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Entity Theory as Myth in the Origins of the Corporate Income Tax

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ENTITY THEORY AS MYTH IN THE ORIGINS OF THE CORPORATE INCOME TAX

STEVEN A. BANK*

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INTRODUCTION

The United States has long operated under a dual system of business taxation in which corporations and partnerships receive disparate treatment. Corporations are treated as separate taxable entities, while partnerships are ignored for most purposes. Perhaps the most notable impact of such disparity is that income from businesses operating in corporate form is taxed twice—first at the corporate level when earned and a second time at the shareholder level when distributed. Income from businesses operating in partnership form, however, is taxed only at the partner level.¹ This dual system has frequently been called unfair and inefficient,² but Congress has addressed only its symptoms.³ The source of the problem can be traced back over one hundred years to the adoption of the first separate corporate income tax.⁴

1. I.R.C. § 11 (West 2001) (imposing a tax on corporate income); *id.* §§ 301, 316 (imposing a shareholder-level tax on distributions in the form of dividends); *id.* § 701 (explaining that the partners, and not the partnership itself, are subject to tax).

2. The dual taxation of corporate income is considered inequitable because the tax on income at the shareholder level is imposed regardless of the relative income levels of the various shareholders. It is considered inefficient because the imposition of a tax on corporations but not other business entities distorts investment decisions and encourages inefficient behavior on the part of corporations. See CHARLES E. MCLURE, JR., MUST CORPORATE INCOME BE TAXED TWICE? 2-3 (1979); Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 YALE L.J. 325, 326-27 (1995); Michael J. Graetz & Alvin C. Warren, Jr., *Integration of Corporate and Individual Income Taxes: An Introduction*, 84 TAX NOTES 1767, 1768 (1999); Katherine Pratt, *The Debt-Equity Distinction in a Second-Best World*, 53 VAND. L. REV. 1055, 1098-1100 (2000).

3. Several partial integration methods were attempted prior to the Tax Reform Act of 1986, including a deduction for dividends at the corporate level, a shareholder-level credit for taxes paid by the corporation on its profits, and an exclusion for dividends at the shareholder level. See Scott A. Taylor, *Corporate Integration in the Federal Income Tax: Lessons from the Past and a Proposal for the Future*, 10 VA. TAX REV. 237, 288-97 (1990). Congress has also enacted a modified version of the partnership tax for a narrow class of corporations. See, e.g., I.R.C. § 1363(a) (West 2001) (exempting certain electing small business corporations, or "S corporations" from the corporate income tax).

4. See Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L.J. 53, 86 (1990) ("The first federal income tax statute to clearly tax corporations was the 1894 Act."); Tariff Act of Aug. 27, 1894, ch. 349, § 27, 28 Stat. 509, 553. The income tax portion of the Tariff Act was later declared unconstitutional as an unapportioned direct tax. *Pollock v. Farmers' Loan & Trust Co.*, 158 U.S. 601 (1895); see also Robert Charles Clark, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 YALE L.J. 90, 96-97 (1977) (describing the adoption of the "separate tax principle" as one of the seven foundational principles of contemporary corporate tax law); Emil

The traditional explanation for the original adoption of a corporate income tax is that developments in entity theory led Congress to consider the corporation, but not the partnership, as a taxpayer or "entity" separate from its owners. During the Civil War and Reconstruction, the use of corporations was still relatively limited and the line between corporations and partnerships was blurred by the spread of general incorporation acts. Consequently, observers suggest that the Tariff Act of 1864,⁵ which treated both corporations and partnerships as conduits for purposes of the country's first income tax, was a reflection of the view that the corporation, like a partnership, was little more than an "aggregate" consisting of its shareholders.⁶ By the end of the century, however, the partnership view of the corporation became increasingly inconsistent with the rise of the large corporation. Academic theorists began to agonize over the legal personality of the corporation.⁷ During the debate over the 1894 Act, this abstract and theoretical question seemed to take on great practical importance.⁸ According to modern observers of this debate, it was the acceptance of the view that the corporation was itself a separate taxable entity

M. Sunley, *Corporate Integration: An Economic Perspective*, 47 TAX L. REV. 621, 621 (1992) ("The U.S. corporate income tax is now almost 90 years old and, except for a two-year period during 1936 and 1937 when a graduated surtax was imposed on undistributed profits, the United States generally has adhered to the classical system of a separate corporate tax.") (footnotes omitted).

5. Tariff Act of June 30, 1864, ch. 173, 13 Stat. 223, 281-85.

6. Under the Act of 1864, investors were directly taxed on their undivided share of a business's gains and profits regardless of the form of organization. *Id.* Companies in certain industries, primarily banking, insurance, and transportation, were subject to an entity-level tax on their dividends and undistributed profits for the year, but their taxation was not explicitly based on corporate status and distributions received from these taxable businesses were exempt from the income of the shareholders or bondholders who received them. *Id.* Thus, the Act deliberately avoided double taxation and ostensibly did not distinguish between corporations and partnerships in the taxation of investments. The entity versus aggregate debate continues today in the treatment of partnerships for tax purposes. See BABETTE B. BARTON ET AL., TAXATION OF BUSINESS ENTERPRISES 885 (1998).

7. MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW 1870-1960: THE CRISIS OF LEGAL ORTHODOXY 101 (1992) ("Beginning in the 1890s and reaching a high point around 1920, there is a virtual obsession in the legal literature with the question of corporate personality.").

8. See Kornhauser, *supra* note 4, at 87 (indicating that, during the debates over the 1894 Act, "Congress grappled with the issue of corporate personality and whether corporations could or should be taxed separately from individuals").

that led to the adoption of a corporate income tax in 1894⁹ and laid the groundwork for the later imposition of double taxation.¹⁰

This explanation overstates the role of entity theory in the development of the dual system of taxing business income. Throughout the nineteenth century the corporation was viewed as a separate entity, capable of being taxed on its income on the same basis as an individual. This was especially true during the Civil War and Reconstruction when the 1864 Act was in effect. States taxed corporations as separate entities both before and after the Civil War and the Supreme Court upheld the separate entity status of a corporation in several state tax cases decided soon after the 1864 Act was instituted.¹¹ The aggregate theory of the corporation was not discussed until well after the adoption of the Civil War income tax acts. Although Congressional debates over the 1894 Act were animated by discussions regarding the nature of the corporation,¹²

9. The American Law Institute, for example, has indicated:

The origin of subchapters C and K and, specifically, the separate entity taxation of corporations as opposed to the conduit taxation of partnerships, can be linked to some extent to a debate that raged during the last part of the 19th century and the early part of the 20th century concerning the nature of corporate and partnership personality Gradually, the entity theory prevailed for corporations but not for partnerships.

AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT—REPORTER'S STUDY OF TAXATION OF PRIVATE BUSINESS ENTERPRISES 35-36 (1999); see also Kornhauser, *supra* note 4, at 136 ("In 1909 [when the corporate excise tax was adopted] the artificial entity theory justified treating corporations separately from their owners and differently than individuals."); Pratt, *supra* note 2, at 1057 ("[T]he corporate tax came into existence and was influenced by turn-of-the-century theories of the firm."); cf. RICHARD GOODE, THE CORPORATION INCOME TAX 9 (1951) ("The corporation income tax in the United States is based on the usual legal view that a corporation and its stockholders are separate persons."); RICHARD WESTIN ET AL., FEDERAL INCOME TAXATION OF BUSINESS ENTERPRISES 649 (2d ed. 1999) ("The U.S. separate corporate income tax is probably based on the (mistaken) notion that corporations are legal persons or aggregations of capital that can, do, and should pay taxes and bear tax burdens.").

10. Under the 1894 Act, shareholders were permitted to exclude from income dividends received from corporations already taxed on their income. Act of Aug. 27, 1894, ch. 349, § 28, 28 Stat. 509, 554. Thus, the 1894 Act did not itself institute a system of double taxation. Observers suggest, however, that the entity theory justifications for the corporate income tax also justified later efforts to impose double taxation. See GOODE, *supra* note 9, at 24-25 ("In the legal sense, of course, the corporate and individual income taxes do not result in double taxation. The corporation and its stockholders are different legal persons and have separate incomes. The criticism is that there is double taxation in the economic sense.").

