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Recommended Citation

Mirit Eyal-Cohen, *When American Small Business Hot the Jackpot: Taxes, Politics and the History of Organizational Choice in the 1950's*, 6 Pitt. Tax Rev. 1 (2008).

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ARTICLES

WHEN AMERICAN SMALL BUSINESS HIT THE JACKPOT: TAXES, POLITICS AND THE HISTORY OF ORGANIZATIONAL CHOICE IN THE 1950s

*Mirit Eyal-Cohen**

When I came to study the income tax problems of the small business man, I had a feeling I had looked at all the ills and diseases of the tax law.

—Charles T. Akre, *Nebraska Tax Institute, 1943*¹

INTRODUCTION

While many political developments affected American small businesses during the twentieth century, the enactment of Subchapter S of the Internal Revenue Code (Code) was of particular significance.² Under Subchapter S, a small business corporation could elect to be treated as a partnership and have its shareholders taxed at the end of each year on their tax return in a pass-through manner.³ The elimination of double taxation for the small business

* S.J.D. Candidate, University of California, Los Angeles. I would like to thank Julie Makinen, Steven Bank, Allison Christians, Naomi Lamoreaux, Eric Zolt, and the participants of the 2008 McGill Tax Workshop for their insightful comments on drafts of this paper. I am especially grateful to my loving father Yossi Cohen, a second-generation small businessman, whose daily experience instigated me to study the history of small business.

1. Charles T. Akre, *Federal Income Tax Problems of the Small Business Man*, 22 NEB. L. REV. 252, 252 (1943).

2. “One of the most far-reaching and important changes in the Internal Revenue Code effected by this act was the addition of Subchapter S—Election of Certain Small Business Corporations as to Taxable Status.” Willard D. Horwich, *The Small Business Corporation*, TAXES, Jan. 1959, at 20, 20.

3. I.R.C. §§ 1371–1377 were first added to the Code by the Technical Amendments Act of 1958, Pub. L. No. 85-866, § 64, 72 Stat. 1606, 1650–57. A corporation that elects to be taxed under Subchapter

corporation resulted in immediate tax savings for this new hybrid entity.⁴ Although various integration proposals over the years have suggested exempting taxes on dividends,⁵ or creating a system to credit individuals for tax paid at the corporate level,⁶ none have gained support in Congress, and double taxation of corporate income prevails to this day.⁷ At very rare moments Congress has been inclined to, at least partially, eliminate the double tax burden.⁸ One of these occasions was in 1958, when Congress added Subchapter S to the Internal Revenue Code of 1954.⁹ For the first time in history, a small business could elect a new organizational form, a hybrid entity that provided limited liability and partnership tax treatment.¹⁰

S becomes known as an "S Corporation," which is defined today as a domestic company with 100 shareholders or fewer, each of whom holds only one class of stock. I.R.C. § 1361(b)(1).

4. See Mortimer M. Caplin, *Subchapter S—Election of Small Business Corporations*, 51 KY. L.J. 308 (1962). The S Corporation was also called a "pseudo-corporate status." Paul W. Clevenger, *Shareholders' Choice to Remove the Corporate Veil in Taxation of Small Businesses*, 1958 U. ILL. L. F. 461, 461; Robert Anthoine, *Federal Tax Legislation of 1958: The Corporate Election and Collapsible Amendment*, 58 COLUM. L. REV. 1148, 1150 (1958).

5. There was much debate over imposing a corporate income tax separate from the tax on shareholders. Countless articles have been written on the effect of double taxation on corporate governance, the market and the economy. Debates on the inefficiency of corporate double taxation and proposals for eliminating it by integrating the individual and corporate tax systems have been common since the enactment of tax on dividends in the 1930s. See generally Steven A. Bank, *The Story of Double Taxation: A Clash over the Control of Corporate Earnings*, in BUSINESS TAX STORIES 153, 153 (Steven A. Bank & Kirk J. Stark eds., 2005).

6. A history of integration proposals can be found in Bank, *supra* note 5, at 178. See also Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 YALE L.J. 325 (1995).

7. The Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, §§ 301-302, 117 Stat. 752, 758-60, reduced the tax on "qualified dividends" to 15%, thus lessening the double tax.

8. When the corporate income tax was introduced in its modern form in 1909, see *Tariff of 1909*, ch. 6, 36 Stat. 11, Congress portrayed it as a small price to pay for the liberty to do business. Legal historians have offered different explanations for the emergence of that tax. Some assert that developments in entity theory shifted the focus from taxing shareholders to taxing corporations. Other historians viewed the corporate income tax as a means of regulating and controlling the flow of information from corporate managers to the public and as a method of preventing the concentration of power in the hands of big conglomerates. See Reuven Avi-Yonah, *Corporations, Society, and the State: A Defense of the Corporate Tax*, 90 VA. L. REV. 1193 (2004); Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L.J. 53, 136 (1990). Later on, another justification raised for maintaining the corporate income tax separate from individual income tax was that it functions as a withholding mechanism for the individual tax and prevents shareholders from sheltering their income from high individual tax rates in the corporate form. Steven A. Bank, *Entity Theory as Myth in the Origins of the Corporate Income Tax*, 43 WM. & MARY L. REV. 447 (2001); Steven A. Bank, *Is Double Taxation a Scapegoat for Declining Dividends? Evidence from History*, 56 TAX L. REV. 463, 467 (2003).

9. Technical Amendments Act of 1958, Pub. L. No. 85-866, § 64, 72 Stat. 1606, 1650-57.

10. Once such an election was made, the S Corporation's earnings and profits were not taxed at the corporate level; rather, they were taxed at the individual shareholder's level. The corporation's profits and losses were reported by the S Corporation, but allocated to shareholders proportionate to their ownership

This article begins with the question: How did the American small business community achieve political victory where large organizations had failed? Put differently, how was it that the “little fellow” accomplished the almost impossible—the elimination of double taxation and permission to essentially choose his tax treatment—when, for years, the business community was unsuccessful in its attempts to integrate corporate and individual taxation? Was it heavy lobbying by interest groups? Or was it part of a planned congressional agenda to bolster the economy in the wake of World War II? By laying out the untold story behind the enactment of Subchapter S, this article will answer those questions and elucidate a more complex picture of how tax policy evolved in the postwar period.

On the surface, the legislative history of Subchapter S suggests that its purpose was to equalize the corporate tax structure and to provide relief for small business corporations.¹¹ Nevertheless, a closer look reveals a more comprehensive picture of the political legislative process in which private interests and lobbyist groups had a large influence. Three major factors paved the way for the creation of the S Corporation: a genuine economic need to aid small business entrepreneurs in times of recession, strong political pressure from the business sector, and political elite who thought the moment was right to aid small concerns.

Although the idea of allowing small corporations to elect to be taxed as partnerships had been raised prior to 1958, it was rejected, together with other proposals to lower the double tax burden on corporate earnings.¹² During World War II, the income tax system went through a large-scale expansion and was transformed “from class tax to mass tax.”¹³ The number of taxpayers was

interest and taxed at each individual’s marginal tax rate. The election was automatically terminated if more than eighty percent of the corporation’s gross receipts were from sources outside the U.S. or if the corporation’s gross receipts from “passive income” that is royalties, rents, dividends, interest, annuities, and capital stock gain exceeds twenty percent of its gross receipts. For criticism of investors’ ability to elect their tax regimes, see William A. Klein & Eric M. Zolt, *Business Form, Limited Liability, and Tax Regimes: Lurching Toward a Coherent Outcome?*, 66 U. COLO. L. REV. 1001 (1995).

11. “In the 1958 act, Congress has made an honest effort to help the ailing financial health of small business by allowing them a certain degree of tax freedom in choosing organizational forms for which they are best suited.” Clevenger, *supra* note 4, at 466. Conversely, another hybrid entity, the LLC, was viewed by the Federal administration as a departure from the neutral corporate tax base. For the story behind the LLC, see Susan P. Hamill, *The Origins Behind the Limited Liability Company*, 59 OHIO ST. L.J. 1459, 1463–69 (1998).

12. See, e.g., RICHARD B. GOODE, U.S. TREASURY DEPT., *THE POSTWAR CORPORATION TAX STRUCTURE* 27–33 (1946).

13. Carolyn C. Jones, *Class Tax to Mass Tax: The Role of Propaganda in the Expansion of the Income Tax During World War II*, 37 BUFF. L. REV. 685, 685–86 (1989). See also EUGENE C. STEUERLE, *CONTEMPORARY U.S. TAX POLICY* 35 (2004); JOHN F. WITTE, *THE POLITICS AND THE DEVELOPMENT OF THE*

increased, as was the scope of the tax. During the 1950s, peacetime tax policy began to focus on important principles—such as equity, efficiency and simplicity—and manipulation of fiscal policy became dominant in the political arena.¹⁴ Taxes were recognized as not only fulfilling the budgetary goal of raising revenue and financing government, but also as an instrument of economic and social policies. Corporate tax policy became central to debates on tax reform because it was seen as having an instrumental role in providing economic stimulus. The 1958 enactment of Subchapter S is one example of this paradigm shift.

While small business owners and interest groups lobbied for tax reforms in the beginning of the 1950s, those efforts were associated with antipathy towards corporate lobbies' integration efforts and as a result were pushed to the bottom of the agenda. However, over the years, the support of professional lawyers, accountants, bankers, and trade organizations convinced Congress of the need for change in the corporate tax base.¹⁵ Unexpected support for the elective tax proposal also came from business leaders who used small-business arguments to promote their agenda, mostly to achieve capital lock-in by eliminating the accumulated earnings tax.¹⁶

However, what eventually tipped the balance in favor of this legislation were political elites¹⁷—such as Wilbur Mills. Although best known for his Medicare legislation, few are aware of Mills's contribution to the enactment of small business tax relief. Mills became familiar with the daily intricacy of small-scale commerce during his days as a small businessman and a probate judge in White county.¹⁸ When he came to chair the House Ways and Means

FEDERAL INCOME TAX 117–18 (1985); W. Elliot Brownlee, *Tax Regimes, National Crisis, and State-Building*, in *FUNDING THE MODERN AMERICAN STATE, 1941–1995*, at 93 (W. Elliot Brownlee ed., 1996).

14. Susan Hansen asserted that this shift in tax policy was a result of the will of “elected officials to maintain sufficient control over revenue and fiscal policy so as to be able to manipulate the economy and government spending for their own electoral benefit.” SUSAN B. HANSEN, *THE POLITICS OF TAXATION: REVENUE WITHOUT REPRESENTATION* 104 (1983).

15. For example, one accountant remarked, “One area of improvement could be made by granting tax relief generally, but primarily to small business . . . to encourage its growth rather than continue tax barriers which prompt mergers with large competitors and in some cases contribute to business failures.” *Tax Problems of Small Business: Hearing Before the S. Select Comm. on Small Business*, 85th Cong. 1076 (1958) [hereinafter *Tax Problems*] (statement of Charles A. Zarini, Certified Public Accountant).

16. Steven Bank claims that business leaders wanted to “lock-in” corporate assets from shareholders and creditors, but the accumulated earnings tax created pressure from shareholders to distribute those earnings and assets. See Steven A. Bank, *A Capital Lock-In Theory of the Corporate Income Tax*, 94 GEO. L.J. 889, 893 (2006).

17. See discussion *infra* note 246.

18. After three years in Harvard Law School, Mills came back to Kensett and managed his father's general store, and community bank. In 1934, Mills was elected county and probate judge. Kay C. Goss,

Committee, the strongest committee in Congress, he remained true to his roots and promoted social security, unemployment and small business legislation.¹⁹ Elected chairman in 1958, Mills hired a small, gifted staff that skillfully drafted a technical amendment act, and made possible the birth of the S Corporation.²⁰

The story of enacting Subchapter S in 1958 is more than adding another organizational tax choice. It stands out because it serves as an example of Congress's way of thinking about tax policy as instrumental in implementing social and economic goals. It also reveals one way in which political interest groups affected the process of legislative decision making. With the creation of this pseudo-corporate status, Congress shaped corporate tax policy for 50 years to come. Following the S Corporation, state legislatures formed other hybrid entities and gradually reduced the barriers to limited liability and other non-tax characteristics of organizational choices. Today, we observe a steady increase in the number of LLCs, which indicates that people favor the pass-through approach for taxation.²¹ At the same time, it is apparent that the existence of different federal tax regimes still plays a significant role in investors' choice of action.²²

Recent consumption tax proposals, such as the Bush Advisory Panel on Federal Tax Reform, threaten to eradicate the preferential treatment granted to small business corporations by applying a flat tax rate on all types of business organizations regardless of their size.²³ While the merits of these proposals are being debated, Congress continues to confirm that it still favors

The Grassroots Politics of Hard Times: Wilbur D. Mills' Career as White County Judge, 59 ARK. HIST. Q. 186, 187-92 (2000).

19. *Id.* at 200.

20. Kay C. Goss, *Mills, Wilbur Daigh*, in ARKANSAS BIOGRAPHY: A COLLECTION OF NOTABLE LIVES 193, 194 (Nancy Williams ed., 2000).

21. For the last decade there has been an increase in the number of S Corporation tax returns, but there has been an even greater increase in the number of tax returns of LLCs. The number of S Corporations tax returns increased twenty-three percent between 2000 and 2004, whereas the number of LLC tax returns increased 76.7% between 2000 and 2004. Internal Revenue Serv., U.S. Dep't of Treasury, SOI Tax Stats: Historical Data Tables: Table 11: Partnership Returns: Selected Balance Sheet and Income Statement Items for Income Years, 1999-2005, available at <http://www.irs.gov/taxstats/article/0,,id=175823,00.html>.

22. See Klein & Zolt, *supra* note 10, at 1003.

23. PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 21-22 (2005). Since the President's Advisory Panel made its proposal, the House Subcommittee on Select Revenue Measures held a series of hearings on tax reform. On May 9, 2006, the Subcommittee examined issues involved in possible corporate tax reforms including rate reduction, base broadening and whether tax accounting should conform to book accounting methods. On September 26, 2006, the Subcommittee received testimony on reform proposals from Members of Congress. H.R. REP. NO. 109-736, at 76 (2006).

S Corporations by constantly liberalizing Subchapter S to allow more corporations to elect pass-through taxation. For example, the Small Business and Work Opportunity Tax Act of 2007 provided small business with increased expensing and a modified alternative minimum tax and work credit.²⁴ Thus, it seems too early to predict the death of the S Corporation form.²⁵

Following this introduction, this article lays out the definition of a “small business” and the organizational dilemmas such an enterprise faced in the 1950s. Part II traces the roots of Subchapter S to the economic conditions in the postwar era and details the tax problems of small businesses at that period. Part III reviews the political interest groups’ lobbying efforts, while part IV details the failed attempt to enact flow-through tax treatment in the 1954 Code as reflecting the transformation of tax policy in the political debate. Part V examines Wilbur Mills’s role in the enactment of Subchapter S in 1958. Finally, part VI concludes with a discussion of why it is highly unlikely that small businesses, which won the political battle in second half of the 20th Century, will lose their special place in tax policy.²⁶

I. TO WHOM IT MAY CONCERN? IDENTIFYING SMALL BUSINESSES

What is a small business? We patronize them daily; they are builders, mechanics, restaurants, and retail stores. They are the local laundry, the neighborhood hairdresser, and the corner bakery. Today, they are also auto dealerships, start-up companies, and service firms. They have a rich history in America, as they were the standard way of doing business in the United States beginning with the founding of the colonies in the 1600s.²⁷ Small firms

24. The Small Business and Work Opportunity Tax Act of 2007, Pub. L. No. 110-28, §§ 8211, 8214, 121 Stat. 190, 191–93. For a survey of past and recent S Corporations reforms, see JAMES S. EUSTICE & JOEL D. KUNTZ, *FEDERAL INCOME TAXATION OF S CORPORATIONS 1–37* (4th ed. 2001); Zev Landau, *Recent Reform and Simplifications for S Corporations*, CPA J. ONLINE, Nov. 2005, <http://www.nysscpa.org/cpajournal/2005/1105/essentials/p46.htm>.

25. Some scholars have anticipated that the LLC will replace the S Corporation. Howard M. Friedman, *The Silent LLC Revolution—The Social Cost of Academic Neglect*, 38 CREIGHTON L. REV. 35 (2004). *Contra* Klein & Zolt, *supra* note 10, at 1001; Vasilios T. Nacopoulos, *Whither (Wither) Subchapter C?: The Effect of the Double-Tax System’s Progeny (The LLC, Check-The-Box and Subchapter S)*, 17 J.L. & COM. 159 (1997); Allan W. Vestal & Thomas E. Rutledge, *Disappointing Diogenes: The LLC Debate that Never Was*, 51 ST. LOUIS U. L.J. 53 (2006).

26. A simple title search on Lexis today reveals over seventy different acts with a title that contains “small business,” which demonstrate their effect on the legislature.

27. Mansel G. Blackford, *Small Business in America: A Historiographic Survey*, 65 BUS. HIST. REV. 1 (1991); see generally ALFRED D. CHANDLER, JR., *THE VISIBLE HAND: THE MANAGERIAL REVOLUTION*

handled the production and distribution of most goods and services until the mid-nineteenth century, when businesses grew to accommodate the demand for supplies during the Civil War.²⁸ Today, small firms employ half of the work force, generate almost all of the net new jobs,²⁹ and produce 50% of the nation's GDP.³⁰ They have adjusted to new economic conditions by developing market niches, and serving as intermediate suppliers to larger firms.³¹

The term "small business" has been used widely with no one standard definition.³² The Small Business Administration (SBA) admits that "[d]efining small businesses and their contributions is a daunting task that requires capturing a moving target."³³ Over the years, the media, legislature and the academic literature have presented different ideas of what a small business is and whether it is distinguished on the basis of total assets,³⁴ number of owners,³⁵ number of employees,³⁶ annual sales,³⁷ or other criteria.³⁸ In 1958,

IN AMERICAN BUSINESS (1977).

28. See Blackford, *supra* note 27, at 5.

29. OFFICE OF ADVOCACY, U.S. SMALL BUS. ADMIN., THE SMALL BUSINESS ECONOMY FOR DATA YEAR 2006: A REPORT TO THE PRESIDENT 1 (2007), available at http://www.sba.gov/advo/research/sb_econ2007.pdf.

30. Veronique De Ruyg, *Let Them Be*, WALL ST. J., Apr. 23, 2007, at A16; Press Release, U.S. Small Bus. Admin., Small Business, Big Contribution (Apr. 16, 2007), available at <http://www.sba.gov/advo/press/07-12.html>.

31. Blackford, *supra* note 27, at 5.

32. Alfred G. Buehler, *The Taxation of Small Business*, 36 AMER. ECON. REV. 250, 250 (1946). A committee staffer noted in a Senate committee hearing, "[T]he committee is always confronted with the problem of defining small business. Any time you delineate to the point that a small business becomes big business you run into problems." *Tax Problems*, *supra* note 15, at 1097 (statement of Floyd K. Haskell, attorney at law).

33. OFFICE OF ADVOCACY, *supra* note 29, at 9.

34. Charles Egan, *Small Business Looks to Washington for Aid*, N.Y. TIMES, Dec. 13, 1953, at E12 (defining small business establishments as those with assets of less than \$1,000,000).

35. For example, section 64 of the Technical Amendments Act of 1958 initially limited S Corporations to ten or fewer shareholders. Pub. L. No. 85-866, § 64, 72 Stat. 1606, 1650. Over the years, this number gradually increased to fifty, then seventy-five, and, recently, section 232 of the American Jobs Creation Act of 2004 increased the number to one hundred shareholders. Pub. L. No. 108-357, § 232(a), 118 Stat. 1418, 1434. The IRS also acknowledged that although the economic right has to be equal, voting rights can be distinguished. Rev. Rul. 73-611, 1973-2 C.B. 312, *obsoleted* by Rev. Rul. 95-71, 1995-2 C.B. 323.

36. In his study in the 1970s on small businesses in the UK manufacturing industry, Jonathan Boswell defined a small firm as a private independent company with less than 500 employees. JONATHAN BOSWELL, THE RISE AND DECLINE OF SMALL FIRMS 199 (1972).

37. *Tax Relief Is the No. 1 Need*, TIME, Apr. 15, 1957, at 106, 106 [hereinafter *Tax Relief*]; JOHN BUNZEL, THE AMERICAN SMALL BUSINESSMAN 30 (1962).

