THE NON-SENSE TAX: A REPLY TO NEW CORPORATE INCOME TAX ADVOCACY

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ABSTRACT

This Article challenges recent attempts by influential scholars to rationalize the existence of the corporate income tax. The corporate income

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tax has long been considered unjustifiable on traditional tax policy grounds. The new justifications recognize this, yet argue that the tax is still desirable because it promotes other goals, such as improvement of corporate governance and restraint of undesirable corporate management power accumulation. This Article demonstrates that the existence and magnitude of these alleged benefits of the corporate income tax are doubtful. Yet, the Article argues, even if taken as correct, the recent rationalization of the corporate income tax cannot support its retention, since it misses certain crucial steps in the analysis. First, the rationalization does not compare the effects of the corporate income tax with its alternatives. This Article demonstrates that once such comparison takes place, the corporate income tax proves to be less desirable than its alternative on the very grounds promoted by its proponents. Secondly, the support of the corporate income tax completely ignores the social costs of the tax. This Article argues that once taken into account, such costs may overwhelm the alleged benefits, if any. Finally, the Article claims that the recent support of the corporate income tax is based on a strong, yet unproven, popular intuition that the tax is fair. The Article goes on to explain the uncertainty that governs the economic analysis of the burden of the tax, which results in confusion and the inability to assess the fairness of the tax as a whole. This understanding should pull the carpet from underneath the very basis of the arguments in support of the corporate income tax. The Article concludes by asserting that the tax not only should, but also could, be repealed consistent with accepted tax policy principles.

INTRODUCTION

The corporate income tax is a peculiar legal instrument. It taxes outcomes of economic reality (income) of fictions that we call corporations, which exist solely in the legal sense.[1] The tax does not, therefore, affect its nominal taxpayers (the corporations), but rather real persons tangentially related to these taxpayers.[2] Moreover, the tax is not particularly effective if evaluated by the usual measures used to evaluate taxes. It is not a primary revenue raiser,[3] yet, it is socially very costly and wasteful. It is also not a

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1. The corporate income tax rules appear mainly in subchapter C of the Internal Revenue Code. Subchapter C currently includes the norms required to apply an income tax to corporations in particular. The basic income tax provisions, such as basic inclusions and deductions, appear in the general sections of the Code and apply to corporations and other persons.

2. The real burden of the corporate income tax is explored throughout this Article, particularly in Part IV.

3. It raises four-to-ten percent of the revenue in the United States and of almost all of its major trade partners. ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, REVENUE STATISTICS 1965–2006 (2007).

particularly good avenue for the implementation of non-fiscal government policies, including social policies and redistribution of wealth.[4] Nonetheless, the corporate income tax is our longest standing federal income tax. It even preceded our current individual income tax.[5] The corporate income tax is extremely stable, and even popular, notwithstanding its shortcomings that have been extensively explored over the years.[6]

The stability of the corporate income tax can only be explained by the general sentiment that the tax is politically impossible to repeal,[7] even though it is very hard to justify the tax's existence on policy grounds. Nonetheless, a group of acclaimed scholars has recently attempted to justify the existence of the corporate income tax based on arguments that are not traditionally related to tax policy.[8] The general idea behind these claims is

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4. The puzzle over the double taxation aspects of the corporate income tax goes back many years. *See, e.g.*, ROSWELL MAGILL, THE IMPACT OF FEDERAL TAXES 26-28 (1943) (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, for example, CHARLES E. MCLURE, JR., MUST CORPORATE INCOME BE TAXED TWICE? (1979); DEPT. OF THE TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE (1992), *available at* http://www.treas.gov/offices/tax-policy/library/integration-paper/integration.pdf; STAFF OF THE JOINT COMM. ON TAXATION, BACKGROUND MATERIALS ON BUSINESS TAX ISSUES PREPARED FOR THE HOUSE COMMITTEE ON WAYS AND MEANS TAX POLICY DISCUSSION SERIES (Doc. No. JCX-23-02) (2002), *available at* http://www.house.gov/jct/x-23-02.pdf; JOINT ECON. COMM., REFORMING THE U.S. CORPORATE TAX SYSTEM TO INCREASE TAX COMPETITIVENESS (2005), *available at* http://www.house.gov/jec/CorporateTaxReform.pdf (evaluating the desirability of corporate income tax repeal); Mihir A. Desai, *The Degradation of Reported Corporate Profits*, 19 J. ECON. PERSP. 171, 191 (2005) (noting that the tax "has long struggled for a rationale").

5. 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* 1 BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 1.01 (7th ed. 2002).

6. *See, e.g.*, *supra* note 4.

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

8. *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, Alexander Dyck & 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, 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 J. Schlunk, *How I Learned To Stop Worrying and Love Double Taxation*, 79 NOTRE DAME L. REV. 127 (2003), which supports the tax by relying on benefit theory rationale. I do not respond to this article here because it does not refer to our corpo-

that the corporate income tax is a desirable societal device because it limits corporate management's power and limits wealth accumulation by majority corporate shareholders and other "rich" stakeholders.

The argument is that even though the corporate tax is not particularly desirable,[9] the tax possesses certain positive "externalities" that justify its existence. The Article interprets this line of reasoning as a version of a fairness-based idea that the tax is desirable because it directly promotes redistribution from the rich to the poor (or at least negates redistribution from the poor to the rich).[10] It demonstrates that the argument essentially follows the false, but very strong, intuition that the corporate income tax is "progressive" in the sense that the better-off are more likely to have stakes in corporations than the less well-off, and that, therefore, the tax primarily targets the former rather than the latter.[11]

The power of this recent support of the corporate income tax is that it attempts to justify our current corporate income tax, whereas some past justifications of the tax were based on a utopian corporate income tax system that was never truly expected to be in place.[12] Furthermore, the recent arguments avoid the general (traditional tax policy) criticism of the tax, and

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rate 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, *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 one hand and explains why management is reluctant to accept a look-through type taxation of corporations on the other hand. It gives a unique basis to tax corporations separately and explains (at least partly) why management has not resisted the tax enough. *Id.* at 946-47. 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.

9. The most important scholar in this group of recent proponents of the corporate income tax, Professor Reuven Avi-Yonah, specifically admits that this is the case. Avi-Yonah, *supra* note 8.

10. *See, e.g.*, *id.*

11. See *infra* Part II for a direct confrontation of 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 are separately taxed as such; hence, the corporate income tax is justified. For a recent primary example, see, e.g., Schlunk, *supra* note 8.

they even acknowledge the soundness of this criticism.[13] Finally, these arguments are the most recent in support of the tax, and, therefore, they are the least exposed to critical analysis.

The Article demonstrates that despite their popular appeal, these attempts are unpersuasive in arguing that the corporate income tax is desirable or even that it promotes fairness.[14] Moreover, it notes that even if the tax resulted in some of the claimed societal benefits, the tax is not necessarily desirable overall, because none of the arguments takes into account the social costs of having the tax, and none evaluate such costs against the alleged benefits. The Article argues that these social costs cannot be ignored.

This Article concludes that these recent attempts to justify the existence of the corporate income tax should not fare better than prior such claims, and as the analysis suggests, the corporate income tax should be repealed. The corporate income tax simply does not make sense,[15] as only limited political advantages, to a few privileged members of our society, allow this chaotic legal instrument to exist.[16] This means that a separate tax should not be imposed on the corporation, which consequently increases the overall tax rate imposed on investments effected through corporations in comparison to investments using non-incorporated entities. However, corporations may be used as collection or withholding agents for the individual income tax that is imposed on the corporate stakeholders.[17]

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13. Avi-Yonah, *supra* note 8, at 1210-11.

14. I note that I generally sympathize with attempts to curb unjust power accumulations. I also favor measures to reduce inequalities in our society. I simply think that the corporate income tax is the wrong vehicle to do that, and, in fact, I suspect that its true effect is the exact opposite to the one claimed by its proponents.

15. *See, e.g.*, Richard M. Bird, *Why Tax Corporations?* 1 (Technical Comm. on Bus. Taxation, Working Paper No. 96-2, 1996), *available at* http://www.fin.gc.ca/taxstudy/wp96-2e.pdf:

> 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.

Id. at 5.

16. At the cost of the rest of society. *See, e.g.*, Arlen & Weiss, *supra* note 7, at 368.

17. 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 an effective 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) income tax rate.

Part I establishes, based on this observation, a model alternative to our corporate income tax. This model serves as a benchmark for evaluating the arguments in support of retaining the corporate income tax. It demonstrates that even if the arguments that are criticized support the contention that the corporate income tax has some desirable social attributes, the same attributes should be either more or equally desirable under the alternative model, pursuant to which the tax is repealed. Therefore, the proponents' arguments cannot stand critical analysis. This analysis of the alternative model reiterates that not only should the corporate income tax be repealed, but also that it could be repealed in a satisfactory manner, as several scholars have demonstrated in the past.[18]

The Article proceeds with the discussion of the two most important lines of recent support for the corporate income tax. First, the primary articulation of such support, Professor Reuven Avi-Yonah's argument, is analyzed. Professor Avi-Yonah argues that the tax is desirable because it reduces corporate income, and consequently reduces the amount of cash and hence power available for corporate management.[19] According to Professor Avi-Yonah, this result is desirable because corporate management occupies excessive power, which is undemocratic and destructive to our society. This is responded to in Part II, which demonstrates that the basic assumptions behind this argument are not substantiated, and explains that even if they were true, such assumptions are still insufficient to support a conclu-

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18. Primarily Michael S. Knoll, *An Accretion Corporate Income Tax*, 49 STAN. 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). 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)). 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. *See, e.g.*, Dodge, *supra*. This meant that the existence of the 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. Therefore, such methods, at best, just ameliorated the corporate income tax's undesirable effects, leaving most of its costs and exposing the tax to further political meddling. This discourse should end. Instead of trying to ameliorate the distortions of the corporate income tax, we should acknowledge its insensibility and work on improving alternative schemes. We can then concentrate on designing a more transparent (single) tax system in the shape of our social and political consensus. *See, e.g.*, Dodge, *supra*; MCLURE, *supra* note 4; Deborah H. Schenk, *Foreword, Colloquium on Corporate Integration*, 47 TAX L. REV. 427 (1992); 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 (1998) (New compilation of the early 1990s integration proposals of the Treasury Department and the American Law Institute).

