to each shareholder. Even ignoring the additional costs to the corporation, this should increase transparence in corporations, normally a bad result for management and good for corporate governance purposes. Along the same lines, I argue that management oftentimes loves the corporate tax because it provides them with one of the most powerful evasive devices. It uses the tax as an excuse to rent-extraction activities that do not necessarily result in reduction of effective taxation of shareholders.[67] Additionally, some tax advantages are left for corporations alone – tax free mergers and acquisitions, certain accelerated depreciation schemes, special credits/deductions, etc. Management uses these special measures to avoid distributions and transparence in general.[68] Using deferral, management is also able to ignore the various (possibly competing) tax positions of their shareholders. In the alternative, transparent world managers may face multiple shareholders demanding different and contradictory courses of actions that would be beneficial to their respective tax positions. The comparison of this system to the current corporate income tax is devastating to Avi-Yonah's argument, yet,

[66] And the loss of the ability to tell shareholders: "we cannot do/must do this or that for tax reasons."

[67] Retention of earning at the corporate level of course defers taxation of shareholders on distribution (since there is no distribution), but that does not mean that the value of the shareholders' investment is not taxed. If taxed at the corporate tax rate of 35% (effectively a bit lower) it is still taxed much higher than the effective (or marginal) tax that it would have faced if the shareholders were taxed on it directly. So, even if we ignored the so-called double taxation aspects of the current system still the collection of 35% at the level of the corporation so long as just refunds are not available benefit the rich – only those with applicable tax rates beyond 35% enjoy some deferral (time value of money) benefits under the current system – clearly not the progressive image that the tax's supporters attempt to portray.

[68] See, e.g., Michael C. Jensen, *Agency Cost Of Free Cash Flow, Corporate Finance, and Takeovers* 76 American Economic Review 323 (1986) (discussing generally the conflicting interests and incentives of managers and shareholders over such issues as the optimal size of the firm and distributions).

there may be justifiable doubt whether such a system can be realistically used, primarily due to the difficulties of attribution. I turn therefore to a less pure solution, but one that I think is more realistic and not less useful in this context.

The alternative system for comparison and evaluation would preserve elements of the corporate tax as an effective collection mechanism, which is particularly appropriate for the large publicly-traded corporations.[69] The corporation would calculate taxable income and pay (withhold) tax on that income. The tax would be credited to the shareholders based on their stake in the corporation together with other tax attributes of the corporation. The credit should be refundable for taxpayers subject to low personal income tax rates. The actual design of such a system is beyond the scope of this section. I will elaborate some on that in part IV, but two things are important: this is not a full integration system but a mere withholding mechanism that could not be "converted" back into a corporate income tax (through a switch to partial integration etc.). The tax base cannot be similar to our current corporate tax base, but rather designed similarly to the personal tax base.[70] Other alternative systems to the corporate tax seemed to me too remote for useful analysis. Next, I use this system in comparison with our corporate income tax to evaluate Avi-Yonah's argument.

2. Corporate Management Powers

One may argue that corporate management accumulates undesirable political, economic and market powers just because of the legal fiction of the corporate separate legal

[69] The attribution of taxes and income to a large number of shareholders, with a significant turn around of shareholders and possibly more extensive use of financial intermediaries and derivative financial instruments is difficult, yet the enforcement of the tax if imposed directly on these shareholders rather than primarily on the corporation as a withholding agent is significantly more costly, difficult and open to additional abuse.

[70] If this linkage is broken, essentially all of the maladies of our current corporate income tax may return, and I would not view this necessarily as an improvement on the current state of the law.

personality (extended to tax law).[71] It may even be the case that the tax system is theoretically capable of reducing such accumulation of power. But, the reality is that the tax system is very bad in curbing accumulation of power. I examine this next with respect to the specific powers mentioned by Avi-Yonah.

a. Political Power

Political power is easily the least exposed to suppression by the income tax system. The tax system is notoriously polluted with political distortions (some of them politely named "tax expenditures").[72] The oil and gas lobby is one example,[73] churches are another[74] – these are just obvious examples of groups that benefit from special beneficiary tax treatment despite their constant accumulation of political powers.

Political power curbing in this context is also tricky because it can mean different things. The most straightforward portrayal of this power is corporate lobbying.[75] This activity is financed from the money of the corporation and therefore one may say that the corporate income tax takes away some of that money and by that reduces such power. This claim, however, is too simplistic. Significant portion of corporate lobbying may not be objectionable or undesirable. For example, if corporate America faced unfair treatment whether in violation of a trade or tax treaty between the violating country and the U.S. or

[71] Although it may be difficult to extend the argument beyond publicly traded corporations, while all corporations are initially subject to the tax.
[72] For an example of explicit corporate tax expenditures (1996-2002), see http://ctj.org/pdf/hideapp2.pdf (the data published by a non-governmental think tank, Citizens for Tax Justice, but they reflect the extent of the problem). For a more official (but not more cheerful) view, see GAO 2006, *supra* note 17.
[73] See, e.g., Citizens for Tax Justice, *The 110th Congress Should End Tax Subsidies for Big Oil* (Dec. 19, 2006) http://www.ctj.org/pdf/energytaxloopholes.pdf (informative of the tax expenditures, though it is part of an advocacy piece).
[74] See, e.g., Diana B. Henriques, *In God's Name,* a four part series in the New York Times' Business section (October 8-11, 2006).
[75] Note that lobbying expenses are anyway non-deductible despite being of a type that normally ought to be recoverable. §162(e).

not, it is acceptable that corporate management should do something about it – this is its job and these are the expectations of our society from corporate management once we garnt corporations their special legal status. Now, one may complain about the substance or proportionality of one lobbying campaign or another, but this is beside the point. This is power that we want them to have. On the other hand, one may argue, as Avi-Yonah does in his liberal/Waltzerite argument that some of this power is diverted to issues that are not intended and are undesirable, such as general political influence. I respond to the argument itself below,[76] but, there is another thing here. As Avi-Yonah himself admits, there are various rules and regulations that attempt to restrain political lobbying power by corporations and other wealthy elements in our society. He argues that these rules are not very effective,[77] even if they tackle the problem face-on. Should we believe therefore that merely reducing somewhat the amount of money available to corporate management to use for these purposes will be more effective? This seems like a reach.

Moreover, even if the corporate income tax simply reduced the amount of money available to corporate management to use for lobbying purposes and by that their power to lobby, this still does not mean that they will choose to simply reduce the unwanted activities. One possible action is that they will choose to invest more or the same in political lobbying[78] and spend less money on charity, tax or "good" lobbying, some of which may be desirable activities, at least to some. An answer to that may be that corporate governance controls will make sure that they will continue to do all that they need to keep their job first, before they extend their actions to the political realm, but this would be quite naïve and very dependent on the circumstances. More simply, managers could easily convince their shareholders –

[76] *Infra,* section II.C.4.
[77] Avi-Yonah, *supra* note 4, at 1237.
[78] Let us use this crude term for unwanted lobbying not related to their job as corporate managers

especially their rich and influential shareholders – that political lobbying is more effective and promising in terms of share value then any other action. Note that this is a situation where corporate governance issues do not necessarily come into play – I will deal with that later in this article.[79]

Finally, Avi-Yonah concludes his attack on the political power of managers by asserting that even if unwanted political lobbying itself was stopped by direct regulation, corporations will still have power over the lives of voters in the politician's constituency.[80] Now, this may be true, but part of the argument is simple criticism of our democratic political system that is not unique to this point and contributes nothing to the understanding of the need for a corporate income tax.[81] More directly, the corporate tax is unhelpful in this regard, because if corporations have influence in a certain constituency because they are, for instance, the biggest employer, or service provider, or customer, then they continue to have that power and influence independently of the cash reduction potentially affected by the corporate tax. I suspect that cash-strapped corporations, for instance, will tend to make sure they assert their political influence more forcefully, immediately and potentially undesirably than other corporations.

b. Economic Power

Corporate management does have economic power over employees and maybe its "community." Avi-Yonah's argument in this context relates to the complex debate over what is a corporation, and particularly to the criticism of the contractarian theory of

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[79] *Infra* section II.D.
[80] Avi-Yonah, *supra* note 4, at 1237.
[81] See my point on the democracy argument, *infra* section II.C.2.

corporations.[82] This debate is beyond the scope of this article and it is in my opinion irrelevant to my point. The relevant power here stems from the mere fact that employees are employees and that the corporation has physical facilities in a community, not (and this is the crucial point) from the corporation being richer or poorer, or the corporate management having more or less money to play with. Yes, it is possible that richer, more powerful, corporate managers will act undesirably toward employees[83] or the community surrounding its facilities,[84] but it is not more likely to happen there than in cash-strapped, less rich corporations. It is also not necessarily more plausible that these undesirable action will happen rather than the same corporate management using its riches to benefit the community surrounding it or its employees in "good times." Portraying the undesirable scenario as the only possible outcome and claiming that it is somewhat relieved by the fact that the corporate income tax reduces the cash available to the same corporate managers, is questionable. Remember, the argument must say that the current situation is better than the alternative. This is obviously a weak argument, and both possible scenarios (better or worse alternatives) are possible. Management may be more rather than less cash-strapped under the alternative, for one, but even if that would not be the case, more transparent corporate accounts that are more responsive to shareholders' rather than management control just shifts some power from managers to, say, shareholders. This could be worse, better or non-different, but it clearly cannot support the notion that the corporate itself serves to safeguard employees and corporate communities from the (destructive) powers of management.