11. *People v. Commissioners*, 71 U.S. (4 Wall.) 244 (1866); *Van Allen v. Assessors*, 70 U.S. (3 Wall.) 573 (1865).

12. See Kornhauser, *supra* note 4, at 87-90.

entity theory was merely one of several rationales offered to justify a corporate tax rather than a legitimate change in the understanding of the corporation.¹³ Moreover, Congress made no attempt to subject corporate income to double taxation in either 1864 or 1894. Thus, there is little basis for the notion that the adoption of a corporate income tax, and the subsequent adoption of double taxation, was the result of a late nineteenth-century vision of the corporation as a separate entity.

If corporations were not taxed because they were considered separate entities, why were they taxed? This Article will establish that the corporate income tax was originally adopted as a substitute or "proxy" for taxing corporate shareholders directly. The rise of intangible wealth and the increasing tax evasion associated with this new wealth led Congress to search for alternative methods of reaching the income of wealthy individuals. Because of its regular and open distribution of dividends, the corporation was an obvious target for an expansion of stoppage-at-the-source collection efforts that had proven so successful during the Civil War and Reconstruction. In effect, the corporate income tax was thought to be a necessary mechanism for enforcing a comprehensive scheme of individual income taxation.

Part I compares the federal taxation of business income during the 1860s, the 1890s and beyond, highlighting the continuing efforts of Congress to avoid double taxation. Part II outlines the growth of the corporation and the development of entity theory in this country in order to rebut the traditional view of its importance in the development of the separate corporate tax. Part III explains how the differences in the treatment of corporations under the 1864 and 1894 Acts are attributable to an increased interest in taxing shareholder income and explains why this interest did not extend to taxing partnerships as well. The Article concludes in Part IV with a discussion of the possible reasons our current corporate income

13. The entity theory discussion occurred during debates over whether a corporation should be entitled to the same \$4000 exemption provided to individuals under the 1894 Act. § 27, 28 Stat. at 553. Although individuals were entitled to exclude dividends from income, corporations did not have any exemption and therefore integration was, at best, only partial. *Id.* § 32, at 556.

tax has strayed so far from its origins as a tax on shareholder income.

I. EARLY FEDERAL REVENUE LAWS AND THE AVOIDANCE OF DOUBLE TAXATION

A. *Civil War and Reconstruction*

1. *1862 Act*

In the face of mounting debt and a pressing need for funds to help finance the war effort,¹⁴ a federal income tax was first collected in 1862.¹⁵ The 1862 Act imposed a tax of three percent on all income between \$600 and \$10,000 and a five percent tax on incomes in excess of \$10,000.¹⁶ Although the Act did not specifically mention income from corporate or partnership profits, it did impose a form of withholding tax on certain businesses. A tax of three percent was levied on all dividends issued and interest paid by railroad corporations and a similar tax was assessed on all dividends issued and on all sums added to surplus by banks, trust companies, savings institutions, and insurance companies.¹⁷ Despite the inclusion of these provisions in a separate section, they were generally regarded as a part of the income tax.¹⁸

Although the simultaneous enactment of an income tax on individuals and a dividend tax on businesses could have been structured to impose a double tax burden, Congress actively sought

14. Prewar debt was almost \$75 million in 1861. JOHN F. WITTE, *THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX* 67 (1985). With the onset of war, the burden grew while traditional revenue sources tightened. *Id.* at 68.

15. Act of July 1, 1862, ch. 119, § 90, 12 Stat. 432, 473. The first federal income tax was actually adopted in 1861. Act of August 5, 1861, ch. 45, 12 Stat. 292, 309. At the beginning of the Civil War, however, Salmon Chase, Lincoln's Treasury Secretary, made no effort to assess or collect any taxes under this Act, rendering it a dead letter. Steven A. Bank, *Origins of a Flat Tax*, 73 DENV. U. L. REV. 329, 345 (1995).

16. § 90, 12 Stat. at 473.

17. *Id.* §§ 81-82.

18. Joseph A. Hill, *The Civil War Income Tax*, 8 Q. J. ECON. 416, 427 (1894). Sections 89-93 were listed under the heading "Income Duty," while the dividend and interest taxes were included under the headings "Railroad Bonds" and "Banks, Trust Companies, Savings Institutions, and Insurance Companies." §§ 89-93, 12 Stat. at 469-75.

to avoid this result. Double taxation was a particularly sensitive charge for supporters of the income tax. As Representative Justin Morrill noted when introducing the bill on behalf of the Ways and Means Committee, one of the principal concerns regarding the general income tax was that it burdened wealth that was already taxed by another jurisdiction.¹⁹ In protesting a related provision, one representative typified these concerns by declaring "I do not think that the Government should derive double taxation from the same property for the same period of time. That is a proposition, the correctness of which I think every member will concede."²⁰ Others confirmed this statement, calling double taxation "not just" and proposing amendments to avoid this result wherever appropriate.²¹

Not surprisingly, given this anti-double-tax sentiment, Congress enacted measures to minimize the double tax risk in the business context. Principally, shareholders and bondholders were permitted to exclude from their income the receipt of dividends and interest from corporations already taxed under the Act.²² This, of course, was not a perfect solution. Unlike the income tax itself, the rate was not graduated and there was no exemption for shareholders with incomes below \$600.²³ While the latter problem was

19. CONG. GLOBE, 37th Cong., 2d Sess. 1196 (1862) (statement of Rep. Morrill) ("The income duty is one, perhaps, of the least defensible that . . . the Committee of Ways and Means concluded to retain or report. The objection to it is that nearly all persons will have been already once taxed upon the sources from which their income has been derived.").

20. CONG. GLOBE, 37th Cong., 2d Sess. 1534 (1862) (statement of Rep. Edwards) (offering an amendment to a proposed inheritance tax that would relieve all property taxed during life from taxation at death).

21. CONG. GLOBE, 37th Cong., 2d Sess. 1527 (1862) (statement of Rep. Sherman) (proposing to exempt mortgages from tax because of concerns about double taxation); *see also id.* at 1486 (statement of Rep. Eliot) (proposing amendment to relieve savings banks from tax on dividends arising from earnings received on bank stock holdings); *id.* at 1545 (statement of Rep. Stevens) (protesting property tax on stocks and bonds as a double tax when combined with an income tax, explaining "[i]f the pending amendment is adopted, we ought to strike out the income tax altogether, and insert this in its place, for I believe there is no single item in the gentlemen's amendment that is not taxed in the shape of income"); *id.* at 2555 (statement of Sen. McDougall) (objecting that tax on insurance companies would be doubled because of the reinsurance industry); *id.* at 2573 (statement of Sen. Howe) (proposing an integration scheme for the manufacture of alcohol).

22. § 91, 12 Stat. at 473-74.

23. The lack of an exemption produced some inequities. Hill, *supra* note 18, at 427-28. Individuals with incomes in excess of \$10,000 would be taxed at three percent on dividends on interest from railroads and other such corporations, but at five percent on all other income. Conversely, individuals not subject to the income tax because their income was less than \$600

controversial,²⁴ albeit rare in occurrence,²⁵ the former problem was partially alleviated by administrative practice. George S. Boutwell, the first Commissioner of Internal Revenue, issued a regulation instructing the assessors of the income tax to assess an additional two percent tax on individuals with income in excess of \$10,000 who received dividends and interest from taxable corporations.²⁶

The 1862 Act did appear to impose a separate tax upon certain corporations in the form of a gross receipts tax. Under section 80 of the Act, businesses operating railroads, steamboats, and ferry boats were required to pay a three percent tax on the gross amount of their receipts.²⁷ The provision, however, applied regardless of whether the business was incorporated.²⁸ It also explicitly permitted the affected company to pass along the amount of the tax to their customers in the form of higher fares.²⁹ Thus, if the business chose to pass on the tax, it was arguably more like a sales tax than a tax on the business itself. Even if it paid the tax without raising rates, however, it was still more similar to a proxy tax because

would still pay at a three percent rate on dividends and interest from specified businesses because the withholding tax was not relieved for dividends and interest paid to lower income taxpayers. *Id.* One commentator has explained the absence of an exemption for taxes paid by corporations on dividends and interest as an administrative problem. See HARRY EDWIN SMITH, *THE UNITED STATES FEDERAL INTERNAL TAX HISTORY FROM 1861 TO 1871*, at 55 (1914) ("The law made no provision for exemptions of any kind in these taxes paid by corporations, for, as the tax was to be assessed in a lump sum on all money paid out as interest or dividends, it seemed impracticable to Congress to permit this deduction.").