38. One article cynically described a small business as "one that cannot afford to keep a lobbyist in the capital." *Tax Relief*, *supra* note 37, at 106.

the Small Business Act defined a small business as an enterprise that is “independently owned and operated and which is not dominant in its field of operation.”³⁹ Most of the laws today that provide special treatment to small enterprises refer to this definition in the Small Business Act.⁴⁰ Nonetheless, in the late 1950s, the SBA clarified that a small business would include an industrial enterprise with 250 or fewer employees,⁴¹ a wholesaler with annual sales of \$5 million or less, and retail and service concerns with sales of \$1 million or less.⁴² Naturally, those figures were different in each industry, and in the 1980s, the SBA created a table adopting small business size standards that accorded with the North American Industry Classification System (NAICS).⁴³

What characterizes small businesses? The academic literature portrayed “small businesses” in different ways, and did not identify one standard attribute that small businesses must possess. Nonetheless, this list of characteristics is helpful when trying to understand how small businesses integrate in their business environment. Some authors claimed that small businesses are more likely to rely on local sources of raw materials, have higher total unit costs of production, be one-plant establishments, and be dependent on large firms.⁴⁴ In the past, small businesses usually did not have offices and plants in more than one locality, and they recruited their work forces from their communities, in which they were usually deeply involved.⁴⁵ This picture is quite different today. Most of the small business community is in the retail trade and services industries, and their products are more likely to be traded in local markets rather than internationally.⁴⁶ Others described small businesses as possessing the characteristics of being independent,

39. Small Business Act, Pub L. No. 85-536, § 3, 72 Stat. 384, 384 (1958). The act added a quantitative indicator by which an agricultural enterprise is considered a small business concern if it has annual receipts not in excess of \$750,000. *Id.*

40. See, e.g., Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users (SAFETEA-LU), Pub. L. No. 109-59, § 1101(b), 119 Stat. 1144, 1156 (2005); National Defense Authorization Act for Fiscal Year 2004, Pub L. No. 108-136, § 851, 117 Stat. 1392, 1556 (2003); 42 U.S.C.S. § 9607(p)(1)(B), (C) (LexisNexis Supp. 2008); 42 U.S.C.S. § 13556 (LexisNexis 2004); 50 U.S.C.S. Appx. § 468 (LexisNexis 1996).

41. Blackford, *supra* note 27, at 2. In 1988, the SBA updated the small business definition to any firm with 500 or fewer employees. *Id.* at 3.

42. *Id.* at 2. For the history of the “small business” definition, see *id.* at 3.

43. SMALL BUS. ADMIN., SMALL BUSINESS SIZE STANDARDS MATCHED TO NAICS (2008), available at <http://www.sba.gov/services/contractingopportunities/sizestandardstopics/tableofsize/index.html>.

44. MANSEL G. BLACKFORD, A HISTORY OF SMALL BUSINESS IN AMERICA, at xii (1991).

45. *Id.*

46. *Id.* at xii–xiii.

privately owned enterprises with fifty shareholders or fewer that are usually owned and managed by the same individuals who possess personal control over the enterprise's operations, and thus are typically under a degree of family influence.⁴⁷ Similarly, scholars who focus on the ownership, management and employment characteristics have stated that "a business remains 'small' as long as its guiding venturer and chief operating officer maintains direct communication with his operating managers and keeps personal ties with a large proportion of his work force, including all key personnel."⁴⁸

Nevertheless, in today's global environment these descriptions have changed as big businesses became gigantic, many family business operations grew to be large business operations,⁴⁹ and it is almost impossible to find one typical characteristic inherent to all small businesses.⁵⁰ Given that "small" is a relative term that differs across industries, laws, disciplines, and time, an emphasis should be given to the field and context in which small business is examined.⁵¹ While clearly the question of what is considered a small business should be approached with caution, analyzing small business tax motives might reveal the interest group concerned with enacting Subchapter S in the 1950s.

Tax Considerations of Small Business

During the 1950s, individual tax rates were significantly higher than corporate income tax rates. Nevertheless, other surtaxes such as the excess

47. BOSWELL, *supra* note 36, at 15.

48. BLACKFORD, *supra* note 44, at xii (footnote omitted).

49. One example of a small family business that developed into a large public corporation is Wal-Mart Stores Inc., which was founded in 1962 by Sam Walton as a discount city store in Arkansas. For the history of Sam Walton and the Wal-Mart conglomerate, see generally SAM WALTON WITH JOHN HUEY, *SAM WALTON, MADE IN AMERICA: MY STORY* (1992).

50. For example, today's restaurants, inns, and agricultural farms rely heavily on seasonal foreign employees. Thus, recent immigration restrictions imposed by Congress raise concerns that the unavailability of a seasonal work force "could cost small companies billions in lost business." Katie Zezima, *Small Businesses Face Cut in Immigrant Work Force*, N.Y. TIMES, Mar. 14, 2008, at A16.

51. For example, in the agricultural field, a small business is defined as "a corporation, partnership, or unincorporated business that has 500 or fewer employees and during the 3-year period prior to the most recent maintenance fee billing cycle, had an average annual global gross revenue . . . that did not exceed \$60,000,000." 7 U.S.C.S. § 136a-1(i)(5)(E)(ii) (LexisNexis 2008). Section 1101(b) of the SAFETEA-LU limited "small business" to those that do not have average annual gross receipts over the preceding three fiscal years in excess of \$19,570,000. SAFETEA-LU, Pub. L. No. 109-59, § 1101(b), 119 Stat. 1144, 1156 (2005). Because this article relies primarily on federal studies, it uses the SBA definition of small business and indicates what economic measure was used as the determinate factor.

profits tax, the accumulated earnings tax and the corporate income tax made it difficult to determine whether a business would achieve savings by choosing the corporate form of organization.⁵² Moreover, double taxation resulted in extremely high marginal tax rates.⁵³ Thus, a business's strategy depended on its purpose and type.⁵⁴

In the 1950s, individuals were taxed in a progressive scale from twenty percent to ninety-one percent.⁵⁵ The rule of thumb at that time was that in choosing between double taxation and pass through tax treatment, the individual was always better off paying tax just once. Thus, individuals who were interested in distributing the company's profits ("money-out" strategy) would have been better off tax-wise to operate as an unincorporated business. Individual taxpayers with marginal effective tax rates higher than the combined corporate marginal effective tax rates were better off incorporating and either reinvesting all their income back into the company or not distributing anything, paying the accumulated earnings tax ("AET"), and sheltering the income in the corporation ("money-in" strategy). Once they wanted to get their money out of the corporation, they faced double taxation of their business earnings and paid higher marginal effective tax rates. Nevertheless, because the decision whether to distribute corporate income as dividends in a closely held corporation was often within the control of the individual owner, this organizational form afforded him greater freedom to minimize his individual tax liability.⁵⁶

Surprisingly, however, wealthy individuals were not the only ones who could benefit from the corporate form of organization. In that period, unincorporated businesses with net incomes exceeding \$14,000 were at a tax disadvantage if they remained unincorporated rather than operating as

52. *General Revenue Revision: Hearing Before the H. Comm. on Ways and Means*, 83d Cong. 2140 (1953) [hereinafter *General Revenue Revision*] (memorandum regarding proposed amendments to Section 102 of the Internal Revenue Code). "After surrendering 52% of his profits over \$25,000 to the tax collector, the small businessman today has proportionately far less than the big company to invest in research, cost cutting equipment and plant expansion." *Needed: Talent, Training & Tax Cuts*, TIME, Nov. 12, 1956, at 98, 98.

53. See Table II, *infra* App. For example, the combination of personal and corporate taxes (double taxation) between 1954 and 1958 resulted in marginal effective tax rates between 48.48% and 91.2%.

54. The following analysis is based on Table I, *infra* App., which provides tax rates of individuals and corporations during the 1950s, and Table II, *infra* App., which demonstrates the combined effect of individual and corporate tax rates when applying double tax ("DT") or accumulated earnings tax ("AET").

55. ROBERT A. WILSON & DAVID E. JORDAN, PERSONAL EXEMPTIONS AND INDIVIDUAL INCOME TAX RATES, 1913–2002, STAT. OF INCOME BULL., Spring 2002, at 216, 219–20.

56. Klein & Zolt, *supra* note 10, at 1003.

corporations with a money-in strategy.⁵⁷ Owners of such unincorporated small businesses wanted to benefit from the limited liability protection offered by the corporate veil, especially in light of the high rate of business failures at that time,⁵⁸ but they did not want to be penalized in the form of the dividend tax, the accumulated earnings tax, and more. If limited liability was “free” for all types of business, individuals would have made an optimal entity choice separate from tax consequences.

Absent such freedom, a suboptimal form of organization was chosen to lower the combined tax liability.⁵⁹ In the 1950s, high individual tax rates encouraged individuals (with income of \$14,000 or more) to incorporate their business, even though some preferred the unincorporated way of doing business.⁶⁰ Having incorporated, individuals who desired to finance their business activity with outside investors and later on distribute their profits as dividends (money-out) favored one form or another of integration of corporate and individual tax. Individuals who self-financed their business operations (money-in strategy) were more interested in eliminating the accumulated earnings tax, which diminished the availability of those funds. The next section examines how economic conditions affected a small business’s strategy and exacerbated the effect of taxation on organizational choice.

II. POTATO CHIPS AND OIL? THE EFFECT OF ECONOMIC CHANGES ON TAXATION OF SMALL BUSINESS CONCERNS

It is a generally accepted truism that “no small business can remain static—it must either expand or die.”⁶¹

During World War II, the tax system concluded its transformation to a wide revenue-raising mechanism. With the growing defense budget demands, Congress began to use taxes on corporations and individuals as a public

57. See *General Revenue Revision*, *supra* note 52, at 1363, 1368 (statement of F.N. Bard); Table I, *infra* App.

58. It was reported that business failures had doubled since 1947 among firms ten years old and older. *Tax Relief*, *supra* note 37, at 106; see also Charles Egans, *Small Business Looks to Washington for Aid*, N.Y. TIMES, Dec. 13, 1953, at E12.

59. On the effect of tax on investors’ choice of suboptimal organizational choice, see generally Klein & Zolt, *supra* note 10.

60. See *General Revenue Revision*, *supra* note 52, at 1368 (statement of F.N. Bard) (“They operate as proprietors rather than corporations because they like that method of doing business. The American way is to give free choice.”); see also *Tax Problems*, *supra* note 15, at 1105 (statement of Richard Robinson, Robinson’s Dairy, Inc.).

61. S. REP. NO. 83-442, at 21 (1953).

finance tool.⁶² President Roosevelt aimed to pay a large portion of the war costs by taxing corporations and upper-income individuals.⁶³ The Revenue Act of 1942 increased the thirty-five percent to sixty percent graduated rate schedule of the excess profits tax to a ninety percent flat rate as a temporary wartime measure.⁶⁴ Corporate tax receipts increased from \$1.1 billion in 1930 to \$16 billion in 1945, whereas corporate net income at the end of the war reached only four times its 1930 value.⁶⁵ Despite a time of massive corporate tax burdens, an unprecedented corporate expansion occurred due to the industrialization of the American economy that followed the war.⁶⁶

Small businesses experienced difficulties adjusting to this large-scale mobilization, failed to compete with large firms and were left out of most procurement contracts.⁶⁷ Although several federal relief plans were offered to encourage construction of defense facilities and training programs, these provided little benefit to small concerns.⁶⁸ While large firms could lower their tax burden by taking advantage of the accelerated depreciation on industrial plants and machinery, small businesses could not take advantage of such provisions because they were not able to retain enough earnings after taxes to invest in plants and machinery.⁶⁹ As firms utilized economies of scale by increasing their production power, big businesses got bigger, and the American economy experienced a tremendous growth and expansion. Consequently, many small businesses that did not adjust to the new economy went out of business, and we witnessed a decrease in the number of small business enterprises during the war.

In 1945, J. Keith Butters and John V. Lintner, two distinguished Harvard economists, published a study concluding that taxes had a more crucial effect

62. In 1940, the maximum corporate tax rate increased from twenty percent to twenty-four percent and in the next two years, to thirty-one percent and forty percent. It remained at this level until the end of the war. JACK TAYLOR, CORPORATION INCOME TAX BRACKETS AND RATES 1909–2002, STAT. OF INCOME BULL., Fall 2003, at 284, 287–88.

63. W. ELLIOT BROWNLEE, FEDERAL TAXATION IN AMERICA: A SHORT HISTORY 90 (1996).

64. *Id.* at 93.

65. Corporate net income was \$6.4 billion in 1930, \$11 billion in 1940, and \$22 billion in 1945. BUREAU OF CENSUS, U.S. DEP'T OF COMMERCE, HISTORICAL STATISTICS OF THE UNITED STATES: COLONIAL TIMES TO 1970: INTERNAL REVENUE COLLECTIONS, 1863–1970, SERIES Y 358–72 (1975).

66. Toward the end of the war, section 122 of the Revenue Act of 1945, Pub. L. No. 79-214, §§ 121–22, 59 Stat. 556, 568, repealed the excess profits tax and reduced corporate tax rates.

67. See generally *Operations of the Small Defense Plants Administration: Hearing Before the Select Comm. on Small Business*, 83d Cong. (1952).

68. *Id.*

69. H.R. REP. NO. 83-1002, at 2, 7–8 (1953).

on small, growing enterprises than on large, established corporations.⁷⁰ Large, established companies have substantially more after-tax funds available to reinvest in new products and technical innovations.⁷¹ They acquire new capital and credit on much better terms than small companies because, in addition to large companies' ability to float common stock with relative ease, they can usually issue preferred stock or bonds.⁷² These alternatives were available to small companies only on a limited scale, under more expensive terms, and at greater risk.⁷³ Significantly, the study's authors demonstrated for the first time the ways in which the corporate income tax system in fact fosters the growth of large concerns and encourages mergers and consolidations.⁷⁴

A later study by Butters and Lintner established a direct connection between the estate tax, double taxation and mergers of small companies.⁷⁵ They determined that the impact of the estate tax on the owners of closely held companies was amplified by the combined effects of high income taxes and low capital gains tax rates.⁷⁶ When the ownership of a small business was transferred as part of an estate, the estate tax had to be paid immediately upon transfer. Owners of closely held corporations were under pressure to make enough earnings and diversify their holdings to give sufficient liquidity to the estate to meet death levies.⁷⁷ As a result, the burdens of estate taxation led to the disappearance of small and midsize independent businesses, or led to their merger with larger firms in the industry and created increased economic concentration that harmed free competition.⁷⁸ The tax structure, the study reported, encouraged independent small enterprises to sell their businesses because it offered favorable tax treatment to such sales through low-rate capital gains taxes or tax-free exchange of securities.⁷⁹ This incentive was especially evident in the case of rapidly growing companies that had developed substantial capital value but still were considered risky

70. J. KEITH BUTTERS & JOHN LINTNER, EFFECTS OF FEDERAL TAXES ON GROWING ENTERPRISES 2-4 (1945).

71. *Id.*

72. *Id.*

73. *Id.*

74. It was also reported that "sales of corporations with assets of less than \$5,000,000 have slipped since 1951, while \$100 million-plus companies have boosted sales 45%." *Needed: Talent, Training & Tax Cuts, supra* note 52, at 98.

75. J. KEITH BUTTERS ET AL., EFFECTS OF TAXATION: CORPORATE MERGERS 8-9, 12 (1951).

76. *Id.* at 12.

77. *Id.*

78. *Id.* at 12-18, 35.

79. *Id.* at 12-13.

investments.⁸⁰ As long as the option of retaining the gain in the corporation was heavily taxed, there was an incentive for the owners to cash in their gains at low tax rates and invest them in less risky operations.⁸¹

The outbreak of the Korean War created a need for additional revenue and, as a result, Congress shifted gears, increasing the tax burden on corporations, adding a temporary excess profits tax of thirty percent up through 1953, and increasing the maximum corporate income tax rate to fifty-two percent, where it remained for decades.⁸² A short period of recession that followed worsened the situation for small businesses.⁸³ By 1953, small business profits had plummeted nearly seventy percent from their 1946 level.⁸⁴ Although various industries increased production to accommodate wartime defense contracts, small businesses did not share that prosperity and faced financing difficulties and managerial problems.⁸⁵ Moreover, there were very few, if any, educational programs for small businessmen, who were buffeted by a complex, fast-changing economy and complicated tax laws.⁸⁶

Legal lending limits, bank credit policies and reluctance to assume risk in long-term loans were said to deter banks from lending money to small concerns.⁸⁷ Typically, only corporations with three to five years of standing were able to secure loans from banks, more so when high income tax rates diminished corporate profits.⁸⁸ Moreover, the securities market was not a viable source of funding due to the cost of issuance and the level of risk in small companies compared to other low-risk, tax-exempt alternatives.⁸⁹ Consequently, small business relied heavily on self-financing—reinvesting their retained earnings to finance expansion and preserve competitiveness.⁹⁰

80. *Id.* at 13.

81. “[T]he incentive to play safe and cash in the gains already attained at capital gains rates is correspondingly strengthened. The tax rate increases of the Revenue Act of 1950 have substantially augmented this incentive to sell out and further increases that appear inevitable will strengthen it still more.”
Id.

82. TAYLOR, *supra* note 62, at 288.

83. Blackford, *supra* note 27, at 5.

84. See BUREAU OF CENSUS, U.S. DEPT. OF COMMERCE, HISTORICAL STATISTICS OF THE UNITED STATES: COLONIAL TIMES TO 1970: SELECTED CORPORATE ASSET, LIABILITY, INCOME, AND TAX ITEMS, AND DIVIDENDS PAID, BY SIZE OF TOTAL ASSETS: 1931–1970, SERIES V 182–96 (1975) (disclosing that total receipts less total deductions of business corporations with less than \$100,000 went down from \$1,012 million in 1946 to \$312 million in 1953).

85. Egan, *supra* note 34.

86. *Needed: Talent, Training & Tax Cuts*, *supra* note 52, at 98.

87. H.R. REP. NO. 83-1002, at 2 (1953).

88. *Id.* at 5.

89. *Id.* at 2.

90. *Id.*

Thus, the threat of taxation on accumulated earnings and profits (plus double taxation if such earnings were distributed) was thought to increase the difficulties of small companies.⁹¹

Along with reducing the attractiveness of small businesses to outside investors, the tax system also lowered the incentive for small concerns to expand existing projects and make new investments because taxes on future earnings increased the ratio of risk to expected return.⁹² Knowing that more than one half of the profits would go to the government, investors and entrepreneurs were disinclined to invest funds or to develop new projects. Owners of growing companies reported to the Senate that they considered any investment in expansion or improvement to be economically unsound under the prevailing tax policies.⁹³ Other claimed woes of small businesses expressed before the Congress included problems complying with government bureaucracy and regulation; a lack of managerial, scientific, and technical skills for improving production and distribution; the high costs of small-scale operations; and a lack of funds for research and development or promotional activities.⁹⁴

At that time, Congress received reports of the deteriorating state of competition in various industries,⁹⁵ which indicated that the tax system promoted monopolies and oligopolies.⁹⁶ Subsequently, the Senate declared: "It is irrational [to] the extreme for Congress to pass laws and provide funds for the purpose of maintaining competition and, at the same time, give every possible inducement through our tax laws for mergers and sales of small independent companies to their larger competitors."⁹⁷ The House also stressed the urgency to change the tax structure to let small businesses retain more of their earnings and encourage investment.⁹⁸

91. *Id.* at 3.

92. *Id.* at 2.

93. S. REP. NO. 83-442, at 7 (1953) (citing one business owner who stated, "it is not economically sound to make any improvements in mechanization and introduce any labor-saving devices (because of present tax policies)").

94. Maurice H. Stans, *What Small Business Needs*, 21 ACCT. REV. 361, 362-63 (1946).

95. "[Taxes] have created larger companies all the time. Although we have set up antitrust legislation to stop mergers, and stop consolidations, through our tax laws, we are forcing them." S. REP. NO. 83-442, at 7; *see also* Egan, *supra* note 34 ("In all walks of business the small man faces handicaps in attempting to hold his ground against bigger rivals.").

96. S. REP. NO. 83-442, at 4.

97. *Id.*

98. *See generally* H.R. REP. NO. 83-1002, at 1 (1953). Unless special adjustments were made to relieve the tax burden on small companies, the House report indicated, tax policies would promote industrial concentration, increase in prices, and would continue to restrict the growth of small independent companies.