19. Avi-Yonah, *supra* note 8.

sion that the corporate income tax should be retained.[20] Second, the argument that the corporate income tax has desirable corporate governance implications that justify its preservation is analyzed.[21] Part III demonstrates that the corporate governance consequences of the tax are not clear, and that the research is far from supporting the above stipulation. It also notes that similarly to the first argument supporting the corporate income tax, the assumptions that may support an argument for the corporate income tax based on its corporate governance benefits do not factor the societal costs of the tax into the equation, further reducing its force.

Part IV discusses the motivations behind some of the recent attempts to justify the corporate income tax and clarifies the belief that most of this

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20. It is difficult to make 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. This is so when the revenue collected is small and dwarfed in comparison to the other, less costly components of the system that draw much less attention. Corporate tax revenues declined in the United States and the rest of the rich world (with the exception of Japan) to between ten-percent and five-percent (and for a while even below that) of total revenue. David M. Walker, Comptroller Gen. of the U.S., *Testimony Before the S. Comm. on Fin.*, *in* U.S. GOV'T ACCOUNTABILITY OFFICE, REPORT NO. GAO-06-851T, TAX COMPLIANCE: CHALLENGES TO CORPORATE TAX ENFORCEMENT AND OPTIONS TO IMPROVE SECURITIES BASIS REPORTING (2006), *available at* http://www.gao.gov/new.items/d06851t.pdf [hereinafter USGAO 2006]. 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). 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 that it can even be made effectively at the present. For obvious reasons it is difficult to assess the full costs of corporate tax planning, but there are some studies on the costs of corporate tax compliance. To date, these studies focused 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 Business* (Office of Tax Policy Research, Univ. of Mich. Bus. Sch., Working Paper No. 914, 2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=913056 (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 two million dollars in 1996. For another review of the costs, see U.S. GOV'T ACCOUNTABILITY OFFICE, REP. NO. GAO-05-878, TAX POLICY: SUMMARY OF ESTIMATES OF THE COSTS OF THE FEDERAL TAX SYSTEM tbl.3 (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. Joel Slemrod, The Costs of Tax Complexity: Presentation to the President's Advisory Panel on Federal Tax Reform (Mar. 3, 2005), *available at* http://www.taxreformpanel.gov/meetings/docs/slemrod_03032005.ppt. *See also* Joel Slemrod, *The Economics of Corporate Tax Selfishness*, 57 NAT'L TAX J. 877 (2004) (explaining estimates of corporate tax compliance costs and the losses to society resulting from the corporate income tax).

21. *See, e.g.*, Desai, Dyck & Zingales, *supra* note 8; Avi-Yonah, *supra* note 8.

support stems from the perception that the corporate income tax has some positive redistributive effects (i.e., it is "fair" or "progressive").[22] Most importantly, it explains that it is difficult to evaluate the fairness of the corporate income tax, primarily because we are unable to simply identify who bears its economic burden.[23] Lack of data and the difficulty analyzing the corporate income tax incidence (burden) make the analysis of the fairness of the tax based on its burden impractical.[24]

I. THE BENCHMARK FOR EVALUATING THE ARGUMENTS IN SUPPORT OF THE CORPORATE INCOME TAX

A proper normative evaluation of the arguments in support of the corporate income tax requires an analysis of the alleged desirable effects of the tax in comparison to a state of the world without the tax. One can imagine several alternative systems that could replace the corporate income tax, yet, in any case the comparison must be performed with a reconstructed benchmark system, since the United States, as well as most other significant economies, have employed a corporate income tax for many years now.[25]

The choice of the benchmark could affect the outcome of the comparison, so one should choose a system that one also believes to be realistically feasible and normatively desirable (to replace the corporate income tax). Therefore, the corporate income tax is compared with an alternative system, and is evaluated as to whether the corporate income tax is indeed superior in terms of undesirable corporate management power accumulation, corporate governance, and fairness, as alleged by the arguments that are criticized in this Article. It concludes that this is not the case.

The alternative system used as a benchmark replaces the corporate income tax with a tax on the appreciation of stakes (shares) in publicly traded

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22. These sentiments were explored by Arlen & Weiss, *supra* note 7, who concluded, however, that they were not the reason for the resilience of the corporate tax.

23. *See, e.g.*, Alan J. Auerbach, *Who Bears the Corporate Tax? A Review of What We Know*, 20 TAX POL'Y & ECON. 1 (James M. Poterba ed., 2006); William M. Gentry, *A Review of the Evidence on the Incidence of the Corporate Income Tax* (U.S. Dep't of Treas., OTA Paper No. 101, 2007), *available at* http://www.treas.gov/offices/tax-policy/library/ota101.pdf.

24. Even though the original understanding upon the enactment of the corporate income tax was that publicity is a key feature of the tax and its desirability. The centrality of publicity to the enactment of the tax was demonstrated originally in Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L.J. 53 (1990). For the lack of data, see Interview by Scott Hodge with Douglas Shackelford, Professor of Taxation & Dir. of Univ. N.C. Tax Ctr., (Nov. 7, 2006), transcript *available at* http://www.taxfoundation.org/podcasts/transcript14.pdf.

25. *See, e.g.*, Graeme S. Cooper & Richard K. Gordon, *Taxation of Enterprises and Their Owners*, *in* 2 TAX LAW DESIGN AND DRAFTING 811 (Victor Thuronyi ed., 1996).

corporations and a look-through taxation system[26] for shareholders of non-publicly traded corporations.[27] In both cases the corporations will withhold the primary portion of the tax on behalf of their shareholders. Such shareholders will be entitled to file for a refund of any excessive taxes paid by the corporations on their behalf.[28] The merits of this system and similar variations on it are discussed elsewhere;[29] this benchmark is used here merely to

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26. For example, a tax system that does not tax the entity, but rather its owners or shareholders in the case of corporations, based on tax attributes or items of the entity attributed to them.

27. This system is very similar to a 1995 proposal by Professor Joseph Dodge. 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. Dodge's article, together with Professor Knoll's article, influenced my thought about the subject the most. Knoll, *supra* note 18. Note that a different taxing mechanism applies to publicly traded and non-publicly traded corporations. I have been convinced that this is appropriate and almost practically necessary due to the significant (mainly organizational) differences between these types of entities; differences that current tax law barely recognizes. *See, e.g.*, John H. Matheson & Brent A. Olson, *A Call for a Unified Business Organization Law*, 65 GEO. WASH. L. REV. 1, 36 (1996) (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, 554 n.169 (1996). On the distinction in the constitutional context, see Victor Brudney, *Business Corporations and Stockholders' Rights Under the First Amendment*, 91 YALE L.J. 235 (1981).

28. 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 have in the literature. Well, this is true to a certain extent, but it 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, 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 free of special rules for businesses (including accelerated depreciation and special deductions). 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.

29. *See, e.g.*, Dodge, *supra* note 18; Knoll, *supra* note 18. Note that solving the complexity of our tax system is not the primary goal here. The complexity 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

demonstrate its superiority to our current corporate income tax system. Throughout this Article, other alternative systems are mentioned in appropriate places to give a more comprehensive analysis of some of the arguments.[30]

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could not be eliminated, but only alleviated, unless we avoid this duality. David A. Weisbach, *The Irreducible Complexity of Firm-Level Income Taxes: Theory and Doctrine in the Corporate Tax* (U. of Chi. L. & Econ., Olin Working Paper No. 327, 2007), *available at* http://ssrn.com/abstract=957358. This Article does not claim that repealing the corporate tax will result in the reduced complexity of our income tax system. 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 that respect the corporate separate legal personality.

30. Simple repeal of the corporate income tax, however, is unfortunately not easy, since 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. Note also that the use of a system that we are familiar with—partnership taxation—is probably impractical (especially for publicly traded corporations) due to the difficulty to attribute many tax items to all shareholders in an accurate and timely manner. Additionally, our partnership tax system is itself complex, burdensome, and difficult sometimes to grasp even for smaller enterprises. *See, e.g.*, Margaret McKerchar, Laura R. Ingraham & Stewart Karlinsky, *Tax Complexity and Small Business: A Comparison of the Perceptions of Tax Agents in the United States and Australia*, 8 J. AUSTL. TAX'N 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 United States based on a survey of tax agents). It is also (as intended) very flexible, following the logic that in small and not so complex businesses, flexibility is desirable and not very difficult for the IRS to monitor for abuse; this is clearly not the case when very large and complex multinational entities are concerned. One considered alternative, which would be the most literal or immediate benchmark system, is an income tax system that is identical to ours but excludes the corporate income tax and includes an individual income tax rate increase to compensate for the revenue loss from the absence of the corporate income tax. John Whalley, *The Incidence of the Corporate Tax Revisited* (Technical Comm. on Bus. Taxation, Working Paper No. 97-7, 1997), *available at* http://www.fin.gc.ca/taxstudy/wp97-7e.pdf. Such a system attributes all tax items—or at least most of them—to the shareholders in proportion to his or her stake in the corporation, similar to the way we tax partners. The other alternative considered preserves certain elements of the corporate tax, but only as an efficient collection mechanism. This is particularly appropriate for the large publicly traded corporations. The attribution of taxes and income to a large number of shareholders, with a significant turnaround of shareholders and possibly more extensive use of financial intermediaries and derivative financial instruments, is difficult. Under this system (very schematically) 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 along 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 Article. Two things are important: first, 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, for instance). Second, the tax base cannot be similar to our current corporate tax base, but should be amended to be as similar as possible to the personal tax base, since it is a mere collection mechanism. 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 of the current state of the law.

Before we get to the thick of the analysis, some observations may be made. If we repeal the corporate income tax, managers may indeed find themselves with more cash at hand in the short term since corporations would not have to nominally pay the tax to the government. Yet, this is not the case if corporations remain the withholding agents for whatever replacement tax one chooses, such as in the benchmark system. In any event, even if it were true, short-term increases in the cash, subject to management's control, are almost meaningless from a policy standpoint. It is easy to see that in such a case, shareholders would put more pressure on management for increased transparency and distributions of the business' earnings, at least to cover the additional tax they need to pay. These distributions may eventually be smaller than the decrease in cash due to corporate income tax payment, but they at least clearly reduce the power of the argument. Shareholders' pressure for increased transparency[31] may be even less desirable for corporate management because management may need to provide more extensive calculations of tax items that are attributed to each shareholder, which is not required under the current corporate tax system. Even ignoring the additional costs to the corporation (which further reduce cash at hand for management), repealing the corporate income tax should increase transparency in the corporation, which is undesirable to management.

