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HISTORICAL PERSPECTIVE ON THE CORPORATE INTEREST DEDUCTION

Steven A. Bank*

One of the so-called "pillars of sand" in the American business tax structure is the differential treatment of debt and equity.[1] Corporations may deduct interest payments on their debt, but may not deduct dividend payments on their equity. This "ancient and pernicious" feature is criticized because it distorts corporate financing choices and inevitably leads to line drawing problems as the government engages in a futile chase to catch up with the latest financial innovation.[2] In the past few years, both the Obama administration and new Senate Finance Committee Chairman Ron Wyden have proposed capping or substantially reshaping the deductibility of corporate interest to "reduce incentives to overleverage and produce more stable business finances."[3]

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[1] DANIEL N. SHAVIRO, DECODING THE CORPORATE TAX 44, 48 (2009); Alvin C. Warren, Jr., *The Corporate Interest Deduction: A Policy Evaluation*, 83 YALE L.J. 1585, 1585 (1974).

[2] Ilan Benshalom, *How to Live with a Tax Code With Which You Disagree: Doctrine, Optimal Tax, Common Sense, and the Debt-Equity Distinction*, 88 N.C. L. REV. 1217, 1219 (2010); Shaviro, *supra* note xx, at 48-49. The controversy over the differential treatment of debt and equity is long-standing. See, e.g., M. L. Seidman, *Deductions for Interest and Dividends*, in HOW SHOULD CORPORATIONS BE TAXED? 130 (1947); NATIONAL INDUSTRIAL CONFERENCE BOARD, II THE SHIFTING AND EFFECTS OF THE FEDERAL CORPORATION INCOME TAX 138-41 (1930).

[3] THE WHITE HOUSE AND TREASURY, THE PRESIDENT'S FRAMEWORK FOR BUSINESS TAX REFORM 10 (Feb. 2012) ("reducing the deductibilility of interest for corporations could finance lower tax rates and do more to encourage investment in the United States"); THE BIPARTISAN TAX FAIRNESS AND SIMPLIFICATION ACT OF 2011, S. 727, Section 211 (the so-called "Wyden-Coats" reform plan, which indexed the interest deduction for inflation and excluded the inflation component from the deduction). For other proposals, *see* Robert C. Pozen and Lucas W. Goodman, *Capping the Deductibility of Corporate Interest Expense*, TAX NOTES, Dec. 10, 2012, at 1207, 1209 (proposing to limit nonfinancial companies to a deduction of 65% of gross interest paid and to limit financial companies to a deduction of 79% of gross interest paid); Calvin H. Johnson, *Corporate Meltdowns and the Deduction of Credit-Risk Interest*, TAX NOTES, May 2, 2011, at 513 (proposing to disallow the deduction of interest paid on debt in excess of the risk-free interest, since it reflects credit risk rather than true interest). Former House Ways and Means Committee Chairman Dave Camp and former Senate Finance Committee chair Max Baucus also recommended considering modification of the deductibility of interest expense as part of reform geared toward lowering the corporate tax rate. Pozen & Goodman, *supra*, at 1209.

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Over the years, several commentators have attempted to make sense of the corporate interest deduction by examining its history or have used historical evidence to buttress their normative arguments.[4] Most recently, Jonathan Talisman, a former Assistant Secretary for Tax Policy in the Treasury Department under the Clinton Administration, forwarded a historical argument that has not been raised before.[5] Talisman noted that the corporate income tax was originally conceived of as a proxy for a tax on shareholders: "It was viewed as necessary to reach shareholders' intangible wealth and prevent them from avoiding tax by keeping profits at the corporate level."[6] From this, Talisman infers that the corporate income tax was *not* intended to reach bondholder wealth, since "the corporation does not provide a deferral shield with respect to debt. Interest generally must be paid periodically . . . Thus, there is no need for a corporate proxy tax for debt to prevent deferral."[7]

This Essay contends that although there may be appropriate arguments in favor of maintaining a full corporate interest deduction, the historical premise for the origins of the corporate income tax system is not one of them. Corporate interest was deductible both in 1894,[8] when deferral was not a concern because corporations routinely distributed all of their profits each year,[9] and in 1909,[10] when there was no individual income tax and therefore no tax incentive to retain earnings. Moreover, it is not that Congress was indifferent to reaching bondholder wealth; that was a major subject of the debates in both 1894 and 1909. Rather, other priorities – including the protection of leveraged domestic industries and concerns about the

[4] *See, e.g.*, Katherine Pratt, *The Debt-Equity Distinction in a Second-Best World*, 53 VAND. L. REV. 1055, 1094-98 (2000); Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L.J. 53, 111-112 (1990); Curtis Jay Berger, *Simple Interest and Complex Taxes*, 81 COLUM. L. REV. 217, 219-20 (1981).
[5] Jonathan Talisman, *Do No Harm: Keep Corporate Interest Fully Deductible*, TAX NOTES, Oct. 14, 2013, at 211.
[6] Id. at 215.
[7] Id. at 216.
[8] Act of Aug. 27, 1894, ch. 349, §32, 28 Stat. 509, 556.
[9] See infra text accompanying notes [28-30].
[10] Tariff Act of 1909, ch. 6, §38(2d), 36 Stat. 113.

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constitutionality of targeting bondholders – took precedence. The corporate interest deduction emerged because of expedience, not tax policy *per se*.

In fact, the early history of the deduction has more in common with modern proposals to cap the interest deduction than it does with the current system of full deductibility. In 1909, because of the fear that shareholders could easily shift their investment to bonds in order to disguise dividends as deductible interest payments, the corporate interest deduction was capped. Under the provision, interest on corporate indebtedness in excess of the aggregate value of the corporation's paid-up capital stock was made non-deductible. Business lobbying began to chip away at this limitation in the post-Sixteenth Amendment revenue acts. In 1913 and 1916, the cap on corporate interest deductions was raised to the value of the capital stock plus one-half the amount of outstanding debt. [11] The cap was not lifted entirely until 1918,[12] when it was done so to offset the exclusion of debt from the definition of invested capital in the war and excess profits tax. Much like today, these early capped interest deduction provisions were an attempt to strike a balance between concerns about the inefficiencies of the debt/equity distinction and concerns about overburdening businesses in industries in which debt financing was a necessity.