[82] For a good review of the debate, begin with Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later* (Symposium: Robert Clark's *Corporate Law*: Twenty Years of Change), 31 Journal of Corporation Law 779 (2006). Refer also to Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 Colum. L. Rev. 1416 (1989) and later references to this key article and the authors later ECONOMIC STRUCTURE OF CORPORATE LAW (1991).

[83] reducing union powers, for example, threatening to export or outsource certain jobs

[84] demanding, for example, relaxed regulation with a threat to relocate if not

A more general point here is that, similarly to the other dimensions of power mentioned by Avi-Yonah, this undesirable economic power is not easily tamed by our tax system in general and there is little done by the corporate income tax itself to support a direct role for it in this context. There are two obvious examples for that. First are the corporate governance aspects of the corporate tax in general, upon which I touch in the next section. Any experienced tax lawyer knows that the code takes no consistent position in this context. There is clearly no intentional and comprehensive coordination of policies between our corporate governance and tax rules to the effect of, say, protecting employees from the power of management. Maybe such coordination is possible or even desirable, but it just does not occur at the present. Arguing for the retention of the corporate income tax for this purpose based on unfulfilled potential cannot help the argument because, remember, the power and uniqueness of the argument is that it support our corporate tax, not a utopian, academic system. The other aspect worth mentioning is that our tax system probably treats corporate managers more rather than less favorably in comparison to employees.[85] This may be objectionable to some, but the system is balanced in favor of management nevertheless. Note that favorable tax treatment of employees compensation, such as stock options and restricted stock compensation, is probably more favorable to top management than the employees that Avi-Yonah is concerned about; they are also employed by the corporation and are more likely to receive more tax-advantaged incentives this way. Even the one occasion when the legislator attempted to directly cut the benefits from the top, dealing only

[85] See, e.g., David I. Walker, "*Is Equity Compensation Tax Advantaged?,*" 84 Boston University Law Review 695 (2004). Michael Knoll, *The Tax Efficiency of Stock-Based Compensation,* 103 Tax Notes 203 (2004). Ethan Yale & Gregg D. Polsky, Reforming the Taxation of Deferred Compensation, 85 N. C. L. Rev. 271 (2007)

with top-management, the result was probably beneficial to management once compared to the core employment force.[86]

c. Market Power

The market power argument is particularly interesting since my own intuition was that the corporate tax serves corporate management well in asserting this type of power. For example, management "sells" acquisition activities to shareholders partly based on their being "tax-free," implying or even promising extraordinary returns, yet in reality it is often the case that these transactions fail to benefit anyone but the sellers and management itself.[87] But even beyond the scope of the corporate income tax, our entire international tax scheme benefits MNEs and grant them (and by that their managers and controlling stakeholders) advantages, either in the name of certain "values," such as competitiveness, or simply because of administrative constraints.[88] This means that the larger corporations with the more powerful management may be further empowered to increase its dominance in the market. Determining whether such dominance is desirable or not is usually the domain of the antitrust laws.

The interaction of the corporate income tax and antitrust laws is probably the most easily understood of the regulatory intersections dealt with by this article. Antitrust laws strike a very delicate balance between what is allowed and what is not in the context of corporate market power asserted over consumers. There is no argument here that the balance cannot be stricken fairly or effectively by these rules. Now, there may of course be

[86] Gregg D. Polsky, *Controlling Executive Compensation Through the Tax Code,* 63 Wash. & Lee L. Rev. (forthcoming November 2007).
[87] See, e.g., the review in Yariv Brauner, *A Good Old Habit, or Just an Old One? Preferential Tax Treatment for Reorganizations,* 2004-1 B.Y.U. L. Rev. 1, at 25-31 (2004).
[88] See, e.g., Kimberly A. Clausing & Reuven S. Avi-Yonah, *Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment,* The Brookings Institution discussion paper 2007-08 (June 2007), available at: http://www3.brookings.edu/views/papers/200706clausing_aviyonah.pdf.

criticism of the specific line drawing or implementation of certain rules, but complementing antitrust with a crude measure such as the corporate income tax is like fine-tuning a delicate machine with a sledgehammer.

This is not the place for a comprehensive analysis of the effect of our income tax system on our society's power structure, but at least the reader should be able now to doubt the appropriateness and effectiveness of using it to correct potentially harmful accumulations of power. In particular, she should be able to doubt the actual role of the corporate income tax in this context. In the end of the day, the effect of the corporate income tax, at least in its current (very stable) formulation, is to grant management probably more rather than less flexibility in its dealing with the other players in the corporate game. This effect is so specific to the circumstances that even if we had better data on corporate tax payments and motivations and strategies of management in tax planning, we may not have been in a better place to judge whether overall we are better off having or eliminating the corporate tax on the mere grounds of its affect over the corporate power structure. This, of course, is even before we take into account the uncertainties of the corporate tax incidence, which result in more or less the same conclusion, as will be elaborated on briefly in section III, and, not less importantly, before we weigh any possible specific or occasional benefits against the costs of the tax.

3. The "Democracy" Argument

The argument that accumulation of power by corporate managers is excessive and not accountable to the people and therefore is undesirable[89] in a democracy may be reviewed from various angles, such as whether it is clearly true, whether it is relevant in our

[89] Avi-Yonah, *supra* note 4, at 1238-1239.

democracy, etc… Such a review, however, is beyond the scope of this article. Our inquiry is merely whether the argument, taken as valid, can support the retention of the corporate income tax. I think it cannot.

Framing the issue as a democracy problem that could be assuaged by the retention of the corporate income tax requires proof of accumulations of power beyond the riches or wealth that management could extract from its position as such. There is no clear articulation of this unique power unrelated to simple wealth that is so beyond the scope of the actual job of management, i.e., within the boundaries of the contractual arrangements that we call corporations that are stamped by the law of the land, or beyond the regular course of our democracy in the realm of politics. Now, note carefully, if the argument is merely about redistribution, as I think it is, and I think it is clearly reflected in context and citations brought by Avi-Yonah in his article,[90] then it is not a separate argument in support of the corporate income tax and it cannot be separated from the discussion of the tax's incidence discussed *infra*, in section III.

The other option is that the argument is part of a general social criticism. Note again, saying that the legal fiction that we call corporation is itself undesirable cannot assist an argument in support of taxing such legal fiction and subjecting society to the costs of this tax. Finally, it is possible to use an argument similar to the one brought up next by Avi-Yonah, criticizing our democracy that allows rich people, including, but in no way only (or demonstrably uniquely) corporate managers political influence. I reject this argument as supporting the retention of the corporate income tax as well next.

[90] Id., at 1238-1240, means etc..

4. The Liberal Equality-Based Argument

This is the heart of the matter as I see it. Notwithstanding the careful, sophisticated argumentation, the support of the corporate income tax seems always to go back to the notion that it is distributionaly desirable. But, because it is essentially impossible to prove that it is distributionally desirable (even though one "feels" that it is), the next best argument is that the tax has desirable effects in the realm of distribution, fairness and equality. Avi-Yonah's articulation of the argument relies on the famous framework for a just society devised by Professor Michael Waltzer in *"Spheres of Justice."*[91] Waltzer's just society maintains what he calls complex (rather than simple) equality, where certain people's domination in one aspect of life is not transformed into domination in (all) other aspects of life. People may not be exactly equal to each other in all aspects of life ("spheres"), but people who dominate, say, in the sphere of "money" (being rich) could not transform this domination into dominating political power (domination of the political sphere), for instance. The key theme is elimination of domination while accepting differences between people that make simple equality impossible.

Now, despite the intuitive appeal of this picture, that almost promises a just world just around the corner, we obviously do not live in one. We all know that domination in certain "spheres" oftentimes does translate to domination in others. Money is essential for those who aspire to gain political power, and plays a major role in our political process. In short, one may criticize our political system and our democracy for allowing that or for being

[91] MICHAEL WALTZER, SPHERES OF JUSTICE: A DEFENSE OF PLURALISM AND EQUALITY (1984).

"unjust" in this sense.[92] I do not think that leaping from this possibly valid social criticism to the retention of the corporate tax is so obvious.

First, and most obvious, we are not sure what is the incidence of the corporate tax is in simple terms,[93] and it is very possible that rich and (politically) influential people actually benefit in relative terms from the tax at the expense of, say, workers who are not averagely rich but do have stakes in corporations in America. This could not be just. If the reader feels by now frustration about the complexity of the incidence analysis and frustration with this author for not getting away from it, fine, but it is inescapable. I am yet to be presented with an argument in support of the tax that is indeed independent of its incidence.