This simple hypothetical narrative points to one important observation of the Article: corporate management does not necessarily hate the corporate tax. This is because it provides management with one of the most powerful evasion devices available. Management uses taxes in general, and the corporate income tax in particular, as an excuse for rent extraction activities that do not necessarily result in reduction of effective taxation of shareholders.[32] Our corporate income tax system developed in a manner that reinforces management's position: certain tax advantages benefit only corporations—tax-free mergers and acquisitions, certain accelerated depreciation schemes, special credits, deductions, and similar measures. Management uses these special provisions to avoid distributions and transparency in gen-

31. And the loss of the ability to tell shareholders, "We cannot do/must do this or that for tax reasons." *See supra* Part II.

32. Retention of earning at the corporate level of course defers taxation of shareholders on distributions (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% (or a bit lower than that effectively), 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 benefits the rich—only those who face tax rates beyond 35% enjoy some deferral (time value of money) under the current system.

eral.[33] Management is also able to ignore the various tax positions of its shareholders by hiding behind the fiction of the corporation's separate legal personality (and "taxpayership"). In the alternative, transparent world managers may face a nightmare of multiple shareholders demanding different and contradictory courses of action that would be beneficial to their respective tax positions. This may not be a desirable outcome, yet the exploration of this point will wait for future study. It is mentioned here because it clearly demonstrates that a repeal of the corporate income tax may well result in corporate management having less power, rather than more, as scholars argue. This is responded to next.

II. THE CORPORATE POWER STRUCTURE AND THE CORPORATE INCOME TAX

A. The Argument and its Appeal

Restraining undesirable corporate management accumulation of power is desirable, and since the corporate income tax results in such restraint, it is desirable, so goes the first argument analyzed in this Article. The most explicit, and most comprehensive, version of the argument was made recently by Professor Avi-Yonah.[34] This Section argues that such a position cannot support the retention of the corporate income tax.

There are several reasons why this argument is appealing. The argument is concerned with consequences that are external to our income tax system and the traditional analysis of its negative effect on society. The argument is therefore effective, since it avoids the overwhelming criticism of the tax contained in the traditional literature. It is smart because it accepts that the tax does not make much sense as a revenue collection mechanism, or as a conventional component of our income tax system.[35] Finally, this is the most recent line of argument in support of the tax, and one that is yet to be properly refuted by corporate income tax opponents.

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33. *See, e.g.*, Michael C. Jensen, *Agency Cost of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 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).

34. Avi-Yonah, *supra* note 8. Avi-Yonah asserts that the more "immediate" burden that the tax imposes on management simply falls on management. *Id.* at 1244, n.235. 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. Therefore, it is arguably hardly surprising that corporate managers have been the strongest supporters of its repeal. *Id.* 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.

35. *See, e.g.*, *id.* at 1210.

Despite its supposed freshness, this Article contends that implicitly this new argument is intimately related to the core tax policy analysis of the corporate income tax, and that it particularly focuses on the fundamental, but false, intuition that the tax is fair because it results in desirable redistribution. This is an important point because it is hard to believe that one would seriously base the retention of the corporate income tax solely on some amorphous corporate power balance benefit, unless one believes it is also a fair tax. This Article argues that both the argument itself and the intuition behind it cannot stand critical analysis. Moreover, even if the alleged benefits were real, this justification of the corporate income tax could hold only if the benefits outweighed the costs of having the tax, especially if such benefits could not be captured by other less costly means. None of the recent literature includes an analysis of the costs aspects, nor does the recent literature include alternative measures to capture the alleged benefits of the tax. Nonetheless, these arguments are powerful. The main source of their power is their attempt to justify "our" corporate income tax, as opposed to a theoretical, never-to-be-implemented, corporate tax scheme.[36] Additionally, they propose a basis for taxation that is indeed unique to corporations and therefore may justify a separate tax on them.[37]

An interesting aspect of this new literature is that it is supported by historical analysis (which I generally accept) that concludes that the so-called "real entity" view of the corporation and the hope to control corporate power accumulation were central to the original political decision to enact the tax in 1909.[38] This, however, is just an anecdote—not true support for the argument—since the circumstances have dramatically changed[39] and since the argument overlooks the fact that the tax was a mere political compromise when it was enacted.[40]

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36. *Supra* note 12. In that it is superior to other potential justifications of the corporate income tax. *See id.* at 1205-08, 1210-12. Moreover, the original and most comprehensive articulation of this argument, by Professor Avi-Yonah (preceded only by Hideki Kanda & Saul Levmore, *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 8, at 1210-11.

37. *See, e.g.*, Avi-Yonah, *supra* note 8. 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.

38. *Id.* 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.

39. *See infra* Section II.A.

40. *See, e.g.*, Avi-Yonah, *supra* note 8, at 1217.

The stated justifications for the corporate income tax enactment included[41] (1) a benefits' theory argument, viewing the tax as one that is imposed on the distinct privilege of doing business in the special corporate form (limiting the liability of shareholders); (2) 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 (3) the federal government's desire to regulate corporations.[42] An important aspect of this desire was the understanding that corporate tax returns will be public.[43] These historical justifications cannot support today's corporate tax, however. The focus of benefit theories on the limited liability feature lost its 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 (for instance, through a limited liability company (LLC)).[44] The administrative convenience argument was never serious because collection at the entity level does not require additional levels of taxation.[45] Finally, with respect to the third argument, the federal government regulates corporations extensively anyway, and since corporate tax returns are generally confidential, the publicity aspect that was central to this argument may have been turned on its head, and in reality, resulted in less rather than more transparency.

B. The General Income Tax System Does not Tax Corporate Management Power Accumulation

The corporate income tax's indirect hindrance of power accumulation by corporate managers is required for the argument in support of the tax because our general income tax system does not otherwise tax mere power accumulation. Corporate income is not the income of the managers as normally defined under our federal income tax law. If one tested the issue against the well-known Schanz-Haig-Simmons definition of income [Income = consumption + change in net wealth ($C + \Delta W$)],[46] she may argue for

41. *Id.* at 1217-20.

42. Kornhauser, *supra* note 24, at 53.

43. *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 8, at 1215-16.

44. *See, e.g.*, INTERNAL REVENUE SERV., DEP'T OF THE TREASURY, PUBLICATION 3402, TAX ISSUES FOR LIMITED LIABILITY COMPANIES (2008), *available at* http://www.irs.gov/pub/irs-pdf/p3402.pdf.

45. *See, e.g.*, Cooper & Gordon, *supra* note 25, at 817-22.

46. Georg von Schanz, *Der Einkommensbegriff und die Einkommensteuergesetze*, 13 FINANZ-ARCHIV 1 (1896); ROBERT M. HAIG ET AL., THE FEDERAL INCOME TAX (Robert M. Haig ed., 1921); HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY (1938).

taxation of power accumulation if such power accumulation translated to either consumption or to an increase in wealth of these managers. Conventional wisdom suggests 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.[47] The second prong of the definition (increase in net wealth) is also not helpful because wealth increases are not taxed under our federal income tax system until realized.[48] Therefore, accumulation of power by itself is not a taxable event.[49] 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.[50] Most countries only tax realized income,[51] 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.[52]

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47. *See, e.g.*, I.R.C. §§ 1, 83 (2000).

48. *See, e.g.*, *id.* § 1001.

49. 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.

50. DAVID F. BRADFORD, UNTANGLING THE INCOME TAX 24-25, 154-56 (1986). 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).

51. For example, income earned upon transformation of an input into a "materially" different output. *See* 26 C.F.R. § 1.1001-1(a). 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 defense of the principle, see Terrence R. 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).

52. 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, *supra* note 51; Noël B. Cunningham & Deborah H. Schenk, *Taxation Without Realization: A "Revolutionary" Approach to Ownership*, 47 TAX L. REV. 725 (1992); 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. *See, e.g.*, Schenk, *supra* note 51. 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.

Avi-Yonah avoids this battle, however. His argument carries some of its flavor when he criticizes Professor Daniel Shaviro's explanation that wealth (or the equivalent power in our context) is nothing but the opportunity to consume in the future.[53] Avi-Yonah 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 its ability to invest, not consume.[54] One initial response to that is embedded in Shaviro's explanation—that investment itself is meaningless if one, or one's heirs, cannot enjoy (consume) its fruits.[55] That still leaves the opportunity (for savers/investors) to defer consumption, and maybe more importantly to engage in alleged advantageous investment opportunities. It may be the case that wealthy people have better investment opportunities due to their high-income status (or their status as managers), but again, our tax system does not tax opportunities—just realized income.[56] 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.

C. Why is Corporate Management Power Accumulation Bad?

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 desirable.[58] 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.[59]

Based on sociological literature, Avi-Yonah mentions three aspects of corporate management power that worry him: political;[60] economic;[61] and

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53. Avi-Yonah, *supra* note 8, at 1236 n.206 (criticizing Daniel N. Shaviro, *Replacing the Income Tax With a Progressive Consumption Tax*, 103 TAX NOTES 91, 106 (2004)).

54. *Id.*

55. Shaviro comments that the confusion over non-direct or monetary consumption may be one source for the misunderstanding of this point. *See* Daniel N. Shaviro, *Replacing the Income Tax With a Progressive Consumption Tax*, 103 TAX NOTES 91, 106 (2004).

56. Note that one cannot criticize our realization-based income tax and at the same time support retention of the corporate income tax based on the very basis criticized.

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 Part III, *infra*.

58. *See* Avi-Yonah, *supra* note 8, at 1249.

59. *Id.* at 1200-01.

60. *Id.* at 1237. Lobbying is the obvious example for this assertion of power.