24. HAROLD Q. LANGENDERFER, II *THE FEDERAL INCOME TAX 1861 TO 1872*, at 507-09 (1954).

25. ROBERT STANLEY, *DIMENSIONS OF LAW IN THE SERVICE OF ORDER: ORIGINS OF THE FEDERAL INCOME TAX 1861-1913*, at 279 n.74 (1993) (suggesting that the number of individuals whose total income fell below the exemption level but paid the tax withheld on corporate dividends must be statistically insignificant given the low proportion of income tax revenues attributable to the dividend provisions).

26. GEORGE S. BOUTWELL, *A MANUAL OF THE DIRECT AND EXCISE TAX SYSTEM OF THE UNITED STATES* 197 (1863); SMITH, *supra* note 23, at 55. This addressed the inequality of taxing five percent taxpayers at a three percent rate on corporate income, but it did not address the reverse problem of taxing zero percent taxpayers at a three percent rate. See SIDNEY RATNER, *TAXATION AND DEMOCRACY IN AMERICA* 75 (Octagon Books 1980) (1942).

27. Act of July 1, 1862, ch. 119, § 80, 12 Stat. 432, 468-69.

28. *Id.*

29. *Id.*, 12 stat. at 469 ("Provided, That all such persons, companies, and corporations shall have the right to add the duty or tax imposed hereby to their rates of fare . . .").

shareholders were entitled to exempt from income the receipt of dividends from corporations subject to the gross receipts tax.³⁰

2. 1864 Act

Between 1862 and 1864, the country's financial position worsened and the public debt grew to over \$1 billion.³¹ Revenue from the 1862 Act had been disappointingly low;³² Congress focused more of its efforts on the income tax in hopes of bolstering its financial condition.³³ Under the 1864 Act,³⁴ Congress increased the individual income tax rate to five percent on incomes between \$600 and \$5000, seven and one half percent on incomes between \$5000 and \$10,000, and ten percent on incomes in excess of \$10,000.³⁵ Unlike the income tax provisions in the 1862 Act, which did not mention income from corporate or partnership profits, the 1864 Act specifically included them in income. Under section 117 of the 1864 Act, "the gains and profits of all companies, whether incorporated or partnership, other than the companies specified in this section, shall be included in estimating the annual gains, profits, or income of any person entitled to the same, whether divided or otherwise."³⁶ The Commissioner interpreted this latter phrase to permit taxation of shareholders on the undivided profits of a corporation,³⁷ but soon

30. *Id.* § 91.

31. LANGENDERFER, *supra* note 24, at 451; RATNER, *supra* note 26, at 80.

32. RATNER, *supra* note 26, at 82.

33. See Hill, *supra* note 18, at 423 ("This act [the 1864 Act] was the most important revenue measure of the war, and was expected to produce revenue of about \$250,000,000.").

34. Act of June 30, 1864, ch. 173, §§ 116-123, 13 Stat. 223, 281-85.

35. *Id.* § 116. Before the 1864 Act went into effect, however, Congress eliminated the middle bracket and imposed a ten percent tax on all incomes in excess of \$5000 in an effort to further increase revenues. Act of March 3, 1865, ch. 78, 13 Stat. 469; Hill, *supra* note 18, at 425; Taylor, *supra* note 3, at 262. Apparently, the need arose because new estimates suggested that the receipts from the 1864 Act would fall far short of projections made at its introduction. See STANLEY, *supra* note 25, at 35.

36. § 117, 13 Stat. at 282.

37. See DIGEST OF DECISIONS AND REGULATIONS MADE BY THE COMMISSIONER OF INTERNAL REVENUE, 1864-1898, at 16, 36, 37, 39, 40 (1906). Although the principal challenges surrounding this provision applied to corporate profits, the provision actually applied to the undistributed profits of both corporations and partnerships. It appears that some limited partnerships operated under a corporate model and agreed not to allow funds to be distributed prior to the liquidation of the partnership. See SMITH, *supra* note 23, at 57. When faced with such a situation, the Commissioner ruled that each partner was required to report his or her

after adoption of the 1864 Act this reading of the statute was challenged in court. Eventually, the Supreme Court considered the issue in *Collector v. Hubbard*.³⁸ The Court agreed, albeit in dictum, that the phrase "whether divided or otherwise" meant that a corporation's undistributed profits were generally taxed as income to its shareholders as if they had been received by the shareholder as a dividend or liquidating distribution.³⁹ Thus, regardless of a business's form of organization, its owners were taxed on a conduit basis.

In the 1864 Act, Congress deviated from the pure conduit approach with respect to "taxable" businesses assessed under the 1862 Act. These included banks, trust companies, savings institutions, and insurance, railroad, canal, turnpike, canal navigation, and slackwater companies.⁴⁰ Such businesses were subject to a tax of five percent on all dividends as well as "all undistributed sums, or sums made or added during the year to their surplus or contingent funds."⁴¹ Additionally, certain businesses were subject to a five percent tax on interest paid pursuant to bonded indebtedness.⁴²

Despite the increased pressure to raise revenue, Congress sought to avoid imposing double taxation.⁴³ As with the 1862 Act, several measures were enacted with this goal in mind. At the company

share of profits as income, as if a distribution had been made. *Id.*

38. 79 U.S. (12 Wall.) 1 (1870).

39. *Id.* at 16-18 (dictum). The Court struck down the challenge, indicating that it was barred on jurisdictional grounds. *Id.* at 14-15.

40. §§ 120-122, 13 Stat. at 283-85. Although it is likely that most such businesses were conducted in corporate form, the critical distinction between these taxable businesses and other businesses was the specified industry rather than the form of organization.

41. *Id.* § 120.

42. *Id.* § 122. Such businesses included railroad, canal, turnpike, canal navigation, and slackwater companies. *Id.* One commentator has speculated that the reason banks and savings institutions were excluded from this list was due to concerns about vertical equity. See Taylor, *supra* note 3, at 261 n.131 (noting that railroad and other transportation companies issued bonds in large denominations, while banks had many depositors with incomes below the \$600 exemption).

43. On several occasions during the debates over the 1864 Act, members of Congress expressed a desire to avoid imposing a double tax burden, although they often raised the charge where it was of doubtful applicability. See, e.g., CONG. GLOBE, 38th Cong., 1st Sess. 2730 (1864) (statement of Sen. Harris) (protesting the gross receipts tax on express companies because it would impose a double tax burden on already taxed railroad companies that used express companies).

level, taxable businesses were permitted to deduct amounts previously taxed, such as undistributed sums, from the tax due on the dividend.⁴⁴ At the investor level, investors were permitted to exclude dividends and interest received from taxable businesses.⁴⁵ Despite these efforts, the 1864 Act did not completely integrate the business/investor income taxes with respect to these taxable businesses. Most seriously, the 1864 Act imposed a flat five percent entity-level withholding tax on dividends and interest from taxable businesses while imposing a graduated tax with an exemption for incomes under \$600 and a top marginal rate of ten percent on income from other sources. As originally introduced by the House Ways and Means Committee, the income tax portion of the 1864 Act proposed a flat five percent tax on all income, including income from dividends and interest.⁴⁶ Graduated rates were later added to the individual income tax sections during the debates in Congress, but no similar change was made to the taxation of the specified businesses on their dividends and interest.⁴⁷ Although some have suggested that this failure to adjust the business rates may have been merely a legislative oversight,⁴⁸ the more likely explanation for this disconnect is the administrative difficulties of imposing a graduated tax at the business level.⁴⁹

The 1864 Act, as amended, remained in effect until the end of Reconstruction in 1872.⁵⁰ Some thought the income tax should be retained as part of a general overhaul of the federal revenue

44. § 121, 13 Stat. at 284.

45. *Id.* § 117.

46. EDWIN R.A. SELIGMAN, *THE INCOME TAX* 440 (1911).

47. *Id.* at 441; Taylor, *supra* note 3, at 264.