Second, even if we agreed that somehow, the tax reduces the power of management in comparison to the other players in the corporate game, we are still probably stuck with an "unjust" result because the most probable winners from this (ignoring incidence, remember) are other rich people, most probably major shareholders in corporations, who are politically powerful independently. The corporate income tax cannot be thought of as simply a management power-neutralizing device. We could go on speculating here, but I think this is enough to draw the basic strokes of the general picture. I also think that this argument does no belong at all to the debate over the desirability of the corporate income tax, especially once we are required to ignore its incidence and redistribution consequences. This is because it is a very general social criticism that happens to resonate, maybe, in the context of corporate management. Attacking corporate management sound good, but the issue is not different from any other piece of government regulation or any other of thousands of tax

[92] In this article I do not analyze Waltzer's theory itself, but rather its application by Avi-Yonah in the context of supporting the retention of the corporate tax. For criticism of Waltzer's arguments, see, e.g., The New York Review of Books Volume 30, Number 6 · April 14, 1983 To Each His Own, By Ronald Dworkin, waltzer's response and Dworkin's reply to that response (APRIL 14, 1983), Norman Daniels *The Philosophical Review*, Vol. 94, No. 1 (Jan., 1985), pp. 142-148

[93] See, *infra* part III.

benefits unrelated to the corporate income tax that bestow benefits on politically powerful people at the expense of the less powerful in our society.[94] Having a separate, very costly, tax for this purpose and in this context only, seems unreasonable.

Finally, even if one wanted to evaluate the argument (academically) standing alone, one must do that in the context of an alternative – are we better of (power-wise) with or without the corporate income tax. I argue that we are better off without it – I hope to at least convince the reader to seriously doubt the validity of the argument. In the last section I attempt to portray our world without a corporate income tax. The reader should note that in that world corporate management is actually under more rather than less scrutiny by others, and the accounts of corporations are more public and transparent, which, remember, was the original idea when federal regulation of corporations through a corporate income tax materialized to the tax we have today.[95] The analysis of whether that world is more "just" than another world, or even our current world, is beyond the scope of this article, but note that Avi-Yonah himself did not claim explicitly that the world with a corporate income tax is more just than a world without one. He just argued that the vector created by the tax was in the just direction.[96] I doubt that argument, limited to its original scope only, concluding that even this normative justification for the corporate income tax could not stand critical analysis.

[94] Arlen & Weiss, *supra* note 3, at 368-369.
[95] Kornhauser, *supra* note 17, at 54, 72-81.
[96] Avi-Yonah, *supra* note 4, at 1255.

5. The Corporate Tax as the Only Effective Regulation of Corporate Management's Power Accumulation

Finally, I also reject Avi-Yonah's argument that the corporate tax is essentially the only possibly effective regulatory scheme to curb accumulations of power by corporate managers.[97] Let us put aside the debate whether government should regulate corporate activities and just accept that it does so to balance the benefits of this legal fiction with its potential societal harm. Avi-Yonah acknowledges the first problem with this argument – that some of the potential harms are already specifically regulated (environmental, labor, etc), but adds that these do not interfere with ordinary accumulation of corporate power through straightforward moneymaking business. For the purposes of responding to this argument, I have to assume general acceptance of the need for corporations and the legal fiction of separate legal personality in our society, since it would be strange to argue in support of taxing a legal fiction without acceptance of the fiction's desirability or at least inevitability. Nonetheless, the argument is problematic: it supports taxing the fictional personality with an aim at balancing the power accumulation that is its inevitable (and actual) consequence, but it does not explain why this fiction is accepted for tax purposes in the first place. Avi-Yonah does not deal with this more preliminary question, since he assumes that having corporations automatically mean that they somehow deserve fictional personalities for tax purposes in addition to "separateness" for other legal purposes. This assumption is unwarranted, and has actually never been rationalized to the best of my knowledge. I discuss it in the final two sections of this article.

Now, that may not satisfy Avi-Yonah, because he promotes the idea that managers have some powers that are not reflected in their enrichment. One way of looking at this is to

[97] Id., at 1244.

focus on the agency problems that are the source of the opportunity for managers to accumulate power. This opportunity is given to managers by the corporation's most fundamental feature – the separation of management and ownership.[98] The law deals with the potential harms of this opportunity in the context of agency problems with the core corporate law rules on corporate governance.[99] In the next subsection, I elaborate on the relationship between the corporate tax and corporate governance rules, but I will say now that these rules are completely uncoordinated. Corporate law does not intend to, and does not in fact rely on tax measure to support its regulatory tasks in this regard, and it is very difficult to argue that the corporate tax is better than corporate law in achieving the task of dealing with agency problems in corporation, or even a necessary complement.

Another way to look at this is to say that management power accumulation extends beyond the above-mentioned agency problems. I suspect an argument that corporate governance deals only with the internal power struggle in the corporation, but not with the power that management gains over complete outsiders (those who are not stakeholders in anyway in the corporation). However, if this is the case, then there is nothing new in this argument – it is the same "fairness" argument - that claims: (1) that redistribution through the tax system (or other regulation) is not complete without the corporate tax (since it does not cover non-monetary power accumulation), and (2) that the corporate tax is effective in non-monetary redistribution. As already apparent, there is not enough support for these arguments, and it is even likely that the effect of the corporate tax is actually opposite.

[98] Featured famously in ADOLF BERLE & GARDINER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).
[99] See, e.g., ROBERT C. CLARK, CORPORATE LAW (1986).

D. *The Corporate Governance Argument*

A second line of defense erected recently in support of the corporate income tax is that the tax may be justified due to its desirable corporate governance benefits. The argument is somewhat similar to the line of argument discussed in the former section because it leans on the same basis – that the tax influences the power structure of the corporation. The idea is that the tax possibly relaxes some of the agency problems that frame the corporate governance problem.[100]

Little work has been done on the relationship between tax and corporate governance to date.[101] The expansion of this work is a worthy project, but it is beyond the scope of this article that focuses only on the arguments made in direct support of the existence of the corporate income tax or that may be used for that purpose.[102] If successful, these arguments

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[100] Namely, the majority-minority shareholders, the management-shareholders, and the shareholders-stakeholders agency problems. See, e.g., Zohar Goshen, *"Agency Cost", as a Unifying Theory in Corporate Law*, in ESSAYS ON LAW IN MEMORY OF PROFESSOR GUALTIERO PROCACCIA 239 (1996) [in Hebrew]; Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, an Ownership Structure,* 3 J. Fin. Econ. 305 (1976); E. F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. Pol. Econ. 288 (1980); Henry Hansmann, *Ownership of the Firm,* 4 J. L. Econ. & Organ. 267 (1988); and John C. Coffee, Jr., Unstable Coalitions: Corporate Governance As a Multi-Player Game 78 Geo. L. J. 1495 (1990) (adding to the economic literature the effects of others, beyond the traditional actors in the principal/agent context, on the firm).

[101] Desai, Mihir A. Desai & Dhammika Dharmapala, *Taxation and Corporate Governance: An Economic approach* (April 2007), forthcoming in W. SCHOEN (ed.), TAX AND CORPORATE GOVERNANCE, Oxford University Press, available at SSRN: http://ssrn.com/abstract=983563; Desai, Dyck & Zingales, supra note 4; Mihir A. Desai & Dhammika Dharmapala, *Corporate Tax Avoidance and High Powered Incentives* 79 J. Fin. Econ. 145 (2006); Mihir A. Desai & Dhammika Dharmapala, *Corporate Tax Avoidance and Firm Value*, available at SSRN: http://ssrn.com/abstract=689562; Michelle Hanlon & Joel B.Slemrod, *What Does Tax Aggressiveness Signal? Evidence from Stock Price Reactions to News About Tax Aggressiveness* (January 23, 2007), available at SSRN: http://ssrn.com/abstract=975252; Arne Friese, Simon P Link & Stefan Mayer, Taxation and Corporate Governance (January 19, 2006), available at SSRN: http://ssrn.com/abstract=877900. For earlier thought of this issues, see Kanda & Levmore, *supra* note 22. I did not include here similar literature on dividend taxation, or state taxation and corporate governance.

[102] Most of the arguments in this section have not been specifically articulated in the academic literature. As will be apparent, this issue picked up the interest of tax scholars, primarily economists, only lately. There is almost no relevant legal scholarship, so I had to predict some of these arguments without anyone actually making and defending them. I as well as others work on more focused projects related to the interaction of the corporate tax and governance rules, so some developments are expected soon. I did not try to comprehensively cover it here – only to demonstrate that unless something surprising comes up, this line of arguments could not support the retention of the corporate income tax.

may be powerful because they avoid the complex incidence analysis of the tax,[103] and they do not have to commit to fairness or positive redistribution effects of the tax. Next, I demonstrate that these arguments do not support the retention of a separate corporate income tax.[104]

The most directly piece of this literature on point is: Desai, Dyck and Zingales' "Theft and Taxes," formerly circulated as "Corporate Governance and Taxation."[105] It argues that the corporate income tax and its design affect the amount of private benefits extracted by corporate insiders,[106] yet, at the same time, it adds, the tax's enforcement (that depends, of course, on its existence) limits such extractions.[107] In corporate governance terms, they point to and explore the alignment of the interests of the corporate minority or "outside" shareholders (including, possibly, other groups that the majority or corporate management may take advantage of) and the IRS (representing the government in general). Because the corporate income tax reduces the wealth and cash flow of the corporation, goes the argument, less is left for corporate management and/or the corporate majority to divert. In addition, the tax requires compliance, tax returns and the furnishing of information that further limits the diversion potential. Fraudulent diversion is further curbed since minority shareholders have not only their monitoring capacity, but also that of the government.[108]

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[103] See *infra* part III.
[104] Note that I do not attempt here to take sides in the important and current debate in the corporate governance field. Also, note that I make no attempt to explain specific behavior of managers with respect to the corporate income tax. This is a worthy project that may be taken on in the future.
[105] Desai, Dyck & Zingales, *supra* note 4.
[106] At the expense of "outsiders."
[107] They also argue that the relationship between the corporate governance and the corporate income tax go both ways, i.e., that effective governance system is positive for tax enforcement since it limits diversions itself and therefore limits the ability of management and corporate majority to engage in tax evasion. As noted above, the inquiry about the relationship between corporate governance and taxation is beyond the scope of this article, that focus solely on the desirability of the corporate income tax.
[108] This interesting idea is tested against Russian data. See Desai, Dyck & Zingales, supra note 4, at 592, 603-606.