61. *Id.* This means power over employees in those aspects that are not simply or effectively covered by the contractual employment relationship.

market powers.[62] He argues that these excessive concentrations of power should be discouraged, and that taxation is one way of doing that.[63] Avi-Yonah calls this a democracy argument since private accumulation of powers (by managers) is not accountable to the people, as all powers should ultimately be in a democracy.[64] Another argument that he raises is a liberal, equality-based argument, in Michael Walzer's tradition,[65] that accumulations of money, as a dominant good in our society, should be curbed by redistribution, including redistributive taxation.[66] 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 (e.g., employees).[67]

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.[68] He argues, however, that alternative direct ways of curbing corporate managers' powers are ineffective, concluding that this task is therefore left to governmental regulation of corporate activities.[69] 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 straightforward money-making business.[70] He argues that only taxation can achieve that regulation.[71]

D. Corporate Management Powers

One may argue that corporate management accumulates undesirable political, economic, and market powers simply because of the legal fiction of the corporate separate personality (extended to tax law).[72] It may even be the case that the tax system is theoretically capable of reducing such accu-

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62. *Id.* at 1238. This refers to power over consumers.

63. Moreover, it is a traditional American way of discouraging these concentrations of power. *See* Avi-Yonah, *supra* note 8, at 1238-39.

64. *Id.*

65. *See infra* notes 101, 103. The argument, concisely, is that people may not be exactly equal to each other in all aspects of life ("spheres"), but people who dominate one sphere (say, economic), should not transform this domination into dominating other spheres of life (political power).

66. Avi-Yonah, *supra* note 8, at 1240-41.

67. *Id.*

68. *Id.* at 1242-43.

69. *Id.*

70. *Id.* at 1243-44.

71. *Id.* at 1244.

72. Although it may be difficult to extend the argument beyond publicly traded corporations, because all corporations are initially subject to the tax.

mulation of power. But, the reality is that the tax system is ineffective in curbing accumulation of power. This is examined next with respect to the specific powers mentioned by Avi-Yonah.

1. *Political Power*

Political power is easily the least exposed, among the powers mentioned above, to suppression by the income tax system. The United States tax system is notoriously polluted with political distortions (some of them politely named "tax expenditures").[73] The oil and gas lobby is one example,[74] and churches are another[75]—these are just obvious examples of groups that benefit from special beneficial tax treatment, despite their constant accumulation of political powers.

Curbing political power in this context is also tricky because it can mean different things. The most straightforward portrayal of this power is corporate lobbying.[76] This activity is financed from the money of the corporation, and therefore, one may say that the corporate income tax takes away some of the money available for lobbying, reducing such political power. This claim, however, is too simplistic. Significant portions of corporate lobbying may not be objectionable or undesirable. For example, if corporate America faced unfair treatment, whether or not in violation of a trade or tax treaty between the violating country and the United States, it is acceptable that corporate management should do something about this treatment. In fact, it is management's job, and society expects this from management once we grant corporations their special legal status. Now, one may complain about the substance or proportionality of one lobbying campaign or another; this, however, is beside the point, since the corporate tax is blind to the substance of corporate actions when the tax applies to corporate income. On the other hand, one may argue, as Avi-Yonah does in his liberal/Walzerite argument, that some of this corporate political power is di-

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73. For an example of explicit corporate tax expenditures from 1996 to 2002, see CITIZENS FOR TAX JUSTICE, CORPORATE TAX EXPENDITURES, FISCAL 1996–2002, A DETAILED LIST, http://ctj.org/pdf/hideapp2.pdf. For a more official (but not more cheerful) view, see USGAO 2006, *supra* note 20.

74. *See, e.g.*, CITIZENS FOR TAX JUSTICE, THE 110TH CONGRESS SHOULD END TAX SUBSIDIES FOR BIG OIL (2006), http://www.ctj.org/pdf/energytaxloopholes.pdf (informative of the tax expenditures, though it is part of an advocacy piece).

75. *See, e.g.*, Diana B. Henriques, *Religion Trumps Regulation As Legal Eemptions Grow*, N.Y. TIMES, Oct. 8, 2006, at A1; Diana B. Henriques, *Where Faith Abides, Employees Have Few Rights*, N.Y. TIMES, Oct. 9, 2006, at A1; Diana B. Henriques, *As Religious Programs Expand, Disputes Rise Over Tax Breaks*, N.Y. TIMES, Oct. 10, 2006, at A1; Diana B. Henriques, *Religion-Based Tax Breaks: Housing to Paychecks to Books*, N.Y. TIMES, Oct. 11, 2006, at A1 (These four articles were part of a four-part series entitled: *In God's Name*).

76. Note that lobbying expenses are non-deductible in spite of being of a type that normally ought to be recoverable. I.R.C. § 162(e) (2000).

verted to issues that are not intended and are undesirable, such as the general political influence of corporations.[77] The response to the argument itself is below,[78] but there is another issue here. As Avi-Yonah himself admits, there are various rules and regulations that attempt to restrain political lobbying power of corporations and other wealthy elements in our society.[79] He argues that these rules are not very effective,[80] even if they tackle the problem head-on. Should we believe, therefore, that merely reducing 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 reduced the amount of money available to corporate managers to use for lobbying purposes and, by that, their power to lobby, this still does not mean that they would elect to simply reduce or eliminate their undesirable rather than their desirable activities. One possible result is that they will choose to invest more or the same in political lobbying[81] and spend less money on charity, tax, or "good" lobbying, some of which may be desirable activities. An answer to that may be that corporate governance controls will make sure that managers will continue to do all that they need to to keep their jobs first, before they extend their actions to the political realm. This suggestion, however, would be quite naïve and very dependent on the circumstances. More simply, managers could easily convince their shareholders—especially their rich and influential shareholders—that political lobbying is more effective and promising in terms of share value than any other action.[82]

Finally, Avi-Yonah concludes his attack on the political power of managers by asserting that even if undesirable political lobbying itself was stopped by direct regulation, corporations will still have power over the lives of voters in a politician's constituency.[83] Now, this may be true, but part of this 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.[84] More directly, it is easy to see that the corporate income tax is completely unhelpful in this regard because if corporations have influence in a certain constituency because they are, for instance, the biggest employer, service provider, or customer, then they continue to have that power and influence independently of the cash reduc-

77. Avi-Yonah, *supra* note 8, at 1240-41.

78. *See infra* Subsection II.C.4.

79. Avi-Yonah, *supra* note 8, at 1243-44.

80. *Id.* at 1237.

81. Let us use this crude term for unwanted lobbying not related to their jobs as corporate managers.

82. 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. *See infra* Section II.D.

83. Avi-Yonah, *supra* note 8, at 1237.

84. For my point on the democracy argument, see *infra* Subsection II.C.2.

tion potentially affected by the corporate income tax. In fact, cash-strapped corporations may be more likely, for instance, to make sure they assert their political influence more forcefully, immediately, and potentially undesirably than other corporations do. Again, the corporate income tax is as likely to serve as a good "fig leaf" for management to explain actions that are not necessarily immediately acceptable to the other players that may have a say in the corporate game.

2. *Economic Power*

Corporate management does have economic power over employees and potentially 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 corporations.[85] This debate is beyond the scope of this Article and irrelevant to my point. The relevant power here stems from the 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 under its immediate control. Yes, it is possible that richer, more powerful, corporate managers will act undesirably toward employees[86] or the community surrounding their corporations' facilities,[87] but it is not more likely than in cash-strapped, less rich corporations.[88] It is also not necessarily more plausible that management will take these undesirable actions, rather than 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 undesirable actions are somewhat relieved by the fact that the corporate income tax is imposed because the 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 where the corporate income tax is abolished. It is not difficult to realize that this is a very weak argu-

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85. For a good review of the debate, begin with Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. CORP. L. 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 its authors in FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991).

86. Reducing union powers, for example, or threatening to export or outsource certain jobs.

87. Demanding, for example, relaxed regulation with a threat to relocate if it is not provided.

88. Since managers in struggling corporations may find such actions easier and quicker to cut costs and maintain cash-flow than comprehensive structural changes that may include their own dismissal.

ment and that both possible scenarios (better or worse alternatives) are possible. Management may be more cash-strapped under the alternative tax scheme, yet even if that would not be the case, more transparent corporate accounts simply shift some power from managers to others (say, shareholders). This could be better, worse, or the same, but it clearly cannot support the notion that the corporate income tax itself serves in any way to safeguard employees and corporate communities from the destructive powers of management.

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 taming the economic power in this context. There are two obvious areas worth mentioning as examples. The first is the general corporate governance aspects of the corporate income tax. The next Section touches upon this, and the area warrants more academic attention, but 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 the 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 with corporate governance problems because the power and uniqueness of the argument is that it supports our current corporate income tax.

The other aspect worth mentioning is that our tax system probably treats corporate managers more favorably, in comparison to employees.[89] This may be objectionable to some, but the system is balanced in favor of management nevertheless. Even 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. Top managers are also employed by the corporation and are more likely to receive more tax-advantaged incentives this way. Even on the one occasion when the legislature attempted to directly cut the benefits from the top, the result was probably beneficial to management once compared to the core employment force.[90]

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89. *See, e.g.*, David I. Walker, *Is Equity Compensation Tax Advantaged?*, 84 B.U. L. REV. 695 (2004); Michael S. 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. 571 (2007).

90. Gregg D. Polsky, *Controlling Executive Compensation Through the Tax Code*, 64 WASH. & LEE L. REV. 877 (2007).

3. *Market Power*

The market power argument is particularly interesting to me 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.[91] But even beyond the scope of the corporate income tax, our entire international tax scheme benefits multinational enterprises ("MNEs") and grants them (their managers and controlling stakeholders) advantages over "domestic" businesses, either in the name of certain "values," such as competitiveness, or simply because of administrative constraints. These include the imperfect cooperation between countries that results in less than perfect information flow to the government with respect to MNEs' activities abroad.[92] This means that the larger corporations, with more powerful management, may be further empowered to increase their corporations' dominance in the market. Determining whether such dominance is desirable 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 this Article deals with. 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 struck fairly or effectively by these rules. Now, there may of course be criticism of the specific line-drawing or implementation of certain antitrust rules, but complementing antitrust with a crude measure such as the corporate income tax is like fine-tuning a delicate machine with a sledgehammer.[93]

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 the corporate tax to correct potentially harmful accumulations of power.

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91. *See, e.g.*, Yariv Brauner, *A Good Old Habit, or Just an Old One? Preferential Tax Treatment for Reorganizations*, 2004 BYU L. REV. 1, 25-31.

92. *See, e.g.*, Kimberly A. Clausing & Reuven S. Avi-Yonah, *Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment* (Brookings Inst. Discussion Paper 2007–08, 2007), *available at* http://www3.brookings.edu/views/papers/200706clausing_aviyonah.pdf.

