¶ 1.01 The Corporate Income Tax

The federal government has taxed the income of corporations continuously since Congress enacted a corporation tax law as part of the Payne-Aldrich Tariff Act of 1909, which antedated by four years the ratification of the Sixteenth Amendment and the enactment of the Revenue Act of 1913.[1] Corporate income was taxed even earlier under an 1894 act, but the Supreme Court held in *Pollock v. Farmers' Loan & Trust Co.* that a federal tax on a corporate trust company's income from its real estate and personal property was a direct tax on that property and was invalid because it was not apportioned among the states in proportion to population, as required by article I, § 9, clause 4 of the U.S. Constitution.[2] Because the Court found the invalid tax on income from property to be inextricably bound up with the possibly constitutional taxation of income from other sources, it held that the entire statute must fall.

Profiting from this experience, Congress based the 1909 tax on “the carrying on or doing business” by corporations (as well as joint stock companies, associations, and insurance companies). This change in approach led the Supreme Court, in *Flint v. Stone Tracy Co.*, to rule that the 1909 tax was not an invalid unapportioned direct tax, but a constitutional excise or indirect tax on exercising the privilege of doing business in a corporate capacity:

> [T]he tax is imposed not upon the franchises of the corporation, irrespective of their use in business, nor upon the property of the corporation, but upon the doing of corporate or insurance business, and with respect to the carrying on thereof, in a sum equivalent to 1 per centum upon the entire net income over and above $5,000

> received from all sources during the year; that is, when imposed in this manner it is a tax upon the doing of business, with the advantages which inhere in the peculiarities of corporate or joint stock organizations of the character described.[3]

Because the "occasion for the tax" was the conduct of business in a certain way and not the mere ownership of property, the Court reasoned that the tax was not levied on property, even though it was measured by income from property. The Court also held that (1) corporate activities were subject to federal taxation even though they were carried on under a state charter; (2) the tax was uniform "throughout the United States," as required by the Constitution, because of its geographical uniformity, even though individual proprietors and partnerships were not taxed; (3) because the tax was an excise, as long as the taxpayer was doing business, the tax could be measured by its income from municipal bonds and other nontaxable securities and from nonbusiness assets; (4) active real estate management constituted a "business" on which an excise could be levied; and (5) various other constitutional objections were invalid.

By virtue of *Flint v. Stone Tracy Co.*, the corporate tax measured by income was well entrenched in the federal fiscal system by 1913, when the Sixteenth Amendment empowered Congress "to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration." Because *Flint v. Stone Tracy Co.* validated the 1909 measure as a tax on the exercise of the privilege of doing business in a corporate capacity, however, it did not explicitly destroy the protection afforded by *Pollack v. Farmers' Loan & Trust Co.* to passive income received from property by a corporation that did not engage in business activities.[4] By empowering Congress to reach such income without apportionment, the Sixteenth Amendment may have enlarged the federal power to tax corporate income. With this possible exception, the federal corporate income tax, unlike the federal income tax on individuals, seems to owe nothing to the Sixteenth Amendment.[5]

The 1909 Act imposed a tax of one percent of net income above an exemption of $5,000 per corporation. The 1909 Act produced 2.2 percent of federal revenues in 1909. In contrast, the Internal Revenue Code of 1986, as amended, imposes rates of 15 percent on the first $50,000 of taxable income, 25 percent on the next $25,000, and between 34 percent and 39 percent at various levels above the first $75,000. The proportion of federal tax revenues derived from the

corporate income tax reached a high of 40 percent in 1943 and has fallen since then; in 1992, the corporate income tax produced about only 10.6 percent of federal tax revenues.[6]

The term “corporation” is defined by **§ 7701(a)(3) of the Internal Revenue Code** to include associations and joint stock companies. Thus, the corporate income tax is imposed on some enterprises that do not constitute corporations under state law.[7] Conversely, the corporate income tax is not imposed on corporations that have elected the pass-through regime of subchapter S; these corporations are known as S corporations,[8] as contrasted with C corporations, which are taxed under subchapter C.