At that time, tax laws were believed to encourage small businesses to merge—even in markets that were not directly related. For example, Senator Alan Bible expressed his surprise in one Senate committee hearing that small businesses commonly had merged into companies that manufactured very unlike products, such as potato chips and oil:

WITNESS: Yes. One in California has merged into an oil company, a hardly understandable merger, but nonetheless, it did occur.

SENATOR BIBLE: Potato chips and oil?

WITNESS: Yes; potato chips and oil.

SENATOR BIBLE: Not even vegetable oil?⁹⁹

Congress was presented with confirmation of the role tax played in the viability of small businesses and the state of competition.¹⁰⁰ Although Congress began to aid small concerns in fields such as labor, finance, and insurance, it took over a decade to enact a bill to lessen the tax burden on small concerns.¹⁰¹ The next section will detail those early attempts and some possible reasons for their failure.

99. *Tax Problems*, *supra* note 15, at 1113 (statement of Milo V. Wilson, Manager, The Colorado Potato Flake Manufacturing Company). Mr. Wilson replied to the Senator:

That's right. The situation is true in our particular case, and I think this is the key to the merger situation, that is someone would come to us and offer a price, and, yet, that is not an exorbitant price under current purchasing structures of corporations because of the fact, if we went out to gain that same equivalent accumulated capital, it would take us approximately 16 years considering the taxes that we would have to pay in that time, and we would be faced with the threat all throughout that same time

Id.

100.

Before considering the use of tax moneys to provide financing to small companies the tax structure should be reviewed and revised to improve the capacity of small companies to finance themselves out of earnings and to attract outside capital. This will not only reduce mortality of small businesses but will increase the ability of owners of small businesses to resist the pressure caused by income and estate tax problems to sell out to larger companies.

S. REP. NO. 81-46, at 1 (1949).

101. *See generally* Stans, *supra* note 94, at 362-63.

III. EARLY LOBBYING EFFORTS TO AID SMALL BUSINESSES

[A] citizen should not be penalized, taxwise [sic], by reason of his choice of the form of his business enterprise.

—*F.N. Bard, small businessman from Illinois*¹⁰²

Long before the 1958 act established the S Corporation, the declining economic state of small businesses had prompted a search for measures to aid small business owners. For instance, in 1939, the National Tax Association suggested applying partnership tax treatment for corporations to ensure equivalent tax treatment among various forms of ownership.¹⁰³ In 1946, the Treasury published a report on revising the postwar corporate tax structure, which suggested taxing closely held corporations under the partnership model.¹⁰⁴ During 1948, both the House and the Senate established special committees that conducted hearings on the difficulties of small business,¹⁰⁵ their participation in government procurement contracts, their shortage in supply and distribution, their lack of long term credit, and so on.¹⁰⁶ However, many small businesses were not interested in the kind of aid the government offered.¹⁰⁷ Small businessmen and financial organizations, such as the Reconstruction Finance Corporation, repeatedly asked Congress to “cut the little man’s taxes . . . and he won’t need any federal loans,”¹⁰⁸ and “to give

102. *General Revenue Revision*, *supra* note 52, at 1365.

103. ROBERT MURRAY HAIG, NAT’L TAX ASS’N, FINAL REPORT OF THE COMMITTEE OF THE NATIONAL TAX ASSOCIATION ON FEDERAL TAXATION OF CORPORATIONS 49 (1939) (recommending application of partnership tax treatment to reach corporations to the fullest extent administratively possible); *see also* Buehler, *supra* note 32, at 264 (proposing small corporations should be taxed as partnerships); Willford I. King, *Relation of Federal Taxation to the Financing of Small Business*, 11 LAW & CONTEMP. PROBS. 371, 375 (1945) (proposing to extend to corporations the privilege of partnership taxation).

104. GOODE, *supra* note 12, at 27–33.

105. For example, the Committee on Small Business was formed by the Senate to study the problems of small business enterprises. This committee realized that the effect of taxes on those enterprises deserved particular attention and appointed a Subcommittee on the Tax Problems of Small Business to conduct hearings in Washington. For the history of the Committee on Small Business, see Comm. on Small Bus. & Entrepreneurship, U.S. Senate, *About the Committee*, <http://sbc.senate.gov/republican/HTML/about.html> (last visited Nov. 9, 2008).

106. *See, e.g., Availability of Long-Term Credit for Small Business: Hearing Before the H. Select Comm. on Small Business*, 80th Cong. (1948); *Problems of American Small Business, Part 26, Oil Supply and Distribution Problems X: Hearing Before the S. Spec. Comm. to Study Problems of American Small Business*, 80th Cong. (1948).

107. *Something for the Boys*, TIME, May 15, 1950, at 85, 85. For examples of the aid Congress offered, and members’ criticisms thereto, *see Just One Flaw*, TIME, Apr. 3, 1950, at 87, 87–88; *Point & Counterpoint*, TIME, June 26, 1950, at 89, 89–90.

108. *Point & Counterpoint*, *supra* note 107, at 89.

attention to the tax burden that bears so heavily on . . . small business concern[s].”¹⁰⁹ The Conference of American Small Business Organizations published a resolution in 1950 in which it declared, “Revision of tax laws can afford better benefits to all small businesses than credit relief or subsidies.”¹¹⁰ In 1951, Congressman Daniel Reed (R-N.Y.), who later chaired the House Ways and Means Committee between 1953 and 1955, introduced a bill allowing proprietorships and partnerships to elect their tax treatment, but the idea was rejected and the Revenue Act of 1951 incorporated merely a small reduction in the excess profits tax on small business.¹¹¹

In 1953, Congress created the Small Business Administration.¹¹² The SBA’s responsibilities were to aid, counsel, assist and protect the interests of small business concerns.¹¹³ It was also in charge of ensuring that a fair proportion of the total purchases and contracts for government supplies and services went to small business enterprises, in an effort to maintain and strengthen the overall economy.¹¹⁴

Throughout 1953, congressional subcommittees continued to investigate the effect of taxes on small businesses and conducted hearings in major cities across the nation.¹¹⁵ They all agreed that the government should encourage

109. *Big, Small Business Have No Basic Conflict: “Problem” Mostly Imaginary, Bank Says*, N.Y. TIMES, May 31, 1950, at 38; see also Egan, *supra* note 34.

Rigid tax laws, which, it is claimed, not only prevent the small man from ploughing profits back into his business but also discourage investors from risking capital in small new ventures, are another headache for small businesses. Owners of the small enterprises believe they should receive special consideration from tax authorities so they can build up backlogs of assets to be used when slack times arrive.

Id.

110. *Something for the Boys*, *supra* note 107, at 85.

111. Revenue Act of 1951, Pub. L. No. 82-183, § 121, 56 Stat. 452, 465–68; see also *Internal Revenue Code of 1954: Hearing on H.R. 8300 Before the S. Comm. on Finance*, 83d Cong. 1251 (1954) [hereinafter *Internal Revenue Code of 1954*] (statement of Sen. Walter F. George, Member, S. Comm. on Finance) (citing a letter from a constituent, Malon C. Courts, of Courts & Company, that mentioned Mr. Reed’s introduction of H.R. 4214, 82d Cong. (1951)).

112. U.S. Small Bus. Assoc., *Overview and History*, <http://www.sba.gov/aboutsba/history/index.html>. The SBA assumed the functions of two small business agencies—the Small Defense Plants Administration and the Reconstruction Finance Corporation. It was assigned to make loans more available to small businesses, and to assist small businesses in obtaining government contracts. *Id.*

113. BRUCE K. MULOCK, CONG. RESEARCH SERV., SMALL BUSINESS ADMINISTRATION: OVERVIEW AND ISSUES I (2001), available at http://ugar.senate.gov/services/pdf_crs/Small_Business_Administration_Overview_and_Issues.pdf.

114. *Id.* at 1.

115. S. REP. NO. 83-442, at 1–2 (1953). The House of Representatives nominated a similar Select Committee on Small Business and a Subcommittee on the Effects of Present Tax Structure on Small Business that conducted their own investigation on that subject. See H.R. REP. NO. 83-1002 (1953).

small businesses to accumulate earnings by allowing them to defer tax on money reinvested in the company,¹¹⁶ and that the government should eliminate the excess profits tax, which presented the gravest problems for small businesses.¹¹⁷ The House and Senate subcommittees also recommended extending the payment period for estate taxes on small business owners and allowing them to deduct their life insurance premiums.¹¹⁸ The subcommittees further concluded that existing depreciation policies did not fit the special characteristics of small businesses, and the Senate subcommittee included excerpts from a Small Defense Plants Administration report recommending liberalization of the depreciation allowance for corporations with assets of less than \$1 million.¹¹⁹

Although in this era every politician was “determined to show that he was a better friend of small business,”¹²⁰ President Eisenhower put extra emphasis on fiscal relief for small businesses. In Eisenhower’s budget message to the nation in January 1954, he proclaimed:

Small businesses should be able to operate under whatever form of organization is desirable for their particular circumstances, without incurring unnecessary tax penalties.

116. See S. REP. NO. 83-442, at 2-3; H.R. REP. NO. 83-1002, at 2.

117. S. REP. NO. 83-442, at 13. The Senate committee reported that the excess-profits tax deterred small business from taking risks, fearing they would be penalized for producing “abnormal” profits. In addition to the combined normal and surtax fifty-two percent tax rate on income above \$25,000, the excess-profits tax imposed thirty percent tax rate on “every dollar earned above an arbitrary determined normal earnings figure.” *Id.* at 10. The Senate committee unanimously declared that “there is no other tax so injurious to small business and so dangerous to our entire free-enterprise capitalism.” *Id.* “The excess profits tax is an inequitable, unjust levy, difficult of administration.” *Id.* at 22. Both the House and Senate committees recommended abolishing the excess-profits tax or at least increasing the exemption level from \$25,000 to \$100,000. *Id.*; H.R. REP. NO. 83-1002, at 4, 6.

118. See generally S. REP. NO. 83-442, at 21; H.R. REP. NO. 83-1002, at 10. Since many small concerns were individually owned, the death of the owner created a substantial cash inheritance tax demand on the owner’s estate. S. REP. NO. 83-442, at 21-22. The Senate Subcommittee unanimously recommended in 1953 extending the payment period for estate taxes, and conducting further studies on the effect of estate tax on the sale or merger of independent small businesses. *Id.* The House Subcommittee echoed these recommendations and further suggested allowing small business corporations a deduction for life insurance premiums of major stockholders. H.R. REP. NO. 83-1002, at 10.

119. S. REP. NO. 83-442, at 15; H.R. REP. NO. 83-1002, at 6-8. The Senate subcommittee declared that the Code’s depreciation policies harm particularly new small operations for which each dollar of capital reinvested is crucial. S. REP. NO. 83-442, at 17. The committee’s report included in its findings a recommendation dividing the depreciation base into two halves, permitting small business owners to apply Treasury regulations to one half, and to determine their own timing of the deductions on the other half. *Id.* at 15 (citing SMALL DEF. PLANTS ADMIN., TAXATION OF SMALL BUSINESS 32 (1952)).

120. *Something for the Boys*, *supra* note 107, at 85. “In recent years, politicians of all the leading political parties have shown great solicitude for small business. To paraphrase Lincoln, they doubtless love small businessmen because God made so many of them.” King, *supra* note 103, at 371.

To secure this result, I recommend that corporations with a small number of active stockholders be given the option to be taxed as partnerships and that certain partnerships be given the option to be taxed as corporations.¹²¹

The 1954 Senate bill included a new Subchapter R that allowed certain corporations and unincorporated businesses to choose their tax treatment.¹²² Specifically, section 1351 permitted corporations with ten shareholders or fewer to elect to be treated as partnerships for tax purposes.¹²³ Similarly, section 1361 allowed unincorporated business enterprises such as partnerships and sole proprietorships to elect to be taxed as domestic corporations.¹²⁴ The decision to be taxed as a corporation was irrevocable unless there was a change in membership of more than twenty percent.¹²⁵ The Senate declared that the purpose of the proposed Subchapter R was to eliminate the discriminatory effects of federal tax laws on the form of organization adopted by small businesses.¹²⁶

Being the “first real face-lifting job” of the tax code in years,¹²⁷ the 1954 bill spurred political debates over the objectives of tax laws, which reflected the transformation in Congress’s idea of postwar tax policy. Political parties claimed that peacetime tax policy should be used as more than a financing tool; it should be used as a powerful means to promote social goals and economic development, specifically in times of economic distress and recession.¹²⁸ The debates over the Senate and the House bills became a

121. 100 CONG. REC. 567, 571 (1954); see *Text of President Eisenhower’s Budget Message to Congress for the Fiscal Year 1955*, N.Y. TIMES, Jan. 22, 1954, at 13. Eisenhower’s proposal was sent to the House Ways and Means Committee and later incorporated into the Code. See *Internal Revenue Code of 1954*, *supra* note 111, at 1250–51 (statement of Sen. Walter F. George, Member, S. Comm. on Finance) (introducing a letter from Mason C. Courts).

122. S. REP. NO. 83-1622, at 118–19 (1954) (reinstating these provisions in sections 1351 and 1361 of H.R. 8300, 83d Cong. §§.1351, 1361 (1954)).

123. *Id.* at 119. “In order to avoid possible complications in the taxation of preferred stock dividends not earned in the year distributed, only corporations having one class of stock outstanding may qualify” to be taxed as partnerships. *Id.*

124. *Id.* This privilege was limited to partnerships in which “50% or more of the gross income consist[ed] of gains, profits, or income derived from trading as a principal or from certain types of brokerage commissions. This [requirement] was meant to rule out firms engaged in professional services such as the law, accounting, medicine, engineering, and others.” *Id.*

125. *Id.*

126. *Id.* at 118.

127. 100 CONG. REC. 3539 (1954) (statement of Rep. Kelley).

128. See, e.g., *id.* at 3550 (statement of Rep. McCormack) (declaring the tax system has a role in ending recessions by tax reductions that restore purchasing power of the masses and by giving incentives to investors). For a description of the transformation of the postwar tax policy, see generally WITTE, *supra* note 13, at 131–54.

political battle between those who focused on aiding low-income taxpayers by raising income tax exemptions, and those who proposed to spur investments by granting business tax concessions.¹²⁹ Small business groups continued to campaign for tax relief in committee hearings across the country. Business organizations sought to utilize political control to receive economic concessions through the tax system. Business leaders employed this debate to promote their own agenda by using small business justifications in their rhetoric.¹³⁰ In the midst of the 1950s, the topic of tax problems of small business occupied many public debates.

*Small Business Lobbying*¹³¹

Increasingly high tax rates intensified the friction between small business taxpayers and the government and enhanced small business lobbyist efforts to lower their tax burden.¹³² In the Senate and House hearings on the 1954 bills, small-business owners associated much of their trouble with taxation. They claimed that taxes restricted their capacity to grow through internal sources, that is, earnings and profits on which they were heavily dependent.¹³³ They argued that the combined impact of the corporate income tax, surtax, accumulated earnings tax, and excess profits tax deterred the normal development and growth of new businesses.¹³⁴ Taxes reduced their main

129. 100 CONG. REC. 3532 (1954) (statement of Rep. Vursell). The bills included a proposal to credit the first \$100 of dividends distributed. *Id.*

130. *To Win Friends . . .*, TIME, Mar. 6, 1950, at 17, 17.

131. Small business interest groups had existed since the days of the Granger Movement and the New Freedom, movements that acted during the pre-wars years and promoted antitrust legislation. Oliver Garceau, *Can Little Business Organize?*, 2 PUB. OPINION Q. 469, 469 (1938). During the New Deal, claimed Harvard Professor Oliver Garceau, small business spokesmen pressed the government to address their long-term credit problems. *Id.* Some of them were the National Federation of Small Businesses, the National Small Business Men's Association, the Smaller Business Association for New York, New Jersey, and Connecticut, Inc., the National Association of Manufacturers, the U.S. Chamber of Commerce and Little Business, Inc. and so on and so forth. *Id.* at 470.

132. Egan, *supra* note 34. Small businesses were the most numerous of firms at that time. If we look at the total asset definition, in 1953, ninety-two percent of the nation's business population was in the category of small business. If we define small business by the number of employees, at the end of 1953, eighty-nine percent of all producers in the manufacturing field employed fewer than a hundred employees. *Id.*

133. *E.g.*, *For Real Help to Small Business*, AVIATION WEEK, Apr. 6, 1953, at 50, 50–51 (lamenting that the excess profits tax, which was applied to corporations that had more than \$25,000 net income per year, took up to 82 percent of every dollar earned above an excess profits credit based on what was earned in 1946–1949; and declaring, “[t]he nation as a whole would be after better off if the excess-profits taxes were allowed to die . . .”).

134. H.R. REP. NO. 83-1002, at 3 (1953). On the excess profits tax, see generally J.S. SEIDMAN,

source of financing, because small businesses did not enjoy easy credit and remained unable to fill their needs for growth and expansion through borrowing.¹³⁵ They needed every dollar of their retained earnings to survive and expand their plant production and inventory.¹³⁶ High taxes also reduced investors' willingness to invest in new small enterprises. A survey published by the Council of State Chambers of Commerce concluded that the high federal taxes enacted following the outbreak of the Korean War stopped the growth of small and medium size companies.¹³⁷ At the same time, small businessmen claimed large businesses could use their power to bargain for better buying conditions, longer credit terms and lower interest rates.¹³⁸

Tax practitioners such as lawyers and accountants also lobbied for tax relief for small businesses. One proponent of partnership tax treatment was the American Institute of Accountants. In testimony before the House Ways and Means Committee, that group's representative stated that the federal tax structure was highly unfair to closely held corporations, although they operated and conducted business similar to partnerships.¹³⁹ The representative further contended that double taxation of income played an unreasonable role in the decision on how to conduct business.¹⁴⁰ In order for similar competing organizational forms to receive equal treatment, the Institute suggested allowing closely held corporations with not more than 25 shareholders to elect the partnership tax treatment.¹⁴¹ The Institute limited their proposal to closely

LEGISLATIVE HISTORY OF FEDERAL INCOME AND EXCESS PROFITS TAX LAWS, 1953-1939 (1954).

135. H.R. REP. NO. 83-1002, at 2.

Small business customarily depends on earnings to expand. Heavy taxation, therefore, cuts off small business at the grassroots. The continuous buffeting by high taxes turns into an unequal struggle, with the result that too many small businesses give up and close shop These small businesses are the lifeblood of our competitive economy.

General Revenue Revision, *supra* note 52, at 581 (statement of American Taxpayers Association).

136. S. REP. NO. 85-1237, at 3 (1958). The problem of tax on retained earnings was particularly grave in the case of new concerns during their early formative years because such firms often encounter great difficulties in securing adequate capital to continue to develop plants, machinery and markets necessary for their survival. H.R. REP. NO. 83-1002, at 4.

137. S. REP. NO. 83-442, at 9 (1953).

138. See H.R. REP. NO. 83-1002, at 5; *Aid to Small Lines is Held Too Limited*, N.Y. TIMES, Nov. 7, 1953, at 25; Egan, *supra* note 34.

139. *General Revenue Revision*, *supra* note 52, at 1391 (statement of American Institute of Accountants) (claiming the income of a closely held corporation is taxed twice unjustly, the Institute stated: "To tax these two types of business entities on a different basis results in taxation based on form rather than on substance.").

140. *Id.*

141. *Id.* at 1392.

As a partial solution to the whole problem of the double taxation of corporate dividends and as a solution to the inequity which exists in the taxing of partnerships and closely held corporations, it

held corporations because they anticipated it would be hard to administer the allocation of profits and losses of large publicly owned corporations.¹⁴²

Bankers and financiers argued for tax relief to small business too, hoping to alleviate the tax burden of their business clients.¹⁴³ Commenting on the financial problems of small businesses, one banker detailed his institution's credit policy:

We used to have a rule in the bank which was pretty general that we would lend no new corporation of less than 3 years standing any money for the simple reason it took 3 years to find out whether they were functioning right or not. . . . If they haven't had 3 years of successful experience, it is hard to get credit. I think in at least 5 years of their early experience they should be free of taxes or have very low taxes.¹⁴⁴

Further committee discussions on the topic of depreciation policies brought an industry representative from the machine-tool industry to support small businesses by expressing concerns about their ability to maintain modern equipment and compete with larger firms.¹⁴⁵ The representative argued that depreciation rates did not make adequate allowances necessary for investments

is proposed that closely held corporations be given the option of being taxed as partnerships. Under this method no tax would be levied on the corporation itself. Instead, its stockholders would be treated as partners and taxed on their proportionate share of the partnership profit and entitled to deduct their proportionate share of the partnership loss.