93. The analysis of international effects of the tax is beyond this Article, yet note that international antitrust regulation is in its infancy, and the effects of an uncoordinated corporate income tax, even if it were in the "correct" direction, may be negative to the system as a whole. Anyway, since the effect is likely insignificant at best and random in its direction, this is a very minor concern.

The cumulative effect of the corporate income tax, at least in its current (very stable) formulation, is probably to grant management more, rather than less, flexibility in its dealings 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 (which we do not due to corporate tax return secrecy), we may not have been in a better place to judge whether overall we are better off having or eliminating the corporate tax based on the mere grounds of its effect on the corporate power structure. At this point we have not yet taken into account the uncertainties of the corporate tax incidence,[94] and, not less importantly, before we weigh any possible specific or occasional benefits against the costs of the tax.

E. The "Democracy" Argument

The argument that accumulation of power by corporate managers is excessive and not accountable to the people, and therefore is undesirable[95] in a democracy, is just too simplistic. If taken seriously, it must be reviewed from many angles, such as whether it is clearly true, and whether it is relevant in our democracy. 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. The conclusion is that 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 (the excess over simple enrichment) unrelated to simple wealth that is so beyond the scope of the actual duties of management (i.e., within the boundaries of the contractual arrangements that we call corporations).[96] Now, note carefully, if the argument is merely about redistribution (which is the assumption of this Article, and is clearly reflected in context and citations brought by Avi-Yonah in his article),[97] then it is not a separate argument in support

94. These uncertainties result in more or less the same conclusion, as will be elaborated on briefly in Part V.

95. Avi-Yonah, *supra* note 8, at 1238-39.

96. Note that the corporate tax potentially interferes with the very reason that we allow these legal fictions to exist. The inefficiency of the corporate tax negates at least some of the efficiencies that corporations allow us, and adds costs, whether in excessive tax payments, wasteful tax planning, or avoidance activities, where the primary justification for the very existence of the "entity" is saving costs, such as transaction costs. *See* Oliver E. Williamson, *The Modern Corporation: Origins, Evolution, Attributes*, 19 J. ECON. LIT. 1537 (1981).

97. Avi-Yonah, *supra* note 8, at 1238-40.

of the corporate income tax, and such an argument cannot be separated from the discussion of the tax's incidence discussed *infra*, in Part IV.

Another/The next option is that the argument is part of a general social criticism. Note again, saying that the legal fiction that we call corporations are in themselves undesirable cannot assist an argument in support of taxing such entities and subjecting society to the costs of this tax. Finally, it is possible to use an argument similar to the one Avi-Yonah next entertains, criticizing a democracy that allows rich people, including, but in no way only (or demonstrably uniquely), corporate managers to have political influence.[98] This Article next rejects this argument as supporting the retention of the corporate income tax as well. Two basic points appear to be devastating to the democracy argument. First, and most obviously, the effect of the corporate income tax on corporate management power is at best minimal, bordering on negligible. Concluding from that that such effect is worth the cost seems impossible to me. Since it is clear that the effect of the tax in this context is so small, there is simply no way to assess its democracy benefits overall (factoring in the costs, dynamic, and international effects). As claimed in the next Section, only simple equity (a tax that would equalize everybody's welfare in society) could ensure, if at all, absolute equality of the opportunity to participate in the political process.[99] Such equality is unrealistic, and one must wonder if it is even desirable. The second point is also quite obvious: the corporate income tax reduces, if we accept Avi-Yonah's claim, the power of only some powerful elements in our society. This may have undesirable democratic consequences, since it is possible that other powerful elements (say, shareholders) would now benefit from

98. Professor Avi-Yonah's argument is in *id.*

99. A similar argument was made recently by Professor James Repetti, *Democracy and Opportunity: A New Paradigm in Tax Equity* (unpublished manuscript) (on file with author), where he argues that an equitable tax system is a system that allows equality of opportunity for self-realization through participation in the democratic process. Based on this view of equity in taxation he concludes that an income tax is superior to a consumption tax, yet his argument that is based on the same approach of Avi-Yonah's argument suffers from the same failures. If the concern is with a minimum of income that will allow everybody in our society to afford to follow the political process and actually vote, then it is difficult to justify the level of progressivity that we already have, *a fortiori* increase it or have a complete corporate income tax system. This cannot be Repetti's or Avi-Yonah's concern. If the concern is about the imbalance between the opportunities of the rich and the poor to affect the tax system, then their solutions are costly, yet obviously ineffective, like a drop in a sea of imbalance. Only simple equality that is rejected by everybody could really achieve true balance here. Moreover, Repetti himself admits that the problem is imbalance of wealth rather than income, and acknowledges that they are very different in effect whole discussions and solutions, however, rely solely on income taxation without accounting for the leap (from wealth to income) and the possibility that the outcome of this second-best (income rather than wealth-based) solution may be worse than the current situation.

the reduction of power of management.[100] This may result in a less balanced democracy rather than a more balanced and fair one.

In conclusion, note that it is strange to support the corporate income tax on democracy grounds because its effect on taxpayers is unclear and maybe impossible to easily articulate, as we shall see in Part IV. The tax may be popular, yet its popularity is not based on an informed understanding of its cost to society as a whole and to any one taxpayer in particular.

F. The Liberal Equality-Based Argument

This is the heart of the matter. Notwithstanding the careful, sophisticated argumentation, the support of the corporate income tax seems to always go back to the notion that it is distributionally desirable. But, because it is essentially impossible to prove that the tax 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 this argument relies on the famous framework for a just society, devised by Professor Michael Walzer in *Spheres of Justice.*[101] A just society à la Walzer (put very simplistically) maintains what he calls complex equality, where certain people's domination in one aspect of life is not transformed into domination in all other aspects of life.[102] 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) should not transform this domination into dominating political power (domination of the political sphere). The key theme is elimination of domination while accepting differences between people that make simple equality impossible.

Despite the intuitive appeal of this illustration, which almost promises a just world around the corner, it is obviously unrealistic. We all know that domination in certain "spheres" oftentimes inevitably translates to domination in others. Money is essential for those who aspire to gain political power and plays a major role in our political process. It is difficult to imagine how equality of political powers could be maintained at the same time that inequality in economic resources exists within our current political framework. One may criticize our political system and our democracy for

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100. It is not always clear that management power is always bad. *See, e.g.*, Milton Harris & Artur Raviv, *Control of Corporate Decisions: Shareholders vs. Management* (CRSP Working Paper No. 620, 2008), *available at* http://ssrn.com/abstract=965559. The picture is not always clear, and no one power balancing measure could optimize. *See, e.g.*, Yair Jason Listokin, *Management Always Wins the Close Ones* (Yale L. & Econ. Research Paper No. 348), *available at* http://ssrn.com/abstract=980695.

101. MICHAEL WALZER, SPHERES OF JUSTICE: A DEFENSE OF PLURALISM AND EQUALITY (1983).

102. *Id.* at 17-20.

allowing this or for being "unjust" in this sense.[103] Leaping from this possibly valid social criticism, however, to the retention of the corporate tax, is not so obvious.

First, and most obvious, we are not sure what the incidence of the corporate tax is in simple terms,[104] 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 rich on the whole but do have stakes in corporations in America. This could not be just. To the best of this author's judgment, an argument in support of the tax that is indeed independent of its incidence is yet to be presented, despite Avi-Yonah's heroic (and notably lone) attempt to do exactly that.

Second, even if we agreed that somehow, overall, the tax reduces the power of management in comparison to the other players in the corporate game, we are still probably left with an "unjust" result because the most probable winners from this (ignoring incidence) are other rich people, most probably major shareholders in corporations, who are independently politically powerful. The corporate income tax cannot be thought of as simply a management power-neutralizing device. This argument does not 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 such an argument encompasses very general social criticism (of inequity) that happens to resonate, maybe, in the context of corporate management. Attacking corporate management sounds good, but the issue is not different from any other piece of government regulation or any other of thousands of tax benefits unrelated to the corporate income tax that bestow benefits on politically powerful people at the expense of the less powerful in our society.[105] 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 off (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 favor of the corporate tax. In a world without a corporate income tax, corporate management is actually under more scrutiny by others, and the accounts of corporations are

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103. In this Article, I do not analyze Walzer's theory itself, but rather its application by Avi-Yonah in the context of supporting the retention of the corporate tax. For criticism of Walzer's arguments, see, for example, Ronald Dworkin, *To Each His Own*, 30(6) N.Y. REV. BOOKS (1983) (reviewing WALZER, *supra* note 101); Michael Walzer & Ronald Dworkin, *'Spheres of Justice': An Exchange*, 30(12) N.Y. REV. BOOKS (1983) (Walzer's response to *To Each His Own*, *supra*, and Dworkin's counterreply); Norman Daniels, Book Review, 94(1) PHIL. REV. 142 (1985).

104. *See infra* Part IV.

105. Arlen & Weiss, *supra* note 7, at 368-69.

more public and transparent, which was the original idea when federal regulation of corporations through a corporate income tax materialized into the tax we have today.[106] 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 simply argued that the vector created by the tax was in the just direction.[107] It is doubtful that this argument, limited to its original scope can withstand critical analysis, which begs the conclusion that even this normative justification for the corporate income tax could not withstand such analysis.

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

Finally, this Article also rejects Avi-Yonah's argument that the corporate tax is essentially the only possibly effective regulatory scheme to curb accumulations of power by corporate managers.[108] Let us put aside the debate about whether government should regulate corporate activities and just accept that it does, so now we can 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 regulations do not interfere with ordinary accumulation of corporate power through straightforward money-making businesses.[109] For the purposes of responding to this argument, I have to assume general acceptance of the need for corporations and the legal fiction of the 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 means that they should be granted 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. This is discussed in the final two Parts of this Article.

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106. Kornhauser, *supra* note 24, at 54, 72-81.
107. Avi-Yonah, *supra* note 8, at 1255.
108. *Id.* at 1244.
109. *Id.*

Now, the above discussion may not interest Avi-Yonah, because he promotes the idea that managers have some powers that are not reflected in their enrichment.[110] One way of looking at this is to 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.[111] The law deals with the potential harms of this opportunity in the context of agency problems by using the core corporate law rules on corporate governance.[112] The next Part elaborates on the relationship between the corporate tax and corporate governance rules, yet note in advance that these rules are completely uncoordinated. It seems clear that corporate law does not intend to, and does not in fact rely on, tax measures 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 corporations, or even that it is a necessary complement. This is further explored in the next Part.