This is a useful insight: higher corporate tax rates increase the return to stealing, or diverting income from outsiders (and tax from the government that is affected like other minority shareholders) to insiders. On the other hand, more effective enforcement reduces the opportunity for such diversions, so outsiders may be better off with stronger tax enforcement, even if tax rates increase at the same time.[109] A possible conclusion is therefore that a separate corporate tax may be desirable because it provides government (and, potentially outsiders) with unique information and because it ameliorates the agency problem between outside and inside shareholders (majority and minority).[110]

Desai, Dyck and Zingales do not claim that their findings necessarily support the retention of a separate corporate income tax; they merely suggest that it may have positive attributes. Note also that even a very small tax, so long as it requires significant information disclosure to the government and some revenue incentive for the government to serve as an effective monitor suffices.[111] To justify the retention of the tax on the basis of corporate governance benefits one had to prove that the tax exerts unique corporate governance benefits, that these benefits are desirable and could not be duplicated in other, potentially less costly means,[112] and that these benefits are desirable despite the social costs of having

[109] If true, this is important because stronger enforcement is costly and may mandate tax rate increases, but then it may be justified, at least from the perspective of corporate outsiders if it resulted in an increase of their returns on the corporate investments.

[110] See Desai, Dyck & Zingales, supra note 4, at 592-594. The authors do not discuss management and the agency problem between managers and shareholders, but a similar argument could be devised along the same lines with respect to this agency problem, whether management acted in concert with majority shareholders or alone. This is not tested against the data, but as explained next, I think that the specific data used is not necessarily relevant to the scope of this article. The two articles discussed next support at least the notion that cheating the government goes hand in hand with cheating shareholders or minority, or at least that this is the perception of the market. See Desai & Dharmapala (High Powered Incentives), *supra* note 101, discussed *infra;* and Hanlon & Slemrod, *supra* note 101, discussed *infra*.

[111] Friese, Link & Mayer reached a similar conclusion, calling it: the corporate income tax as a "certification tax." See Friese, Link & Mayer, *supra* note 101, at 30-31. Kanda & Levmore, *supra* note 22, expressed a similar idea.

[112] Adjusted to the costs of the system.

the system.[113] To the best of my knowledge there has been no attempt to even begin to factor the social costs of having the corporate income tax to the analysis of these (or other) arguments. At this point, however, I would like to the identity or alignment of interest between corporate outsiders and the government as claimed

In reality, the assumption of this study are heroic and unattainable, if they were to be used to support retention of the corporate income tax. The authors do not allow side deals in their model, so the state and insiders could not coordinate their actions at the expense of outsiders,[114] and outsiders and insiders could not coordinate their actions at the expense of the state, and even not negotiate the level of diversion with insiders.[115] The details of this argument clarify the extent of their argument: they really talk about extreme forms of illegal tax planning, namely tax fraud. This explains also the direction taken in replacing the "Corporate Governance and Taxation" title with "Theft and Taxes." They argue that collusion between insiders and outsiders is essentially possible only in closely held corporations.[116] The costs of coordination, especially for outsiders, are just prohibitive in other cases according to the authors.[117] That is true when, for instance, fictitious expenses are concerned – outsiders in publicly held corporations are not going to invest in exploring what insiders do in that regard and then risk approaching insiders and negotiate a portion of the tax bounty. It is also true that insiders would not approach outsiders to split fraudulent tax savings in publicly traded firm, only even out of fear of discovery. The same, however, as I think is acknowledged by the authors, cannot be said of closely held corporations that may not have outsiders in the same sense, and despite the costs it is very feasible for majority

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[113] For reference to some of the costs, see *supra* note .
[114] See Desai, Dyck & Zingales, *supra* note 4, at 600-601.
[115] Id.
[116] Id., at 600.
[117] Id.

shareholders to collude with minority shareholders even in the context of tax fraud. The exclusion of closely-held corporations is not particularly problematic to this aspect of their argument since practically most corporate tax revenue is collected from large public corporations anyway.[118] Note, however, that their insight about this difference between widely and closely held corporations exposes further the inefficiency of the tax.

In this very limited context of "theft", I doubt that the argument supports the U.S. corporate income tax in terms of corporate governance. First, having a separate tax on corporate earnings itself increases the opportunities of tax fraud – there are simply more rules and more accounts, and the system is more complex.[119] If we agree that corporate tax returns will probably never be made public, despite its being the original justification for the enactment of the tax, then clearly the alternative will be superior even if not less complex or costly. This is because in the alternative all accounts will be somehow attributed to shareholders and eventually to individuals who can monitor them, an inherently more transparent system. Their argument is limited to extreme fraud situations, as suggested by the cases of Russian tax fraud examples discussed in the empirical part of the article. In more regular (not obviously illegal) tax avoidance situations insiders may very well cooperate with outsiders to share the tax benefits of potentially objectionable transactions. Equally, insiders (and particularly management) may, and do cooperate with the government at the expense of outside shareholders. The general observation of Desai, Dyck and Zingales is meaningful and powerful, but it is also obvious to the participants, and particularly to sophisticated insiders or management, who will choose their battles carefully. This is not difficult to see. Let's assume that insiders wish to engage in an aggressive tax planning that is likely to be

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[118] See, e.g., Auerbach, *Who Bears the Corporate Tax?,* 20 Tax Pol'y and the Econ. 1 (2006), at 4.

[119] See, e.g., GAO 2006, *supra* note 17 (noting the effect of the complexity of the corporate tax on tax collection); and Slemrod (2004), *supra* note 16 (questioning the sense of the corporation as the efficient "node of collection" in light of the way the tax evolved – particularly in light of corporate tax sheltering).

opposed by the IRS if it knew about it in detail. They will make sure that shareholders in general are inactive. One indication for that was recently explored in testimonies of two experts (one of which is Professor Desai), who explained that tax shelters do not result in financial profits reduction (only those reported to the tax authorities).[120] Since tax planning is primarily in the power of management, it is typically important for management to make sure its aggressiveness is not exposed by shareholders. The majority vs. Minority agency problem is relevant as well here, because strong and active majority could be very involved with management in aggressive tax planning, and for the reasons mentioned by Desai, Dyck and Zingales they will be careful not to let minority shareholders expose it. This does not have to happen by active coercion – it may be enough to maintain satisfactory share value or distributions. The next two articles may be interpreted as contradicting my impressions above, because they expose the perception, primarily in poorly governed firms, that aggressive tax planning goes hand in hand with management misconduct vis-à-vis shareholders. I do not view this as a problem for my argument, however, because management or insiders do not have to "bribe," to use a strong word, shareholders, so they won't expose the corporate tax aggressiveness. They only want to keep them from getting active, seeking disclosure and exposure of the scheme. Indeed, we see that the market is not extremely negative about corporate tax planning, and in well-governed firms this is even a lesser deal – their argument is meaningless for well-governed firms anyway.

In the other direction, management or insiders deal with the IRS constantly at the same time that they take advantage over outsiders. Corporate mergers and acquisitions are classic examples of transactions that often result in losses to shareholders, while widely held

[120] The actual quote was: "No corporate tax shelter was even undertaken that reduced book income and often the primary benefit of a corporate tax shelter is the reported income it produces" Mihir Desai, Testimony Before the Subcomittee on Select Revenue Measures of the House Committee on Ways and Means (May 9, 2006) in Hanlon & Slemrod, *supra* note 101, at 2.

corporations almost always seek agreement with the IRS regarding the basic tax position taken - typically via a private letter ruling. There is plenty more to say in this context, but for the purposes of this article, I conclude that Desai, Dyck and Zingales' argument in support of our corporate income tax based on certain governance benefits is very weak, at best. This is because their argument applies primarily to very unique extreme tax fraud situations, and even then justifies the information furnishing aspects of the tax, and not a significant distortionary tax like the one we have. Of course, they do not take the costs of the tax into account, and they never attempted to imply that this argument alone supports retaining the tax.[121] An intriguing project that is beyond the scope of this article should be to explore whether it is possible to redesign our tax system in a manner that would be more consistent with corporate governance norms; maybe that is a viable hope for corporate tax proponents.

An interesting recent paper by two of the authors of the above paper[122] researched the types of people who blew the whistle on corporate fraud provides some anecdotal insights that could be further developed in the context of this article, yet here I only comment briefly on its findings. Interestingly, the article found that fraud detection relies on a variety of mechanisms, and at times, improbable actors. SOX improved the performance of actors with an explicit mandate, from 35% to about 50% of the cases tested, but still no one type of regulator (SEC, auditors and industry regulators) is dominant here. Specifically for the purposes of this article, I found it interesting that no tax authority was a significant player in this context, and, even more interesting, shareholders, including all shareholders

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[121] Naturally, therefore, they do not compare the benefits of the corporate income tax with possible alternative regimes.