Id.

142. *Id.*

Since the partnership method of taxing corporations would not be feasible for taxing large corporations whose stock is widely held and frequently traded, this option to be taxed as a partnership would be available only to closely held corporations. A corporation would be considered a closely held corporation entitled to the election of being taxed as a partnership only if (1) it had only common stock outstanding, and (2) at all times during the year all of its outstanding stock is owned, directly or indirectly, by or for not more than 25 individuals. The election to be taxed as a partnership would have to be made by not less than 95 percent of the outstanding stock. All corporations which could qualify to be taxed as a partnership would be given the right to elect to be so taxed.

Id.

143. *Big, Small Business Have No Basic Conflict*, *supra* note 109, at 39.

[G]ive attention to the tax burden that bears so heavily on both the small business concern and the local capitalist, reducing the supply of venture capital and the incentive to invest it, and interfering especially with the plowing back of earnings, which is the soundest of all methods of raising capital.

Id. One businessman observed that banks tend to lend more to corporations than to partnerships because "they feel that [corporations] are a little better security because, due to the tax structure, they cannot take and deplete the funds from the corporation quite so readily." *Tax Problems*, *supra* note 15, at 1105 (statement of Clement F. Hausman, Treasure Chest Homes, Incorporated).

144. H.R. REP. NO. 83-1002, at 5 (1953).

145. *General Revenue Revision*, *supra* note 52, at 667-68 (statement of I.D. McDonald, Chairman, Subcomm. on Tax Policy, National Machine Tool Builders' Association).

in new machinery by small businesses.¹⁴⁶ Among the suggestions was to permit taxpayers greater flexibility in determining the length of the depreciation period and allow more rapid tax-free recovery on investments.¹⁴⁷ The representative believed these actions would greatly reduce the investment risk in small businesses and improve the credit condition of those companies.¹⁴⁸

Representatives from the unincorporated business sector also participated in the 1953 House Ways and Means hearings.¹⁴⁹ They protested against their elevated tax burden compared to corporations, which came without the benefit of limited liability.¹⁵⁰ F.N. Bard, a proprietor from Illinois, noted that things had reached a point where “[t]hey cannot stand taxes higher than corporation taxes any longer.”¹⁵¹ While the combined tax rate upon a corporation was around seventy percent, the maximum tax rate on a partner or proprietor at that time was ninety-two percent.¹⁵² The business portion of partnership income not only elevated their personal marginal tax rates and put them in higher tax brackets, but also made it impossible for them to compete with corporations with the same income level.¹⁵³

One of the strongest arguments unincorporated business owners raised in support of the idea that they should be allowed to elect to be taxed as corporations was that it would not harm the federal budget. As one businessperson testified: “Under the present tax system, all proprietors and partners may be forced to incorporate and get the corporate tax rates anyway.”¹⁵⁴ They noted that most low-income business owners preferred to do business in the pass-through form, but once their income reached a certain

146. *Id.* at 671.

147. *Id.* at 672.

148. *Id.*

149. *E.g.*, *General Revenue Revision*, *supra* note 52, at 1391 (statement of F.N. Bard).

150. For an examination of the tax problems facing unincorporated business, see generally Buehler, *supra* note 32, at 250.

151. *General Revenue Revision*, *supra* note 52, at 1364 (statement of F.N. Bard).

152. *Id.* at 1368.

153. Nevertheless, as demonstrated in Part I of this article, some investors preferred double taxation when their marginal individual tax rates were higher than the combined shareholder and corporate tax liability. For a discussion of the effects of tax treatment on choice of entity analysis, see Klein & Zolt, *supra* note 10, at 1002–05.

154. *General Revenue Revision*, *supra* note 52, at 1365 (statement of F.N. Bard); see also *Internal Revenue Code of 1954*, *supra* note 111, at 1251 (statement of Sen. Walter F. George, Member, S. Comm. on Finance) (introducing a letter from a constituent, Malon C. Courts, of which an excerpt read: “It is this type of business which would secure relief from the proposed bill and I am confident that it would result in a very nominal loss of revenue.”).

level, they chose to incorporate to lower their tax burden.¹⁵⁵ “Forcing proprietors and partners to incorporate against their will is wrong,”¹⁵⁶ one proprietor protested, and he urged Congress to separate their income into two classifications: investment income and business operation income.¹⁵⁷ The proprietor or partner would then pay corporate tax rates on his business income and individual income tax rates on his non-business income.¹⁵⁸

Behind this proposal was the desire of unincorporated business owners to have venture capital flow in and out of the business as needed without penalty. They wanted Congress to recognize the differences between business income and capital gains, and to ensure that the first type would not be taxed more than similar business-like income only because it was produced by a different form of organization.¹⁵⁹ At that time, proprietors had no corporate veil of protection against liabilities, they could not deduct salaries, and they had to pay their taxes one year ahead of corporations.¹⁶⁰ Despite the incentive to incorporate, most of them remained proprietors rather than corporations, many simply because they liked that form of organization.¹⁶¹ Other unincorporated businesses were unable to incorporate due to industry regulations.¹⁶²

Lobbying Efforts of Big Business Groups

Although the proposed new Subchapter R would not have had a direct effect on businesses with more than 10 shareholders, it was promoted by

155. *Internal Revenue Code of 1954*, *supra* note 111, at 1251 (statement of Sen. Walter F. George, Member, S. Comm. on Finance) (referencing a letter from Malon C. Courts whose partnership was a southern cotton business that needed to accumulate capital free of the high individual tax rates, but was not able to incorporate and was obliged to operate as a partnership under the Cotton Exchange Customs and Trade rules). On the southern unincorporated lobbyist link to the enactment of Subchapter R of the Internal Revenue Code of 1954, see William L. Cary, *Pressure Groups and the Revenue Code: A Requiem in Honor of the Departing Uniformity of the Tax Laws*, 68 HARV. L. REV. 745, 750 (1955), and Stanley S. Surrey, *The Congress and the Tax Lobbyist—How Special Tax Provisions Get Enacted*, 70 HARV. L. REV. 1145, 1149 n.4 (1957).

156. *General Revenue Revision*, *supra* note 52, at 1363, 1365 (statement of F.N. Bard).

157. *Id.* at 1364.

158. *Id.*

159. *Id.* at 1364–65. “[T]here is no reason why this great class of fundamental Americans, the real back-bone of American industry and commerce, should not be permitted a situation which will not balance out corporate benefits which they do not enjoy.” *Id.* at 1366.

160. *Id.*

161. “They operate as proprietors rather than corporations because they like that method of doing business. The American way is to give free choice.” *Id.*; see also *Tax Problems*, *supra* note 15, at 1059, 1069 (statement of Harry L. Baum, Jr., Noreen Products, Incorporated).

162. *Internal Revenue Code of 1954*, *supra* note 111, at 1251 (statement of Sen. Walter F. George, Member, S. Comm. on Finance) (introducing a letter from Malon C. Courts, Courts & Company).

leading business groups, trade agencies and manufacturing associations. This support may be partly explained by the “capital lock-in” theory, which legal historians have cited to explain business managers’ silent approval of double taxation. These scholars claim double taxation persisted as a result of corporate managers’ attempts to eliminate tax on accumulated wealth with the intention of preserving capital lock-in, that is, the firm’s control over distributing earnings.¹⁶³ In a way, double taxation allowed corporate managers to maintain earnings and profits under the pretext that they were protecting shareholders from the second layer of double taxation,¹⁶⁴ hence their efforts to diminish double taxation were considerably more muted.¹⁶⁵

Although in the 1950s small corporations were least likely to need capital lock-in because of their small number of investors and their partnership-like structure,¹⁶⁶ corporate managers called for the elimination of the accumulated earnings tax on small businesses in hope to achieve a “foot in the door” in their own fight. They were interested in eliminating the accumulated earnings tax entirely because, as with any other tax on accumulated wealth, it generated pressure from shareholders to disburse income left in the company.¹⁶⁷

Almost all of the witnesses at the House Ways and Means committee hearings on the topic of accumulated earnings tax (AET) were representatives from business interest groups, managers, and business chambers.¹⁶⁸ Nevertheless, those interest groups focused their attention on the negative effects of the tax on small businessmen to substantiate their arguments.¹⁶⁹

163. Arlen & Weiss, *supra* note 6, at 327, 348, 359; Bank, *supra* note 16, at 893.

164. See Arlen & Weiss, *supra* note 6, at 327, 329 (arguing that double taxation persists because of the fact that shareholders and managers have different and sometimes opposite interests, and arguing the corporate income tax system serves as a retained earnings trap by allowing shareholders to avoid the dividend tax (and thus double taxation) by retaining corporate earnings indefinitely in the corporation); Bank, *supra* note 16, at 945 (arguing that capital lock-in is a more suitable explanation for the persistence of a separate corporate tax (and thus double taxation) because it was a necessary tool corporate managers used in their battle to protect capital lock-in against undistributed profits tax enacted in the late 1930’s).

165. Bank, *supra* note 16, at 938 n.293.

166. *Id.* at 941.

167. *General Revenue Revision*, *supra* note 52, at 2136–37 (statement of Clarence D. Laylin, Ohio Chamber of Commerce and the Council of State Chambers of Commerce) (claiming the purpose of the tax was to prevent lock-in, and stating: “[W]hile it is called a surtax, in fact it is and ought to be a penalty, designed primarily to restrain boards of directors from ‘preventing the imposition of the surtax upon [their] shareholders through the medium of permitting earnings or profits to accumulate instead of being divided or distributed.’” (quoting *Helvering v. Nat’l Grocer Co.*, 304 U.S. 282, 283 (1938))).

168. See *generally id.* at ix.

169. *Id.* at 2155 (statement of the United States Chamber of Commerce) (“This [AET] is particularly a problem for small businesses which are just getting started or trying to take advantage of opportunities to grow.”); *id.* at 2158 (statement of Addison B. Clohosey, Research Institute of America) (“The 102 statute [AET] is particularly burdensome to so-called smaller businesses.”).

Addison B. Clohosey, an attorney testifying on behalf of Research Institute of America, dramatized the effect of the AET on small business, stating “small corporations are [the AET’s] victims.”¹⁷⁰ Clarence D. Laylin underscored the psychological effect of the AET that “[struck] terror into the hearts of managers of small-business enterprises,”¹⁷¹ who urgently needed to maintain their internal funds but distributed their earnings out of fear of the AET. Laylin further avowed that “[i]t is this feature of the section which creates so much apprehension in the minds of managers of small and closely held corporations and may well deter them from reinvesting earnings so as to maintain a healthy growth.”¹⁷² When suggesting a 75-day grace period for all corporations to determine their ability to pay out dividends, Clarence Turner, a public accountant speaking on behalf of the Pennsylvania State Chamber of Commerce, noted that “a lot of small corporations take inventory once a year. So it is almost impossible to know exactly what the earnings will be until that inventory is taken at the close of the year.”¹⁷³

National corporate lobbies also used small business in their fight to repeal the AET. Ellsworth Alvord of the U.S. Chamber of Commerce advocated temporarily suspending the AET to permit small businesses to build up reserves for times of economic hardship.¹⁷⁴ Charles W. Stewart of the Machinery & Allied Products Institute, representing nationwide industrial manufacturers, warned that the AET had a depressing effect and especially penalized small firms¹⁷⁵ that are “subject to cyclical fluctuations in income and sales and are required to accumulate funds for sudden contingencies.”¹⁷⁶

170. *Id.* at 2158.

171. *Id.* at 2137. “It is this feature of the section which creates so much apprehension in the minds of managers of small and closely held corporations and may well deter them from reinvesting earnings so as to maintain a healthy growth.” *Id.* at 2137–38. “The effect of section 102 [AET] on corporate business in general, and particularly on small corporate business which is typically closely held, is probably more far reaching than any other single section of the Revenue Code.” *Id.* at 2141 (memorandum regarding proposed amendments to section 102 of the Internal Revenue Code).

172. *Id.* at 2137–38.

173. *Id.* at 2123–24 (statement of Clarence L. Turner, Certified Public Accountant, on behalf of the Pennsylvania State Chamber of Commerce).

174. *Id.* at 2151 (statement of Ellsworth C. Alvord).

175. *Id.* at 2134 (statement of Charles W. Stewart, Secretary, Machinery and Allied Products Institute) (“At the present time the section 102 [AET] penalty tax is levied on all undistributed income of the taxable year or years concerned regardless of the portion held to be unreasonably accumulated. Such a penalty is inappropriate and unnecessarily extreme.”).

176. *Id.* at 2126 (“American industry . . . and more especially small and medium-sized companies, must have a very substantial cushion to fall back on if they are to be continually mobilized for an emergency.”). Back in 1952, the Machinery and Allied Products Institute, published its recommendations titled “How to Improve Federal Tax Policy.” Referring to the issue of retained earnings, the institute stated

Although there was much unity among business groups on the need to repeal the AET, when it came to double taxation, opinions on the proper solution varied.¹⁷⁷ Yet again, many business trade and interest groups promoted their proposals by claiming that eliminating double taxation of corporate earnings would benefit small businesses.¹⁷⁸ For example, Charles E. Oakes, Chairman of the Edison Electric Institute Special Tax Policy Committee, an association of U.S. shareholder-owned electric companies, declared that “adequate supply of funds must be available from the savings of countless people for small business to grow and for all business to improve.”¹⁷⁹

Even though most small business corporations were not publicly traded, Keith Funston, president of the New York Stock Exchange, stated that double taxation made it very difficult for small business corporations to attract investors.¹⁸⁰ Although corporate profits had increased over the years, “it [was] only the big fellows,” through their ability to secure favorable lending terms, who could do this; in contrast, “[t]he little fellow, who is growing or expanding or starting a new venture, does not have established credit and he has to get somebody to come in and share with him the risk of that business.”¹⁸¹ As possible solutions to the double tax problem, he suggested granting a dividend income credit to individuals, dividend income exemption to corporations, or applying partnership tax treatment to corporations.¹⁸² This proposal, naturally, did not aim to benefit just small businesses, but in fact all corporations. Arguing on behalf of small business was good publicity, and was well used at that time by corporate lobbies.¹⁸³

The media recognized that business leaders were not lobbying for small business out of benevolence, but out of calculated self-interest. Newspapers

that corporate surpluses represented the main source of financing for small concerns, especially in times of economic stress. It recommended shifting the burden of proof regarding improper retention of earnings to the government. The next year, the Senate adopted this proposal and recommended Treasury to issue a set of criteria so small business owners could assess their risk properly. MACH. AND ALLIED PRODS. INST., *HOW TO IMPROVE FEDERAL TAX POLICY 20-22* (1952).

177. Some commerce organizations advocated for the elimination of double taxation as a way to repeal the AET claiming that integration will eventually remove the need to tax accumulated earnings in order to achieve tax symmetry. *General Revenue Revision, supra* note 52, at 2151-52 (statement of Commerce and Industry Association of New York).

178. *Id.* at 527 (statement of Charles E. Oakes, Chairman, Special Tax Policy Committee, Edison Electric Institute).

179. *Id.*

180. *Id.* at 480 (statement of G. Keith Funston, President, New York Stock Exchange).

181. *Id.* at 480-81.

182. *Id.* at 473.

183. MARK GREEN & ANDREW BUCHSBAUM, *THE CORPORATE LOBBIES: POLITICAL PROFILES OF THE BUSINESS ROUNDTABLE & THE CHAMBER OF COMMERCE* 29 (1980).

accused business groups of using small business organizations as their front.¹⁸⁴ They used small business arguments as a justification for their push to eliminate the accumulated earnings tax on corporations in order to preserve the lock-in of corporate assets and prevent the government from replacing their business judgment.¹⁸⁵ More specifically, they did not want anyone, including their shareholders and creditors, to interfere with their way of doing business. They were afraid the AET would bolster stockholders' suits, reveal business facts to competitors, and cause the loss of their company's prestige.¹⁸⁶

The United States Chamber of Commerce (USCC) standpoint on tax relief for small business was mixed. It blamed the economic distress of small business corporations on unfair double taxation.¹⁸⁷ However, unlike state chambers,¹⁸⁸ the USCC opposed applying partnership tax treatment to corporations on three grounds: First, the USCC said, it would be unconstitutional to tax shareholders on their unrealized corporate income;

184. *To Win Friends . . .*, *supra* note 130, at 17.

A lobbyist is paid to win friends—pick up luncheon checks, wangle World Series tickets, give cocktail parties—and thus to influence legislation. For such services, 256 organizations paid a record \$8,000,000 last year . . . other big spenders: . . . National Small Business Men's Association (which the House Small Business Committee charged last week is really a front for big business): \$192,070.

Id.; see also 4 "Small Business" Organizations Found "Fronts" for Other Purposes, N.Y. TIMES, Feb. 22, 1950, at 39. Senator Benton similarly remarked in one of the Senate committee hearings "that is more than I can say for some other so-called small-business organizations, scattered around the country, which I have occasionally found to be not as truly representative of the interests of smaller businessmen as their letterheads purport." *Tax Problems*, *supra* note 15, at 2.

185. Bank, *supra* note 16, at 893–94. However, there were some business organizations that did recommend the elimination of double taxation as a first step towards the repealing the AET. "The association has recommended gradual elimination of the double tax on corporate income. As the credits to the shareholders on the dividend income received by them would increase, the need for the pressure from section 102 [AET] to distribute dividends would decrease and eventually would be eliminated." *General Revenue Revision*, *supra* note 52, at 2151–52 (statement of Commerce and Industrial Association of New York).

186. *General Revenue Revision*, *supra* note 52, at 2141 (memorandum regarding proposed amendments to I.R.C. § 102).

187. *Id.* at 576 (statement of the United States Chamber of Commerce).

The small corporation and small-business man face a very serious problem in connection with this unfair double taxation. Most of the small corporations represent individual businessmen and their families who prefer for one reason or another to conduct their business activities in the form of a corporation rather than a partnership or a sole proprietorship.

Id.; see also *id.* at 578 (statement by Addison B. Cohosey, on behalf of Research Institute of America) ("The double taxation of dividends has, to our personal knowledge, been responsible for the sale of small business enterprises to larger companies.").

188. Membership of the national chamber was not required from the state chambers. Thus, in various occasions, state chambers differ in their opinions from the national chamber. GREEN & BUCHSBAUM, *supra* note 183, at 21.

second, it would be unfair for the majority of shareholders to impose partnership tax treatment on the minority of shareholders; and third, it would not be administratively possible to apply or allocate the tax in cases of large-scale enterprises with various shareholders or frequently traded stocks.¹⁸⁹ These types of USCC arguments were not unusual. Although the USCC included individual and corporate members of all sizes, its policy objected to favoritism of small business. While the interests of large and small firms often overlapped, when they were in conflict, the voice of large corporations at the United States Chamber of Commerce usually prevailed¹⁹⁰ due to the power large firms' representatives held at that time.¹⁹¹ The USCC's objection to partnership tax treatment also supports a lock-in theory motive; namely, that managers promoted legislation that allowed them to accumulate capital and to keep it locked in the corporation, free from shareholder and creditor pressure.¹⁹²

A similar national corporate lobbyist, the National Association of Manufacturers, appeared in the House hearings on the 1954 Code. Although its representatives did not refer to the proposal to grant special tax treatment to small businesses, in its statement regarding rates on smaller corporate income, the National Association of Manufacturers also objected to favoritism of small firms and rejected the increase of the surtax exemption or expanding the graduation of the corporate tax.¹⁹³

Most of the business community's recommendations in 1954 to alter the AET were rejected. Still, their lobbying succeeded in attracting political attention to small business interests, and both the Senate and House unanimously agreed that the existing federal tax structure acted as a deterrent to the growth and expansion of small businesses that were "vital to a sound competitive economy."¹⁹⁴ Against this background, Congress approached the

189. *General Revenue Revision*, *supra* note 52, at 576–77 (statement of the United States Chamber of Commerce). Administering the partnership tax treatment for corporations was also one of the concerns the National Tax Organization had when suggesting this treatment in 1939 and limiting it to corporations with ten shareholders or fewer: "A method that may without difficulty be applied to a partnership with a half-dozen beneficial owners is not so easily applied to a corporation with 100,000 beneficial owners." HAIG, *supra* note 103, at 347.