Another way to look at this is to say that management power accumulation extends beyond the above-mentioned agency problems. An argument may be made 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 any way in the corporation). But, if this is the case, then there is nothing new in this argument—it is basically 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 is already apparent, there is not enough support for these arguments, and it is even likely that the effect of the corporate tax has actually been the opposite.

III. CORPORATE GOVERNANCE AND THE CORPORATE INCOME TAX

A somewhat similar line of argument in support of the corporate income tax is that the tax may relax some of the agency problems that frame the corporate governance problem,[113] and therefore it is desirable. Like the

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110. *Id.* at 1235-36.

111. Featured famously in ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

112. *See, e.g.*, ROBERT CHARLES CLARK, CORPORATE LAW (1986).

113. 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 (Aharon Barak ed., 1996) (in Hebrew); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Owner-*

argument discussed in the last Part, the corporate governance argument is based on the effect that the tax has on the power structure of the corporation. Unlike that argument, the corporate governance argument has not been directly and comprehensively articulated in the legal literature, and this Part constructs it from various resources, some of which specifically suggest that the support of the corporate income tax may be a possible application, and some that contradict such a conclusion.[114] Notably little work has been done on the relationship between tax and corporate governance to date,[115] yet lately there is increasing interest in this interaction. The focus of this Article, however, is limited to the extent that existing research justifies the existence of the corporate income tax.[116]

None of the studies mentioned in this Part limits itself to the defense of the corporate income tax, so they all fail to balance the potential benefits of the tax against its costs. This flaw is referred to later in this Part. Again, similar to the corporate power structure, the power of corporate governance is in its avoidance of the complex incidence analysis of the tax.[117] It also side-steps the controversy over the fairness of the tax. Next, it is demon-

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ship Structure, 3 J. FIN. ECON. 305 (1976); Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88(2) J. POL. ECON. 288 (1980); Henry Hansmann, *Ownership of the Firm,* 4 J.L. ECON. & ORGS. 267 (1988); 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).

114. Primarily Desai, Dyck & Zingales, *supra* note 8; and Mihir A. Desai & Dhammika Dharmapala, *Corporate Tax Avoidance and High-Powered Incentives*, 79(1) J. FIN. ECON. 145 (2006) [hereinafter *High-Powered Incentives*].

115. Mihir A. Desai & Dhammika Dharmapala, *Taxation and Corporate Governance: An Economic Approach* (2007) (forthcoming in TAX AND CORPORATE GOVERNANCE (W. Schoen ed.)), *available at* http://ssrn.com/abstract=983563; Desai, Dyck & Zingales, *supra* note 8; Desai & Dharmapala, *High-Powered Incentives*, *supra* note 114; Mihir A. Desai & Dhammika Dharmapala, *Corporate Tax Avoidance and Firm Value*, *available at* 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* (2007), *available at* http://ssrn.com/abstract=975252; Arne Friese, Simon P. Link & Stefan Mayer, *Taxation and Corporate Governance* (2006), *available at* http://ssrn.com/abstract=877900. For earlier thought of these issues, see Kanda & Levmore, *supra* note 36. I did not include here similar literature on dividend taxation, or state taxation and corporate governance.

116. Most of the arguments in Part III 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.

117. *See supra* Part I.

strated that, nonetheless, it is not clear that the corporate governance implications of the tax are desirable, and that therefore corporate governance cannot support the retention of a separate corporate income tax.[118]

As already mentioned, there is no single comprehensive articulation of the corporate governance argument, yet there is one notable article among the relevant economic literature that directly makes the same point: Mihir Desai, Alexander Dyck, and Luigi Zingales' "Theft and Taxes," formerly circulated as "Corporate Governance and Taxation."[119] It argues that the corporate income tax and its design affect the amount of private benefits extracted by corporate insiders;[120] yet, at the same time, it adds that the tax's enforcement (that depends, of course, on its existence) limits such extractions.[121] In corporate governance terms, these authors 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).[122] Since the corporate income tax reduces the wealth and cash flow of the corporation, so 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, which furthermore limit the diversion potential.[123] Fraudulent diversion is curbed because minority shareholders have not only their monitoring capacity, but also that of the government.[124]

This is a useful insight: higher corporate tax rates increase the incentive to steal or divert income from outsiders (and divert taxes from the government, which is affected like other minority shareholders) to insiders.[125] Conversely, more effective enforcement reduces the opportunity for such diversions, so outsiders may be better off with stronger tax enforcement,

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118. 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.

119. Desai, Dyck & Zingales, *supra* note 8.

120. At the expense of "outsiders."

121. They also argue that the relationship between the corporate governance and the corporate income tax goes both ways, i.e., that an effective governance system is positive for tax enforcement since it limits diversions itself and therefore limits the ability of management and corporate majorities 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, which focuses solely on the desirability of the corporate income tax.

122. Desai, Dyck & Zingales, *supra* note 8, at 596-98, 618-19.

123. *Id.* at 595-97, 618-19.

124. This interesting idea is tested against Russian data. *See id.* at 592, 603-06.

125. *Id.* at 618-19.

even if tax rates increase at the same time.[126] Therefore, a possible conclusion is that a separate corporate tax may be desirable because it provides government, and potentially outsiders, with unique information that would not otherwise be available to them, and because the tax ameliorates the agency problem between outside and inside shareholders (majority and minority shareholders).[127]

Desai, Dyck, and Zingales do not explicitly claim that their findings necessarily support the retention of a separate corporate income tax; they merely suggest that it may have positive attributes in that direction.[128] 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.[129] To justify the retention of the tax on corporate governance grounds, one must prove that the tax exerts unique corporate governance benefits and that these benefits are desirable and could not be duplicated in other, potentially less costly, means. Moreover, to justify retention, these benefits should be desirable despite the social costs of having the tax.[130] To the best of my knowledge, there has been no attempt to factor the social costs of having the corporate income tax into the analysis of these (or other) arguments. First, however, the strength of the claim regarding the identity or alignment of interests between corporate outsiders and the government is explored.

The relevant fundamental assumptions of Desai, Dyck, and Zingales are realistically heroic and unattainable if they were to be used to support retention of the corporate income tax. First, 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,[131] and outsiders and insiders could not co-

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126. 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 corporate investments.

127. *See id.* at 592-94. 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 the notion that cheating the government goes hand in hand with cheating shareholders or the minority, or at least that this is the perception of the market. *See* Desai & Dharmapala, *High-Powered Incentives*, *supra* note 114 (further discussed *infra*); Hanlon & Slemrod, *supra* note 115 (further discussed *infra*).

128. See their use of a certification tax terminology in Desai, Dyck & Zingales, *supra* note 8, at 619.

129. Friese, Link, and Mayer reached a similar conclusion, calling it the corporate income tax as a "certification tax." *See* Friese, Link & Mayer, *supra* note 115, at 30-31. Kanda & Levmore, *supra* note 36, expressed a similar idea.

130. Such as administrative, compliance and enforcement costs.

131. *See* Desai, Dyck & Zingales, *supra* note 8, at 600-01.

ordinate their actions at the expense of the state.[132] The details of this argument clarify its extent: the authors really talk about extreme forms of illegal tax planning, namely tax fraud.[133] They argue that collusion between insiders and outsiders is essentially possible only in closely held corporations,[134] since the costs of coordination, especially for outsiders, are just too high in other cases.[135] 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 firms, even just out of fear of discovery.

The same, however, as acknowledged by the authors, cannot be said of closely-held corporations. Closely-held corporations may not have outsiders in the same sense, and despite the costs, it is very feasible for majority 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 most corporate tax revenue is collected from large public corporations anyway.[136] Note, however, that their insight about this difference between widely- and closely-held corporations further exposes the inefficiency of the tax that applies to both equally.

In this very limited context of "theft," it is doubtful 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 for tax fraud—there are simply more rules and more accounts, and the system is more complex.[137] If we agree that corporate tax returns will probably never be made public,[138] 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, resulting in an inherently more transparent system.

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132. Outsiders and insiders cannot even negotiate a certain level of diversion between themselves. *Id.*

133. This also explains the direction taken in replacing the "Corporate Governance and Taxation" title with "Theft and Taxes."

134. *Id.* at 600.

135. *Id.*

136. *See, e.g.*, Auerbach, *supra* note 23, at 4.

137. *See, e.g.*, USGAO 2006, *supra* note 20 (noting the effect of the complexity of the corporate tax on tax collection); Slemrod, *supra* note 20 (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).

138. This is despite its being the original justification for the enactment of the tax.

The authors' 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.[139] 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, particularly to sophisticated insiders or management, who will "pick their battles" carefully. This is not difficult to demonstrate. Assume that insiders wish to engage in aggressive tax planning that is likely to be opposed by the IRS if it knew about the plan in detail. Insiders will make sure that shareholders in general are inactive. Two recent expert testimonies of two experts (one of whom is Professor Desai), touched on this point. They explained that tax shelters do not result in financial profits reduction.[140] 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 versus minority agency problem is relevant as well here, both because a strong and active majority could be very involved with management in aggressive tax planning, and, because of the reasons mentioned by Desai, Dyck, and Zingales, a majority 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 studies may be interpreted as contradictory to the observations 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. If this were always true, there would not be collusion between them, and Desai, Dyck, and Zingales's implication in support of the corporate income tax would be powerful. This is not a problem for the argument made in this Article, however, because management or insiders do not have to "bribe" (to use a strong word) shareholders so they will not expose the corporate tax aggressiveness. They only want to keep shareholders from becoming active and seeking disclosure, therefore leading to exposure of the scheme. Indeed, we see that the market is not extremely negative about corporate tax planning, and in well-

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139. *See* Desai, Dyck & Zingales, *supra* note 8, at 603-06.

140. The actual quote was, "No corporate tax shelter was ever undertaken that reduced book income and, often, the primary benefit of a corporate tax shelter is the reported income it produces." Hanlon & Slemrod, *supra* note 115, at 2 (quoting *Testimony of Mihir Desai Before the Subcomm. on Select Revenue Measures of the H. Comm. on Ways and Means*, 109th Cong. (2006)).

governed firms this is even a lesser issue—their argument that . . . is meaningless for well-governed firms anyway.