Part I of this Essay will discuss the 19th century origins of the corporate interest deduction, adopted amid controversy over the nature of income in the early income tax statutes. Part II will focus on the adoption of a deduction in the 1909 corporate excise tax. It will explore the debates over reaching bondholder wealth, which eventually led to the insertion of a cap on the amount of the deduction. In Part III, the Essay will examine the continuation of the capped interest deduction in the first two post-Sixteenth Amendment revenue acts of 1913 and 1916,

[11] Tariff Act of 1913, ch. 16, §IIG(b), 38 Stat. 173; Revenue Act of 1916, ch. 463, §12(a)(3d), 39 Stat. 767, 768.
[12] Revenue Act of 1918, ch. 18, §234(a)(2), 40 Stat. 1077.

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before the cap was ultimately lifted during World War I. The Essay will conclude by offering some reflections on the historical basis for modern proposals.

I.

The deductibility of interest on corporate debt was controversial as far back as the first attempt to impose an entity-level income tax on corporations in 1894. Although it is almost taken as a given today that interest is a deductible business expense, while dividends represent a non-deductible return on ownership,[13] the matter was far less settled at the end of the nineteenth century. According to contemporary economist Edwin Seligman, who has been described as one of the "pivotal historical figures" in 19th century American public finance,[14] "the most advanced tax laws in America, as well as in Europe, permit an individual to deduct his indebtedness or the interest on his debts, while the corporation is assessed on both bonds and stock, or on both interest and dividends."[15] The reason for this, Seligman explained, is

> there is a distinction between individual income and corporate income. In the case of individuals, true taxable property consists in the surplus above indebtedness. Net income can therefore be arrived at only by deducting interest on debts. But in the case of corporations the matter is somewhat different. Capital stock represents in many cases only a portion of the property, the remainder being represented by the bonded indebtedness. It is the stock and bonds together that represent the property and the earning capacity of the corporations.[16]

Such theoretical distinctions may have been influential, but there were practical considerations that favored denying a deduction for corporate interest. In his State of the Union address in 1893, President Grover Cleveland suggested levying "a small tax upon incomes

[13] *See* Adam O. Emmerich, *Comment, Hybrid Instruments and the Debt-Equity Distinction in Corporate Taxation*, 52 U. CHI. L. REV. 118, 122 (1985) ("Apparently, the idea that interest payments are deductible as an ordinary business expense is so intuitively appealing that Congress has thought it unnecessary to explain section 163(a) or its predecessors.").
[14] AJAY K. MEHROTRA, MAKING THE MODERN AMERICAN FISCAL STATE: LAW, POLITICS, AND THE RISE OF PROGRESSIVE TAXATION, 1877-1929 98-99 (2013).
[15] EDWIN R. A. SELIGMAN, THE INCOME TAX 513 (2d ed. 1914).
[16] Id.

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derived from certain corporate investments" to replace revenues lost as part of tariff reform.[17] It was clear that he intended to reach income from bonds as well as stocks when, in an address before Congress, Treasury Secretary John Carlisle subsequently proposed a tax on incomes "derived from investments in stocks and bonds of corporations and joint stock companies" in order to "most conveniently and justly" replace the shortfall caused by Cleveland's proposed tariff reform.[18]

Eventually, Cleveland's proposal morphed into a corporate income tax proposal as policymakers sought to harness the corporation as a mechanism for taxing income at the source.[19] This meant that both dividends and interest would be taxed at the source as well. Thus, noted lawyer and political economist Thomas Shearman testified before a House subcommittee in favor of an entity-level tax on corporate dividends and interest, plus all net income from corporate monopolies.[20] According to Shearman one of the greatest virtues of a tax on corporations was that "dividends upon stock and interest upon the bonds of corporations, and, in general, all income which is in any way paid through corporations" can be ascertained and taxed "without requiring a single return from the persons receiving such income."[21] Shearman noted that "every government which collects an income tax at all makes it a prime object to collect that tax as far as possible through the medium of corporations, requiring them to deduct

[17] President Grover Cleveland, *First Annual Message*, in A COMPILATION OF THE MESSAGES AND PAPERS OF THE PRESIDENTS, 1789-1897434, 460 (1899).
[18] Sidney Ratner, *Taxation and Democracy in America* (Octagon Books 1980) (1942): 174 (*quoting* Treasury Report 83 (1893)).
[19] This was partly a reaction to concerns about the inquisitorial nature of the administration of the income tax during the Civil War and Reconstruction. See, e.g., David A. Wells, *An Income Tax: Is It Desirable?*, 17 FORUM 1, 3 (1893); William L. Wilson, *The Income Tax on Corporations*, 158 N. AM. L. REV. 1 (1894).
[20] Statement of Hon. Thomas G. Shearman before Ways and Means Subcommittee on Internal Revenue, 53d Cong., 1st Sess. 11 (Oct. 16, 1893).
[21] Shearman, supra note xx, at 7.

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the tax from all dividends and interest paid."[22] Not surprisingly given these origins, the House bill in 1894 did not permit a deduction for corporate interest.

A corporate interest deduction was only added in the Senate bill in 1894.[23] The bill's sponsor, Senator George Vest, a Democrat from Missouri, explained that "[i]f the provision in the bill as it came from the other House had been retained, which put a 2 per cent tax upon the bonded indebtedness of corporations, we should have heard from the other side of this Chamber and from this side such a protest as never was heard before in Congress in regard to a tax law."[24] Apparently, the House bill had provoked much outrage on this point, with heavily leveraged railroads claiming that the inability to deduct the interest expense risked leaving them "in ruin."[25] Nevertheless, Seligman argued that because of this concession, "the definition of 'income' was certainly an uneconomic one; and that whatever arguments apply to the advisability of making corporations responsible for the tax on dividends apply with equal force to the interest on indebtedness."[26]

Notwithstanding Seligman's objections, the distinction between the treatment of debt and equity in the 1894 act was likely not viewed to be very significant at the time. During this period, the notion that corporations would defer dividends to shield them from taxation would have been considered quite foreign. As Republican Senator William Boyd Allison of Iowa noted during the debates, "as to the great body of the corporations of our country they make dividends covering practically [all] their earnings each year."[27] Similarly, William Ripley explained that outside of the railroad industry "it was the common practice [in the nineteenth century] to divide

[22] Ibid. at 11.
[23] 26 Cong. Rec. 6866 (June 27, 1894) (statement of Senator George Vest).
[24] Id. at 6867.
[25] SELIGMAN, THE INCOME TAX, *supra*, at 513.
[26] Id.
[27] 26 Cong. Rec. 6869 (1894).