48. See Taylor, *supra* note 3, at 264.

49. See SELIGMAN, *supra* note 46, at 444 ("The graduated principle of the income tax could, however, obviously not be applied to the dividends and interest tax, and it was for this reason that the proportional rate of five per cent was imposed."). Discussing the same provision under the 1865 Act, one authority noted that

[d]ividends, salaries, and interest were subject to a straight five per cent withholding tax on all amounts above \$600. In other words, the progressive feature did not apply to these sources of income even though Congress had had several years experience with the tax. The apparent reason seems to have been the problem of administration.

LANGENDERFER, *supra* note 24, at 475.

50. Jeffrey L. Kwall, *The Uncertain Case Against the Double Taxation of Corporate Income*, 68 N.C. L. REV. 613, 618 n.23 (1990).

system.⁵¹ The general sentiment, however, was that the income tax was an emergency measure that should exist only so long as the lingering financial effects of the war continued to be felt.⁵² Each of the acts passed from 1864 through 1867 thus contained a provision stipulating that the income tax would remain in effect until 1870 and no longer.⁵³ After receiving a short reprieve, the income tax ultimately expired after 1872.⁵⁴ Financial prosperity and the declining national debt combined to drain the income tax of its original wartime imperative.⁵⁵

B. 1894 Act

Although political support for an income tax continued after the end of Reconstruction,⁵⁶ it was not successfully revived until after the Panic of 1893.⁵⁷ The high rates instituted by the McKinley Tariff in 1890 had already focused attention on the inequity of the current revenue system.⁵⁸ Coupled with the unrest occasioned by the Panic's economic dislocation,⁵⁹ the time was ripe for another attempt at an income tax. In early 1894, Democrats attached an income tax amendment to the Wilson Tariff Bill in the House.⁶⁰ After much

51. See, e.g., JOHN SHERMAN, SELECTED SPEECHES AND REPORTS ON FINANCE AND TAXATION, FROM 1859 TO 1878, at 319 (1879) ("[T]he modification or repeal of the income tax should be postponed until, by a general revision of our whole revenue system, we can determine what taxes bear most heavily upon the people, and distribute the reduction so as to give them the greatest relief."). David Wells, the Commissioner of Internal Revenue, stated in his annual report of December 1869 that he was in favor of continuing the income tax. SELIGMAN, *supra* note 46, at 456.

52. RATNER, *supra* note 26, at 121-27; STANLEY, *supra* note 25, at 45.

53. ROY G. BLAKEY & GLADYS C. BLAKEY, THE FEDERAL INCOME TAX 7 (1940).

54. RATNER, *supra* note 26, at 126-27; Kwall, *supra* note 50, at 618 n.23.

55. See STANLEY, *supra* note 25, at 54.

56. See WITTE, *supra* note 14, at 70; Bennett D. Baack & Edward John Ray, *Special Interests and the Adoption of the Income Tax in the United States*, 45 J. ECON. HIST. 607, 608 (1985). Fourteen different income tax bills were introduced in Congress between 1873 and 1879. LAWRENCE M. FRIEDMAN, A HISTORY OF AMERICAN LAW 565 (2d ed. 1985). Representative Benton McMillin of Tennessee introduced bills to reinstitute an income tax virtually every year from 1879 through the early 1890s. RATNER, *supra* note 26, at 172.

57. WITTE, *supra* note 14, at 70.

58. *Id.*; Baack & Ray, *supra* note 56, at 609.

59. RATNER, *supra* note 26, at 170; WITTE, *supra* note 14, at 70.

60. 26 CONG. REC. 1594 (1894) (statement of Rep. McMillin); Baack & Ray, *supra* note 56, at 609; George Tunell, *The Legislative History of the Second Income-Tax Law*, 3 J. POL. ECON. 311, 311 (1895).

political wrangling, including an attempt to separate the income tax provision from the larger tariff bill,⁶¹ the 1894 Act was passed by Congress and became law.⁶²

Under the income tax provisions of the 1894 Act, Congress abandoned the graduated tax employed during the Civil War and Reconstruction in favor of a flat rate. All incomes in excess of \$4000 were taxed at a rate of two percent per year.⁶³ As the high exemption suggests, however, the tax was still aimed primarily at the wealthiest segment of society.⁶⁴ Perhaps a more significant change was that Congress specifically imposed a tax on corporate income. As passed in the House, this provision was fairly similar to the dividend tax employed during the Civil War and Reconstruction. Following the model of the 1864 Act, a two percent tax was first imposed on the "dividends" and "undistributed sums, or sums made or added during the year to [the] surplus or contingent funds" of certain banks and insurance companies.⁶⁵ The innovation lay in extending this tax to cover all corporations or limited liability

61. RATNER, *supra* note 26, at 173; STANLEY, *supra* note 25, at 113.

62. Tariff Act of 1894, ch. 349, 28 Stat. 509. The Act passed over the objections of and without the signature of President Grover Cleveland. KOSSUTH KENT KENNAN, *INCOME TAXATION: METHODS AND RESULTS IN VARIOUS COUNTRIES* 259 (1910); Taylor, *supra* note 3, at 268. Cleveland's objections arose primarily from disagreements over the Democrats' compromise on tariff relief. See BLAKEY & BLAKEY, *supra* note 53, at 17 ("The President was thoroughly disheartened at the emasculation of his tariff reform bill and at his own betrayal at the hands of Senators of his own party; indeed, he was so outraged that he refused to sign the measure."). Cleveland, however, "kept Congress in session the required ten days so that the measure became law without his signature." *Id.*

63. Act of June 30, 1864, ch. 173, § 27, 28 Stat. at 553.

64. Taylor, *supra* note 3, at 268. The tax was expected to affect no more than one-tenth of a percent of the population. STANLEY, *supra* note 25, at 133, tbls 3-7.

65. Section 59 of the House Bill provided, in relevant part:

There shall be levied and collected a tax of 2 per cent on all dividends in scrip or money thereafter declared due, wherever and whenever the same be declared payable to stockholders, policy holders, or depositors or parties whatsoever, including nonresidents, whether citizens or aliens, as part of the earnings, income or gains of any bank, trust company, savings institution, and of any fire, marine, life, inland insurance company, either stock or mutual, under whatever name or style known or called in the United States or Territories, whether specially incorporated or existing under general laws, and on all undistributed sums, or sums made or added during the year to their surplus or contingent funds....

26 CONG. REC. 6831 (1894).

business enterprises. Specifically, the House bill provided that the tax would apply to

all dividends, annuities, or interest paid by corporations or associations organized for profit by virtue of the laws of the United States or of any State or Territory, by means of which the liability of the individual stockholders is in anywise limited, in cash, scrip, or otherwise; and the net income of all such corporations in excess of such dividends, annuities, and interest, or from any other sources whatever⁶⁶

As with the 1864 Act, all entities taxable under this provision of the House bill were required to deduct and withhold from any dividends paid the amount necessary to pay the two percent tax.⁶⁷

In the Senate, the corporate tax provision was further removed from its 1864 Act form. Rather than imposing a tax on dividends and undistributed profits, the Senate Finance Committee version of the bill imposed a tax directly on the net income of corporations. In another variation, the Senate bill specifically set forth those corporations that were not subject to the tax. These included states and municipalities as well as corporations organized for charitable, religious, or educational purposes.⁶⁸ In contrast to the 1864 Act, therefore, the Senate bill subjected all corporations to the tax, while exempting certain corporations where the application of the tax would rest upon questionable constitutional or political footing.⁶⁹ Ultimately, the Senate version of the corporate income tax provision prevailed. Under section 32 of the 1894 Act, a two percent tax was imposed on all "corporations, companies, or associations doing business for profit in the United States, no matter how created and organized, but not including partnerships."⁷⁰

66. *Id.*

67. *Id.*

68. *Id.* This was not necessary in the 1864 Act because its income tax provisions specified the industries to which the tax would apply. See Taylor, *supra* note 3, at 271.

69. See 26 CONG. REC. 6621 (1894) (statement of Sen. Hill) (questioning the constitutionality or prudence of taxing certain public or quasipublic corporations).