In the other direction, management or insiders deal with the IRS while, at the same time, they take advantage of outsiders. Corporate mergers and acquisitions are classic examples of transactions that often result in losses to shareholders,[141] while widely-held corporations almost always seek agreement with the IRS regarding the basic tax position to take—typically via a private letter ruling. There is plenty more to say in this context, but for the purposes of this Article, the conclusion is that Desai, Dyck, and Zingales's argument in support of our corporate income tax based on certain governance benefits is weak, at best. This is because their argument applies primarily to very unique and extreme tax fraud situations, and even then, their argument justifies only the information-furnishing aspects of the tax. It certainly cannot justify a significant and distortionary tax like the one we have. Of course, they do not take the costs of the tax into account, and they never attempt to imply that this argument alone supports retaining the tax.[142]

An interesting recent article (two of which authors are also authors of the above paper)[143] researched the types of people who blew the whistle on corporate fraud. Interestingly, the article found that fraud detection relies on a variety of mechanisms, and at times, improbable actors. Sarbanes-Oxley (SOX), with an explicit mandate to expose corporate misbehavior, improved the performance of actors from 35% to about 50% in the cases tested, but still no one type of regulator (SEC, auditors, and industry regulators) is dominant. Specifically for the purposes of this Article, it is interesting that no tax authority was a significant player in this context, and even more interestingly, shareholders, including all shareholders and short-sellers, initiated only nine percent of the cases.[144] Now, this may be attributed to the methodology used in the study.[145] 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

141. For a concise review of these findings, see Brauner, *supra* note 91, at 34-36.

142. 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.

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

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

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

there are understandable difficulties of data retrieval, but still, the lack of data about these two groups (revenue authorities and shareholders) and the insight that they are not dominant monitors of corporate behavior makes the argument of Desai, Dyck, and Zingales even more limited in its support of the corporate tax (even in its 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. The corporate tax shelter phenomenon puts even that into question, which diminishes the relevance of the authors' insight as supporting the retention of our corporate income tax, and makes this explanation (i.e., that management understands the above insight and responds to it by striking "deals" with either the outsiders or the IRS), more plausible. In any event, such an article cannot assist much in our quest for a good rationale in support of retaining the corporate income tax.

A second insightful article that may be read as supporting the retention of the corporate income tax due to its beneficial corporate governance implications is Mihir Desai and Dhammika Dharmapala's "Corporate Tax Avoidance and High-Powered Incentives."[146] Their study focuses on corporate tax avoidance activities and their relationship with what the authors call high-powered incentives (or rewards) for corporate management.[147] The intuition is that shareholders, for example, want management to be aggressive in tax planning and therefore should reward management for corporate tax avoidance, since such activity is expected to result in increased share value.[148] The authors demonstrate that this is not always the case and that, in fact, increases in management incentive compensation, which is considered to be a popular way of aligning the interests of management and shareholders, tend to correlate with a reduced level of tax sheltering (a popular tax avoidance strategy), rather than an increase.[149] This might mean, simply put, that shareholders believe that managers who "game" the tax system (engage in tax avoidance) also "game" them by diverting profits, for management's (rather than shareholders') own benefit. Another way of thinking about it is that tax sheltering obscures corporate transactions and accounts, and the fact that management is allowed to maintain this fog of war creates further diversion opportunities for management under the disguise of the fog.

Desai and Dharmapala's findings are particularly strong in poorly governed corporations, so their original intuition (more avoidance is good and will be rewarded by shareholders) is still correct, yet it is safe for shareholders only if they feel "in control" of the corporation and its management. These findings help to explain, for instance, what is sometimes called the

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146. Desai & Dharmapala, *High-Powered Incentives*, *supra* note 114.
147. *Id.* at 177.
148. *Id.* at 147.
149. *Id.* at 147-48.

"undersheltering puzzle,"[150] (i.e., why everybody does not engage in tax sheltering activities).[151]

They are further supported by a slightly different recent article by Michelle Hanlon and Joel Slemrod, who investigated stock price (market) reactions to news about tax aggressiveness.[152] They found that, on average, there was a negative market reaction to news about tax sheltering. However, this reaction was smaller than reactions about other major corporate "accounting mishaps." They also note that the reaction 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, actually effective tax rates of corporations published by a Washington, D.C. think tank. They 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.[153] This means that shareholders, particularly in less well-governed firms, suspect that managers engaging in tax sheltering are in a better position to take advantage of shareholders otherwise.[154] Such managers are more likely to take costs and risks in tax planning that may be less than optimal to shareholders (if such managers succeed, they will reap 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 managers are less likely to be accountable to shareholders in general.

Now, these two articles do not articulate direct support of the corporate income tax, as they focus particularly on the effect of corporate governance on tax-sheltering activities. Note that they demonstrate that the story of alignment of interests between groups in the firm is more complex than the one assumed by Desai, Dyck, and Zingales, who focus on alignment of interests between the IRS and corporate "outsiders." One conclusion that may be drawn is that these authors indirectly support the elimination, not retention, of the corporate tax because without the tax there would be no corporate tax sheltering. Shareholders would also have to monitor management less closely than in the costly current world that has a corporate income tax. This, however, is too simplistic, even if convenient to this argument. The interaction of the tax with the corporate governance rules and practices creates this complex web of checks and balances that results in, inter alia, undersheltering (a possibly good thing) and maybe even a reduction in agency problems in corporations overall (another good result). Of

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150. David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215 (2002); Joseph Bankman, *The Tax Shelter Problem*, 57(4) NAT'L TAX J. 925 (2004).

151. Desai & Dharmapala, *High Powered Incentives*, *supra* note 114.

152. Hanlon & Slemrod, *supra* note 115.

153. *Id.* at 35.

154. Through empire building or diversion of profits.

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, for our purposes, it is important to conclude that what we know by now (at this point) still cannot support the retention of the corporate income tax.

Finally, John, Nair, and Senbet added to the picture the perspective of stakeholders.[155] In particular, they explored the effect of the corporate income tax on the alignment of interests between shareholders and non-financial claimants of the corporation. Their basic story is that limited liability affects investment decisions to the effect that shareholders make too risky investments 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.

In other ways, the corporate tax is the price to pay for limited liability.[156] The authors do not argue that, but one could add, following Desai, Dyck, and Zingales,[157] that the IRS could be added to the picture as a co-monitor of management behavior. Now, John, Nair, and Senbet's article does not really develop the story of the effect of the tax on corporate governance.[158] In this regard, they do not add on Desai, Dyck, and Zingales, except for adding stakeholders to the picture. The problem with the assertion that stakeholders assist in monitoring corporate income tax collection is that it does not help to justify the corporate tax, and stakeholders' role is diminished 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 quantification of the benefit against the costs of the tax has been made/exists. 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 the corporate tax in order to support 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.

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155. Kose John, Vinay B. Nair & Lemma W. Senbet, *Law, Organizational Form and Taxes: A Stakeholder Perspective* (2005), *available at* http://ssrn.com/abstract=676987.

156. Finally, the authors test the effect of the strength of the legal regime, *id.*, but since the implications for the United States are not clear, I do not explore this part of the Article here.

157. Desai, Dyck & Zingales, *supra* note 8.

158. On the benefit theory flavor of their argument, see Schlunk, *supra* note 8; Chorvat, *supra* note 8; and accompanying text. It is beyond the scope of this Article.

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 in response to the 2003 reduction of the dividend tax rates, which was followed by a significant surge in distributions, providing such literature with a natural experiment.[159] 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 an anti-pyramidal business groups mechanism.[160] 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.[161]

Finally, even though it is not unique to the corporate governance and taxes context, note the general power that management has due to its control of a corporation's business, financial, and tax strategies. This, of course, is its 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. This was briefly mentioned in responding to the argument raised in Part II, but there is 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 United States, yet there are also some serious costs. Primary to them is the reduced role 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 several years. Recent literature, including a 2005 paper by Professor Mihir Desai,[162] substantiates this phenomenon, concluding that currently both the financial reporting and tax reporting systems have degraded in quality.[163] Desai specifically mentions that the current state of things brings into question the nature of the corporate tax system.[164] One could have argued that the corporate income tax

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159. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752.

160. Randall Morck & Bernard Yeung, *Dividend Taxation and Corporate Governance*, 19(3) 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 the tax's arguments against its costs.

161. Steven A. Bank, *Dividends and Tax Policy in the Long Run*, 2007 U. ILL. L. REV. 533, 571-72.

162. Desai, *supra* note 4.

163. *Id.* at 172.

164. *Id.* at 172-173 (". . . the degree to which a dual reporting system enables managerial malfeasance provides yet another argument against the current corporate tax system.").

allows the dual reporting system to exist and function as a balancing and monitoring, costs-reducing mechanism. It is doubtful that a separate tax is required for that, but 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 understanding upon the enactment of the tax that publicity was critical to the meeting of the original goals of the tax.[165]

IV. FAIRNESS AND THE CORPORATE INCOME TAX

Fairness is the true focus of the corporate tax debate. There is little doubt that overall the tax is costly, inefficient, and welfare reducing. My experience from participation in the debate in various fora is that both corporate income tax opponents and proponents avoid a sober analysis of the desirability of the tax, and tend to defend their respective positions based on their fundamental intuitions: the first group believes that the tax represents unfair, indirect redistribution from the more to the less successful in society, and the second that it represents some desirable redistribution from the rich to the poor. Note that the basic intuition is the same, only the rhetoric colors it differently. The goal of this Part is to explain why the above intuition is simply false and should not be relied on. It all goes back to the simple, yet central, question of who bears the burden of the tax. If the burden was spread in our society in a way that reflects the social consensus, then the tax may be perceived as fair; if not, then it could not be viewed in this way. Unfortunately, there is no clear answer to that question, and there probably could not be one that would satisfy a conclusion regarding the fairness of the tax. Economists have known this for a while now, but the legal literature is missing a non-technical explanation that could be used for tax policymaking purposes. This Part hopes to provide such an explanation. If this is the case, the whole debate is misplaced, as suggested here, resulting in a very stable tax that simply has no good policy reason to exist, but exists only to provide some political advantages to the better-off and the more powerful in our society—diametrically opposed to the goal of the proponents of the tax criticized in this Article.

The most important thing to understand in this context is that there is no simple answer to the basic question: who bears the burden of the corporate income tax? This is so because the answer is inherently complex and rich in variations to the extent that it may not be useful to seek such an answer.[166] Nonetheless, understanding the complexity of the question is useful

165. *See, e.g.*, *id.* at 176. *See also* Kornhauser, *supra* note 24, at 54, 72-81.