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all profits in sight and to finance new construction by the issue of securities. Such policies were fully sanctioned by the public opinion of the day."[28] This was in part because, in the absence of robust stock markets or readily available financial information, dividends provided an important signal about the stability and value of a company and they were the sole source of liquidity for most shareholders.[29] In such an environment, there would not have been concern about a corporate retained earnings deferral shield that would have necessitated an entity-level tax on dividends, but not interest.

II

The controversy over the interest deduction continued when income taxation was revisited in 1909. The corporate excise tax was supposed to reach the "great accumulated wealth of the country, or its earnings, engaged in corporate enterprise," which meant that it was a proxy for taxing shareholders *and* bondholders, rather than just the former.[30] Therefore, the possibility that wealth represented by bond interests would be excluded from the tax was considered problematic. The *New York World* reported "[t]here were indications to-day of growing opposition to the corporation tax plan. This was chiefly because Senators believed bondholders might escape payment of the tax while the small holders of stock would contribute all the revenue."[31] The difficulty was that in the absence of an individual income tax as a backstop to the corporation tax, an interest deduction meant that "the 'bloated bondholder . . . escapes altogether . . . Multimillionaires like Mr. Carnegie, whose wealth is mostly in bonded

[28] WILLIAM Z. RIPLEY, RAILROADS: FINANCE AND ORGANIZATION 244 (1915). *See* STEVEN A. BANK, FROM SWORD TO SHIELD: THE TRANSFORMATION OF THE CORPORATE INCOME TAX, 1861 TO PRESENT 51, fig. 2 (2010) (the dividend payout ratio for public corporations was approximately 80 percent between 1871 and 1895).
[29] STEVEN A. BANK, ANGLO-AMERICAN CORPORATE TAXATION: TRACING THE COMMON ROOTS OF DIVERGENT APPROACHES 108-112, 117-118 (2011).
[30] 44 CONG. REC. 3756 (statement of Sen. Francis Newlands, D-Nev.).
[31] *Taft's Corporation Tax Framed to Reach the Rich*, N.Y. WORLD, June 18, 1909, at 5B.

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investments, go free, while the owner of no more than one share of stock in any paying corporation is taxed."[32] Similarly, insurgent Republicans argued that it was "manifestly unfair to single out corporations whose lists of stockholders include men of nearly every degree of poverty, while wealthy bondholders will be exempt."[33] One constituent wrote a letter to Senator Joseph Bristow of Kansas asking "does the proposition reach the very wealthiest citizens, such as Rockefeller and Carnegie, whose holdings are not in stocks of corporations, but in bonds?"[34] Senator Moses Clapp of Minnesota answered, complaining that it "absolutely exempts the man who has gone still further in the process of accumulation and has laid his accumulated savings in the form of bonds."[35] Senator Albert Cummins of Iowa echoed this point, observing "I do not wonder that a man like Harriman should favor this measure rather than the general income tax; because the part of his great fortune, which has been segregated from the corporations in which he is interested, lies beyond the operation of this law."[36] There were complaints that this inequity would not only play out on the investor level, but on the entity level. As one individual complained in a letter to the editor of the *Washington Post*, "heavily bonded concerns doing business in competition with those with little or no funded debt would practically escape taxation, an obviously inequitable advantage."[37]

Originally, it appears that the Administration and its supporters in the Senate had approached the problem as a drafting exercise, proposing to solve it through more precise

[32] *Is Corporate Taxation Just, and Will It Aid the Revenues?*, WALL ST. J., June 26, 1909, at 6.
[33] *Insurgents' Fight Will Hold Congress*, N.Y. TIMES, June 28, 1909, at 2.
[34] 44 Cong. Rec. 4036 (1909) (read by Sen. Joseph Bristow, R-Kansas).
[35] 44 Cong. Rec. 4008 (1909) (statement of Sen. Clapp). See id. at 4036 (statement of Sen. Bristow, R-Kans.) (favoring an income tax because "[i]t would then include the bondholders and those who have large fortunes that are not reached by this tax. It would more equitably distribute the burden as to population than this corporation tax.").
[36] Id. at 4038 (statement of Sen. Cummins). See "The President Takes a Hand," *LaFollette's Weekly Magazine*, June 26, 1909, at 13, 14 ("They [Senators Borah and Bristow] could see no reason, however, for exempting from taxation the vast incomes of individuals like Carnegie and Rockefeller, only a part of whose fortunes are in the form of corporations stocks.").
[37] *Reaping the Whirlind; Proposed Corporation Tax Strikes a Deadly Blow at Protection*, WASH. POST, June 21, 1909, at 6D.

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language. According to one report, they used the phrase "net income," rather than "net earnings" or "net profit," in the statutory language to avoid the overbonding issue.[38] Apparently, courts and businessmen had disagreed about the interpretation of the latter two phrases, leaving open the possibility that they would exclude from the tax base such "fixed charges" as interest on bonds and dividends on preferred stock.[39] The *New York World* reported that "the 'net income' of a corporation, as interpreted by the president, Secretary Knox, Attorney-General Wickersham, Senator Root and Secretary Nagel, all lawyers of high standing, is all the money the corporation has made outside its operating expenses."[40] The drafters distinguished, however, between operating expenses, which were deductible, and fixed charges, which were not. "For instance, the tax must be paid by a railroad before the railroad board sets aside any of the gross earnings for improvements, sinking fund, dividends on preferred stock or interest on its bonds."[41]