70. Tariff Act of 1894, ch. 349, § 32, 28 Stat. 509, 556. In full, the statute provided: That there shall be assessed, levied, and collected, except as herein otherwise provided, a tax of two per centum annually on the net profits or income above actual operating and business expenses, including expenses for materials purchased for manufacture or bought for resale, losses, and interest on bonded

The simultaneous income taxation of individuals and corporations was unprecedented at the federal level, but there was no evidence of the intent to double tax corporate income through this system. In fact, the evidence is quite to the contrary. The anti-double tax sentiment was at least as high or higher than it had been during the Civil War and Reconstruction. Entire pamphlets were dedicated to the subject and their rhetoric was highly charged. One pamphleteer wrote that "those features of our tax laws which involve double taxation . . . violate the principles at the foundation of all systems of taxation; namely, justice or equality, certainty, efficiency, and economy."⁷¹ Another asserted that "[t]he folly, injustice, and demoralization which go with our present attempts at double taxation are first to be assailed."⁷² Other sources, though treating the subject more even-handedly, were similarly consumed with double taxation.⁷³

Double taxation concerns were evident during consideration of the corporate income tax provisions of the 1894 Act. One senator stated pointedly, "if I understand the bill, as it stands now there is to be double taxation; first, the dividends are taxed as the income of corporations, and then they are taxed when they reach the stockholders."⁷⁴ Members of Congress were quick to point out that the corporate income tax was deliberately structured so that it would complement rather than overlap the individual income tax.⁷⁵ Section 28 of the Act excluded from income those dividends received from entities already taxed under the Act.⁷⁶ As under the 1864 Act,

and other indebtedness of all banks, banking institutions, trust companies, savings institutions, fire, marine, life, and other insurance companies, railroad, canal, turnpike, canal navigation, slack water, telephone, telegraph, express, electric light, gas, water, street railway companies, and all other corporations, companies, or associations doing business for profit in the United States, no matter how created and organized, but not including partnerships.

Id.

71. GEORGE GLOVER CROCKER, AN EXPOSITION OF THE DOUBLE TAXATION OF PERSONAL PROPERTY IN MASSACHUSETTS 3 (1885).

72. J.P. QUINCY, DOUBLE TAXATION IN MASSACHUSETTS 4 (1889).

73. See FRANCIS WALKER, DOUBLE TAXATION IN THE UNITED STATES 9 (1895); Edwin R.A. Seligman, *The Taxation of Corporations III*, 5 POL. SCI. Q. 636 (1890) ("[T]he problems that hinge about this particular subject [double taxation] are so especially important in the United States as to demand the most serious attention.").

74. 26 CONG. REC. 6876 (1894) (statement of Sen. Dolph).

75. See *id.* (statement of Sen. Hill).

76. Tariff Act of 1894, ch. 349, § 28, 28 Stat. 509, 554.

however, this was only a partial solution because the entity-level tax could not be avoided by reason of the individual-level \$4000 exemption.⁷⁷ For shareholders with incomes below the exemption level, the tax on corporate income thus imposed an indirect tax where none should have been imposed at all. At least with respect to the possibility of double taxation of corporate income, however, Congress was clear in its intent to avoid it.

The 1894 Act's primary innovation was to impose an income tax on corporations directly. Although the 1864 Act had imposed both a gross receipts tax and a dividends and undistributed profit tax on businesses operating in certain industries, these businesses ostensibly were not specifically targeted because of their corporate status. The 1894 Act was thus the first to impose a true "corporate" income tax. Because of a challenge to the constitutionality of the 1894 Act, however, this innovation in federal income taxation was not implemented. Almost immediately after the Act took effect on January 1, 1895, two shareholder suits were filed in federal court in New York to prevent their respective corporations from paying the tax.⁷⁸ Eventually, the Supreme Court declared the income tax unconstitutional as an unapportioned direct tax in *Pollock v. Farmers' Loan & Trust Co.*⁷⁹ Arguably, the Court could have concluded that the corporate income tax provision was permissible yet still struck down the individual income tax.⁸⁰ On rehearing, however, the Court emphasized that notwithstanding the existence

77. See Taylor, *supra* note 3, at 269.

78. The cases were consolidated before the Supreme Court under the name *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429 (1895). As originally filed, the other case was *Hyde v. Continental Trust Co.* See WITTE, *supra* note 14, at 73 n.14 (discussing the consolidation of the cases).

79. *Pollock*, 157 U.S. at 572. Article I of the Constitution provides: "No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken." U.S. CONST. art. 1, § 9, cl. 4. The rule of apportionment, a compromise borne in part out of the divide between small and large states and in part out of the question of how to count slaves, requires that direct taxes such as poll or property taxes be apportioned between the states according to each state's population. SELIGMAN, *supra* note 46, at 594. In this manner, large and powerful states are prevented from causing the national government to impose all the taxes on citizens of the smaller states. See generally, Erik M. Jensen, *The Apportionment of "Direct Taxes": Are Consumption Taxes Constitutional?*, 97 COLUM. L. REV. 2334, 2380-89 (1997) (discussing dangers of general taxes and constitutional limitations).

80. See Taylor, *supra* note 3, at 271-72.

of certain potentially valid provisions, the income measure was void in toto.⁸¹

The *Pollock* case was only a temporary bump in the road to a corporate income tax. In 1909, soon after it sent the Sixteenth Amendment to the states for ratification,⁸² Congress passed a corporate excise tax as part of the Payne-Aldrich Tariff Act.⁸³ Although styled as an "excise tax," it was effectively an income tax because the excise was measured by a corporation's net income. Because it was not accompanied by an individual income tax, however, the double tax risk was minimized. Upon ratification of the Sixteenth Amendment, a corporate income tax was adopted once again as part of the individual income tax imposed under the Revenue Act of 1913.⁸⁴ Just as in the 1894 Act, double taxation was avoided by excluding dividends from the individual income tax base. This method of integrating the corporate and individual income taxes served as a model until the dividend exclusion was removed in 1936.⁸⁵ Since that time, Congress has employed a variety of different methods of partially alleviating the burden of double taxation, but it has never seriously considered eliminating the corporate income tax itself.

The development of a separate corporate income tax was motivated by a number of factors, but a desire to double tax corporate income was not one of them. Opposition to double taxation ran deep during the latter half of the nineteenth century and income tax proponents sought to avoid any appearance of injustice. Consequently, both experiments with a federal income tax during this period—during the Civil War and Reconstruction and during the early 1890s—were deliberately structured to minimize the risk of double taxation.

81. *Pollock*, 157 U.S. at 635-37.

82. U.S. CONST. amend. XVI; see RATNER, *supra* note 26, at 292-93.

83. Tariff Act of August 5, 1909, ch. 6, § 38, 36 Stat. 11, 112.

84. RATNER, *supra* note 26, at 335-36.

85. Kwall, *supra* note 50, at 619-20.

II. THE ENTITY-THEORY EXPLANATION FOR THE CORPORATE INCOME TAX

If Congress did not enact a separate corporate income tax in order to tax corporate income twice, why did it enact such a tax at all? The transformation from a pass-through system of business taxation during the Civil War and Reconstruction to a separate corporate income tax system in the 1894 Act and subsequent revenue measures was a striking shift in approach. Whereas the 1864 Act did not distinguish between income from corporations and partnerships, choosing to attribute both to the business's owner for tax purposes, the 1894 Act taxed corporate, but not partnership, income at the entity level.

What accounts for this change? The traditional explanation is that it was due in large part to developments in the nature of the corporation and in our understanding of its legal personality. A recent American Law Institute report on the federal income taxation of private business enterprises reflects this traditional view, stating that the "[entity] theory of business-organization personality influenced the income-tax rules that developed" for corporations and partnerships.⁸⁶ The 1864 Act's failure to impose an income tax on corporations suggested to the Reporters that "as of the time of the Civil War period, there was no clear indication that corporations should be treated any differently from partnerships for income-tax purposes."⁸⁷ By the time a corporate income tax was adopted in the 1894 Act, however, this attitude appeared to have changed. Between the end of Reconstruction and the adoption of the 1894 Act, the underlying attributes of a corporation and a partnership under state law began to diverge. "Legal theory, following these basic differences between a corporation and a partnership, veered toward a natural entity theory in the corporate area, but resisted it, at least partially, in the partnership area."⁸⁸ Under the traditional view, the triumph

86. AMERICAN LAW INSTITUTE, *supra* note 9, at 36-37; see also George K. Yin, *The Future Taxation of Private Business Firms*, 4 FLA. TAX REV. 141, 145 (1999) (reflecting same view).