190. GREEN & BUCHSBAUM, *supra* note 183, at 25, 27.

191. *Id.* at 22–23, 29; DONALD R. HALL, COOPERATIVE LOBBYING: THE POWER OF PRESSURE 221–22, 224 (1969).

192. See Steven A. Bank, *Corporate Managers, Agency Costs, and the Rise of Double Taxation*, 44 WM. & MARY L. REV. 167, 202–03 (2002).

193. *General Revenue Revision*, *supra* note 52, at 1690 (Specific Recommendations from the Federal Tax Program of the Nat'l Ass'n of Mfr's.).

194. H.R. REP. NO. 83-1002, at 11 (1953).

enactment of the 1954 Code, but nevertheless eventually failed to permit partnership tax treatment for small business corporations.

IV. THE TRANSFORMATION OF TAX POLICY IN THE POLITICAL DEBATE

The rhetoric congressional representatives used at the time while debating small business tax relief reflected a change in the role of taxes in society. Realizing its potential to direct behavior, income tax became a critical policy issue, and tax reform focused on the tradeoffs between economic efficiency and tax equity.¹⁹⁵ For example, cutting taxes on small business was viewed as an anti-recession measure.¹⁹⁶ Most Republicans, whose public policy espoused minimal government intervention, advocated lowering the corporate tax burden and emphasized the negative effect of double taxation on investors. When discussing the 1954 Code, Congressman John W. Byrnes (R-Wis.) stated: "For a strong economy and for a healthier economy we need more shareholders."¹⁹⁷ At the same debate, Congressman Thomas E. Martin (R-Iowa) declared that corporate tax integration was not meant to benefit people who already owned stock, but to encourage more people to become stockholders.¹⁹⁸ When addressing the issue of small business, Congressman Victor A. Knox (R-Mich.) argued that the tax system should not be an obstacle to the dynamic growth of these concerns, as they are essential to the balanced economic development of the nation.¹⁹⁹ He added that section 102 [imposing AET] has "particularly affected small business . . . whose profits do not permit the immediate undertaking of a building or expansion program but require gradual accumulation for future needs . . ." ²⁰⁰ Indeed, tax policy became a central topic in political rhetoric, emphasizing its consequences on the American economy.

195. 100 CONG. REC. 3538 (statement of Rep. Philbin); see also WITTE, *supra* note 13, at 154.

196. Allen Drury, *House Group Asks 1.5 Billion Outlay to Help Jobless*, N.Y. TIMES, Apr. 22, 1958, at 1.

197. 100 CONG. REC. 3524 (1954) (statement of Rep. Byrnes).

198. *Id.* at 3550 (statement of Rep. Martin).

Double taxation of dividends on corporation stock causes many people to invest their funds in tax-exempt bonds rather than invest them as risk capital. It has also caused corporations to turn to bonded indebtedness rather than common stock to keep their business going even though heavily bonded indebtedness makes any business organization especially vulnerable to adversity when their continues operation is most important.

Id.

199. *Id.* at 3552 (statement of Rep. Knox).

200. *Id.* at 3553.

Opponents of the 1954 bill characterized it as a corporate give-away and a “rich man’s tax bill.”²⁰¹ Debating the bill on the floor, Congressman Sidney A. Fine (D-N.Y.) described the proposed dividend tax credit provision as “the most flagrant help-the-rich clause” and predicted that it would cost the government more than \$800 million.²⁰² Congressmen Fine and Harold Donohue (D-Mass.) described the efforts to reduce double taxation as part of the “trickle down” policy of Republican administrations that “seem to think they should concentrate on giving every possible advantage to those few at the top of our economic structure, so that some benefits can then trickle down to the rest of the people.”²⁰³ The minority report on the House bill criticized the bill’s focus on reducing taxes for businesses, primarily corporations, instead of focusing on granting individuals tax relief that would increase their purchasing power.²⁰⁴ The minority report claimed that the bill made a fundamental change in the nation’s tax philosophy by reversing the ability-to-pay principle of taxation and giving an advantage to unearned income over earned income.²⁰⁵

At that time, “[a]lmost everybody agreed that taxes should be cut,” “[b]ut almost nobody agree[d] on what taxes should be cut first.”²⁰⁶ When it came to the final moment of enactment, the 1954 bill contained some major compromises.²⁰⁷ The high political pressure resulted in giving priority to individual income tax breaks over major business tax cuts.²⁰⁸ The 1954 Code

201. *Id.* at 3543 (statement of Rep. Fine). He also claimed that the bill would grant corporations tax benefits of \$619 million in fiscal 1955 alone. *Id.* Congressman Vursell contested that “minority leaders pull out that old shopworn scarecrow by calling this a rich man’s tax bill. Of course, nothing could be further from the truth.” *Id.* at 3532 (statement of Rep. Vursell); see also WITTE, *supra* note 13, at 149.

202. 100 CONG. REC. 3543 (1954) (statement of Rep. Fine). For the anti-business atmosphere in Congress, see *Business & Congress: The Bark Was Worse than the Bite*, TIME, Aug. 15, 1955, at 68 [hereinafter *Business & Congress*].

203. 100 CONG. REC. 3543 (1954) (statement of Rep. Fine); see also *id.* (statement of Rep. Donohue).

204. *Id.* at 3530 (statement of Rep. Rabaut).

What we do need is a tax measure that will increase the purchasing power of those who will spend their money and that means the millions and millions of Americans in the lower-income brackets, because purchasing power is the only economic force that will increase sales, reduce inventories, increase orders to wholesalers and manufacturers, and then, increase production, payrolls, and jobs. *Id.*; see also H.R. REP. NO. 83-1337, at B1 (1954); 100 CONG. REC. 3521 (1954) (statement of Rep. Angell). Congressman Homer was one of few republicans who objected to granting dividend relief and siding with Democrats on the more important need to increase individual exemptions for low income families. H.R. REP. NO. 83-1337, at B1.

205. H.R. REP. NO. 83-1337, at B7.

206. *Priorities*, TIME, May 16, 1955, at 23, 23.

207. John D. Morris, *Child-Care Credit on Taxes Favored*, N.Y. TIMES, July 17, 1954, at 6.

208. *Priorities*, *supra* note 206, at 23.

provided benefits to a wide range of groups and individuals,²⁰⁹ and though small businessmen believed it would be the panacea for their economic difficulties, they, in fact, received very little relief. In the Conference Committee, the House surprisingly struck the part of Subchapter R that allowed small corporations to choose their tax status.²¹⁰ Yet, it left intact the part allowing unincorporated businesses to choose to be taxed as corporations due to pressure from high-bracket southern businessmen.²¹¹ William L. Cary, a Columbia University law professor who was later appointed Chairman of the U.S. Securities and Exchange Commission, aptly described this episode as “putting the cart before the horse” stating that “two provisions linked together by the President and Senate were separated, and only the minor one—benefiting a handful—was ultimately enacted.”²¹²

Although the reasons for the deletion were not discussed publicly, it is safe to speculate that lawmakers wanted to avoid being seen as passing a “rich men’s tax bill.” Furthermore, Democrats described certain provisions as the Republicans’ way of thanking their business supporters:

Everyone knows that the election of 1952 broke all records in the amount of money spent by the Republicans . . . Everyone knows that is the reason for the present give-away policy. The administration unfortunately must keep faith with the \$13 billion corporations that put up most of the purchase price of the 1952 election . . . The commitments they made in order to get the cash for the campaign cannot be ignored.²¹³

Later on, the Democratic National Committee echoed the claims of “[t]ax favoritism for the rich” in their digest, stating: “For every dollar of tax relief to stockholders, the Eisenhower Administration felt we could only ‘afford’ to

209. WITTE, *supra* note 13, at 146; Morris, *supra* note 207, at 6.

210. H.R. REP. NO. 83-2543, at 72 (1954) (Conf. Rep.).

211. Subchapter R of the 1954 Revenue Code contained a new § 1361 that allowed proprietorships and partnerships to elect to be taxed as corporations under certain conditions. Internal Revenue Code of 1954, Pub. L. No. 83-591, § 1361, 68A Stat. 3, 350 (1954). Stanley S. Surrey described § 1361 as “a complicated provision with many problems unsolved, which permits a proprietorship or partnership to elect corporate tax treatment, apparently received its main impetus and perhaps the only real reason for its existence from the situation of a particular Georgia partnership.” Surrey, *supra* note 155, at 1149 n.4. William Cary also stated that

a new case of congressional generosity in the 1954 Code seems tailored to the needs of certain commission merchants in the South. Whether by custom or rules of trade, a few of them are required to do business as partnerships although for tax purposes their preference would be in favor of operating in the corporate form.

Cary, *supra* note 155, at 750; see also Judson A. Crane, *Election of Certain Small Business Corporations as to Income Tax Status*, 10 HASTINGS L.J. 271, 271 n.3 (1958).

212. Cary, *supra* note 155, at 750.

213. 100 CONG. REC. 3536 (1954) (statement of Rep. O’Hara).

give less than a nickel to working mothers, a little over a penny to families with foster children, less than a dime to families with heavy medical expenses.”²¹⁴ Indeed, this anti-business atmosphere did not facilitate enacting tax relief for small business corporations.

Some Congressmen associated partnerships’ income as part of individuals’ earned income whereas classifying small corporations’ income as business investment income.²¹⁵ While debating the double taxation of closely held corporations on the House floor, Congressman Barratt O’Hara (D-Ill.) considered small businesses as not affecting the economy of the nation.²¹⁶ He remarked that the corporate form of business is, by choice, aimed to achieve maximum capital gain or to avoid personal liability in case of loss.²¹⁷ O’Hara also expressed his concern that salaries of those in control of small corporations were deductible expenses and could be manipulated to take the form of dividends, if dividends were taxed less or none at all.²¹⁸ But not all Democrats regarded small businesses as rich men’s firms. Congressman Philip J. Philbin, (D-Mass.), noted that “[t]he American people have long staggered under oppressive burdens of taxation The well-to-do classes were taxed almost to the point of confiscation. The small business groups were mulcted and sacked I think these people are entitled to relief.”²¹⁹

Such rhetoric illustrates Congress’s confusion about which small business corporations would elect partnership tax treatment. It was not clear from the bill how the convoluted partnership tax would apply in practice to small corporations. Some associated Subchapter R with favoritism to businesses, due to the attention it received from managers and business groups, who aimed

214. *Ten for the Show*, TIME, Jan. 2, 1956, at 12, 12–13.

215. 100 CONG. REC. 3537 (1954) (statement of Rep. O’Hara).

216. *Id.*

217. *Id.*

218. Rep. O’Hara received a letter from Joseph F. Grossman, which was excerpted on the floor: [T]he salaries of those in control of small corporations as well as widely held corporations are deductible expenses in computing the corporate tax and if dividends are taxed less than other income there may be a shift in the small corporations from taking earnings in the form of salaries to the form of dividends.

Id.

219. *Id.* at 3538 (statement of Rep. Philbin). Stanley Surrey criticized this kind of Congressional rhetoric, writing that:

Any argument for relief which starts off by stating that these high rates are working a “special hardship” in a particular case or are “penalizing” a particular taxpayer—to use some words from the tax lobbyist’s approved list of effective phrases—has the initial advantage of having a sympathetic listener.

Surrey, *supra* note 155, at 1150.

at eliminating the AET.²²⁰ The reported antipathy of Democrats toward large conglomerates did not facilitate the enactment of tax measures in small businesses' favor.²²¹

Budgetary effects, complexity, and administrative difficulties were also reasons Congress gave for rejecting partnership tax treatment for small corporations.²²² Additionally, massive Cold War defense spending increased pressure on the government to step up the already high rates of taxation.²²³ The government opposed any tax changes involving more than a "minimum" revenue loss, whereas this bill was expected to incur a substantial deficit without any promise of increased federal revenue in return.²²⁴ Specifically, it was estimated that allowing corporations to elect partnership tax treatment would have cost the government \$50 million a year, an expensive direct tax cut that would have been difficult to offset at that time.²²⁵ Since 92.5% of

220. This was a time when even government agencies and trade organizations were attacked for representing private business interests:

Favoritism to big business . . . Government agencies have been put in the hands of businessmen. The Federal Power Commission includes two men who formerly represented private utilities; the National Labor Relations Board includes two lawyers who formerly represented management in cases before the NLRB as well as a former Taft assistant who helped push the Taft-Hartley law through Congress; the Securities and Exchange Commission includes two former stockbrokers, a former investment banker, and two lawyers whose firms represent major brokerage houses; the Federal Trade Commission's first G.O.P. chairman formerly represented companies in price-discrimination brought by the FTC.

Ten for the Show, *supra* note 214, at 12; *see also Business & Congress*, *supra* note 202, at 68 ("Kefauver repeatedly railed against 'conflict of interest,' thus helped the Democratic campaign to require businessmen serving without compensation in the Government to list in the Federal Register the names of all corporations or partnerships in which they own shares.").

221. "[O]n Capitol Hill, particularly after the U.S. elected a Democratic-controlled Congress last fall, there has been a barrage of anti-business talk." Although later the author acknowledged that there no active steps against business were taken: "for all the anti-business talk, not much came of it . . . Nor did Congress pass any law punitive to business" as "the U.S. was in no mood to harass its businessmen." *Business & Congress*, *supra* note 202, at 68.

222. *Internal Revenue Code of 1954*, *supra* note 111, at 1251 (statement of Malon C. Courts, Courts & Company) ("I understand that some objections have been made based upon the technical difficulties of adapting such provisions to the new code."). On the floor, Wilbur Mills declared: "I fear that taxpayers are going to find so many rules, limitations, and qualifications, that it will be practically impossible for them to intelligently fill out a tax return." 100 CONG. REC. 3527 (1954).

223. JULIAN E. ZELIZER, *TAXING AMERICA: WILBUR D. MILLS, CONGRESS AND THE STATE, 1945-1975*, at 86-87 (1998).

224. It was estimated that allowing corporations the option to elect to be taxed as partnership will reduce revenues in the fiscal year 1955 by \$50 million, while it was estimated that the election for partnerships would decrease revenue in fiscal 1955 only by \$20 million due to the high-bracket individuals who would choose to organize their business income in the corporate form. *See* S. REP. NO. 83-1622, at 4752-53 (1954); *see also* ZELIZER, *supra* note 223, at 93.

225. *Tax Relief*, *supra* note 37, at 106; *see* S. REP. NO. 83-1622, at 4752. This estimated loss would

businesses were unincorporated at that time,²²⁶ such tax relief was perceived by the legislature as individual tax relief and not a business tax cut.²²⁷

Although the small corporation flow-through treatment was not enacted as part of the 1954 Code, the new Code did include other small business tax benefits.²²⁸ The Code extended the period in which estate taxes were due²²⁹ and gave the IRS the discretion to allow installment payments.²³⁰ It also provided for a more liberal depreciation policy²³¹ and alleviated the tax on accumulated earnings of small businesses.²³²

When referring to the enactment of the 1954 Code, scholars and commentators stated that it was apparent that “[i]nterest groups left their footprints all over the legislation, which contained \$1.5 billion in new tax breaks.”²³³ Although Congress’s declared purpose in enacting the Internal Revenue Code of 1954 was to remove inequities, in fact, it created new imbalances.²³⁴ For example, Congress left the details of Subchapter R to the Treasury, but four years later, Treasury had not yet promulgated regulations

have occurred since fifty-nine percent of all corporations were corporations with assets of \$100,000 or less, that would likely have chosen partnership tax treatment. In 1953, the total number of corporate tax returns was 640,073, from which 377,639 were corporate tax returns with total assets of \$100,000 or less. BUREAU OF CENSUS, *supra* note 84, at Series V 182–96.

226. In 1953, the total number of business enterprises was 9,371, from which 8,674 were partnerships and proprietorships. The total net profits, less losses of all business enterprises that year were \$64 billion, from which \$25 was from partnerships and proprietorships. BUREAU OF CENSUS, U.S. DEP’T OF COMMERCE, HISTORICAL STATISTICS OF THE UNITED STATES: COLONIAL TIMES TO 1970: PROPRIETORSHIPS, PARTNERSHIPS, AND CORPORATIONS: NUMBER, RECEIPTS, AND PROFITS: 1939 TO 1970, Series V 1–12 (1975).

227. S. REP. NO. 83-1622, at 89 (“[T]he partnership form of organization is much more commonly employed by small businesses and in farming operations than the corporate form.”).

228. As for general business tax breaks, the 1954 Code lowered the normal corporate tax rate from thirty percent to twenty-five percent and included a dividend relief for the first fifty dollars of dividend income and one-hundred dollars excludable dividend in subsequent taxable years. I.R.C. § 116 (1954). In addition, § 34 provided for a five percent dividend-received credit for part of the corporate tax paid on the dividends in excess of the amount excluded. *See* S. REP. NO. 83-1622, at 5–6.

229. The estate tax due period was extended from five to ten years. I.R.C. § 6161(a)(2)(B) (1954).

230. *Id.*

231. *Id.* § 167(a).

232. It shifted the burden of proof to the Government, added clarification of criteria for application of the penalty tax and provided a minimum amount that would not be subject to the AET. S. REP. NO. 83-1622, at 68–72.

233. ZELIZER, *supra* note 223, at 93; *see also* HANSEN, *supra* note 14, at 105 (arguing that tax revenues were misused to political advantage as “Christmas tree” bills to confer benefits on many social groups.); Cary, *supra* note 155, at 750; Surrey, *supra* note 155, at 1149.

234. Wilbur Mills stated on the House floor: “How can you justify reducing on individuals’ tax under this bill by over \$10,000 and declining to reduce the tax of another by \$120 Are we so blind to fairness, are we so blind to understanding” ZELIZER, *supra* note 223, at 94 n.39.

filling in those details.²³⁵ Since a partnership's election to apply corporate tax treatment was irrevocable, tax consultants and their clients were reluctant to make this choice and set up a new bookkeeping system until they had the opportunity to see the final regulations.²³⁶ The paradox was that years later in 1957, Congress sought to repeal Subchapter R, for it had not been effectively used. A measure intended by Congress to benefit small businesses was rendered useless by the failure of the Treasury to issue regulations.²³⁷

Nevertheless, nationwide efforts to aid small business continued.²³⁸ In the field of outside financing, newspapers reported that the SBA and bankers improved their loan policy by increasing their lending to small businesses.²³⁹ In 1956, the Democratic Party critiqued the Republicans for "scrap[ping] the Reconstruction Finance Corporation" which had lent money to small businesses at a lower interest rate.²⁴⁰ As for training options, the American Management Association and the SBA developed educational programs and offered various courses in colleges and universities nationwide designed solely for small business executives.²⁴¹ Time Magazine reported that those programs reinstated the confidence in small business leaders "that they can outperform,

235. Crane, *supra* note 211, at 271 n.3.

236. "The extent to which [section 1361] makes it unnecessary to incorporate to obtain full tax advantages is not altogether clear." Edward M. Ford, Jr., *Rights of the Minority Shareholders to Dissolve the Closely Held Corporation*, 43 CAL. L. REV. 514, 515 n.3 (1955); see also Robert S. Ashby & Albert L. Rabb, Jr., *Suggestions for the Drafting of Partnership Agreements Under the 1954 Internal Revenue Code*, 10 BUS. LAW. 29, 41 (1955) ("[a]ny such retroactive election would, however, involve difficulties as yet unsolved by the statute or regulations. For example, there is a question whether the retroactive election would involve payment of penalties because of failure to make timely payments of estimated corporate income tax."); Wallace M. Jensen, *Elections To Be Taxed as a Corporation or as an Unincorporated Business*, 13 INST. ON FED. TAX 'N 1029, 1051 (1955).

237. S. REP. NO. 85-1237, at 19 (1958); *Washington Tax Talk*, 36 TAXES 454, 455 (1958) ("[A] section enacted by Congress for the benefit of small business has been rendered useless by the failure of the Treasury to issue regulations."); *Tax Report, A Special Summary and Forecast of Federal and State Tax Developments*, WALL ST. J., Apr. 3, 1957, at 1 ("Sen. Byrd also wants to know why the Treasury hasn't yet issued regulations under the 1954 Code which would give partnerships or individual proprietorships an option to elect to be taxed as a corporation.").