166. *See, e.g.*, Auerbach, *supra* note 23, at 13. *See also* Whalley, *supra* note 30, at 10, 13 (concluding that the complex web of various effects makes a general analysis that is "not well-posed" nor "well-focussed [sic]").

in understanding the composite of consequences that the tax imposes on our society, and in drawing the policy conclusions from what we know about the incidence relevant to the debate over the desirability of the tax.[167] The debate among economists over the incidence of the corporate tax is more than half a century old.[168] The incidence question is 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 they 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 quite complex.[169] Then, there are many candidates for bearing this burden—shareholders, other stakeholders, employees, consumers,[170] 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.[171] Finally, different components of the tax may have different incidences, so there is little worth in a general analysis of the incidence of the corporate tax with no change or "reform" in mind.[172] In short, no credible information could be sought by such a simple, direct attribution exercise.[173]

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 affected by the corporation's need 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 higher

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167. I base my review and analysis mainly on the assessments in Auerbach, *supra* note 23. 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.

168. Auerbach, *supra* note 23, at 8-10. For additional information about the chronology of the debate, see Diane Rogers, *The Incidence of the Corporate Income Tax* (Congressional Budget Office Paper, 1996), *available at* http://www.cbo.gov/ftpdocs/3xx/doc304/corptax.pdf.

169. Auerbach, *supra* note 23, at 5-8. We should acknowledge that the better-off do own more corporate stock than the less affluent.

170. MARIAN KRZYZANIAK & RICHARD A. MUSGRAVE, THE SHIFTING OF THE CORPORATION INCOME TAX: AN EMPIRICAL STUDY OF ITS SHORT-RUN EFFECT UPON THE RATE OF RETURN (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.

171. *See, e.g.*, Whalley, *supra* note 30, at 3, 10-11.

172. Auerbach, *supra* note 23, at 33-34.

173. *Id.* at 7-8.

prices of essential products, or lower wages to corporate employees. We do not, however, deal particularly with the distribution of this waste by following the available economic literature that treats it as part of the general effect of the corporate income tax,[174] 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; 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.[175] 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 the heart of the problem for economists who attempt to model corporate behavioral responses to the tax, changes in the tax, and similar phenomena.[176] Corporations can respond to the corporate income tax in a variety of ways and can take several courses of action 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 draw conclusions about its incidence.

The original, and most famous, work on the corporate tax incidence was done by Professor Arnold Harberger, who concluded that the tax was borne fully by owners of capital, economy-wide, i.e., all the capital bears the burden, not just corporate capital, and neither employees nor consumers (the other groups in his model) significantly bear the burden of the tax.[177] This means, in simple terms, that the corporate tax distorts the allocation of capital between the corporate and non-corporate sectors. Furthermore, the tax is not as helpful, in terms of progressivity (and fairness), as it would be if only corporate capital bore its burden,[178] because owners of capital in society in general are less affluent than corporate shareholders.[179] Even Har-

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174. *See, e.g.*, Whalley, *supra* note 30, at 6.

175. *See, e.g.*, Rogers, *supra* note 168, at 11-12, 26.

176. Professor Auerbach reviews this literature in Auerbach, *supra* note 23.

177. Arnold C. Harberger, *The Incidence of the Corporation Income Tax*, 70 J. POL. ECON. 215 (1962).

178. This is the basic intuition of corporate tax proponents mentioned above.

179. Auerbach, *supra* note 23, 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 progressiveness of the tax system.

berger's model does not completely reject the possibility that labor suffers some of the burden, which could change for better or worse in different markets, 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 primary concern.[180] Note also that taxpayers may hedge the risks of tax changes (such as corporate tax rate increases). Alan Auerbach notes that this is not an important issue at present, but could become one in the future.[181] There is little debate, however, that if hedging becomes a possibility, this mechanism will be more readily available to the better-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.[182]

Moving 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 include: 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.[183] 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[184] to significant shifting of the burden to countries' non-mobile factors, such as labor.[185] 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

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180. *Id.* at 10-13.

181. *Id.* at 13.

182. It seems to me uncontroversial that the rich have more access to innovative financial instruments, particularly derivatives, than the less well-off, and that this imbalance is more severe than the ratio of, say, corporate share ownership by the respective groups.

183. *Id.* at 33-37.

184. Jane G. Gravelle, *Corporate Tax Incidence in an Open Economy*, *in* NAT'L TAX ASS'N, PROCEEDINGS OF THE 86TH ANNUAL CONFERENCE ON TAXATION, 1993 (1994). A more recent paper by the same author revisits the issue and particularly tests the issue of exportation of the burden, concluding that most of the burden is born by domestic capital (similar to Harberger's conclusions), and that when it is not, it is mostly exported, i.e., little, if any, of the burden is born by domestic labor. Jane Gravelle & Kent A. Smetters, *Who Bears the Burden of the Corporate Tax in the Open Economy?* (NBER Working Paper No. W8280, 2001), *available at* http://ssrn.com/abstract=268889.

185. 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).

to other countries and maybe even benefit overall from the tax.[186] Now, could we draw any conclusions from this literature about the international effects except for acknowledging the literature's complexity and the need for additional thinking and empirical studies? One conclusion may be that this is great. The United States can both have the corporate tax and not suffer its complete burden. Many different countries reached this conclusion, however. 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. 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.[187] He also cautions against an attempt to describe the effects of the tax in terms of a simple breakdown of households by wealth or income, for instance.[188] 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.[189] 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 in our society at certain times may not be very informative.[190] 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.[191]

Very little work was done on the lifetime incidence of the tax in contrast to annual or other shorter perspectives, but what we do have indicates that the tax is less "progressive," i.e., distributionally desirable, from that perspective than some of the consequences of shorter-term analyses.[192]

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186. See several studies referred to in Rogers, *supra* note 168, at 19-20.

187. Auerbach, *supra* note 23, at 13.

188. *Id.*

189. *Id.* at 40.

190. 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).

191. *Id.* at 33-34. *See also* Whalley, *supra* note 30, at 10.

192. DON FULLERTON & DIANE LIM ROGERS, WHO BEARS THE LIFETIME TAX BURDEN? (1993). *See also* Rogers, *supra* note 168, at 20-21.

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 in 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.[193] This study also acknowledged the hybrid properties of the corporate income tax as being partly a tax on cash flow, a feature normally ignored, which led them to conclude that the tax is less progressive than has been assumed.[194]

It is beyond the scope of this Article to take part in the economic debate, but several conclusions are important. First, there is not enough empirical evidence on the corporate tax burden on people in America today, and the empirical evidence that does exist points to the direction that (at least some) of the significant burden is shouldered by labor.[195] Second, even if capital bears the burden of the tax, it is not just shareholders who bear the burden; the burden is shifted at least to all capital. Third, probably some of the burden is shifted not only to workers,[196] but also to consumers; it is not clear, however, how much of, when, and whether the burden on consumers is significant.[197] This part of the controversy is the most heated and most politicized, but this is for a reason. If workers and consumers bear a good portion of the burden, then the tax may be redistributing from the less well-off to the better-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 variables constantly change (even more rapidly than other relevant factors in this context)—economies open, substitutability of products change as globalization thrives.[198] Fourth, the tax is not a tax on pure profits of corporations and there is no basis, therefore, to conclude that those who benefit from corpo-

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193. Gerald E. Auten & 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 168, at 25-26.

194. See analysis and explanation in Rogers, *supra* note 168.

195. See the summary of recent empirical studies by Gentry, *supra* note 23. Note also that this does not mean that really only highly-skilled workers (who are also more likely to be capital owners more often) bear the burden of the tax. The negative effect of the tax on wage income is quite uniform across skill groups. *See id.* at 10.

196. *See id.*

197. A recent study investigated a large sample of companies from ten different countries (not the United States), 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* (Oxford Univ. Centre for Bus. Taxation Working Paper No. WP07/07, 2007), *available at* http://users.ox.ac.uk/~mast1732/RePEc/pdf/WP0707.pdf.

198. Auerbach, *supra* note 23, at 33-37.

rate 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 no strong support for the claim that retaining our corporate income tax clearly, or even most probably, involves 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.[199]

CONCLUSION

It is apparent by now that the argument for a separate tax on corporate earnings is unconvincing. Most importantly, it is unconvincing 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, the symbol of the rich and powerful. The reader is urged to think about the possibility that it is likely that the fairness effects of the tax are actually the reverse/opposite: that the tax is both highly inefficient and unfair (in the sense that it probably distributes from the low-middle class to the rich). The management power argument may be turned on its head if the tax is viewed as a convenient tool used by management to accumulate power rather than reduce the power of corporate management. This view of the tax is not new by any means. The seminal article by Jennifer Arlen and Deborah Weiss explains the stability of the tax exactly on these grounds—that the tax is politically convenient to corporate management.[200] It may seem naïve, but a word about the absurdity of having a long-lasting major tax, such as the corporate income tax, with significant societal effects, yet not rhetorical justification for its existence, should be added.

Simple repeal of the corporate income tax, however, is unfortunately not easy. Our tax law still sticks to the fiction of separate legal personalities for corporations and allows deferral of U.S. taxation of some income earned by foreign corporations that are owned by U.S. residents. If we retain our realization-based income tax system and keep 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.

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199. 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 the fairness aspect is their argument, and their only real argument in support of this costly, inefficient tax.

200. Arlen & Weiss, *supra* note 7.

A more surgical solution is therefore required. 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 are persuasive. 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 in corporate entities.

This Article is not about comprehensive tax reform, but rather another link in a chain of scholarly work that puzzles over our acceptance of this harmful party-crasher, the corporate income tax, whose existence has never been truly rationalized (and 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 such research is missing the crucial step of comparing all the consequences (including costs) of the tax with the alternatives. The tax is not a necessary evil; it not only should, but also could, be repealed consistent with the principles promoted in this Article—primarily the single tax principle.[201] The design of the alternative could, understandingly, be difficult, but since others have done a convincing job in this area, there is no need to attempt to re-invent the wheel; only to point to the desirable direction.

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201. This is borrowed from Professor Avi-Yonah, who coined it in the international context, and of course would not apply it here for reasons explored in Part I, *supra*. Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301 (1996).