87. AMERICAN LAW INSTITUTE, *supra* note 9, at 37; Yin, *supra* note 86, at 146.

88. AMERICAN LAW INSTITUTE, *supra* note 9, at 36 (quoting Kornhauser, *supra* note 4, at 57-62).

of the entity conception of the corporation necessitated its taxation as a unit separate and distinct from the taxation of its owners.⁸⁹

From these supposed origins, entity theory continues to provide the foundation for our separate system of corporate income taxation. Until quite recently, the tax system relied upon the distinguishing state-law features of a corporation to determine which business enterprises would be subject to corporate income tax.⁹⁰ As one former Commissioner of Internal Revenue declared, "[t]he separateness of the corporate personality or the corporate entity is one of the cornerstones of our present income tax law."⁹¹ Perhaps just as importantly, traditional entity theory appears to explain, at least partially, the continued popular and political support for the double taxation of corporate income.⁹² One significant problem with the traditional entity-theory explanation for the origins of the corporate tax, however, is that it is historically inaccurate. As suggested below, advances in the theory of corporate personality appear to have had only a modest influence, if any, on the taxation of the corporation during the three major periods of the corporation's

89. See GOODE, *supra* note 9, at 12 ("These economic developments stemming from the legal nature of the corporation provide a partial answer to the argument that the separateness of the corporation and its stockholders is only a convenient fiction of the legal mind.").

90. In 1997, the Department of the Treasury adopted "check-the-box regulations," which permit business enterprises to elect their tax classification under the Code. Treas. Reg. § 301.7701-3 (1998). Under the former "corporate resemblance" test, the tax classification of business enterprises was determined by testing for the presence of four corporate characteristics designed to replicate the criteria used under state corporation law. See Steven A. Bank, *Federalizing the Tax-Free Merger: Toward an End to the Anachronistic Reliance on State Corporation Laws*, 77 N.C. L. REV. 1307, 1364-67 (1999).

91. Mortimer M. Caplin, Comment, *Income Tax Pressures on the Form of Business Organization: Is It Time for a "Doing Business" Tax?*, 47 VA. L. REV. 249, 252-53 (1961).

92. As Arlen & Weiss explain:

In one view, the double tax persists because the public views corporations as distinct entities, not merely as vehicles for transferring profits to shareholders. According to this theory, the public supports the double tax because it believes that all individuals, including corporations, should pay taxes on their income. The entity theory was indeed the original basis for imposing a separate corporate tax.

Arlen & Weiss, *supra* note 2, at 331; see also William A. Klein, *Income Taxation and Legal Entities*, 20 UCLA L. REV. 13, 54 (1972) (stating that the personification of the corporation was "a significant element in the public's support of the law imposing the [corporate income] tax"); Pratt, *supra* note 2, at 1106-07 (noting that polling data suggests that "the public thinks of the corporation as having taxable capacity and its own income, separate from its shareholders").

development in the nineteenth century: (1) the special charter era at the beginning of the nineteenth century, (2) the advent of general incorporation statutes prior to the Civil War, and (3) the growth of the large corporation at the end of the century.

A. Special Charters and the Early History of the Corporation

1. Development of the Grant or Concession Theory

The separate entity concept developed early on in human civilization as a method of distinguishing between an aggregation of individuals and the groups formed by such individuals.⁹³ During the Medieval Period, this concept was readily used to describe villages, towns, churches, and trade guilds.⁹⁴ Although such groups admittedly existed only through the residence and attendance of their respective members, they were nonetheless thought of as separate entities in their collectivist dealings with the outside world.⁹⁵ As Professor Arthur Machen explained: "Any group ... whose membership is changing, is necessarily an entity separate and distinct from the constituent members."⁹⁶ In this sense, however, classifying a group as an entity may be viewed as "merely an abbreviated way of writing the names of the several members," and thus be considered nothing more than an intellectual construct of little practical significance.⁹⁷

An artificial entity transcends this descriptive quality and becomes real to the extent an authority recognizes it as such. The

93. As one commentator put it:

The conception of a number of individuals as a corporate or collective entity occurs in the earliest stages of human development, and is essential to many of the most ordinary processes of thought. Thus, the existence of tribes, village communities, families, clans, and nations implies a conception of these several bodies of individuals as entities having corporate rights and attributes.

1 VICTOR MORAWETZ, *A TREATISE ON THE LAW OF PRIVATE CORPORATIONS* § 1, at 2-3 (2d ed. 1886).

94. 1 ARTHUR W. MACHEN, JR., *A TREATISE ON THE MODERN LAW OF CORPORATIONS* § 4, at 4 (1908); John Dewey, *The Historic Background of Corporate Legal Personality*, 35 *YALE L.J.* 655, 667 (1926).

95. MORAWETZ, *supra* note 93, § 1, at 2-3.

96. Arthur W. Machen, Jr., *Corporate Personality*, 24 *HARV. L. REV.* 253, 259 (1911).

97. JOSEPH K. ANGELL & SAMUEL AMES, *TREATISE ON THE LAW OF PRIVATE CORPORATIONS AGGREGATE* § 6, at 4 (9th ed. 1871); Machen, *supra* note 96, at 257.

Church was one of the first authorities to attempt to confer official recognition upon entities. During the height of ecclesiastical power in the thirteenth century, Pope Innocent IV advanced an organizational conception of divine authority.⁹⁸ Under his vision, God created the Church in an effort to organize and harmonize society. The Church in turn was the sole body empowered to concede to individuals the right to create lesser entities or associations.⁹⁹ Thus, an entity existed only through a grant of authority from the Church. Although it eventually shared this power with the State, the competition for authority intensified. Organizations such as feudal trade guilds and communes, municipalities, trading companies, and business organizations such as corporations began to rival the claims of the Church or the State to supremacy in their respective spheres.¹⁰⁰ The most effective manner of beating back such individual and collective threats to their sovereignty "was to treat all minor organizations as 'conjurations' and conspiracies, except as they derived all their powers from an express grant of supreme power."¹⁰¹ This strategy sought to justify the supremacy of the Church and the State by marginalizing nonapproved entities and placing them outside the organizational hierarchy.

From this history emerged the grant or concession theory of the corporation. According to this theory, "there is no capacity to act as a body corporate without positive authorization."¹⁰² In England, this came to mean a grant of authority from the King or Parliament. According to Blackstone in his famous study of the English common law, "the king's consent is absolutely necessary to the erection of any corporation, either impliedly or expressly given."¹⁰³ The corporation was thus considered a "franchise" or privilege to establish

98. SHAW LIVERMORE, *EARLY AMERICAN LAND COMPANIES: THEIR INFLUENCE ON CORPORATE DEVELOPMENT* 10 n.4 (Octagon Books 1968) (1939); Dewey, *supra* note 94, at 665-66; Mark M. Hager, *Bodies Politic: The Progressive History of Organizational "Real Entity" Theory*, 50 U. PITT. L. REV. 575, 588 (1989); Gregory A. Mark, Comment, *The Personification of the Business Corporation in American Law*, 54 U. CHI. L. REV. 1441, 1469 (1987).

99. Mark, *supra* note 98, at 1469.

100. Dewey, *supra* note 94, at 667.

101. *Id.* at 666.

102. ERNEST FREUND, *STANDARDS IN AMERICAN LEGISLATION* 39 (1917).

103. 1 WILLIAM BLACKSTONE, *COMMENTARIES* *472.

an independent legal person.¹⁰⁴ Frequently, the royal charter transmitting the grant of authority also constituted a concession of power to the corporation to conduct activities normally reserved for the sovereign. This was because it was necessary to enlist the corporation as an arm of the Crown, especially in the case of corporations engaged in foreign trade because the "royal charter legitimized a range of public functions performed by such trading companies in organizing terms of trade, setting up local governments, controlling customs, and, in effect, making foreign policy in their areas of operation."¹⁰⁵ Although royal charters were arguably sought for private benefit by trade guilds such as the weavers, goldsmiths, haberdashers, fishmongers, vintners, and merchant tailors,¹⁰⁶ the primary purpose of even these charters was to advance the political interests of the Crown by serving as regulatory bodies for their respective trades.¹⁰⁷

Not surprisingly, the grant or concession view of the corporation found new strength amidst the grab for power in America.¹⁰⁸ While universities such as Dartmouth College and the foreign trading companies that founded many of the colonies existed by virtue of royal charters, locally inspired corporations "all claimed legitimacy by grants from colonial governors or legislatures."¹⁰⁹ In some cases, these local chartering bodies exercised their authority through a

104. ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 128 (1932).