Requiring corporations to pay interest with post-tax money, however, was also controversial. The *New York Times* reported that "the important point, which threatens to cause a real division among the [Senate Finance] committee members, is the question of taxing that part of a corporation's earnings set aside for the payment of interest on bonds."[42] The dissension spilled outside the committee room. Thus, for example, Republican Senator Stephen Elkins of West Virginia reportedly spent more than an hour discussing the reasons for his opposition to the proposed corporation tax in a meeting with President Taft, including the inequity of failing to "distinguish between capital and capital stock, as some corporations raised all their capital by

[38] *See Taft's Corporation Tax Framed to Reach the Rich*, N.Y. WORLD, June 18, 1909, at 5B.
[39] Id.; Editorial, *Earnings, Profit, Income*, N.Y. TIMES, June 23, 1909, at 6. Under the 1894 Act, corporations were taxed on their "net profits or income" and bond interest was explicitly made deductible. Act of Aug. 27, 1894, 53rd Cong., Sess. II, ch. 349, § 32, 28 Stat. 556.
[40] *Taft's Corporation Tax Framed to Reach the Rich*, N.Y. WORLD, June 18, 1909, at 5B.
[41] *Taft's Corporation Tax Framed to Reach the Rich*, N.Y. WORLD, June 18, 1909, at 5B.
[42] *Taft Plan for Tax Splits Committee*, N.Y. TIMES, June 19, 1909, at 5.

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bond issues and had very little stock."[43] Similarly, a group of Progressive senators issued a statement declaring that "[t]here is no reason for exempting from the tax the vast incomes of individuals like Carnegie, Rockefeller, and others, a very large part of whose fortunes do not consist of corporation stock."[44] According to the *New York Times*, the dispute was largely along regional lines. "The division here, it is understood, is somewhat geographical, the Eastern Senators being as a general thing opposed to taxing any money connected with bonds, while the Westerners are said to be in favor of finding a way to tax such fortunes as that of Andrew Carnegie, which consists almost entirely of bond holdings."[45]

Even among the provision's supporters there were concerns about the constitutionality of taxing bond interest. In part, this related to the so-called "tax-free covenants" on many corporate bonds, which had been utilized by railroads and many larger industrial corporations to assuage bondholder concerns about the effects of income taxation after their experience with the Civil War-era tax.[46] Under the 1864 Act, companies were required to pay a five percent tax on interest payments, but were authorized to deduct the tax from those interest payments.[47] In practice, however, most corporations chose to bear the tax on interest themselves and they permitted to do so under the original Civil War-era provisions.[48] Bondholders sought to ensure the continuation of that practice by inserting tax-free covenants in their bonds. Under the covenants, corporations promised to pay principal and interest "without deduction for any tax or taxes which the

[43] *Rush of Objections to Taft Tax Plan*, N.Y. TIMES, June 22, 1909, at 1.
[44] *Oppose Taft Plan*, WASH. POST, June 17, 1909, at 1F, 4F.
[45] *Taft Plan for Tax Splits Committee*, N.Y. TIMES, June 19, 1909, at 5.
[46] SELIGMAN, THE INCOME TAX, *supra* note xx, at 695; A. C. Rearick, *Simplification of the Federal Income Tax*, 8 PROC. ANN. CONF. ON TAX'N UNDER THE AUSPICES OF THE NAT'L TAX ASS'N 298, 303-05 (1914).
[47] Act of June 30, 1864, ch. 173, §§ 120, 122, 13 Stat. 223, 283-84.
[48] Edwin R.A. Seligman, *The Income Tax*, 9 POL. SCI. Q. 610, 628-29 (1894); Rearick, *supra* note xx, at 303-04.

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company may be required or permitted to pay thereon, or to retain therefrom, under any present or future law of the United States or of any state, county or municipality therein."[49]

Given the existence of these tax-free covenants, one objection to the proposal to tax corporations without permitting a deduction for interest is that the entity-level tax would require that corporations reduce the amount of interest by the tax due, which could be construed as unconstitutionally impairing a contract.[50] The response was that the interest could be distributed and then taxed to the bondholder, but this could violate the constitutional prohibition on income taxation in *Pollock,* which the proposed corporate excise tax had sought to elide.[51] Moreover, if the interest was paid at the pre-set amount despite being subject to tax at the corporate level, there were objections that it would effectively "amount to a double tax. In the first place, the tax would be levied on the interest fund itself. . . . [and in the second place, since] in order to replenish the interest fund by the amount paid to the government for taxation on it, the proportion of net income to be devoted to paying dividends to stockholders would be curtailed by the amount of the tax on the interest fund."[52] There was some thought given to trying to impose a more narrowly tailored withholding tax on interest paid to bondholders as a way to equalize the treatment of debt and equity, but President Taft later conceded that this idea was scuttled because of constitutional concerns:

> [T]he defect was fully recognized by those who drafted the corporation tax. They would have been glad if possible to impose a tax upon the bondholders who are only less interested in the earnings and success of the corporations than are stockholders, but the difficulty of including them and of collecting from the corporation before the payment of interest on the bonds an income tax proportionate to a percentage of interest to be paid on the bonds was that Congress could not use a corporation to recoup itself in the payment of such a tax from the interest to be paid, because thus to impose a tax on the bondholders

[49] Rearick, *supra* note xx, at 303.
[50] *Taft Plan for Tax Splits Committee*, N.Y. TIMES, June 19, 1909, at 5.
[51] Id.
[52] *Taft is to Fix Tax*, WASH. POST, June 22, 1909, at 1F.