238. "The biggest and most justified complain of small businessmen is that the present revenue law, which taxes all corporate income profits over \$25,000 at the same rate, keeps the small enterprise from growing and competing with big business." *Needed: Talent, Training & Tax Cuts*, *supra* note 52, at 98.

239. *Id.*

Small-Business Loans will be speeded up by Small Business Administration to ease tight-money squeeze. S.B.A. now will allow its 15 regional directors-to approve credit up to \$100,000 (v. \$50,000 limit before), provided private banks put up 25% of the credit. Administration expects record 700 loan applications in October v. previous peak of 514 last June.

Time Clock, TIME, Oct. 29, 1956, at 89, 89.

240. *Ten for the Show*, *supra* note 214, at 12-13.

241. *Needed: Talent, Training & Tax Cuts*, *supra* note 52, at 98.

even outgrow the biggest companies in the U.S. As one vice-president said at a small-business seminar in Manhattan last week: My company's bigger now than G.M. was 40 years ago."²⁴² Various tax cuts were proposed to ease the tax burden on small businesses, but were eventually defeated.²⁴³ It was members of the Senate Finance Committee and the House Ways and Means Committee, such as Wilbur Mills, who finally brought to fruition the attempts to create elective flow-through tax treatment for small business.

V. THE MILLS BILL

The ways of Congress probably are more predictable than is a slot machine. But there are times, it must be admitted, when there is a certain tantalizing resemblance.²⁴⁴

The phrase "Mills Bill" was coined by Congress and widely used to describe the Technical Amendments Act of 1958.²⁴⁵ This was no coincidence. Acts were named after political elites who proposed the legislation and advocated its passing.²⁴⁶ In our story, one such elite was Wilbur Mills, Chairman of the House Ways and Means Committee between 1957 and 1975.

In reporting Arkansas Democratic Representative Wilbur D. Mills's appointment to the chairmanship of the House Ways and Means Committee, *Time* magazine described him as the spokesman for low-income groups and small business.²⁴⁷ A biographer of Mills's life remarked: "Wilbur Mills'

242. *Id.* Not surprisingly, big businesses opposed some of the small business tax cuts claiming those amendments would not serve the interests of small or any size business and those proposals should be delayed until a general tax would be instated. *Tax Relief Fought by Business Aides*, N.Y. TIMES, Mar. 23, 1957, at 38.

243. *Roll-Call Vote in Senate on Small Business Tax*, N.Y. TIMES, Mar. 28, 1957, at 16.

244. Richard Rutter, *Small Business Hits the Jackpot*, N.Y. TIMES, Aug. 17, 1958, at F1.

245. *Washington Tax Talk*, 36 TAXES 669, 669 (1958).

246. Other Senators and Representatives were instrumental in passing small business tax relief too. For example, Senator Kerr (D-OK) promoted small business interests through "the Kerr Amendment" to H.R. 8381. H.R. 13382, 85th Cong. (1958). Senator John J. Sparkman (D-Ala.) succeeded Edward J. Thye (R-Minn.) as Chairman of the Select Committee on Small Business and served between 1955 and 1967. Senators Thye and Sparkman co-sponsored the Small Business Tax Bill (S. 3194) that reinstated the Select Committee's recommendation to alleviate the tax burden of closely held small business corporations in the 1958 bill, and acted to promote the bill in the Senate. 104 CONG. REC. 5018-19 (1958) (statement of Sens. Neuberger and Hoblitzell), Other sponsors of S. 3194 were Senators Humphrey, Morse, Bible, Proxmire, Saltonstall, Goldwater, Kuchel, Javits, Hoblitzell, Yarborough, Payne, Ives, Flanders, Watkins, and Allott. 104 CONG. REC. 17075 (1958) (statement of Sen. Morse). Another group of six Republican members of the House Small Business Committee introduced legislation calling for substantial tax relief for small firms with incomes under \$150,000 a year, with a Subchapter S-like provision. 104 CONG. REC. 14479-80 (1958) (statement of Rep. Hill).

247. *One More for Arkansas*, TIME, Dec. 30, 1957, at 14, 14.

actions as White County judge during the Depression years may reflect his public philosophy and personal views even more clearly than his years in congress,” and “Mills’ actions reflect the challenges of grassroots politics in a poor, rural county during the Depression”²⁴⁸

Born in Kensett, a small railroad town in Arkansas with nearly 1,000 residents,²⁴⁹ Mills experienced small business operations daily. His father, Ardra, was a small businessman who operated a general store, a cotton gin and a community bank.²⁵⁰ After leaving Harvard Law School, Mills took over the businesses and managed both the Bank of Kensett, and the A. P. Mills general store.²⁵¹ In 1934, Mills was elected White County’s probate judge after campaigning with the slogan “Give a Young Man a Chance.”²⁵² During his term, he brought this heavily indebted and unemployed county to a positive balance. In this position, Mills changed the salary system of county employees, made innovations in the procurement of county supplies, secured federal and state aid during the New Deal, and supported private efforts to promote economic development.²⁵³ Mills surmounted the consequences of the Depression in his county and gained firsthand knowledge of small-scale fiscal management, which he later employed in Congress. After being elected to Congress, “[t]o stay in close touch with the people of his county, Mills visited all the country stores in White County on a regular basis”²⁵⁴ and learned about their daily struggles.

In December 1957, after the sudden death of his predecessor,²⁵⁵ Mills stepped into the powerful position of chairman of the House Ways and Means Committee, where he remained for 20 years, longer than any other person in U.S. history.²⁵⁶ After apprenticing with House Speaker Sam Rayburn and specializing in tax matters, Mills became the leader of the committee in charge of writing tax legislation and the authority on tax policy in Congress, wielding

248. Goss, *supra* note 18, at 200.

249. *Id.* at 186.

250. *Id.*

251. Goss, *supra* note 20, at 193; *see also* Goss, *supra* note 18, at 186.

252. Goss, *supra* note 18, at 190.

253. *Id.* at 194–95. As White county’s primary economic activity was agriculture, Mills formed the White County Livestock Commission Company that conducted annual livestock show, weekly sales and “dollar days sales.” Mills also supported the formation of White County Industrial Club and adult education programs. *Id.* at 195–96.

254. *Id.* at 199–200.

255. “Chairman Jere Cooper died in December 1957 [leaving] Mills as the second-ranking majority member of the committee.” Kay C. Goss, *Congressman Wilbur D. Mills’ Influence on Social Legislation*, 54 ARK. HIST. Q. 1, 1 (1995).

256. *Id.*; Goss, *supra* note 20, at 193.

great influence over the nation's tax system.²⁵⁷ He became knowledgeable about his committee work and memorized social security law and the tax code.²⁵⁸ He mastered his chairmanship by learning "the importance of tailoring bills so that they would be likely to receive a solid House majority."²⁵⁹ To this end, Mills worked closely with the business sector, the media, academics and the legislature.²⁶⁰ He usually "took legislation to the floor under a 'closed' rule" to limit opposition, personally presented legislation to the House, and offered an organized and convincing summary of his proposals.²⁶¹ "His skills of persuasion were such that he could change members' votes on the very day of a vote by the eloquence of his presentation."²⁶²

In his book, *Taxing America: Wilbur D. Mills, Congress and the State, 1945–1975*, historian Julian Zelizer wrote about Mills's influence on the nation's tax policy between 1945 and 1975.²⁶³ He claimed that during those years, Congress influenced tax policies through the decentralized committee system, which provided an isolated arena in which representatives from both parties could achieve difficult compromises without public scrutiny.²⁶⁴ In the twentieth century, this committee system dramatically enhanced the power of the representatives who chaired committees.²⁶⁵

Zelizer attributes much of the shift in the postwar nation's tax policy during that period—from a revenue-raising device to a government tool to manage economic growth—to Mills's leadership.²⁶⁶ During this transformation, Congress began to realize its power to affect economic stimulus via tax legislation as well as the important role of tax reform. Mills

257. Goss, *supra* note 20, at 194; ZELIZER, *supra* note 223, at 33–35.

258. Goss, *supra* note 20, at 194.

259. ZELIZER, *supra* note 223, at 34.

260. *Id.* at 8–9 (noting that the members of this tax community included "political party officials, leaders and experts from umbrella business and financial associations (such as the Chamber of Commerce), staff members of the executive and congressional branch, bureaucrats and administrators, university professors, independent specialists, editors, and writers of the specialized policy media, and participants in think tanks.").

261. Goss, *supra* note 20, at 194.

262. *Id.*

263. ZELIZER, *supra* note 223, at 8–9. For a similar account of his influence on public policy, see Goss, *supra* note 255, at 1; Goss, *supra* note 18, at 186.

264. ZELIZER, *supra* note 223, at 7.

265. For instance, chairmen of the House committees "maintained authority over committee staffs, they created and dismantled subcommittees, they controlled the committee agenda and parliamentary procedure, they scheduled committee proceedings and they served as the floor managers for committee bills." *Id.*

266. *Id.* at 12; see also BROWNLEE, *supra* note 63, at 110; HANSEN, *supra* note 14, at 61.

believed that only by incremental reform could Congress achieve true “horizontal equity,” or equal treatment of those with equal incomes,²⁶⁷ including the income of different types of small business concerns. Starting in 1955, Mills initiated congressional hearings that promoted this concept.²⁶⁸

After the enactment of the 1954 Code, small business arguments continued to be used in political rhetoric.²⁶⁹ Newspapers reported that a political consensus seemed to emerge that “tax relief for small businessmen was long overdue[,] and both parties pledged to ease the tax burden on small business at the next session of Congress.”²⁷⁰ The Committee for Economic Development, an organization formed by top businessmen in 1942 devoted to industrial planning and economic research,²⁷¹ published its recommendation to lower tax rates to facilitate outside financing of small businesses.²⁷² In November 1956, the House Ways and Means Subcommittee on Internal Revenue Taxation conducted studies on existing unintended benefits and technical problems in the 1954 Code, among them, small business taxation.²⁷³ California’s state assembly publicly called on Congress to provide tax relief for “small and independent businesses.”²⁷⁴ Politicians echoed this notion, stating that “[e]very single barometer indicates a general worsening of conditions for smaller firms. Time is running out for the small businessman.”²⁷⁵

The election of the 85th Congress in 1957 continued to reflect the shift in the nation’s focus from issues of defense to economic policy and the role of

267. ZELIZER, *supra* note 223, at 15.

268. *Id.*

269. “Small Business has always been regarded as something you had to be for, like honesty or the American flag, but this year it seems Democrats and Republicans alike are hugging small business tighter than ever.” Lester Tanzer, *Small Business*, WALL ST. J., Feb. 28, 1956, at 1 (quoting an unnamed Congressman); *see also Something for the Boys*, *supra* note 107, at 85 (“[T]he President was apparently determined to show that he was a better friend of small business.”).

270. *Needed: Talent, Training & Tax Cuts*, *supra* note 52, at 98. *But see Fulbright Assails GOP on Small Business Relief*, L.A. TIMES, Oct. 1, 1956, at 18.

271. JAMES Q. WILSON, POLITICAL ORGANIZATIONS 163 (1973).

272. *Priorities*, *supra* note 206, at 23.

273. 104 CONG. REC. 1034 (1958) (statement of Rep. Mills).

Work toward this bill begun in July of 1956, when the Committee on Ways and Means established the Subcommittee on Internal Revenue Taxation, of which I served as chairman The subcommittee held public hearings in November of 1956. The hearings have been published and cover some 500 pages of testimony and statements. In addition, both the subcommittee and the Committee on Ways and Means have spent many in executive session studying these problems before reporting out H.R. 8381.

Id.

274. *Tax on Small Business Hit by Assembly*, L.A. TIMES, June 3, 1957, at 12.

275. *Tax Relief*, *supra* note 37, at 106.

tax policy in shaping the national economy.²⁷⁶ But this time, the one issue Republicans and Democrats appeared united on was the immediate need to aid small businesses.²⁷⁷ Each party declared that it would alleviate the tax burden on small businessmen. In the Democratic platform, the party promised “tax relief for all small and independent businesses by fair and equitable adjustments in Federal taxation which will encourage business expansion and to apply the principle of graduated taxation realistically to such corporate income.”²⁷⁸ Supporting the re-election of President Dwight Eisenhower, the Republicans vowed: “We pledge the continuation and improvement of our drive to aid small business [in] [e]very constructive potential avenue of improvement—both legislative and executive . . . Small business can look forward to expanded participation in Federal procurement . . . and certain tax reductions as budgetary requirements permit.”²⁷⁹

On the floor of Congress and in the newspapers, legislators expressed their support for a bill to relieve the tax burden on small businessmen.²⁸⁰ Senator Thomas H. Kuchel (R-Cal.), stated that Congress was interested in helping all small business units—be they corporations, partnerships or individuals—and that legislation should assist “small-business men, regardless of the type of structure legally under which he carries on his trade or occupation.”²⁸¹ Referring to the tax burden of small businesses, Senator Barry Goldwater (R-Ariz.) declared: “I think that small-business men across the Nation will agree pretty much that if they were allowed to keep more of the

276. See *From Lag to Sag*, TIME, Feb. 17, 1958, at 25.

As Democratic chieftains in the Senate saw it last week, their party's Big Issue for this fall's congressional elections will no longer be the missile lag but the economic sag. The shift from lag to sag was evident both in dark grey oratory on the Senate floor and in busy bill-drafting off the floor.

Id.

277. See Karl R. Price, *The Small Business Tax Revision of 1958*, 14 BUS. LAW. 329, 329 (1959); 3 *In Hearing Back Small Business: Congress Members Support Tax Relief Before Senate Committee Session Here*, N.Y. TIMES, Oct. 3, 1957, at 24.

278. *Text of the Democratic Platform Adopted by Voice Vote by the Convention Delegates*, N.Y. TIMES, Aug. 16, 1956, at 12.

279. *Text of the Republican Platform as Adopted by the Party's National Convention*, N.Y. TIMES, Aug. 22, 1956, at 16.

280. *Conferees Agree on Tax Measures*, N.Y. TIMES, Aug. 14, 1958, at 35; *Senate Approves Major Tax Bills: Acts to Aid Small Business, Ease Theatre Ticket Levy, Close Loopholes in Code*, N.Y. TIMES, Aug. 13, 1958, at 16; *Small Business Backed: Thye Urges President's Group to Ask Tax Relief*, N.Y. TIMES, Dec. 23, 1957, at 15; *Thye Urges Tax Cut: Bids Senate Unit Push Relief for Small Business*, N.Y. TIMES, Dec. 17, 1957, at 64; C.P. Trussell, *Senate Bill Would Give Tax Help to Nation's Small Business Men*, N.Y. TIMES, Jan. 31, 1958, at 27; *U.S. Asked to Aid Small Business: Head of American Exchange Suggests New Type of Investment Trust*, N.Y. TIMES, Nov. 23, 1957, at 33.

281. *Tax Problems*, *supra* note 15, at 3.

money that they earned, that small business would not be in difficulties that they find themselves in today.”²⁸²

The state of small business was a large part of the agenda for congressional committees, who, along with others, argued that “[t]he welfare of small companies is a key condition for prosperity.”²⁸³ The Senate Select Committee on Small Business conducted a second round of hearings in 14 cities on the impact of federal taxation on small businesses and afterward declared: “There is a real need to permit all business the same opportunity under our taxing system.”²⁸⁴ It reviewed 163 written testimonies and heard from more than 500 people representing small businessmen, economists, attorneys, professors, bankers and accountants, in order to get a comprehensive picture of the problems facing independent small business and to develop a plan to relieve them from any unfair tax.²⁸⁵ This increasing interest in small business also resulted from high small business failures that reached its postwar peak in those years.

In 1957, the American economy suffered another period of recession, which was attributed to overproduction by large industrial firms in prior years²⁸⁶ and a series of natural disasters.²⁸⁷ In October 1957, prices on the New York Stock Exchange fell sharply, industrial production dropped, and consumer prices rose to record levels. By mid-1958, unemployment had risen to 7.5%,²⁸⁸ and business failures reached their highest rate since 1940 in that year.²⁸⁹ Small businesses accounted for most of the 1,100 business failures a month that can be seen in Chart 1, and more than 50% of those failures were

282. *Id.*

283. *Needed: Talent, Training & Tax Cuts*, *supra* note 52, at 98 (“The demands of some 4,000,000 other small operators for a bigger share of the nation’s business are being pushed by twelve congressional committees and Government agencies, dozens of politicians and economists who argue that the welfare of small companies is a key condition for prosperity.”).

284. S. REP. NO. 85-1237, at 4 (1958). The hearings included Phoenix, Los Angeles, San Francisco, Boston, New York City, Miami, Chicago, Minneapolis and Portland. *See Tax Problems*, *supra* note 15.

285. *Tax Problems*, *supra* note 15, at iii–vii.

286. Arthur F. Burns, *The Current Business Recession*, 31 J. OF BUS. 145, 145–46 (1958).

287. In 1955 and 1956, a series of natural disasters aggravated the economic condition of small businesses. Hurricanes hit the Atlantic Coast and heavy rains fell on the West Coast, causing severe floods and destruction. *See generally* Gordon E. Dunn et al., *Hurricanes of 1955*, 83 MONTHLY WEATHER REV. 315 (1955).

288. Bureau of Labor Statistics, U.S. Dep’t of Labor, *Civilian Unemployment Rate* (2008), <http://research.stlouisfed.org/fred2/data/UNRATE.txt> (last visited, Sept. 15, 2008).

289. Business failures in 1956 reached fifty-two per 10,000 (the highest rate since 1940) and that year, profits of manufacturers worth less than \$1,000,000 represented just 4.7% of U.S. manufacturers’ total earnings, down from 13.8% in 1947. *Needed: Talent, Training & Tax Cuts*, *supra* note 52, at 98.

of business under five years old.²⁹⁰ A *Time* article warned that “the newest figures on small business are cause for some alarm.”²⁹¹

Chart 1
Number of Business Failures 1950-1960²⁹²

<u>Year</u>	<u>Number</u>	<u>Per 10,000</u>
1950	9162	34
1951	8058	31
1952	7611	29
1953	8862	33
1954	11086	42
1955	10969	42
1956	12686	48
1957	13739	52
1958	14964	56
1959	14053	52
1960	15445	57

These economic conditions spurred government action to help boost the economy. Redressing the financial hardships of small businesses and improving their condition became the subject of public debate. Small business witnesses appearing before specialized tax committees expressed a forlorn and almost hopeless situation.²⁹³ Small businessmen testified that in order to pay taxes, many small businesses were abstaining from distributing dividends, and small businesses had to borrow funds to purchase equipment and continue operations.²⁹⁴ In addition to acting as a disincentive for business expansion,

290. *Keeping the Records Straight*, *TIME*, Aug. 20, 1956, at 82, 82.

291. *Needed: Talent, Training & Tax Cuts*, *supra* note 52, at 98.

292. Richard Sutch, *Business Incorporations and Failures—Numbers and Liabilities: 1857–1998 Table Ch408–413*, in *HISTORICAL STATISTICS OF THE UNITED STATES, EARLIEST TIMES TO THE PRESENT: MILLENNIAL EDITION Ch408–413* (Susan B. Carter et al. eds., 2006).

293. See Richard Sanzo, *Small Business: Alive and Not Kicking*, *MGMT. REV.*, Dec. 1957, at 30, 30 (“[I]s small business really thinking of cashing in its chips—or is it staking them hopefully on the future?”); *The ‘Little Fellow,’* *N.Y. TIMES*, Jan. 2, 1957, at 97; *Tax Slash for Smaller Firms Asked*, *L.A. TIMES*, Oct. 25, 1956, at B1.