105. JAMES WILLARD HURST, *THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES 1780-1970*, at 4 (1970); see also GERARD CARL HENDERSON, *THE POSITION OF FOREIGN CORPORATIONS IN AMERICAN CONSTITUTIONAL LAW* 11 (1918) ("*In partibus infidelium*, the corporations were themselves an arm of sovereignty, exercising political and diplomatic functions."). According to one observer, the East India Company, a prominent British trading corporation, "for a time in effect constituted the government of India." JAMES S. COLEMAN, *POWER AND THE STRUCTURE OF SOCIETY* 27 (1974).

106. HURST, *supra* note 105, at 4.

107. As Professor Williston explained:

The guilds or companies ... made by-laws governing their respective trades, which were not simply such regulations as a modern trade-union might make, since any one carrying on a trade, though not a member of the guild of that trade, was bound by its by-laws In short, the guilds exercised a power similar to that exercised by the municipal corporations

Samuel Williston, *History of the Law of the Business Corporations Before 1800*, 2 HARV. L. REV. 105, 108-09 (1888).

108. See Julius Goebel, Jr., *Editor's Introduction* to LIVERMORE, *supra* note 98, at x-xiii, xxv.

109. HURST, *supra* note 105, at 15.

delegation of the Crown's prerogative,¹¹⁰ but when English rule ended, any prerogative ended as well.¹¹¹ The newly formed states hurried to establish their claims to authority by filling this void.¹¹² Individuals desiring a charter had to apply to the state legislature for a special act of incorporation. Special charters were of necessity voted on one-by-one, and the powers granted were carefully limited to those needed for the business or project to be undertaken by the individuals making the application.¹¹³

As in England, the American corporation was viewed as a creation of the state by virtue of its grant of a corporate charter. In *Trustees of Dartmouth College v. Woodward*,¹¹⁴ Chief Justice Marshall described the corporation by borrowing from Blackstone and other English legal theorists:¹¹⁵ "A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly, or as incidental to its very existence."¹¹⁶ Reinforcing this grant or concession theory of the corporation was the fact that special charters were often reserved for those activities promoting

110. Initially, the Crown had a difficult time asserting its authority over colonial government chartering efforts, as it took nearly fifty years to establish the existence of a royal prerogative. See Simeon E. Baldwin, *Private Corporations 1701-1901*, in *TWO CENTURIES' GROWTH OF AMERICAN LAW 1701-1901*, at 261, 264 (Yale Law Faculty eds., 1980) (1901).

111. 1 MACHEN, *supra* note 94, § 2.

112. Under the Articles of Confederation, the federal government had no power to charter corporations. See HARRY G. HENN, *HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES* 16 (1961). During the constitutional convention in 1787, James Madison twice proposed giving the federal government a power of incorporation, but his proposals were defeated because of fear that it would permit Congress to create national monopolies. *Id.*; HENDERSON, *supra* note 105, at 19-20.

When Congress did attempt to issue a federal charter to the Bank of North America in 1781, its power to do was implicitly questioned by the Bank, which also secured a charter in its home state of Pennsylvania and in several other states. HENN, *supra*, at 16 n.4.

113. FRIEDMAN, *supra* note 56, at 188-89; Susan Pace Hamill, *From Special Privilege to General Utility: A Continuation of Willard Hurst's Study of Corporations*, 49 AM. U. L. REV. 81, 84 (1999); see HAROLD F. LUSK, *BUSINESS LAW: PRINCIPLES AND CASES* 694 (1946).

114. 17 U.S. (4 Wheat.) 518 (1819).

115. HURST, *supra* note 105, at 9.

116. *Dartmouth Coll.*, 17 U.S. at 634. Because of Justice Marshall's description of the corporation, the grant or concession theory is sometimes called the "fictional" or "artificial" entity theory of the corporation, but all of the names tend to signify the same thing. David Graver, Comment, *Personal Bodies: A Corporeal Theory of Corporate Personhood*, 6 U. CHI. L. SCH. ROUNDTABLE 235, 237-38 (1999).

the public good. Although the demand for corporate charters in America was exceedingly light prior to 1780,¹¹⁷ corporations receiving charters during the burst of activity prior to the turn of the century were overwhelmingly "quasi-public"¹¹⁸ in operation. According to Willard Hurst:

Of the 317 separate-enterprise special charters enacted from 1780 to 1801 in the states, nearly two-thirds were for enterprises concerned with transport (inland navigation, turnpikes, toll bridges); another 20 per cent were for banks or insurance companies; 10 per cent were for the provision of local services (mostly water supply); less than 4 per cent were for general business corporations.¹¹⁹

117. HURST, *supra* note 105, at 7; LIVERMORE, *supra* note 98, at 61; MACHEN, *supra* note 94, § 14. One explanation for this lack of demand was the aftermath of the Bubble Act's application to the colonies in 1741. See HURST, *supra* note 105, at 8; HENN, *supra* note 112, at 14-16. In the Bubble Act, adopted by Parliament after the "bubble" burst on financial speculation in the South Seas, the grant of corporate charters was severely restricted. *Id.* In both England and America, businessmen avoided the Act by using deeds of settlement to form joint-stock companies. *Id.*

118. Or, as Shaw Livermore describes them, "semi-political." See LIVERMORE, *supra* note 98, at xxvii.

119. HURST, *supra* note 105, at 17; see also BERLE & MEANS, *supra* note 104, at 10 ("In 1800 the corporate form was used in America mainly for undertakings involving a direct public interest: the construction of turnpikes, bridges and canals, the operation of banks and insurance companies, and the creation of fire brigades."); ROBERT HEILBRONER & AARON SINGER, *THE ECONOMIC TRANSFORMATION OF AMERICA: 1600 TO THE PRESENT* 183 (2d ed. 1984) ("The early colonial settlers had corporations for the performance of certain activities, such as charity work and other activities that were associated with the public welfare."); Baldwin, *supra* note 110, at 276 (noting that "[o]f the charters granted prior to 1800 for moneyed corporations, two-thirds were of a quasi-public character"). Other writers suggest that America produced a much higher number of business corporations during this period. See, e.g., Oscar Handlin & Mary F. Handlin, *Origins of the American Business Corporation*, 5 J. ECON. HIST. 1, 4 (1945) ("[B]y contrast to English and Continental experience, the less advanced economy of the United States produced almost 350 business corporations between 1783 and 1801."). This discrepancy, however, may be due to the fact that these latter numbers do not distinguish between quasipublic businesses and general businesses. As one commentator notes:

Although many corporate charters granted after 1800 for canals, turnpikes, and banks went to private business entrepreneurs, these corporations did not operate as private businesses in the same sense as unincorporated businesses. To encourage much needed improvements, the early special charters normally granted privileges in the form of monopolies or franchises, causing these early corporations to resemble more closely towns' public bodies rather than private competitive businesses.

Hamill, *supra* note 113, at 93 n.51.

This bias in favor of quasipublic corporations arose in part out of the belief that the performance of a public service was deemed to be a precondition for the grant of a corporate charter.¹²⁰ One Virginia Supreme Court Justice wrote in 1809 that special acts of incorporation "ought never to be passed, but in consideration of services to be rendered to the public."¹²¹ To satisfy this requirement, many early special charters declared the public usefulness of their enterprise in the preamble.¹²² This is not to say that the entities themselves were public or necessarily had public powers; rather, the early American corporation was private but received its charter in exchange for performing a public service.¹²³

2. *Taxation of Corporations as "Persons"*

As a creature of the state endowed with special privileges, one would expect the corporation to be an object of special attention from taxing authorities.¹²⁴ In reality, despite the corporation's growing importance during the early 19th century, legislatures made no special provisions for their taxation. In fact, corporations were treated as ordinary persons for the purposes of most tax provisions. Entity theory appears to have had little influence.