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> proportioned to the interest he received would be in violation of the Constitution as interpreted by the Supreme Court as an income tax not apportioned among the States.[53]

Given these obstacles, it was not surprising that the *Washington Post* reported that "[t]he proposition to tax corporation funds put aside for the purpose of paying interest on bonds has been abandoned."[54]

Although taxing bond interest was off the table, the fight was not over. The concern was that because of the different treatment of debt and equity, corporations and investors would take advantage of the relative fungibility of the different instruments and evade the tax by substituting bonds for stocks.[55] Senator Augustus Bacon, a Democrat from Georgia, noted during the debates over the bill that it was a frequent occurrence that "the owners of a corporation owning stock convert that stock into bonds, and therefore under that conversion, instead of paying dividends upon stock they pay interest on bonds, and the exact amount which would have been paid upon dividends is diverted to the payment of the bonds, which stand in the place of the stock which has thus been converted."[56] Bacon noted that "I have seen in the papers, for instance, that one of our great transcontinental railroads is now engaged in that very process of converting stock into bonds."[57] Similarly, the *Wall Street Journal* reported that "the United States Steel Corporation converted $250,000,000 of its preferred seven per cent stock into bonds bearing five per cent interest. It is argued that if this corporation would thus convert stock into bonds then it could do so now, and that other corporations existing under similar state laws and liberal charters could do

[53] *Taft Defends Tax on Corporations*, N.Y. TIMES, Sept. 22, 1909, at 7.
[54] *Taft is to Fix Tax*, WASH. POST, June 22, 1909, at 1F.
[55] ROY G. BLAKEY & GLADYS C. BLAKEY, THE FEDERAL INCOME TAX 46 (1940). The fact that the spread between stock yields and bond yields was relatively small may have contributed to the perception of fungibility, although the equivalence could also have been ensured through the drafting of the instruments. In 1909, the average yield of American railroad bonds varied between a low of 3.605 and a high of 3.727, while common stock yields (the actual dividends paid in a year divided by the average of the monthly stock values) averaged 4.31. *See* U.S. DEP'T OF COMMERCE, HISTORICAL STATISTICS OF THE UNITED STATES, 1789-1945, 280, Series N 201-211 (1949).
[56] 44 Cong. Rec. 4007 (1909) (statement of Sen. Bacon).
[57] Id.

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likewise, and thus convert net earnings into fixed charges and avoid the payment of taxes on net earnings as contemplated in the recommendations of the President."[58] Because of this concern, at a dinner Taft held for members of the Senate Finance Committee to convince them to back the corporation tax, "the senators told the president that it would be necessary to find some way to prevent corporations from so manipulating their stocks and bonds as to evade their tax on earnings."[59]

The compromise to this thin corporations problem was to permit corporations to deduct interest, but to cap the amount of the deduction to an amount of bonds equal to the par value of the corporation's capital stock.[60] Senator Elihu Root, a Republican from New York who was one of the principal drafters of the bill, explained that "[a]s we found that the bonded indebtedness of the corporations of the country does not vary very much from the capital stock as it is now, we thought that the simplest and most efficacious way to prevent abuse on any considerable scale would be to introduce into the measure the limitation . . . not permitting the corporation to deduct from its gross income any amount assignable to the payment of interest upon indebtedness in excess of the amount of its capital stock."[61] Root's theory was that the cap would generally limit bonded indebtedness from growing beyond its existing one-to-one status with capital stock.

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[58] *Taxation of Net Earnings*, WALL ST. J., June 19, 1909, at 8.
[59] *Taft Banquets Senate Finance Committeemen*, L.A. HERALD, June 21, 1909, at 1.
[60] *Rush of Objections to Taft Tax Plan*, N.Y. TIMES, June 22, 1909, at 1; Curtis Jay Berger, *Simple Interest and Complex Taxes*, 81 COLUM. L. REV. 217, 220 (1981); Michael Asimow, *Principle and Prepaid Interest*, 16 UCLA L. REV. 36, 63, n. 130 (1968). According to Marjorie Kornhauser, there was no deduction for interest in the June 17th draft, but by the June 21st draft it had been added. Kornhauser, *supra* note xx, at 111.
Some taxpayer corporations attempted to argue that the value of the deduction should be tied to the total amount paid to the corporation even if it was in excess of par value, but this was rejected by the courts. *See New York, N.H. & H.R. Co. v. U.S.*, 269 F. 907, 909 (2d Cir. 1920).
[61] 44 CONG. REC. 4007 (1909) (Statement of Sen. Root). Recent empirical studies suggest that the cap was effective, insofar as the average amount of corporate debt financing did not appreciably change before and after the adoption of the corporate excise tax in 1909 and the individual income tax in 1913. Leonce Bargeron et al., *Taxes, Investment, and Capital Structure: A Study of U.S. Firms in the Early 1900s* (March 2014), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2408490.

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The cap also reflected Congress' concern about the practice of over-leveraging. For corporations that already had outstanding indebtedness in excess of the par value of their paid-up capital stock or were tempted to incur such sizable debt obligations, the cap would serve as a dividing line between legitimate and what might have then been considered excessive business debt. New York practitioner George Holmes offered this explanation in his prominent income tax treatise:

> In limiting the amount of interest which a corporation could deduct under [the 1909 law] Congress evidently had in view the fact that some corporations carry a current indebtedness exceeding the amount of paid up capital stock and with respect to such corporations intended to limit the interest deduction to so much of the indebtedness as did not exceed the capital. It appears that Congress deemed that where the indebtedness exceeded that capital it should no longer be treated as an incident, but should be considered as a principal object of the corporate activities, and that the operations of such a corporation were conducted more for the benefit of the creditors than of the stockholder.[62]

In effect, this suggests that Congress viewed excessive amount of debt, or debt that exceeded a corporation's capital stock, as no longer constituting an ordinary and necessary incident of business as other deductible expenses.

There was some concern that corporations could evade this limitation by increasing their authorized capital stock with meaningless "watered stock," which prompted drafters to define the cap in terms of "paid-up capital stock" so as to make this evasion technique costly.[63] Thus, the bill provided that "such net income shall be ascertained by deducting from the gross amount of the income of such corporation . . . interest actually paid within the year on the bonded or other indebtedness not exceeding the paid-up capital stock of such corporation . . . outstanding at the close of the year."[64] Progressives and insurgents did not consider the cap to be a satisfactory

[62] GEORGE E. HOLMES, FEDERAL INCOME TAX 855 (1920).
[63] 44 CONG. REC. 4008 (1909) (colloquy between Senators Bacon and Root).
[64] *Corporate Tax Bill Laid Before Senate*, N.Y. TIMES, June 26, 1909, at 2.

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compromise, with Senator Clapp calling the treatment of bonds under the corporate tax "badly defective" and still complaining that it "exempts the man with the great fortune who has invested his millions in bonds,"[65] but it nevertheless passed in the final act.[66]

III

A.