[122] I.J. Alexander Dyck, Adair Morse & Luigi Zingales, *Who Blows the Whistle on Corporate Fraud?* (January 2007). CRSP Working Paper No. 618, available at SSRN: http://ssrn.com/abstract=959410.

and shortsellers revealed only 9% of the cases[123]. Now, this may be attributed to the methodology used in the study.[124] Identifying a single whistle blower is a difficult task due to the nuances involved in the parameters used, so, it is possible that a shareholder who discovered the fraud exposed it to the media or the authorities, yet her identity was kept out of reach of this study. Additionally, the study covers only fraud in large corporations and there are understandable difficulties of data retrieval, but, still, the lack of data about these two groups and the insight that they are not dominant monitors in this context makes the argument of Desai, Dyck and Zingales even more limited in its support of the corporate tax even in the already limited context of corporate fraud. The sole role potentially left for the corporate tax therefore is to deter insiders from cheating both the IRS and others, i.e., make sure they play "good boys" with the tax authorities. The recent corporate tax shelter phenomenon puts even that into question, which makes the relevance of the authors insight as support for the retention of our corporate income tax weak, and my explanation of the reality of the game, i.e., that management understands the insight and responds to it by striking "deals" with either the outsiders or the IRS, more plausible. In any event, this article cannot assist much in our quest for a good rationale in support retaining our corporate income tax.

A second article that may be read as supporting the retention of the corporate income tax due to its beneficial corporate governance implications is Desai and Dharmapala's "Corporate Tax Avoidance and High-Powered Incentives."[125] This article focuses on corporate tax avoidance activities and their relationship with what the authors call high-powered incentives for corporate management. The simple intuition in this context was

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123 And even this number, the authors note, is reached *"using the most comprehensive and generous interpretation."* Id., at 2.

124 For the description and discussion of the difficulties with the methodology, see id., at 11-13.

125 Desai & Dharmapala (High Powered Incentives), *supra* note 101.

that shareholders, for example, want management to be aggressive in tax planning and therefore will award management for corporate tax avoidance, since such activities are expected to result in increased share value.[126] The authors demonstrate that this is not always the case and that in fact increases in (management) incentive compensation, which is considered a popular way of aligning the interests of management and shareholders, tend to reduce the level of tax sheltering (popular tax avoidance strategy).[127] This means, simply put, that shareholders believe that managers who "game" the tax system (engage in tax avoidance) also "game" the corporate governance system by diverting profits, for example, to the benefit of management rather than shareholders. Another way to think about it is that tax sheltering obscures corporate transactions and accounts, and just the fact that management is allowed to maintain this fog of war creates further diversion opportunities for management under the disguise of the fog. Their findings are particularly strong in poorly governed corporations, so the original intuition (more avoidance is good and will be awarded by shareholders) is still correct, but it is safe for shareholders only if they feel "in control" of the corporation and its management. The findings help to explain, for instance, what is called the "undersheltering puzzle,"[128] or why don't everybody engage in tax sheltering activities.[129]

The findings of this article are supported by a slightly different recent article by Hanlon and Slemrod, who investigated stock price (market) reactions to news about tax aggressiveness.[130] They found on average negative reaction of the market to news about tax sheltering, which was their focus. The reaction was, however, smaller than reactions about

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[126] Id., at 2. .
[127] Id., at 2-4. .
[128] David Weisbach, *Ten Truths about Tax Shelters*, 55 Tax L. Rev. 215. (2002); Joseph Bankman, *The Tax Shelter Problem,* 57 Nat'l Tax J. 925 (2004).
[129] Desai & Dharmapala (High Powered Incentives), *supra* note 101.
[130] Hanlon & Slemrod, *supra* note 101.

other major corporate "accounting mishaps." They also note that the concern was smaller in better governed firms. Finally, they tested for the source of these findings, by exploring market reactions to news not about specific tax sheltering, but about (low) actual effective tax rates of corporations published by a D.C. think-tank, and found no statistically significant reaction, which led them to conclude that the negative market reaction identified was not predominantly affected by reputation in this context.[131] This means that shareholders (particularly in less well governed firms) suspect that managers engaging in tax sheltering in particular are in a better position to take advantage of shareholders otherwise,[132] are more likely to take costs and risks in tax planning that may be less than optimal to shareholders (if they succeed they will rip the benefits, if they fail and the IRS, say, imposes penalties, the effect on management will be minor in comparison to the loss to shareholders), and are less likely to be accountable to shareholders in general.

Now, these two articles do not articulate direct support of the corporate income tax, and they focus more on the effect of corporate governance on tax sheltering activities. One conclusion is of course that they indirectly support elimination of the corporate tax because without the tax there would be no corporate tax sheltering and shareholders will have to monitor management less than in the costly current world with a corporate income tax. This, however, is too simplistic, even if convenient to my argument. The interaction of the tax with the corporate governance rules and practices, an argument may be made, create this complex web of check and balances that results in, inter alia, undersheltering (a possibly good thing) and maybe even reduces agency problems in corporations overall (another good result). Well, of course this is very hypothetical and the research in this area is in its infancy, suffering from a devastating lack of data and complexities even in the theory. Nonetheless,

[131] Id., at 35. .

[132] Through empire building, diversion of profits, etc.

for our purposes, it is important for me to conclude that what we know by now cannot support the retention of the corporate income tax.

Finally, John, Nair & Senbet added to the picture the stakeholders.[133] In particular they explored *inter alia* the effect of the corporate income tax on the alignment of interest of shareholders and non-financial claimants of the corporation. Their basic story is that limited liability affects investment decisions to the effect of too risky investment in limited liability firms. The corporate income tax then acts to reduce the cash flow available for management to engage in this non-optimal behavior. This is also beneficial for both shareholders and non-financial claimants on the corporation. In other ways, the corporate tax is the price to pay for limited liability.[134] The authors do not argue that, but one could add, following Desai, Dyck & Zingales,[135] that the IRS could be added to the picture as a co-monitor of management behavior. Now, this article does not really develop the story of the effect of the tax on corporate governance.[136] In this regard, they do not add on Desai, Dyck & Zingales except for adding stakeholders to the picture. The problem with the assertion that stakeholders assist in monitoring the corporate tax collection is that it does not help to justify the corporate tax, and their role is diminished anyway by the confidentiality of the corporate tax returns. There is no evidence that the corporate tax affects corporate investment decisions in the way the authors assume, and clearly no quantifying of the benefit against the costs of the tax. It is extremely difficult to evaluate such a benefit, and even harder to determine the superiority of the tax in this role over other measures. Note that it is awkward to support retention of this costly, burdensome and possibly unfair tax to support

[133] Kose John, Vinay B. Nair & Lemma Senbet, *Law, Organizational Form and Taxes: A Stakeholder Perspective* (November 2005), available at SSRN: http://ssrn.com/abstract=676987.
[134] Finally, the authors test the effect of the strength of the legal regime, but since the implications for the U.S. are not clear, I do not explore this part of the article here. Id.
[135] Desai, Dyck & Zingales, *supra,* note 4.
[136] On the benefit theory flavor of their argument, see, *supra,* note 4 (Schlunk; Chorvat and the accompanying text). It is beyond the scope of this article.

weak legal protection of non-financial claimants on corporations. This seems to me particularly true when the trigger of the negative externality is limited liability and firms can in many cases choose to keep limited liability without being taxed as corporations.

This conclusion is not different in a related line of study that explores the relationship between tax and corporate governance in the context of corporate dividend policy. This academic literature awakened particularly because the 2003 reduction of the dividend tax rates that was followed by a significant surge in distributions provided it with a natural experiment. One study suggests possible benefits to dividend taxes (that may be interpreted to require a complimentary separate corporate tax), such as encouragement of ownership, institutional investors control and as an anti-pyramidal business groups mechanism.[137] A recent study by Professor Steven Bank, however, casts doubt over this conclusion and generally over attempts to resolve corporate governance concerns through the tax code.[138]

Finally, even though it is not unique to the corporate governance and taxes context, I wish to note the general power that management has due to its control of the corporation's business, financial and tax strategies. This, of course, is their job, but the separate tax on corporate earnings with its special rules and reporting mechanism adds to the ability of management to shield itself from monitoring, whether by shareholders, stakeholders, regulatory agencies and so on. I briefly mentioned this in my response to Avi-Yonah in the prior section, but I wish to add here another aspect, which is the distancing of corporate tax reporting from financial reporting. There are some good reasons for the dual reporting system in the U.S., yet there are also some serious costs. Primary to them is the reduced role

[137] Randal Morck & Bernard Yeung, *Dividend Taxation and corporate Governance,* 19 J. Econ. Persp. 163 (2005). I should add that the study does not attempt to claim that it presents a justification to retain the corporate income tax, or any cost benefit analysis to evaluate the weight of its arguments against its costs.