294. One small businessman noted:

The problem becomes most apparent each time the business fiscal year ends and taxes are computed. If business has been good and a profit realized the question is asked, “Where am I going to get the money to pay income taxes?” Usually money’s on hand are barely sufficient for payroll, et cetera,

the high tax burden affected labor–management relations.²⁹⁵ Since everyone knew that the government would get most of the benefits of the earnings, labor unions used this fact to demand higher wages, arguing that little of the wage expense would come out of the company’s pocket. The depressed mood of small business owners was expressed by one of the speakers before the Senate Select Committee on Small Business in these words:

The Government tax collector is like that Texan who drove up to the gas pump in a black, shiny, block-long car and said to the small boy, “Fill ‘er up, Sonny.” Moments later the lad said desperately, “Turn off your motor, will you mister. You’re gaining on me.” Unless you turn off some of these taxes, and soon, gentlemen, and soon, we can’t make it. Because you’re gaining on us, too.²⁹⁶

In his 1958 Budget Message, President Eisenhower repeated his recommendation to alleviate the tax burden of small businesses: “There are certain technical tax revisions which will give substantial benefits to small business, with a minimum loss of revenue and with no changes in tax rates.”²⁹⁷ While congressional representatives repeatedly expressed concern for the state of small business (mostly as political rhetoric),²⁹⁸ some worked to enact tax relief for small businesses²⁹⁹ and to reincorporate a partnership tax election for small corporations in the 1958 act. Faithful to his grassroots past, Mills

and the profits of the year have been reinvested in the business in the form of depreciable assets or inventory in an effort to keep pace with competition.

Tax Problems, *supra* note 15, at 617 (statement of J.W. Barfield). For a survey of small business arguments, see Richard Rutter, *The “Little Man” Keeps His Chin up*, N.Y. TIMES, Mar. 30, 1958, at F1.

295. *Tax Problems*, *supra* note 15, at 150.

296. *Id.* at 4–5.

297. 104 CONG. REC. 331 (1958).

298. *Keeping the Records Straight*, *supra* note 290, at 82.

As political orators began addressing themselves to the state of the economy this week, it was clear that between now and November the beleaguered U.S. voter will hear some wildly confusing statements about how he and the economy are doing. . . . Leon H. Keyserling, . . . for the Truman Administration, accused the Eisenhower Administration of sustaining a “cultivated economic slack” designed to eliminate the inefficient small farmer and small businessman.

Id.

299. For example, Senators John J. Sparkman (D-Ala.) and Edward J. Thye (R-Minn.) introduced a small business tax relief bill in the Senate. *Measure Would Deal with Specific Taxation Problems of Little Firms*, WALL ST. J., Apr. 3, 1957, at 3; *Tax Report: A Special Summary and Forecast of Federal and State Tax Developments*, WALL ST. J., Feb. 19, 1958, at 1; Trussell, *supra* note 280; see also *Small Business*, TIME, Apr. 15, 1957, at 106 (“Since an overall tax cut seems out of the question, members of both parties in Congress, and the Administration itself, are backing measure to give the small businessman tax relief in at least these areas.”); *Time Clock*, TIME, Mar. 18, 1957, at 96, 96 (“TAX RELIEF for small business stands chance of congressional approval this session. Both parties have introduced measures . . .”).

personally undertook to promote small business interests issue in Congress and in the press.³⁰⁰

To gain broad bipartisan support in the tax-writing committees in the House and Senate, Mills initiated studies about correcting technical errors in the tax laws.³⁰¹ Those studies indicated that taxes have a significant impact on the economy and that changes to the income tax code could promote economic growth.³⁰² Following of those studies, Mills appointed an advisory group of outside experts on several complex areas.³⁰³ Subsequently, a version of subchapter S was prepared by the Treasury staff at the request of the Ways and Means Committee for possible inclusion in the Small Business Tax Revision Act of 1958. However, the Ways and Means Committee dropped the proposal because it sought to grant substantial tax relief for small businesses in a different bill tailored specifically for that purpose.³⁰⁴ When Mills presented a version of the 1958 House bill in floor debates, he admitted that the act was only intended to achieve small business tax revision rather than tax relief.³⁰⁵

300. Together with several other congressmen Mills introduced an Income tax bill for small-business enterprise and for family-sized farms “[t]o provide an election for filing income-tax returns for small and independent businesses engaged in trade or commerce whether or not such businesses operate as individuals, partnerships, or corporations.” *General Revenue Revision*, *supra* note 52, at 23; *see also* Price, *supra* note 277, at 329 (“[A] Small Business Tax Revision Bill was introduced by ranking members of the House Ways and Means Committee on behalf of the Administration.”).

301. BROWNLEE, *supra* note 63, at 110. The Staff of the Joint Committee on Internal Revenue Taxation and the Treasury Department reported their recommendation to the House Ways and Means Committee in 1956. STAFFS OF THE J. COMM. ON INTERNAL REVENUE TAXATION AND THE TREASURY DEP’T, SUMMARY OF THE TECHNICAL AMENDMENTS BILL OF 1957, at 1–6 (Comm. Print 1956) [hereinafter SUMMARY OF 1957 TECHNICAL AMENDMENTS]; STAFFS OF THE J. COMM. ON INTERNAL REVENUE TAXATION AND THE TREASURY DEP’T, LIST OF SUBSTANTIVE UNINTENDED BENEFITS AND HARDSHIPS AND ADDITIONAL PROBLEMS FOR THE TECHNICAL AMENDMENTS BILL OF 1957 (Comm. Print 1956).

302. ZELIZER, *supra* note 223, at 93–94; *see also* SUMMARY OF 1957 TECHNICAL AMENDMENTS, *supra* note 301.

303. “These groups have quite recently submitted comprehensive reports for the study by the Committee of Ways and Means. The committee has asked for the views of the public and especially of those of the various professional groups on these advisory reports.” 104 CONG. REC. 1034 (1958) (statement of Rep. Mills).

304. 104 CONG. REC. 13200 (1958) (statement of Rep. Mills).

[T]he act may be cited as the “Small Business Tax Revision Act of 1958.” This title is highly significant because the bill has as its primary purpose tax revision for small business, not tax relief for small business. I draw attention to this fact, not to minimize in any way what I believe to be the highly significant tax relief aspects of the bill, but to point out to the Members of the House and to the many small-businessmen of the United States that this bill does not represent any purported ultimate resolution of the tax problems of small business or any Christmas-in-July gift of a tax bonanza.

Id. (statement of Rep. Mills).

305. *Id.* (statement of Rep. Mills).

He reported that the Ways and Means Committee had considered the proposal to enact small business tax relief and that they hoped to be able to incorporate it when they enacted Subchapter S in the 1958 act: "In reporting this bill the Committee on Ways and Means has investigated thoroughly the many proposals advanced to postpone or reduce taxes of small business. Many of the proposals advanced for inclusion in the bill have merit."³⁰⁶ However, the Ways and Means Committee had assessed that, in spite of the need for small business tax relief, budgetary constraints prevented them from including it in the current bill. Maintaining a balanced budget was always of most importance to Mills.³⁰⁷ Mills explained that, in light of present government expenditures, tax reduction had a lower priority.³⁰⁸ Fiscal responsibility, he said, prohibited the Committee from enacting such tax relief at the time:

This bill does not go as far as any one of us would have it go. It does not meet more than the minimum requirements of small businesses with respect to taxation.

...

However, I am sure that all of us realize that the undertaking of the Committee on Ways and Means with respect to small business has been limited by the harsh realities of the fiscal position of the Federal Government. We of the membership of the Committee on Ways and Means look forward to the time when tax relief can be provided.

...

306. 104 CONG. REC. 14427 (1958) (statement of Rep. Mills).

307. ZELIZER, *supra* note 223, at 197. For example, Mills commented on the House floor:

Mr. Speaker, undoubtedly the popular thing to do by any Member of the House during an election year is to vote for any bill that proposes to reduce anyone's taxes. However, I am concerned over the fiscal affairs of the Government and the present policy of enlarging our debt even at a time when we are not engaged in a shooting war. I for one believe that we, as Members of the House, should face up to our responsibilities as legislators and not in effect, short-change the taxpayers. Running the financial affairs of the Government is no different, except as a matter of degree, than running our own financial affairs. If we in either case are going further into debt, we must face the day of reckoning at some time in the future. The tax reductions in H.R. 8300 mean a further increase in our deficit, and in turn our national debt.

104 CONG. REC. 12431 (1958) (statement of Rep. Mills).

308. 104 CONG. REC. 13201 (statement of Rep. Mills).

We should be thinking in terms, as we proceed in the future, not only of the priority to be given between expenditures of the Government but also of priority between expenditures and tax reduction . . . I think in many instances if we measure a given expenditure against a comparable tax reduction, we will reach the conclusion that tax reduction will permit greater economic growth. But remember this. We cannot continue to enjoy expenditures by the Government of 78 or 80 billion dollars and at the same time provide for the type or relief for small business and our other taxpayers that they desire and want and must have if we are to continue to grow in the future.

[A]n estimated deficit of approximately \$11 billion for the fiscal year 1959 does not provide a setting in which tax relief for any segment of the taxpaying public can be considered without severe limitations.³⁰⁹

Nevertheless, Mills pledged on the House floor that he would promote the awaited small business tax reduction at the first feasible opportunity:

I am sure that I speak for the Committee on Ways and Means as a whole when I state that it is our hope that conditions will permit us to consider in the near future significant tax reduction for all American taxpayers. I assure you that I will do everything in my power to work toward that end.

...
[T]he great problem that small business faces . . . is one of tax rates. If you are to give to small business that degree of relief which it needs in order to grow and in order to enjoy economic prosperity in the future, it will be necessary for us to bring our fiscal situation under control to the point where we may bring some reduction in taxes for the benefit of small business. . . .³¹⁰

He stressed the importance of small businesses in sustaining a healthy, growing economy and a competitive market:

There is, I believe, a sound basis for emphasizing and perpetuating the importance of small business in our economy. Small businesses are the concrete expressions of the creativeness and the entrepreneurial imagination which are basic resources for the economic progress. By fostering a flow of new businesses, which means a flow of new ideas, techniques, and methods, we provide our best assurance that established, old-line companies will continue to face the challenges of creating new products and new and better production methods, with the result that the economy will maintain the vitality necessary to maintain our position in the world. In addition, by pursuing policies which assure the existence of a large number of small businesses, we do much to see to it that control over the use of resources and capital is widely diffused, that prices are reasonable, and that our economic resources will be most efficiently used.³¹¹

Mills apologetically acknowledged that the present bill was the best relief that could be granted under the circumstances.

309. *Id.* at 13200 (statement of Rep. Mills). Congressman Byrnes (R-WI.) supported Mills, his Committee fellow on the floor, and read from the Committee report in order to explain the dilemma and the impossible situation in which the Committee had been placed by reason of expenditure policies:

Because of its revenue-raising function, your committee must be mindful of the fiscal implications of any of its recommendations, and must give particular attention to their effect on the Federal budget. This has been made more difficult by the fact that Congress generally has accorded a higher priority to expenditures than to tax reductions. As a result your committee has been foreclosed from recommending worthwhile and needed tax reductions.

Id. at 13201 (statement of Rep. Byrnes).

310. 104 CONG. REC. 13200, 13201 (1958) (statement of Rep. Mills).

311. *Id.* at 13200.

Until that time arrives, we can only put forth our best efforts to meet the more pressing problems of small business and the public as a whole. Perhaps the greatest problem confronting small and medium sized businesses today is the acquisition of sufficient capital with which to modernize and maintain a rate of expansion which will permit them to contribute their full value to the well-being of the economy as a whole. The bill attempts to deal with this problem and attempts to remove some of the pressures which tend to be the breakup of small businesses once they are established and to prevent their consolidation into larger businesses by merger.³¹²

The proposed House bill attempted two means of solving the capital acquisition problem experienced by small businesses, making capital more readily available for expansion from both external and internal sources. First, the bill increased the volume of outside funds by providing incentives (e.g., favorable loss treatment) to investors who invest in small businesses. Second, the bill allowed small businesses generous tax loss carryback, better write-offs of depreciable property, and also increased the AET credit, to increase its available internal funds.

Finally, when the Senate Finance Committee reported out a bill that included a provision to allow small business corporations to elect their tax treatment, Mills negotiated and worked out the budget constraints, and this time, unlike the 1954 episode, the House receded and agreed to include this provision.³¹³ Mills then introduced the 1958 act as a "Member Bill" that allowed speedy passage without opposition in the House.³¹⁴ He promoted the 1958 act as correcting "technical errors," or advantages in current tax laws "that were costing the government and taxpayers millions of dollars."³¹⁵

312. 104 CONG. REC. 13201 (1958) (statement of Rep. Mills). Congressman Byrnes (R-WI) repeated that notion and quoted from pp. 3-4 of the Committee report:

Your committee believes, for example, that rate reductions are needed by small business as well as others, but that the high level of current expenditures makes significant tax reductions, under present conditions, inconsistent with sound financial management. In view of these limitations, your committee of necessity has had to limit this bill to an extremely small revenue loss and has had to select a few areas of high sensitivity from the standpoint of small business and concentrate the relief in these limited areas.

Id. (statement of Rep. Byrnes) (quoting H.R. REP. NO. 85-2198, at 3-4 (1958)).

313. In the conference committee the House receded with clerical amendments and Subchapter S became law. Anthoine, *supra* note 4, at 1150; *see also* H.R. REP. NO. 85-2632, at 35-37 (1958).

314. A Member Bill is a process designated for committee members to propose minor provisions, usually by a "Voice Vote" method by which members vote just "yes" or "no." *See House Approves Tax Cuts to Help Small Business*, N.Y. TIMES, July 22, 1958, at 1; *see also* ZELIZER, *supra* note 223, at 123. Mills negotiated compromises among various constituencies and "packaged [the] legislation so that numerous members of the community could perceive it as a partial victory." *Id.* *See also* WITTE, *supra* note 13, at 162.

315. ZELIZER, *supra* note 223, at 97.

During this process, Mills occasionally was criticized for “catering to the economic intellectuals of the business and educational world to the detriment of his own party’s interests.”³¹⁶ Mills’s connections in Congress enabled him to pass the 1958 act.³¹⁷

On September 2, 1958, Congress enacted the Small Business Technical Amendment Act³¹⁸ in “a rapid-fire order,”³¹⁹ and with very little opposition.³²⁰ Among the act’s key provisions were extending the grace period for payment of the estate tax, applying accelerated depreciation for small businesses’ used property, allowing small business investment write-offs,³²¹ and permitting partnership tax treatment under Subchapter S to closely held corporations with ten or fewer shareholders.³²² Now, small businesses were free to decide whether to incorporate or not, independent of income tax considerations.

VI. CONCLUSION

S Corporations marked a key point in the development of the corporate tax system.³²³ During World War II, the tax system finalized its transformation

Mr. Chairman, as its name, the technical amendments bill of 1958, implies, this bill is a technical bill. It is concerned with unintended hardships in the income-estate, and gift tax laws. It is also contains numerous highly technical provisions designed to clarify the statute and remove obvious minor errors in the statute.

104 CONG. REC. 1205 (1958) (statement of Rep. Mills).

316. *Economic Statesman: Wilbur Daigh Mills*, N.Y. TIMES, Dec. 20, 1957, at 22.

317. “Arkansas’ Mills has plenty of home-state Company in Congress’ higher reaches.” *One More for Arkansas*, *supra* note 247, at 14.

318. Technical Amendments Act of 1958, Pub. L. No. 85-866, § 64, 72 Stat. 1606, 1650.

319. *Senate Approves Major Tax Bills*, *supra* note 280, at 16.

320. A few voices of opposition at that time protested that the bill did not provide enough relief. Representative Thomas B. Curtis, Republican of Missouri, objected that the measure was not a small business bill because its benefits would go largely to manufacturers. . . . Representative Noah M. Mason, Republican of Illinois, declared that the tax relief offered by the measure was a “mirage—a beautiful picture with very little substance.”

House Approves Tax Cuts to Help Small Business, *supra* note 314; *House Group to Begin Shaping Small Business Tax Relief Bill Today*, WALL ST. J., June 3, 1958, at 19; *see also Lay Those Curlers Down*, N.Y. TIMES, Feb. 18, 1957, at 15 (Federal Reserve Board Chairman Martin William McChesney was quoted as saying “[t]he oft-raised claim that tight money presses unfairly on small business and local government is ‘debatable.’”).

321. *Time Clock*, TIME, Apr. 29, 1957, at 90.

322. *Tax Relief*, *supra* note 37, at 106; *see also* Technical Amendments Act of 1958, Pub. L. No. 85-866, § 64, 72 Stat. 1606, 1650.

323. “The new election which permits a small business corporation to be taxed as a partnership or proprietorship is in many respects the most important contribution that the recently Technical amendments Act of 1958 made to tax law.” N.R. Cain, *New Tax Provision for Small Business Firms*, L.A. TIMES, Nov. 2, 1958, at D11.

from a “class tax” into a “mass tax” and became a widely applicable collection and withholding mechanism. Nevertheless, taxes were soon recognized to be not only a revenue-raising device and a means of financing the government, but also a powerful instrument that could impact the nation’s economic growth and social policy.³²⁴ Special tax provisions in the Code were increasingly utilized to provide federal tax relief to particular interest groups and were highly criticized for harming tax fairness.³²⁵ Tax committees became the strongest committees in Congress and their members were carefully selected by party leaders.³²⁶

The congressional intent behind the Small Business Tax Revision Act of 1958, as expressed in floor debates, was to reinforce the competitive position of small businesses by reducing their tax burden.³²⁷ Moreover, congressional leaders declared in 1958 that the act intended to aid small businesses out of support for entrepreneurship and free competition of the American economy.³²⁸ However, this political rhetoric did not reflect a decade of small businesses’ lobbying efforts to enact this legislation in Congress. Stanley S. Surrey, one of our nation’s foremost authorities on federal tax law,³²⁹ once said: “Political considerations naturally overhang this whole area, for taxation is a sensitive and volatile matter. Any major congressional action represents the compromises of the legislator as he weighs and balances the strong forces constantly focused on him by the pressure groups of the country.”³³⁰

The development of the first hybrid entity with a pass-through tax treatment altered the corporate tax base and allowed individuals, for the first time, to elect their business tax treatment.³³¹ While the intent to aid small business was one objective that promoted this development, it surely was not the only one. A combination of unique political and economic conditions led

324. ZELIZER, *supra* note 223, at 12–14; *see also id.* at 15 (“Although government officials of earlier historical periods were aware that taxation affected matters such as capital investment and regional industry, they did not deliberately manipulate taxation to help manage the national economy.”).

325. Cary, *supra* note 155, at 747; Surrey, *supra* note 155, at 1148.

326. Surrey, *supra* note 155, at 1155.

327. S. REP. NO. 85-1237, at 3 (1958).

328. *Tax Problems*, *supra* note 15, at 1108, 1111 (statement of B.I. Noble, a small businessman from Littleton, Colorado) (“small businesses . . . provide the heart and the life for these towns and cities, which combined together we call ‘the free and the American way of life.’”).

329. City College of N.Y., *The Townsend Harris Medal: Alphabetical List of Names: S–Z*, http://www.ccny.cuny.edu/townsend_harris/awards/s_z.htm (last visited Nov. 15, 2008) (awarded by the City College of New York for outstanding postgraduate achievement).

330. Surrey, *supra* note 155, at 1153.

331. *See generally* David A. Gibson, Note, *The Election Concept in Tax Law*, 47 VA. L. REV. 72 (1961) (providing an overview of the election concept in tax law).

Congress to pass this unusual piece of legislation. Subchapter S was created as a reaction to the needs of a business community that was facing economic crisis, but was also a product of political interest groups and intensive lobbying efforts by small and big business organizations.³³²

The economic climate in the 1950s was a time of recessions, natural disasters and alarming bankruptcy rates,³³³ involving “financial losses to banks and other institutions, with a curtailment in employment.”³³⁴ Congress’s response was to develop loan programs and furnish special investments in small businesses.³³⁵ Though increasing small businesses’ borrowing capacity was beneficial, improving their earning capacity was a more urgent need to enable them to pay back their loans.³³⁶ One of the fundamental reasons for small business failures was lack of investment capital as a result of high tax rates.³³⁷ At that time, the prevailing public opinion was that small concerns suffered genuine financial difficulties and lack of proper training. But mostly, taxes were regarded as a major reason for the failures of small business and “a

332. See generally MORTON J. HORWITZ, *THE TRANSFORMATION OF AMERICAN LAW: 1870–1960* (1992) (discussing the evolution of American law as reflecting dictates of private capital). For implementing this view on the Subchapter S, see also Sheldon D. Pollack, *Tax Complexity, Reform, and the Illusions of Tax Simplification*, 2 GEO. MASON IND. L. REV. 319 (1994).