In 1909, there had been little concern about the deferral shield, or the possibility that earnings would be retained by the corporation to permit shareholders to evade the personal income tax, because there was no individual income tax. Starting with the enactment of the first post-Sixteenth Amendment income tax in 1913, however, this was theoretically a legitimate concern and one means of reconciling the differential tax treatment of debt and equity. Nevertheless, a cap on the interest deduction remained in place.

During the Senate Finance Committee Hearings on the proposed revenue bill in 1913, several interest groups submitted statements complaining about the retention of the cap on the deductibility of corporate interest that had been adopted in 1909. J.T. Clark, speaking on behalf

[65] 44 CONG. REC. 4009 (1909) (statement of Sen. Clapp).

[66] Act of Aug. 5, 1909, ch. 6, §38(3), 36 Stat. 113. The cap on deductibility of corporate interest was subsequently challenged in court, but ultimately upheld. *Flint v. Stone Tracy*, 220 US 107 (1911) (upholding the corporate excise tax itself, but also commenting on the capped interest deduction):

> Again, it is urged that Congress exceeded its power in permitting a deduction to be made of interest payments only in case of interest paid by banks and trust companies on deposits, and interest actually paid within the year on its bonded or other indebtedness to an amount of such bonded and other indebtedness not exceeding the paid-up capital stock of the corporation or company. This provision may have been inserted with a view to prevent corporations from issuing a large amount of bonds in excess of the paid-up capital stock, and thereby distributing profits so as to avoid the tax. In any event, we see no reason why this method of ascertaining the deductions allowed should invalidate the act. Such details are not wholly arbitrary, and were deemed essential to practical operation. Courts cannot substitute their judgment for that of the legislature. In such matters a wide range of discretion is allowed.

Id. at 173-74. *See Anderson v. The Forty-Two Broadway Company*, 239 U.S. 69, 73 (1915) (upholding the cap); *Realty Company Loses*, N.Y. TIMES, Nov. 9, 1915, at 19.

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of corporations owning real estate, argued that the cap systematically disadvantaged such corporations due to the fact that "real estate is mortgaged for two-thirds of its value . . . Therefore, if its capitalization equals the amount of its equity in the property, which is most frequently the case, its capitalization is only one-half of the amount of its mortgage indebtedness, so that under the operation of the pending bill a company will be permitted to deduct only one-half of the actual interest it is obliged to pay during the year, because of this illogical provision in the bill."[67] Clark contrasted this with the situation in most other large interstate corporations where the capital stock generally exceeds the corporation's indebtedness.[68] Thus, "large corporations with millions of bonds outstanding are permitted to deduct all the interest which they pay on their bonds," while, according to Clark, the small corporation that own the buildings leased by the large corporations, "is penalized by being unable to deduct from the rents paid it by the large corporations the full amount of the interest which it has been obliged to pay to its mortgagee."[69]

Walker D. Hines submitted a brief on behalf of a number of railroad interests that also argued against the interest deduction cap. Hines argued that the concern that corporations would evade the 1909 tax by heavily capitalizing themselves with debt no longer existed in 1913 because "under the income tax law, the persons who receive the interest will pay the tax thereon . . . and hence the loss of revenue which was anticipated under the corporation excise tax law will not be realized under the income tax law."[70] Moreover, Hines contended that the possibility of

[67] J.T. Clark, *Memorandum in Relation to Amendment Sough to Pending Income-Tax Bill*, Briefs and Statements filed with the Committee on Finance, United States Senate, 63rd Cong., 1st Sess. on H.R. 3321, Vol. III at 2078, 2079 (1913).
[68] Id. at 2080.
[69] Id.
[70] Walker D. Hines, Some Suggestions and Comments, on Behalf of Certain Railroad Companies, Relative to the Provisions of the Income Tax Section of H.R. 3321, Regulating the Ascertainment of the Net Income of Corporations, Briefs and Statements filed with the Committee on Finance, United States Senate, 63rd Cong., 1st Sess.

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using leverage to evade the income tax was minimal due to the bankruptcy risk of heavy leverage and due to the fact that "[a]t the present time no corporation can put forward any bond with the hope that it will be attractive unless the bond contains a provisions supposed to mean that the interest will be paid free of any tax which may be required to paid or deducted at the source."[71]

At the same time, the issue of reaching bondholder wealth was still prominent in policy discussions. The bill's authors reportedly designed the measure to "reach the rich man and be effective in equalization of taxation."[72] At the time, Andrew Carnegie was in the news for reportedly retiring with $213 million worth of bonds in the newly formed United States Steel Corporation, all of which would be exempt from taxation under New York state property law after paying a one-time recording tax.[73] Moreover, beyond the sensationalism of individual massive bond wealth was the reality that corporation bonds were an important part of corporate financing at this time, with the gross amount of corporate bonds outstanding equaling $17.4 billion in 1913, compared to only $5.6 billion in combined tax-exempt federal and state bonds.[74]

Ultimately, Congress elected to raise the interest cap rather than eliminate it. In the Senate Finance Committee the ceiling on deduction of interest was increased from an amount equal to the paid-up capital stock to an amount "not exceeding one-half of the sum of its interest-bearing indebtedness and its paid-up capital stock outstanding at the close of the year."[75] There was some confusion about the construction of this clause. Treasury initially interpreted this to

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on H.R. 3321, Vol. III at 2058, 2059 (1913). Indeed, the existence of the income tax led Hines to point out that the cap would result in double taxation on the non-deductible portion of the interest. Id. at 2060. *See* Letter to the Editor, *Double Income Taxation*, N. Y. TIMES, May 17, 1913, at 10.

[71] Hines, *supra* note xx, at 2062.

[72] *Taxes Piled Up in Succession Under Operation of Income Bill*, WALL ST. J., June 20, 1913, at 1.

[73] *Taxation of Bonds, Financial News for the Investor*, 47 REV. OF REVIEWS 126 (1913). New York's so-called "secured debt" exemption only added to the confusion among investors trying to understand the tax consequences of holding bonds at this time. *See Bonds and Taxes*, 49 MUNSEY'S MAG. 421, 423 (1913).