[138] Steven A. bank, *Dividends and Tax Policy in the Long Run,* 2007 U. Ill. L. Rev. 533 (2007), 571-572.

of the inherent internal conflict that management faces with respect to profit reporting: the desire to report as much profit as possible to the market while reporting as little profit as possible to the tax authorities. This conflict keeps the system balanced, but it has been reduced in importance over the last years. Recent literature, including a 2005 paper by Professor Mihir Desai,[139] substantiate this phenomenon, concluding that currently both of the two reporting systems have degraded in quality. Desai specifically mentions that the current state of things brings into question, inter alia, the nature of the corporate tax system.[140] One could have argued actually that the corporate income tax allows the dual reporting system to exist and function as a balancing and monitoring costs reducing mechanism. I doubt that a separate tax is required for that, but, anyway, it is failing, which makes such a possible argument a non-starter. In this context, it is interesting to note Desai's questioning of the desirability of keeping corporate tax returns confidential, in contrast to the primary assumption and rationale upon the enactment of the tax.[141]

III. Let's Talk about Fairness…

Fairness obviously is the focal point of the corporate tax debate. The tax is costly, inefficient and welfare reducing, now I hope to convince the reader that there is little certainty that it is fair. The fairness of the tax cannot be determined with certainty because the preliminary question of who bears the economic burden of the tax has no simple answer.

Solving the problem of the tax's incidence is beyond the scope of this article. It is also not possible, because the answer is inherently complex and rich in variations to the

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[139] Desai (Degradation), *supra* note 2 of Reported Corporate Profits" *Journal of Economic Perspectives* 19, no. 4 (Fall 2005).

[140] Id., at 2 ("…the degree to which a dual reporting system enables managerial malfeasance provides yet another argument against the current corporate tax system.")

[141] Id., at 6-7, 22. See also Kornhauser, *supra* note 17, at 54, 72-81.

extent that it may not be useful to seek it.[142] This section attempts to explain why it is so, and draw the policy conclusions from what we know about the incidence relevant to the debate over the desirability of the tax.[143]

The debate among economists over the incidence of the corporate tax is more than half a century old.[144] The incidence question is so difficult from the start since nominal incidence (who actually pays the tax to the government?) provides no useful guidance to the analysis of the real incidence. Very heroic assumptions are immediately necessary because only individuals can bear the burden of a tax and individuals do not bear the nominal burden of the tax. Even if we attempted to attribute the tax directly to shareholders in proportion to their "ownership" stakes in the corporation the task would be very difficult because the attribution would be very complex.[145] Then, there are many candidates for bearing this burden – shareholders, other stakeholders, employees, consumers[146] and really everybody who comes in contact with the corporation. Moreover, timing matters – both the length of the "relationship" with the corporation and the specific instance of it.[147] Finally, different components of the tax may have different incidences, so there is little worth in general

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[142] See, e.g., Auerbach, *supra* note 118, at 13. See also Whalley, *supra* note 64, at 10, 13 (concluding that the complex web of various effects makes a general analysis "not well-posed" or "misfocussed.").

[143] I base my review and analysis mainly on the assessments in Auerbach, id. I do not attempt to cover the issue comprehensively, but rather explain in terms understood by non-economists the implications of the academic literature struggling with this complex and important issue.

[144] Id., at 8-10. For additional information about the chronology of the debate, see Diane Rogers, *The Incidence of the corporate Income Tax,* a Congressional Budget Office paper (1996), available at: http://www.cbo.gov/ftpdocs/3xx/doc304/corptax.pdf.

[145] Auerbach, id., at 5-8. We should acknowledge that the better off do own more corporate stock than the less affluent.

[146] MARIAN KRZYZANIAK & RICHARD A. MUSGRAVE, THE SHIFTING OF THE CORPORATION INCOME TAX (1963) (empirical study concluding that the tax is shifted to consumers, and, surprisingly, that shareholders may even benefit from the tax even in the short run). More recent studies found less shifting on consumers, if at all. This is still a point of strong disagreement among economists.

[147] See, e.g., Whalley, *supra* note 64, at 3, 10-11.

analysis of the incidence of the corporate tax with no change or "reform" in mind.[148] In short, no credible information could be sought by such simple direct attribution exercise.[149]

Let us try and understand this a little better. Corporations pay the tax with money that would have otherwise served another purpose. The question is who are the individuals that were affected by the need of the corporation to pay the tax. Note that the inefficiencies (or waste) of the tax are relevant here. The waste is a loss to somebody, and it is relevant for our purposes whether, for example, it means less enrichment to the "rich" shareholders or, maybe higher prices of essential products or lower wages to corporate employees. We do not, however, deal particularly with the distribution of this waste following the available economic literature that treats it as part of the general effect of the corporate income tax,[150] yet, at the same time we do not ignore it. It is not difficult to sense how every one of these components complicates the analysis.

The most direct effect of the tax could be on workers, who may be paid less because of the tax, consumers who may need to pay more for the product of the taxpaying corporation, shareholders, whose profits from the corporation may be reduced by the need to pay the tax, and so on. This, however, is just the beginning of the analysis, since the tax's burden may also be shifted to other, less direct individuals that "brush" with the corporation, through what economists call substitution effects.[151] To mention only some simple examples: the effect of wage adjustments in the taxpaying corporations on wages in the market in general, the effect of product price adjustments on competing or complimentary products, and most obviously the effect on the cost of capital in the market as a whole. The richness of possible responses of corporations to the need to pay taxes is at

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[148] Auerbach, *supra* note 118, at 33-34.
[149] Id., at 7-8.
[150] See, e.g., Whalley, *supra* note 64, at 6.
[151] See, e.g., Rogers, *supra* note 144, at 11-12, 26.

the heart of the problem for economists who attempt to model corporate behavioral responses to the tax, changes in the tax etc. Corporations can respond to the corporate income tax in a variety of ways and take several courses of actions to avoid the tax – the degree of avoidance also affects the results of such studies. This complexity is at the heart of the difficulty that economists face in their quest to model the effects of the corporate income tax and conclude about its incidence.

The original, and most famous, work on the corporate tax incidence was done by Harberger, who concluded that the tax was borne fully by owners of capital economy-wide, i.e., all the capital bears the burden, not only corporate capital, and neither employees nor consumers (the other groups in his model)significantly bear the burden of the tax.[152] This means, in simple terms, that the corporate tax distorts the allocation of capital between the corporate and non-corporate sectors, and that it is not as helpful, in terms of progressivity (and fairness, if that is how one views fairness), as it would be if only corporate capital bore its burden[153] as owners of capital in society in general are less affluent than corporate shareholders.[154] Even Harberger's model does not completely reject the possibility that labor suffers some of the burden, and that could change to the better or worse in different markets, different times or circumstances.

Later, dynamic analyses pointed to the fact that while it is possible that Harberger's model is more or less accurate in the long run, much more is happening in the transitional periods, which can further cast doubt on the desirability of the tax if redistribution is our

[152] Arnold C. Harberger, *The incidence of the corporation income tax*, 70 J. Pol. Econ. 215 (1962)
[153] This is the basic intuition of corporate tax proponents mentioned above.
[154] Auerbach, *supra* note 118, at 9. Nonetheless, he adds that since capital owners are generally more affluent than workers or consumers in general, it may contribute something to the overall progressivity of the tax system

primary concern.[155] Note also that taxpayers may hedge the risks of tax changes (such as corporate tax rate increases). Auerbach notes that this is not an important issue at the present, but could become one in the future.[156] I do not think that there is much debate, however, that if this becomes a possibility, this mechanism will be more readily available to the more well-off than the less well-off and therefore by itself creates another opportunity for the former to effectively reduce the fairness of the tax in terms of redistribution.[157]

Next to the dynamic analysis, the most potent critique of Harberger's model involved international effects, since he assumed a closed economy setting. The key issues here are the degree of mobility of capital between countries, the elasticity of substitution between countries (substitutability of products manufactured, for instance, in one country for products manufactured in another), and the relative sizes of the relevant countries. It is easy to note the complexity and difficulty of modeling this, but some of the most prominent public economists in the world contributed to this literature, though with no consensus. Results ranged from the burden falling completely on (global) capital[158] to significant shifting of the burden to countries non-mobile factors, such as labor.[159] The country size aspects are particularly interesting, although they significantly complicate the analysis, because it is possible that a (large) country will, simply put, export the burden to other countries and

[155] Id., at 10-13.
[156] Id., at 13.
[157] It seems to me uncontroversial that the rich have more access to innovative financial instruments and particularly derivatives than the less well-off, and that imbalance is more severe than the ratio of, say, corporate share ownership by the respective groups.
[158] Jane G. Gravelle, *Corporate Tax Incidence in an Open Economy,* in National Tax Association Proceedings of the 86th. Annual Conference on Taxation (1994). A more recent paper of the same author revisits the issue and particularly test the issue of exportation of the burden, concluding that most of the burden is born by domestic capital (similarly to Harberger's conclusions), and when it is not, it is mostly exported, i.e., little if any of the burden is born by domestic labor, for instance. Jane G. Gravelle & Kent Smetters, *Who Bears the Burden of the Corporate Tax in the Open Economy?* NBER Working Paper No. 8280 (2001), available at SSRN: http://ssrn.com/abstract=268889.
[159] John H. Mutti & Harry Grubert, *The Taxation of Capital Income in an Open Economy: The Importance of Resident-Nonresident Tax Treatment*, 27 J. Pub. Econ. 291 (1985).

maybe even benefit over all from the tax.[160] Now, could we draw any conclusions from this literature about the international effects except for acknowledging its complexity and the need for additional thinking and empirical? One conclusion may be that this is great. The U.S. can both have the corporate tax and not suffer its complete burden. I have heard this, however, in many different countries. One aspect of this argument is true: that some of the burden of our corporate income tax falls on non-voters, but it is equally true then that some of the burden of foreign corporate taxes falls on U.S. taxpayers. Note also that if some of the tax's burden is shifted to labor, for instance, that burden is not shifted abroad. To conclude in crude terms, there is no strong evidence that U.S. taxpayers do not suffer a corporate tax burden that is lighter than the burden of its own corporate income tax. Also, there is no question that even if that were the case, the picture could change in time as countries respond to that effect. International effects therefore do not seem to help corporate tax proponents in terms of redistribution.