[I]n 1958 Congress passed legislation that provided for the creation of an entirely new tax entity, the so-called “S corporation,” for the express purpose of providing business with a new “pass-through” entity as an alternative to the traditional business corporation. The S corporation is strictly a creature of the Federal tax code, and its creation illustrates how the tax laws can develop to accommodate private economic interests.

Id. at 337.

333. See generally WALTON WITH HUEY, *supra* note 49.

334. H.R. REP. NO. 83-1002, at 4 (1953); see also Egans, *supra* note 58 (“storm clouds gathering on the economic horizon have been worrying small-business experts here.”).

335. See *Time Clock*, TIME, Jan. 16, 1956, at 83 (“SMALL-BUSINESS MEN will get a solid boost from the U.S. Government. Under a new ‘limited loan participation plan,’ split 75%-25% between the Small Business Administration and the borrower’s local bank . . . now the banks will take on the job.”).

336. *Big, Small Business Have No Basic Conflict*, *supra* note 109, at 38 (“A really effective program to aid small business would be directed primary at increasing its earning capacity rather than its borrowing and capital-raising capacity; for where earning capacity exists, capital and credit are almost automatically forthcoming”).

337. *Just One Flaw*, *supra* note 107, at 88.

[T]he subcommittee had missed the main point which its investigation brought out. One of the “fundamental causes” of small business failure was a lack of investment capital, said Taft & Herter. This was due mainly to the “high tax rates on middle and higher incomes,” and the double taxation of dividends. Said the Republicans: “The best reservoir of equity capital should be the direct investment of millions of small-income savers . . . directly encouraged by [lower taxes and] elimination of double taxation.”

Id.

far more formidable threat to small business than tight money.”³³⁸ Powerful political elites in the House and Senate,³³⁹ including Wilbur Mills, were another instrumental factor in the passage of 1958 act.

The bipartisan support for the 1958 act would not have been possible without the help of Wilbur Mills, chairman of the House Ways and Means Committee, who supported small business tax relief. In his unique way, Mills negotiated and resolved the budgetary constraints involving this legislation and aimed to correct existing inequities in the Code. By presenting this measure to Congress as merely a technical amendment act, Mills succeeded where his predecessors had failed. From then on, the rhetoric around Subchapter S portrayed it as another progressive feature of the corporate tax system and part of a nationwide assistance plan to correct the accidental inequality between the tax treatment of partnerships and small corporations.³⁴⁰

Over the years, Congress enacted many legislative changes to Subchapter S in an attempt to keep it viable and relevant. While the 1958 Congress set the maximum number of shareholders at 10,³⁴¹ Congress increased that number in 1976 to 15 shareholders.³⁴² Congress again increased the limitation on the number of shareholders in 1981 to 25,³⁴³ to 35 shareholders in 1982,³⁴⁴ and to 75 shareholders in 1996.³⁴⁵ In 2004, Congress debated whether to entirely eliminate the limitation on the number of shareholder in order to accommodate small business corporations with many family members and small community banks with many shareholders, but eventually expanded the limitation to a maximum of 100 shareholders.³⁴⁶ The 1958 act provided that the Subchapter S election would terminate if 20% or more of the corporation’s gross receipts consisted of passive income, in order to prevent Subchapter S elections made solely to avoid the personal holding company tax.³⁴⁷ In 1996, Congress relaxed this rule to accommodate start-up companies by setting a maximum

338. *Taxes Are Held Biggest Factor in Failures of Small Businesses*, N.Y. TIMES, Mar. 23, 1957, at 25; see also *Needed: Talent, Training & Tax Cuts*, *supra* note 52, at 98 (“Business failures in 1956 [were] at their highest level . . . since 1940.”).

339. See discussion *supra* note 246.

340. *Tax Relief*, *supra* note 37, at 106.

341. Technical Amendments Act of 1958, Pub. L. No. 85-866, § 64, 72 Stat. 1606, 1650.

342. Tax Reform Act of 1976, Pub. L. No. 94-455, § 902(a), 90 Stat. 1520, 1608.

343. Economic Recovery Act of 1981, Pub. L. No. 97-34, § 233(a), 95 Stat. 172, 250.

344. Subchapter S Revision Act of 1982, Pub. L. No. 97-354, § 2, 96 Stat. 1669, 1669.

345. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1301, 110 Stat. 1755, 1777; see also Landau, *supra* note 24 (presenting a survey of past and recent S Corporations Reforms).

346. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 232(a), 118 Stat. 1418, 1434.

347. Technical Amendments Act of 1958, Pub. L. No. 85-866, § 64, 72 Stat. 1606, 1650–52.

amount of permitted passive income, and later acknowledged that liquidating distributions would not be treated as passive income.³⁴⁸

In an attempt to simplify the S election, Congress made substantial changes to Subchapter S and implemented several aspects of partnership taxation in the Subchapter S Revision Act of 1982.³⁴⁹ The act allowed certain trusts and non-voting common stock owners to be shareholders, removed the requirement that new shareholders consent to a Subchapter S election, and permitted pass-through of capital losses.³⁵⁰

Significant changes to Subchapter S were also enacted in the Small Business Job Protection Act of 1996.³⁵¹ The 1996 act increased the number of shareholders to 75,³⁵² allowed S corporations to hold subsidiaries (“qualified subchapter S subsidiary”)³⁵³ and to form employee stock ownership plans,³⁵⁴ permitted tax-exempt organizations and trusts to own S corporation stock,³⁵⁵ and authorized certain financial institutions and banks to elect S status.³⁵⁶

The Jobs and Growth Tax Relief Reconciliation Act of 2003 lessened the attractiveness of S corporations to some extent, as it reduced double taxation through lowering the tax rate on qualified dividends to 15% percent.³⁵⁷ To counterbalance this effect, the American Jobs Creation Act of 2004 added incentives for S corporations in the hope that businessmen would continue to favor this organizational choice.³⁵⁸ The 2004 act increased the number of shareholders to one hundred³⁵⁹ and allowed more members of one family to be treated as a single shareholder.³⁶⁰

In 2007, the Small Business and Work Opportunity Tax Act determined that capital gains of S corporations from the sale or exchange of stocks or securities would not be treated as passive investment income.³⁶¹ Furthermore,

348. Small Business Job Protection Act of 1996 § 1305, 110 Stat. at 1779–80; *see also* I.R.C. § 1362(d)(2), (3).

349. Subchapter S Revision Act of 1982 § 2, 96 Stat. at 1669–77; *see also* EUSTICE & KUNTZ, *supra* note 24, at 1–34.

350. EUSTICE & KUNTZ, *supra* note 24, at 1–37.

351. Small Business Job Protection Act of 1996 §§ 1301–1317, 110 Stat. at 1777–87.

352. *Id.* § 1301, 110 Stat. at 1777.

353. *Id.* § 1308, 110 Stat. at 1783.

354. *Id.* § 1316, 110 Stat. at 1785–87. This created a need to increase the limitation on number of S corporation’s shareholders.

355. *Id.* § 1302, 110 Stat. at 1777.

356. *Id.* § 1304, 110 Stat. at 1779.

357. Pub. L. No. 108-27, §§ 301–303, 117 Stat. 752, 758–64.

358. Pub. L. No. 108-357, §§ 231–240, 118 Stat. 1418, 1433–37; *see also* Landau, *supra* note 24.

359. American Jobs Creation Act of 2004 § 232, 118 Stat. at 1434.

360. *Id.* § 231(a), 118 Stat. at 1433.

361. Pub. L. No. 110-28, § 8231, 121 Stat. 112, 196–97.

even though in the past a qualified subchapter S subsidiary had to be wholly owned by the S corporation parent, the parent company is now permitted to sell the subsidiary's shares and recognize a gain or loss on this portion of the sale, without terminating the subsidiary's Subchapter S status.³⁶² Indeed, these legislative adjustments demonstrate that a viable regime is the one that sustains itself by changing over time.

Today, many entities having the control and ownership characteristics of corporations³⁶³ are in fact organized as hybrid entities to eliminate corporate double taxation.³⁶⁴ Although recent developments in organizational choice have slowed down the growth rate of this unique entity,³⁶⁵ the S Corporation is still vastly used in every business sector. Over 3.5 million family-owned operations, closely held businesses and small banks have chosen to organize as S Corporations.³⁶⁶ Throughout the years, Congress has realized the importance of Subchapter S, and thus has amended its requirements to

362. *Id.* § 8234, 121 Stat. at 198–99. The transaction is treated as a sale of followed by a deemed transfer to the Q Sub under non-recognition rule of I.R.C. § 351.

363. The LLC offers limited liability and one-level tax on shareholders—but with fewer restrictions than in Subchapter S. One other key difference is that LLCs are incorporated and taxed separately by each state. See generally Klein & Zolt, *supra* note 10, at 1004–07; Larry E. Ribstein, *The Emergence of the Limited Liability Company*, 51 BUS. LAW. 1, 2–6 (1995).

364. These developments in entity choice provided not only new incorporation possibilities with preferential tax treatment, but also new tax planning opportunities and many scholars criticized the creation of these hybrid entities as designed solely to avoid taxes at the entity level. See generally J. William Callison, *Rationalizing Limited Liability and Veil Piercing*, 58 BUS. LAW. 1063 (2003); Susan P. Hamill, *The Story of LLC: Combining the Best Features of Flawed Business Tax Structure*, in BUSINESS TAX STORIES 295, 311 (Steven A. Bank & Kirk J. Stark eds., 2005); Martin C. McWilliams, *Who Bears the Costs of Lawyers' Mistakes?: Against Limited Liability*, 36 ARIZ. ST. L.J. 885 (2004); Nacopoulos, *supra* note 25, at 159; Lee A. Sheppard, *The Dark Side of Limited Liability Companies*, 55 TAX NOTES 1441, 1444 (1992).

365. In 1995, the Treasury's Check-the-box regulations made partnership/corporate tax election widely available. See I.R.S. Notice 95-14, 1995-1 C.B. 297. On the story of the check-the-box regulation, see Steven A. Dean, *Attractive Complexity: Tax Deregulation, the Check-The-Box Election, and the Future of Tax Simplification*, 34 HOFSTRA. L. REV. 405 (2005). For a discussion of those developments, see John W. Lee, *A Populist Political Perspective of the Business Tax Entities Universe: "Hey the Stars Might Lie but the Numbers Never Do"*, 78 TEX. L. REV. 885 (2000); Nacopoulos, *supra* note 25, at 173.

366. See Internal Revenue Serv., U.S. Dep't of Treasury, 2004 Corporation Returns, Table 1–S Corporations: Total Receipts and Deductions, Portfolio Income, Rental Income, and Total Net Income, by Major Industry, available at <http://www.irs.gov/pub/irs-soi/04co1120s01.xls> (last visited Nov. 15, 2008); see also *Hearing on S Corporation Reforms Before H. Subcomm. on Select Revenue Measures of the H. Comm. on Ways & Means*, 108th Cong. 27, 29 (2003) [hereinafter *Hearing on S Corporation Reforms*] (prepared statement of the Honorable Donald C. Alexander, Former IRS Comm'r, currently with Akin, Gump, Strauss, Hauer, & Feld, LLP, on behalf of the United States Chamber of Commerce) (“[S]ome entities, like banks, must conduct their businesses in corporate form and others are required to do so by state laws or other rules.”).

conform the S Corporation to modern economic realities and to encourage its wide use.

Recent consumption tax proposals have suggested eliminating hybrid entities by applying a single-level business tax.³⁶⁷ Doing so would not be politically easy and would require overturning fifty years of preferential tax treatment granted to small businesses. In the 1950s, the plight of small businesses became a matter of public concern and sympathy, and politicians rallied to their cause. Small businesses won a major political victory with the establishment of S Corporations in 1958, and to this day remain a significant part of the economy and the “cornerstone of the free-enterprise system.”³⁶⁸ Given this history, as well as the strong support of the Congress and business organizations,³⁶⁹ it is reasonable to predict that small businesses’ preferred organizational form will not be abolished without a similar—if not greater—fight. Although much can be done to simplify and further liberalize Subchapter S, it is too soon to bury the S Corporation.³⁷⁰

367. The most current tax proposal is the REPORT OF THE PRESIDENT’S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR AND PRO-GROWTH: PROPOSALS TO FIX AMERICA’S TAX SYSTEM 21–22 (2005), which was followed by H.R. REP. NO. 109-736, at 76 (2006). See generally ROBERT E. HALL & ALVIN RABUSHKA, *THE FLAT TAX* (2d ed. 1995) (discussing a flat-tax proposal); DAVID BRADFORD, *UNTANGLING THE INCOME TAX* (1986) (discussing an X-Tax proposal). Beginning 1997, former Congressman Dick Arney and Senator Richard Shelby continuously proposed incorporating those flat tax proposals into legislation. The Arney-Shelby Flat Tax, H.R. 1040, 105th Cong. (1997) and S. 1040, 105th Cong. (1997), S. 1040, 108th Cong. (2003), and S. 1099, 109th Cong. (2005); see also generally LAURENCE S. SEIDMAN, *THE USA TAX: A PROGRESSIVE CONSUMPTION TAX* (1997) (discussing the Unlimited Saving Allowance Tax, which is known as the Nunn-Domenici USA Tax Act of 1995, S. 722, 104th Cong.).

368. S. REP. NO. 85-1237, at 24 (1958); see also OFFICE OF ADVOCACY, U.S. SMALL BUS. ADMIN., *THE SMALL BUSINESS ECONOMY FOR DATA YEAR 2005: A REPORT TO THE PRESIDENT 5* (2005), available at http://www.sba.gov/advo/research/sb_econ2005.pdf (“Entrepreneurship has long been implicit in the American Dream—the belief that, given constitutional freedom, it is possible through hard work, courage, and imagination to achieve financial security. The federal government too has underscored the fundamental importance of entrepreneurship and small business to a vibrant, growing, sustainable economy.”).

369. *Hearing on S Corporation Reforms*, supra note 366, at 27–30 (prepared statement of the Honorable Donald C. Alexander, Former IRS Comm’r, currently with Akin, Gump, Strauss, Hauer, & Feld, LLP, on behalf of the United States Chamber of Commerce) (promoting the liberalization of Subchapter S).

370. Though some scholars have suggested doing just that. See Anthoine, supra note 4, at 1149–50, 1174–75; Walter D. Schwidetzky, *Is It Time to Give the S Corporation a Proper Burial?*, 15 VA. TAX REV. 591 (1996). But see EUSTICE & KUNTZ, supra note 24, at 1–37.

APPENDIX

Table I
Statutory Tax Rates of Individuals/Partnerships and
Corporations 1954–1958

Top Individual Marginal Effective Tax Rates	Individual/partnership Marginal Tax Rates³⁷¹		Corporate Income Tax Rates³⁷²
20.00%	20%	\$0-\$2000	30% on the first \$25,000 52% on the rest
20.99%	22%	\$2,001-\$4,000	
22.66%	26%	\$4,001-\$6,000	
24.49%	30%	\$6,001-\$8,000	
26.39%	34%	\$8,001-\$10,000	
28.32%	38%	\$10,001-\$12,000	
30.41%	43%	\$12,001-\$14,000	
32.49%	47%	\$14,001-\$16,000	
34.43%	50%	\$16,001-\$18,000	
36.28%	53%	\$18,001-\$20,000	
38.07%	56%	\$20,001-\$22,000	
41.29%	59%	\$22,001-\$26,000	
45.17%	62%	\$26,001-\$32,000	
48.30%	65%	\$32,001-\$38,000	
51.12%	69%	\$38,001-\$44,000	
53.63%	72%	\$44,001-\$50,000	
57.19%	75%	\$50,001-\$60,000	
60.16%	78%	\$60,001-\$70,000	
62.76%	81%	\$70,001-\$80,000	
65.12%	84%	\$80,001-\$90,000	
67.31%	87%	\$90,001-\$100,000	
74.54%	89%	\$100,001-\$150,000	
78.40%	90%	\$150,001-\$200,000	
	91%	\$200,001- and over	

371. Tax Foundation, *Federal Individual Income Tax Rates History, Income Years 1913–2008*, <http://www.taxfoundation.org/publications/show/151.html>. These rates apply for married filing separately and singles. Married filing jointly tax rates are determined by those brackets corresponding with one-half of the income.

372. TAYLOR, *supra* note 62.

Table II
Combined Individual and Corporate Marginal Effective
Tax 1954-1958

	Partnership	Corporation	
	Pass-through tax treatment ³⁷³	Money-In Strategy (Corporate income tax + accumulated earnings tax) ³⁷⁴	Money-Out Strategy (Corporate income tax + Individual income tax on dividends) ³⁷⁵
Individuals with income under \$25,000 Ex. Taxpayer with \$10,000 ³⁷⁶	20% to 41% 26.4%	30% + 27.5% 30% to 49.25%	30% + 20% to 41% 48.48%
Individuals with income between \$25,000 and \$100,000 Ex. Taxpayer with \$100,000 ³⁷⁷	41% to 67% 67.3%	30% to 52% + 27.5% 46.5% to 61.2%	30% to 52% + 41% to 67% = 75.93%

According to Table I, between 1954 and 1958, individuals with income of \$25,000 and under who operated partnerships or sole proprietorships faced marginal tax rates between 20% and 59%. For example, if a taxpayer had earned \$10,000 of income, it placed him in the 34% marginal tax bracket. His marginal effective tax rate would have been 26.4%.³⁷⁸ However, if the

373. These rates are the individual marginal effective rates from Table I and take into account the progressive taxation feature.

374. Accumulated earnings tax rates were 27.5% on the first \$100,000 and 38.5% on the rest.

375. This figure reflects the maximum effective marginal tax rate when the company distributes all its profits as dividends, and the individual hits tax twice.

376. The calculation is as follows: $X=10,000$. In the money-in option the taxpayer pays tax of $0.3X$ or $[0.3 + (1-0.3)0.275]X=0.4925X$; in the money-out option: the taxpayer pays $[0.3 + (1-0.3)0.264]X=0.4848X$.

377. The calculation is as follows: $X=100,000$. In the money-in option the taxpayer pays marginal effective corporate tax 46.5% calculated as: $[25,000 \times 0.3 + (X-25,000)0.52]/X$. If the money is not reinvested in the company and hits AET the marginal effective corporate tax is $[0.465 + (1-0.465)0.275]X=0.612X$; in the money-out option the taxpayer pays 46.5% marginal effective corporate income tax, and individual income tax rates on what is left.

378. Marginal effective tax rate on capital income is defined as the expected pretax rate of return minus the expected after-tax rate of return on a new marginal investment, divided by the pretax rate of

taxpayer decided to incorporate, after paying 30% corporate income tax on his \$10,000 business income, he had the following options: First, he could reinvest the remaining money back in the company, which would leave his marginal effective tax rate at 30%. Second, whatever was not reinvested in the company could have been distributed and taxed at individual marginal tax rates (double taxation) or taxed under the accumulated earning tax (AET). The marginal effective tax rate on the total income if incorporated would have been between 48.48% and 49.25% (AET). Thus, the low bracket individual's best strategy in the 1950s would have been to conduct his business as an unincorporated enterprise. Once he earned more than \$14,000 (when his marginal effective rates went above 30%), he would have been better off incorporating his business and reinvesting his income.

Individuals with income between \$25,000 and \$100,000, paid marginal tax rates of 59% to 87%. For example, the marginal effective tax rate on an individual with total income of \$100,000 in 1954 was 67.3%. His best option was to incorporate his business, pay 46.5% marginal effective corporate income tax,³⁷⁹ and reinvest the profits back in the company. He could also choose to leave the money in the company and pay AET. That would make his marginal effective corporate tax rate 61.2%, which was still less than the rate he faced if operated as a partnership or proprietorship (67.3%). However, it would have been highly disadvantageous for him to distribute the company's profits as dividends, because his combined marginal effective tax rate could have reached 75.93%.

return. Marginal effective rates take into account the progressivity feature of the tax system and is a forward-looking measure in the sense that it is used to determine the incentive to invest in the private, non-financial corporate sector offered by the tax laws. See Don Fullerton, *Marginal Effective Tax Rate*, in THE ENCYCLOPEDIA OF TAXATION AND TAX POLICY 231 (Joseph J. Cordes et al. eds., 1999).

379. The marginal effective corporate tax of 46.5% calculated as: $[25,000 \times 0.3 + (X - 25,000) \times 0.52] / X$.