[74] GEORGE E. LENT, THE OWNERSHIP OF TAX-EXEMPT SECURITIES, 1913-1953 10, tbl. 1 (1955).

[75] Tariff Act of 1913, ch. 16, §II(G), 38 Stat. 114, 173; Blakey & Blakey, *supra* note xx, at 84.

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mean that the capital stock and the debt should be added together and then cut in half to arrive at the amount of debt for which interest may be deducted. [76] Corporations were even instructed to calculate their interest this way on their returns.[77] Nevertheless, Treasury soon changed its stance and issued a ruling to explain that it would construe the language as the paid up capital stock, plus one-half of the outstanding debt.[78] This confusion only underscores the arbitrariness of the number chosen for the ceiling on the interest deduction. Seligman called it a "compromise . . . more favorable to the corporations than was the excise tax," but one was that was "entirely arbitrary. Either there should have been no deduction at all, or the deduction should have been permitted on all the indebtedness which might be regarded as a result of purely consumption credit."[79]

B.

After 1913, Congress was subjected to "several years of intensive lobbying by corporate interests" on the subject of the corporate interest deduction.[80] Some argued that the interest cap was hard to justify in a post-Sixteenth Amendment world. Representative J. Swagar Sherley, a Democrat from Kentucky, asked Chairman Cordell Hull whether the Ways and Means Committee "had considered a simplification of the law by providing that the corporation could do as individuals do, and that all interest paid should be considered as an expense of doing business."[81] As Sherley explained, "I can see why, when you do not tax individuals but only tax corporations, you should have a particular provision touching interest payments. But now you

[76] *New Income Tax Returns Necessary from Corporations*, WALL ST. J., Mar. 21, 1914, at 1.
[77] Id.
[78] Id. at 1, 7; T.D. 1960, 16 Treas. Dec. Internal Rev. 43 (1914).
[79] Seligman, *supra* note xx, at 685.
[80] Berger, *supra* note xx, at 221, n. 32.
[81] 53 CONG. REC. 10656 (1916).

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are taxing both the corporation and the individual."[82] Railroad lawyer Alfred Thom echoed these sentiments in a brief he submitted to the Senate Finance Committee during the consideration of the 1916 Act "[i]t is difficult to appreciate the reason for any arbitrary limitation on interest in calculating net income as would be the case in any expense incident to the business, and no satisfactory reason has been assigned. The present provision has apparently been taken over from the old corporation excise law without consideration of the effect of the establishment of a net income tax on individuals."[83]

One impetus for change was the continuing perception that the cap on the deductibility of interest payments was effectively hitting either common stockholders with a second or third layer of tax or consumers in the form of higher prices, rather than reaching bondholder wealth. This was partly due to the continued presence of tax-free covenants and other structural features of the bond instruments that prevented corporations from factoring in the deductibility cap into previously issued bonds. Harvard Economics Professor Charles Bullock wrote that "[a]t present the average corporation is obliged to assume payment of the ordinary tax upon bond interest. . . . It therefore comes about, if the tax is not shifted, that the holders of common stock may be taxed at two or three times the ordinary rate."[84] These tax-free covenants had expanded far beyond the original confines of those enacted as a result of the Civil War-era income tax:

> The language of the typical "tax-free" clause, however, framed at the instance of creditors who demanded protection against every possible contingency in the premises, is, in its usual form, so broad as apparently to comprehend not only an excise tax upon

[82] Id.

[83] Alfred P. Thom in Regard to the Duplicate Taxation of the Holders of Common Stock by the Pending Revenue Act, in Briefs and Statements filed with the Committee on Finance, United States Senate, 64th Cong., 1st Sess., on H.R. 16763 75, 76 (1916).

[84] Charles J. Bullock, *Financing the War*, 31 Q. J. ECON. 357, 374 (1917). *See* W. Elliot Brownlee, *Wilson and Financing the Modern State: The Revenue Act of 1916*, 129 PROC. AM. PHILOS. SOC'Y 173, 197 (1985) (describing practice of tax-free covenants). *But see* Roy G. Blakey, *Amending the Federal Income Tax*, 58 ANNALS AM. ACAD. POL. & SOC. SCI. 32, 38 n. 4 (1915) (arguing that the tax burden was properly on corporations or shareholders because the tax burden was built-in to the higher price the corporation received for the bond).

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> the business of the corporation deductible against its security-holders but a tax like the present income tax which is levied, not upon the corporation, but upon the recipient of the interest, and which solely, as a means of collection, the corporation is required to withhold and to pay to the government. . . . The result has been a tax which Congress intended to levy upon the *income-receiver* has, in this case, been shifted to the *income-producer*. It thus falls not upon the "swollen fortune" which it is the professed purpose of this act particularly to reach, but primarily upon the corporation and finally upon the unfortunate "ultimate consumer" who was supposed already to be more than sufficiently taxed.[85]

This meant that one argument for differentiating between the cap in 1909 and the cap post-1913 – that the individual income tax would ensure that bondholders paid their fair share of tax on the interest payments – may not have been entirely accurate. In effect, permitting the corporation to deduct interest payments may have become a way to ensure the corporation (or its stockholders, customers, or whoever bore the ultimate burden) would not pay the tax twice, since its bondholders were already being spared one layer of tax as a result of the covenants.[86]

In 1916, Congress was not ready to abandon the cap completely, but it was willing to further the effort begun in 1913 to raise it. Thus, a bill was introduced to permit corporations to deduct interest on an amount of debt equal to twice its capital stock. As Chairman Hull explained, this was once again a compromise relating to concerns about the fungibility of debt and equity: "the original theory was that corporations could issue quite a lot of watered stock, transfer that into bonds, mortgage their property, and incur interest, and make a great many shifts in many ways that would result in avoiding the real purpose of the law. This bill allows them to

[85] Rearick, *supra* note xx, at 304.

[86] The Senate Finance Committee in 1916 also sought to ameliorate the problem by prohibiting tax-free covenants for future bond issuances, but ultimately simply barred the deductibility of income tax payments made as a result of such guarantees. *See* Brownlee, *supra* note xx, at 201; Cedric A. Major, *The Revised Federal Income Tax Law*, 2 CORNELL L.Q. 73, 87 (1917).