In a recent paper, Auerbach summarizes the literature as cautioning against simple assignment of the economic burden of the corporate income tax to all capital at once, even if it is true in the long-term.[161] He also cautions against an attempt to describe the effects of the tax in terms of simple breakdown of households by wealth, income etc..[162] Auerbach does note that distribution of share ownership (i.e., who owns shares in corporations) is relevant to the analysis, potentially implying that to some extent the burden of the tax does fall on corporate shareholders more than others, which may be translated to the tax being distributionally desirable. He cautions, however, from making such assumptions because of the complexity of the analysis and the fact that simply assigning the burden to certain groups

[160] Several studies referred to in Rogers, *supra* note 144, at 19-20.
[161] Auerbach, *supra* note 118, at 13.
[162] Id.

in our society in a certain time may not be very informative.[163] Adding to that the fact that certain components of the tax have different incidences, Auerbach concludes that it is more meaningful to analyze corporate tax changes rather than the corporate income tax in its entirety.[164]

Very little work was done on the lifetime incidence of the tax in contrast to annual or other shorter perspective, but what we do have indicate that the tax is less "progressive," i.e., distributionally desirable from that perspective than some of the consequences of shorter term analyses.[165]

Finally, note that little work has been done on the role of consumption in the analysis. Consumers deviate in their responses, both in total consumption and specific choice changes, making real world behavior different from Harberger's "simple" model. One notable study in this context, exposed the importance of consumption to the analysis.[166] They also acknowledged the hybrid properties of the corporate income tax as partly a tax on cash flow, a feature normally ignored, which led them to conclude that the tax is less progressive than assumed.[167]

It is beyond my expertise, and beyond the scope of this article to take part in the economic debate, but several conclusions are important. First, there isn't enough empirical evidence on the corporate tax burden on people in America today. Second, It is not only shareholders who bear the burden; the burden is shifted at least to all capital. Third, some of

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[163] This is because different points in time present arbitrary snapshots that are difficult to interpret in terms of what is desirable and what is not; they may result in very different distributions and only the changes over time can really tell us what is happening in terms of fairness (based on redistribution as it occurs over time).
[164] Auerbach, *supra* note 118, at 33-34. See also Whalley, *supra* note 64, at 10.
[165] Don Fullerton & Diane Lim Rogers, Who Bears the Lifetime Tax Burden? (Brookings Institute, 1993). See analysis in Rogers, *supra* note 144, at 20-21.
[166] Gerald E. Auten and Laura T. J. Kalambokidis, *The Effect on the Distribution of the Tax Burden of Replacing the Corporate Income Tax with a Consumption Tax* (U.S. Treasury, Office of Tax Analysis, 1995), referred to in Rogers, *supra* note 144, at 25-26.
[167] See analysis and explanation in Rogers, Id.

the burden is shifted to workers and consumers, but not clear how much, when and whether it is significant.[168] This part of the controversy is the most heated and most politicized, but this is for a reason. If workers and consumers bear much of the burden then the tax may be redistributing from the less-well-off to the more well-off. International analysis further inflames this debate, because it may suggest that more of the burden is shifted to immobile factors, such as labor, but the international model is very complex and its variable constantly change (even more rapidly than other relevant factors in this context) – economies open, substitutability of products change as globalization thrive, etc. Fourth, the tax is not a tax on pure profits of corporations and therefore there is no basis to conclude that those who benefit from corporate profits suffer from the imposition of this tax. The effect on relative prices of products has been particularly neglected.

The apparent short version of what we know is that there is clearly no strong support to the claim that retaining our corporate income tax (alternatively to its repeal) clearly (or even most probably) involve fairness (in redistribution terms) benefits. Factoring in the costs of the tax and its efficiency costs makes things worse for the tax. Most importantly, the complexity of corporate behavior and globalization effects make it essentially impossible to "control" the fairness of the tax, even if we thought that it was somewhat beneficial in terms of redistribution in America now.[169]

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[168] A recent study investigated a large sample companies from 10 different countries (not the U.S.), and concluded that much (in fact, most) of the corporate income tax they suffered was really shifted to labor. As we already know, this does not assist us in drawing conclusions about the U.S. tax, but provides some food for thought and good explanations of this shifting mechanism. Wiji Arulampalam, Michael P Devereux & Giorgia Maffini, *The Incidence of Corporate Income Tax on Wages* (April 2007)(unpublished manuscript), available at: http://www.sbs.ox.ac.uk/NR/rdonlyres/2F6B459F-7EC7-4F88-B510-360FBAA06707/0/WP0707.pdf.

[169] One may argue that the literature also cannot support the notion that the tax is unfair, yet I think that reasonably the burden of proof is on the proponents since that is their argument, and their only real argument in support of this costly, inefficient tax.

IV. Conclusion: the Corporate Tax Should and Can be Repealed

It is apparent by now that I am unconvinced in the need for a separate tax on corporate earnings. Most importantly I am unconvinced that the tax is fair, despite its stability and the persistence of its proponents, demonstrated throughout this article to rely on their almost primal intuition that the tax must be fair because it is levied on corporations as the symbol of the rich and powerful. I urge the reader to think about the possibility that it is likely that the fairness effects of the tax are actually reverse: that the tax is both highly inefficient and regressive (in the sense it probably distributes from the low-middle class to the rich). The management power argument may be turned on its head, since I view the tax as a convenient tool used by management to accumulate power rather than reduces the power of corporate management. This view of the tax is not new by any means. A seminal article by Arlen and Weiss explains the stability of the tax exactly on these grounds – that the tax is politically convenient to corporate management.[170] It may seem naïve, but I should add a word about the absurd of having a long-lasting major tax, such as the corporate income tax, with significant societal effects, that lacks even the legal rhetoric in justification of its existence – this is the "party crasher" characteristic of the tax.

Simple repeal of the corporate income tax, however, is unfortunately not easy. Our tax law still sticks to the fiction of separate legal personality for corporations and allows deferral of U.S. taxation of some income earned by foreign corporations owned by U.S. residents. If we retain our realization-based income tax system and the above ground rules intact, then repealing the corporate tax will merely replace the distortions of the current tax with other distortions such as a strong incentive to invest through corporations.

[170] Arlen & Weiss, *supra* note 3.

A more surgical solution is required therefore. I have been convinced in the merits of some past proposals to replace the corporate income tax with a tax collected at the entity level that will `serve as a proxy to the individual income taxation of the shareholders. This proxy shall not be a separate tax, but rather an effective collection mechanism at the entity level for tax due from individuals who happened to invest through corporate entities.

Finally, I have been convinced that different schemes may be appropriate for publicly traded and non-publicly traded ("private") corporations.[171] Next, I shortly describe two possible regimes for taxation of publicly and non-publicly traded corporations that I support and present to convince the reader that the corporate income tax not only should but also could be repealed. This system is very similar to a 1995 proposal by Professor Joseph Dodge.[172] Even though I chose to frame it differently, the tax systems envisioned are practically very similar.

A. Taxing Publicly-Traded Corporations

When we single out publicly-traded corporations, we usually do that in reference to the significant separation of ownership from control.[173] Agency problems and particularly

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[171] See, e.g., John H. Matheson & Brent A. Olson, *A Call for a Unified Business Organization Law*, 65 Geo. Wash. L. Rev. 1 (1996), at 36 (promoting the idea that the decision to accord conduit versus dual-level taxation should hinge on the distinction between publicly traded entities and private entities). See also Victor E. Fleischer, *If It Looks Like a Duck:: Corporate Resemblance and Check-the-box Elective Tax Classification,* 96 Colum. L. Rev. 518 (1996), note 169 and accompanying text; and on the distinction in the constitutional context: Victor Brudney, Business Corporations and Stockholders' Rights Under the First Amendment, 91 Yale L.J. 235 (1981).

[172] Dodge, *supra* note 18. His detailed proposal deals with most of the design difficulties that a system may face, and I agree with most of his analysis. His proposal, however, came in the context of integration, which I reject, and it possibly contains an element of partial integration that I think should not be tolerated. This article, together with Professor Knoll's article mentioned below influenced my thought about the subject the most. Knoll, *supra* note 18.