With some exceptions,[9] the taxable income of a corporation is computed in essentially the same fashion as an individual's taxable income. Thus, the corporation's annual accounting period (calendar year or fiscal year) is employed; the corporation's regular accounting method (cash receipts and disbursements, accrual, percentage of completion, and so forth) is controlling unless the method does not clearly reflect income; the corporation must include in gross income, and may deduct, most of the items that are taxable to or deductible by individuals; and the Internal Revenue Service may reallocate income and deductions between or among two or more businesses under common control in order to clearly reflect income, whether the businesses are incorporated or not. Similarly, the grand principles or doctrines of income taxation (e.g., no assignment of earned income, substance over form, business purpose, and step transactions) are applicable to corporations as well as to individuals.[10] Finally, most of the administrative provisions of the Code governing the filing of returns and payment of tax, assessments, collection, interest on deficiencies and overpayments, penalties, procedure in the Service, and litigation are equally applicable to both corporations and individuals.

As will be seen in Chapter 5, where the major deviations between the corporate income tax and the individual income tax are discussed, the most vexing tax problems in the use of the corporation do not arise in determining its income tax liability. The principal difficulties arise, rather, because (1) distributed corporate income is taxed to the shareholder, while undistributed income is not; (2) an exchange of stock or securities by the investor may or may not be an appropriate occasion for recognizing gain or loss, and a sale may be a dividend in disguise; and (3) transactions between a corporation and its shareholders and affiliates often are not conducted

at arm's length. The succeeding chapters of this book address in detail the ramifications of these problems, but a few words of introduction may be in order. [10.1]

But 2003 legislation lowering the top rate on dividends and capital gain to 15 percent effected a profound (albeit temporary) change in the corporate-shareholder relationship which resonates throughout this work. [10.2] A return to higher rates, however, seem increasingly likely.

[1]

The principal provisions of the U.S. Constitution regarding taxation are:

> *Article I, Section 8, Clause 1:* The Congress shall have Power to lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States.
>
> *Article I, Section 9, Clause 4:* No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken.
>
> *Amendment XVI:* The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.
>
> See also U.S. Const., art. I, § 2, cl. 3 (concerning apportionment of direct taxes), and art. 1, § 7, cl. 1 (requiring that revenue bills originate in the House).

[2]

Pollock v. Farmers' Loan & Trust Co., 158 US 601 (1895), vacating 157 US 429 (1895) .

3

Flint v. Stone Tracy Co., 220 US 107, 115–116 (1911) .

4

See **Zonne v. Minneapolis Syndicate, 220 US 187 (1911)** , and **McCoach v. Minehill & S.H. Ry. Co., 228 US 295 (1913)** (holding that such corporations were not subject to the tax).

5

The shift from an excise tax to an income tax probably resulted, at least initially, in the exemption of state and local debt interest from the corporate income tax base. But see **South Carolina v. Baker, 485 US 505 (1988)** (holding federal exemption of state debt interest not constitutionally required).

6

See Report of Department of Treasury, Integration of the Individual and Corporate Tax Systems, Taxing Business Income Once 156 (U.S. Gov't Printing Office, Jan. 6, 1992); Statistical Abstract of the United States, Table No. 520.

7

See Chapter 2.

8

See Chapter 6.

9

See ¶ 5.02.

10

See infra ¶ 1.05.

10.1

For retrospective and prospective looks at the problems of the corporate tax, see Ferguson, “How to Save the Corporate Income Tax,” 132 Tax Notes 951 (Aug. 29, 2011); Gravelle, “The Corporate Income Tax: A Persistent Policy Challenge,” 11 Fla. Tax Rev. 75 (2011).

10.2

The greatest impact of this change will be felt in Chapters 8, 9, 11, and 12. These cuts were extended for two years, however, by 2006 legislation (expiring for 2011). Unless Congress extends them again, the pre-2003 rates will receive and the eight-year honeymoon will be over. But Congress extended the low rates for two more years in December 2010.