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deduct interest on an amount of indebtedness double their capital stock."[87] As Hull explained, "[t]he original provision was modified, but it was not thrown wide open."[88]

Congress did not adopt the same cap proposed in the House bill, but it did employ language to ratify the more generous interpretation employed by Treasury starting in 1914. Thus, under the Revenue Act of 1916, it revised the statutory language to make clear that corporations were permitted to deduct the interest on an amount of debt equal to the paid-up capital stock and one-half the outstanding indebtedness.[89] While this fell far short of the critics' arguments for repeal, it laid the groundwork for a push to eliminate the cap completely a few years later.

The entry of the United States into the war and the adoption of war and excess profits taxes in 1917 had complicated the question of the corporate interest deduction. In its definition of an "invested capital" base upon which to measure "excess profits" and "war profits" for purposes of levying a tax, Congress had omitted most borrowed funds.[90] The *New York Times* argued that this was inequitable since "all funds used in business, and at the risk of business, are capital for that purpose in an economic sense."[91] The *Times* suggested that "[a] small step toward solving the problem would be to remove, or at least to enlarge, the limit upon the allowance deductible for interest before calculating the tax."[92] As George Holmes explained, the interest cap's "arbitrary limitation resulted in the creation of a fictitious income on which the

[87] 53 Cong. Rec. 10656 (1916).
[88] Id.
[89] Revenue Act of 1916, ch. 463, tit. I, §12(a), 39 Stat. 756, 768 ("The amount of interest paid within the year on its indebtedness to an amount of such indebtedness not in excess of the sum of (a) the entire amount of the paid-up capital stock outstanding at the close of the year, or, if no capital stock, the entire amount of capital employed in the business at the close of the year, and (b) one-half of its interest-bearing indebtedness then outstanding."); *See Revenue Bill Amended*, N.Y. TIMES, Aug. 13, 1916, at XX2.
[90] ROBERT H. MONTGOMERY, EXCESS PROFITS TAX PROCEDURE 108 (1920).
[91] *Taxation of Borrowed Capital*, N.Y. TIMES, June 17, 1918, at 12.
[92] Id.

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corporation was taxed, and since the such fictitious income not only was subject to a heavy income tax but entered very materially into the computation of an extraordinarily heavy excess-profits tax, the provision operated with rank injustice in the case of corporations which had an indebtedness greatly in excess of their capital stock."[93]

In 1918, the House Ways and Means Committee used similar reasoning in a report recommending a repeal of the cap:[94] "Since borrowed money is not allowed to be included in computing invested capital for the purpose of the war profits and excess profits tax, it seems only fair to allow as a deduction in computing net income the whole amount of the interest paid during the year."[95] Under the Revenue Act of 1918, Congress adopted this logic and interest on corporate debt became fully deductible for the first time.[96] This move was considered momentous and hailed by businesses and practitioners, where the cap had not only limited deductibility, but also caused significant confusion for corporate taxpayers.[97] As the *Wall Street Journal* had commented when the repeal of the cap was before the Ways and Means Committee, "[h]alf-way concessions [on the interest deduction cap] were made in the present law, but the new bill contains the first full measure of justice to corporations" on this issue.[98] Similarly, the *New York Times* hailed the change: "Considering that all interest paid by corporations is subject to tax as income of those to whom it is paid, the limitation in the old law likewise resulted in

[93] HOLMES, *supra* note xx, at 856.
[94] *Retains Taxation on Issues of Bonds*, N.Y. TIMES, Sept. 18, 1918, at 17.
[95] Revenue Bill of 1918, Report of the Committee on Ways Means to accompany H.R. 12863, Rep. No. 767, 65th Cong., 2d Sess. 12-13 (Sept. 3, 1918).
[96] Revenue Act of 1918, ch. 18, §234(a)(2), 40 Stat. 1057, 1077 (1919).
[97] *See, e.g., Income Tax Allowance with Respect to Interest*, WALL ST. J., June 10, 1918, at 4; *Answers to Inquirers; War Revenue Problems*, WALL ST. J., Feb. 15, 1918, at 2; *Borrowed Funds Allowable as Capital in Cases*, WALL ST. J., Feb. 14, 1918, at 4; ROBERT H. MONTGOMERY, INCOME TAX PROCEDURE 1920 ed. 584 (1920).
[98] *The Revenue Bill*, WALL ST. J., Aug. 31, 1918, at 1.

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double taxation to the extent that a corporation was not permitted to deduct interest in arriving at net taxable income."[99]

IV.

The capped origin of the corporate interest deduction contradicts the notion that a full interest deduction was part of the original deesign of the corporate income tax. Indeed, there was significant concern about bondholder wealth and tax evasion as a result of the fungibility of debt and equity in 1909 and this concern continued even after an individual income tax was enacted. The cap on the interest deduction, although criticized as "logically indefensible,"[100] reflected a pragmatic compromise between those concerned that corporations would become over-leveraged to avoid the entity-level tax and those concerned that not permitting an interest deduction would unfairly disadvantage corporations that needed such leverage. It was only removed when the larger issue of taxing wartime profits made the tax treatment of heavily leveraged companies more problematic.

This historical context also provides perspective for modern advocates of a cap on the corporate interest deduction. For instance, Senator Wyden justifies the proposal contained in his bill with Republican Senator Dan Coats on similar grounds of over-leverage and the ease of shifting between equity and debt. According to the information statement on bill, the cap is justified as necessary to "create[] a more even playing field between corporate debt and equity by cutting the value of inflation from a corporation's interest deduction on debt."[101] "Cutting the

[99] *Shows Injustice of Revenue Bill*, N.Y TIMES, Jan. 12, 1919, at 29.
[100] ROBERT H. MONTGOMERY, INCOME TAX PROCEDURE, 1919 ed. 459 (1919).
[101] http://www.wyden.senate.gov/imo/media/doc/Wyden-Coats%20Two%20Pager%20FINAL1.pdf (last visited March 10, 2014).

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value of this tax deduction," the statement continues, "will reduce a company's financial incentive to take on debt."[102]

[102] Id.

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