[173] Following the famous model of BERLE & MEANS, *supra* note 98. This model has been challenged lately, most notably by Andrei Shleifer & Robert Vishny, *A Survey of Corporate Governance,* 52 J. Fin. 737 (1997). There are, of course, large shareholders in some large corporations, yet this does not change my conclusions – even if we identified one large shareholder, we still have many additional shareholders to attribute taxes and income to, which makes attribution based taxation of corporations problematic. Moreover, in a world where one (for the

the agency problem between shareholders and management typify the dynamics of these corporations. We tend to think about corporations with strong and powerful management, and widely spread, dispersed and relatively weak shareholders, among which may be a few players who own blocks of stock that give them some influence over management, but none can, acting alone, seriously challenge management. These features of public corporations make identification of shareholders and shareholders' relative rights (embedded in their shares) very difficult, and probably deem direct attribution of profits and other tax attributes (i.e., "looking through" the corporation to its shareholders) to these shareholders impractical.

Therefore, the use of a system that we are familiar with – partnership taxation – is probably impractical due to the difficulty to attribute many tax items to all shareholders in an accurate and timely manner. That is not the whole story – our partnership tax system is itself complex, burdensome and difficult sometimes to grasp even for smaller enterprises.[174] It is also (intendedly) very flexible, following the logic that in small and not so complex businesses flexibility it is desirable and not so difficult (for the IRS) to monitor for abuse; this is clearly not the case when very large and complex multinational entities are concerned.

One way of dealing with this problem while maintaining the flexibility of use of publicly traded corporations is to collect a tax at the entity level, and later attribute this tax and distribute it among the shareholders. This attribution process is still complex and highly manipulable - not much different than the partnership model in my mind. Moreover, most

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sake of the example) strong shareholder controls the corporation the corporate governance or the power structure benefits of the our corporate tax are likely to be reduced or non existent, which means that replacing it as proposed here is still better policy.

[174] See, e.g., Margaret McKerchar, Laura R Ingraham & Stewart Karlinsky, *Tax Complexity and Small Business: A Comparison of the Perspectives of Tax Agents in the United States and Australia,* 8 J. Australian Tax. 289 (2005), available at: http://www.austlii.edu.au/au/journals/JATax/2005/9.html. (finding partnership tax to be the most complex of small business tax items in the U.S. based on a survey of tax agents).

of the complexity and inefficiency of the current system will stay intact, because corporations will still need to calculate income and the rest of the tax attributes annually.

The problem is, as demonstrated recently by Professor David Weisbach, inherent to the system of dual ownership and double calculations (at both corporate and the shareholders level), and probably could not be eliminated, only alleviated unless we avoid this duality.[175] One proposal that showed promise in that regard was Professor Michael Knoll's Accretion Corporate Tax proposal.[176] Knoll proposed to replace the corporate income tax with an accretion corporate tax that would tax the change in the total market value of a corporation's outstanding securities. His proposal included design and implementation (including transition) details, including a solution how to treat non-traded securities of traded corporations. The proposal was not made in the context of repeal of the corporate income tax, and it seems to assume, without justification, a separate tax on corporate earnings, yet, with the adjustments proposed below, I find it complete, convincing and the closest to my view of the issues among recent scholarship on point. The benefits of the proposal were significant administrative and compliance cost reduction, and probably (my caveat) a significant decrease of the incentive to engage in tax planning.[177]

As already mentioned I believe that this proposal is easily adjustable to fit in here. The most straight-forward way to do that is a system that Knoll mentions in his introduction

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[175] David A. Weisbach, *The Irreducible Complexity of Firm-Level Income Taxes: Theory and Doctrine in the Corporate Tax,* 60 Tax L. Rev. (forthcoming 2007). This article does not claim that repealing the corporate tax will result in reduced complexity of our income tax system. If the repeal of the corporate income tax is affected as illustrated here, we exchange its complexity with (probably not less complex) detailed rules of tax attributes' attribution to shareholders. If complexity may be distinguished from costliness, I think that it is still more likely that the repeal of the corporate income tax will result in some simplicity and costs benefits. The distribution rules will be replaced with the MTM-type taxation for public corporations, for instance, and a lot of special rules that exist only in a corporate income tax will be eliminated. Nonetheless, simplicity is not a primary advantage, nor is it a disadvantage, of these proposals – for that one should probably explore beyond realization-based income taxes.

[176] Knoll, *supra* note 18.

[177] Knoll added that this tax more closely approximate the income ideal, and of course it is much simpler than our corporate income tax. Id., at 1.

– David Slawson's mid-1960's proposal to tax individual investors on changes in the market value of their publicly-traded securities. This mark-to-market type solution may work and it is probably the purest solution consistent with my thinking, yet it may have some problems, such as the timing of the tax and snapshot identification of the taxpayers, which may be too exposed to gaming and circumvention by sophisticated financial instruments, for instance. The advantage of Knoll's proposal is that the entity itself calculates the tax on the whole value change, and it does so once, with a single tax number resulting from it. This is a serious advantage that begs retention if one were to use this system.

One way of doing that is to simply keep Knoll's proposal and exempt all dividends and capital gains from sales of securities subject to the tax. This is a good and practically appealing solution, but it brings us back to the integration debate – since that what it is: partial integration. I still think that the experience with integration demonstrates that it politically diverts the discourse to undesirable directions. If this were the solution, I would be (rightfully) criticized that in no time Politicians could meddle with the system and restart the debate over the preferred integration method and there is no guarantee that the key achievements of the Knoll system would be maintained. Therefore, I think that a better solution is to make the accretion corporate income tax a withholding tax that consequently will be attributed to individual shareholders, and, if needed refundable to appropriate shareholders. Now, this shall reduce the attractiveness of the tax from a cost and simplicity standpoint, but it is clearly still much better than the current system on these grounds. The difference from other attributions is that no complex calculations are required at the entity level or the attribution stage.[178]

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[178] Several obvious design issues come to mind. Solving them all is beyond the scope of this article, but a couple of observations are warranted. First, attribution is not impossible. Most of the information is readily available in digitized forms. This may be open to some gaming and of course to the creative (and wasteful) use

B. *Taxing Non-Publicly Traded Corporations*

Private corporations are different from public corporations in the degree of separation of ownership and control. We tend to think about these corporations as having few shareholders. Shareholders are closer and have stronger stakes at these corporations. Shareholder involvement is high and shareholder turnover rather rare. Finally, these corporations are normally smaller and less complex than public corporations.

Identification of shareholders and attribution of profits (and other tax attributes) to shareholders in these corporations should therefore be generally feasible. We cannot use a mark-to-market system in these cases because the shares are not traded on a market. The choice here would be between the partnership model and entity level taxation plus refund or additional tax payment at the shareholder level. Between these two, I tend to favor the latter, and, in fact, would apply it to all business entities (not only corporations), in order to eliminate the anachronistic tax choice of entity distortion.[179]

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of financial instruments to misrepresent ownership stakes in corporations. The latter argument may be true, but it is not detrimental to this proposal when compared to the current system that is at least equally exposed to these risks. The exact manner of attribution should be further explored, but one could think of daily stock ownership attribution as not impossible due to the availability of this data electronically. Second, I have no problem with the withholding tax being potentially final, allowing individual shareholders the option (by election) of attribution and a potential refund. The effectiveness of this impure mechanism depends on the rate, but I tend to prefer trusting politicians with rates than trusting them with tax base rules (inclusions, deductions, credits, etc.), primarily because of transparence.

[179] This solution may be viewed as inconsistent with my opposition to a (separate) corporate tax, and here I advocate an entity level tax on non-publicly traded corporations that is not separate but may deteriorate to one at the hands of our politicians much in the same way that full integration, which I opposed for this very reason, may and have in the literature. Well, this is true to a certain extent, but is the best alternative if we confine ourselves to an income tax system (this is my assumption, not personal preference). There are at least three reasons to believe it has a better chance than a full integration reform. One, it will be much more difficult for politicians to ruin a scheme that applies only to non-publicly traded entities and not to publicly traded entities. Two, once all businesses are treated similarly if not publicly traded the incentive to gain tax advantage may be weaker and the cost higher as the system will be more transparent. This is partly related to point three, which requires that the entity level (withholding) tax will be different in many senses from our corporate income tax. Being in essence a withholding tax it should be a proxy for the principal tax (the individual income tax) and therefore clean of special rules for businesses (including accelerated depreciation, special deductions etc..). I am not naïve to think these will just go away, but at least they will be shifted to the individual income tax where they may be hopefully more transparent or at least readily comparable to other "special" tax incentives. In addition, the pressure to enact distortionary rules at the entity tax level will subside, since, if properly enforced, the incentives will be meaningless – if one pays less at the entity level, she will have to pay the difference anyway at her personal level.

C. A Final word

This article is not about comprehensive tax reform, but rather another link in a chain of scholarly work that puzzles about our acceptance of this harmful party-crasher, the corporate income tax, which existence has never been truly rationalized (and I claim cannot be rationalized anyway except for political benefit to a privileged few). Recent research that emphasizes external potential benefits of the tax is not convincing either, as demonstrated in this article, and it is missing the crucial step of comparing all the consequences (including costs) of the tax with the alternatives. I concluded the article with the claim that the tax is not a necessary evil; it not only should, but also could, be repealed consistently with the principles promoted in this article – primarily the single tax principle.[180] I understand that the design of the alternative could be difficult, but since others have done a convincing job in this area, I did not attempt to reinvent the wheel. I only point to the desirable direction.

[180] Borrowing from Professor Reuven Avi-Yonah who coined it in the international context, and of course would not apply it here for reasons explored in part II, *supra.* Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification,* 74 Tex. L. Rev. 1301 (1996).