Perhaps because of the relative rarity of the corporate form, early tax laws contained no references to corporations.¹²⁵ Legislators appeared to assume there was little reason to distinguish between

120. ANGELL & AMES, *supra* note 97, § 13, at 7; GEORGE HEBERTON EVANS, JR., *BUSINESS INCORPORATIONS IN THE UNITED STATES 1800-1943*, at 21 (1948).

121. *Currie's Admin. v. Mutual Assurance Soc'y*, 14 Va. (4 Hen. & M.) 315, 347 (1809).

122. EVANS, *supra* note 120, at 21 n.21.

123. MORTON J. HORWITZ, *THE TRANSFORMATION OF AMERICAN LAW, 1780-1860*, at 112-13 (1977). Self-destruction clauses and the threat of *quo warranto* actions both emphasized the public benefit requirement of early special charters and served to ensure the proper use of the privileges associated with such charters. Herbert Hovenkamp, *The Classical Corporation in American Legal Thought*, 76 GEO. L.J. 1593, 1659, 1660 n.443 (1988). Justice Story observed:

A private corporation created by the legislature may lose its franchises by a *misuser* or a *non-user* of them; and they may be resumed by the government under a judicial judgment upon a *quo warranto* to ascertain and enforce the forfeiture. This is the common law of the land, and is a tacit condition annexed to the creation of every such corporation.

Terrett v. Taylor, 13 U.S. (9 Cranch) 43, 50 (1815).

124. See Pratt, *supra* note 2, at 1097 (suggesting that corporate taxation was sometimes justified as payment for the special privileges of operating as an artificial entity).

125. EDWIN R.A. SELIGMAN, *ESSAYS IN TAXATION* 138 (1895).

corporate and noncorporate property because property taxation itself did not depend upon the status of the holder.¹²⁶ Obviously, this assumption was not always a valid one. In Massachusetts, for example, a manufacturing corporation resisted the application of a tax assessed in 1817 for the support of the church parish in which the corporation's plant was located.¹²⁷ The attorney for the corporation argued that because "corporations have no souls" for the parish to save, the tax cannot possibly apply to them.¹²⁸ In rejecting this argument, the court not only noted that a tax is not like a fee that may be charged only to those who benefit from it, but it also pointed out that a corporation benefits just as much as an individual when its "[p]roperty is made more secure both by the education of children, and the religious and moral instruction of adults."¹²⁹ A subsequent change in law, however, called this justification into question.

Under a statute enacted by Massachusetts in 1823, property could only be assessed in the parish or other religious society in which the property's owner was a member.¹³⁰ The tax, then, could not possibly serve to protect the property of a nonresident or nonparish affiliated owner. When the parish tax was challenged as imposed against a manufacturing corporation in 1830,¹³¹ the corporation's attorneys argued that because none of the shareholders belonged to the parish in which the property was located, the property should be exempt from the tax.¹³² The court rejected this partnership or aggregate view of the corporation, concluding that a corporation is "an independent legal person" and the owners of its stock are not the owners of its real estate.¹³³ Because the corporation itself did not belong to any other religious society, the exemption did not apply. Perhaps recognizing the awkward nature of this logic, the court noted in a footnote that the legislature had in the interim enacted

126. *See id.*

127. *See Amesbury Nail Factory Co. v. Weed*, 17 Mass. 53 (1820).

128. *Id.* at 53-54.

129. *Id.* at 55.

130. *Goodell Mfg. Co. v. Trask*, 28 Mass. (11 Pick.) 514, 515 (1831) (citing MASS. GEN. LAWS ch. 106, § 3 (1823)).

131. *See id.*

132. *Id.* at 515. In fact, each of the shareholders belonged to different religious denominations altogether. *Id.* at 516.

133. *Id.* at 517.

a statute providing that "no corporation shall be taxed for any parochial purpose."¹³⁴

Even when some states decided to clarify the treatment of corporations under their tax laws, it was generally to make explicit that corporations should be treated like persons for purposes of taxation. New York did little more than underscore the broad applicability of its tax laws when it enacted the first provision regarding the general taxation of corporations in 1823.¹³⁵ Under the law, "all incorporated companies, receiving a regular income from the employment of capital, shall be considered persons within the meaning of this act, and assessments shall be made and taxes imposed, levied and collected in the same manner as upon individuals."¹³⁶ There were special provisions providing for a corporation's payment of the tax,¹³⁷ but nothing altered the way the tax applied to a corporation as opposed to an individual. This pattern was repeated in the states that followed New York's example.¹³⁸ In fact, several states adopted constitutional provisions mandating that corporations be taxed like individuals for property tax purposes.¹³⁹

There were a few exceptions to this early tendency to tax corporations like individuals, but, if they signified anything, they tended to disprove any connection between corporate status and taxation. Banks have long been singled out for special treatment by taxing authorities. As early as 1805, Georgia imposed a two and a half percent tax on the capital stock of banks and a one and a half percent tax on their total amount in circulation.¹⁴⁰ A few states

134. *Id.* at 518 n.1.

135. See SELIGMAN, *supra* note 125, at 138.

136. Act of April 23, 1823, ch. 267, § 14, 1823 N.Y. Laws 390, 395 (1823).

137. Corporations were required to submit a list of taxable assets and were permitted to pay the tax by deducting from dividends or by paying ten percent of all dividends, profit or income. *Id.* § 15.

138. States following New York's law included Connecticut in 1826 and Massachusetts in 1832. Edwin R.A. Seligman, *The Taxation of Corporations I*, 5 POL. SCI. Q. 269, 273 (1890); see also FRIEDMAN, *supra* note 56, at 569 (noting that railroad corporations were taxed under the general property tax prior to 1850).

139. States adopting constitutional provisions requiring that corporations be taxed like individuals included Alabama, Colorado, Florida, Iowa, Mississippi, Nevada, Ohio, and South Carolina. See Seligman, *supra* note 138, at 273 n.3.

140. The Georgia law established that

there shall be a tax of two and an half per cent. levied and collected on the amount or capital of any bank or banks, office or offices of discount and deposit

followed suit, relying principally on the taxation of bank capital stock or dividends.¹⁴¹ Insurance companies were also treated differently in some jurisdictions. In 1824, New York enacted the first such statute, taxing foreign fire insurance companies at a ten percent rate on all premiums for property located in New York.¹⁴² When other states imposed similar taxes on foreign insurance companies, Massachusetts enacted what came to be known as a "reciprocal act" in 1832.¹⁴³ This legislation provided that if any state taxed a Massachusetts insurance company doing business in that state, the insurance companies of that state would be subject to a similar tax on policies sold in Massachusetts.¹⁴⁴ Although the early taxation of banks and insurance companies clearly differed from the taxation of individuals, the difference does not appear to reflect a decision to treat corporations differently for tax purposes. In both cases, taxation was based on the type of activity conducted rather than the form of organization.¹⁴⁵

While there were antebellum instances of corporate taxation, they were isolated at best. The first state to impose a tax on corporations on account of their corporate status was Pennsylvania. An 1840 statute provided that "banks, institutions and companies whatsoever, incorporated by or in pursuance of any law of this commonwealth" must pay a tax on their capital stock based on the amount of dividends or profits.¹⁴⁶ Maryland imposed a "tax on

within this state, and the further sum of one half per cent. On the amount of bills issued from any such bank or office of discount and deposit, over and above the amount or capital as aforesaid

Act of Dec. 4, 1805, § 3, 1805 Ga. Laws 19, 20.

141. See, e.g., Act of Mar. 18, 1814, ch. 98, § 10, 1813-14 Pa. Laws 154, 169 ("[E]ach of the said banks shall transmit six per cent. on the whole amount of the dividends which shall have been declared on said day and during the preceding year"); Act of June 4, 1830, ch. 28, § 2, 1830 Conn. Pub. Acts 305, 306 (stating banks and insurance companies shall "cause to be paid . . . a sum equal to one third of one per cent. of the value of all of the stock of their respective institutions"); SELIGMAN, *supra* note 125, at 143-45 (discussing direct taxation of banks).

142. SELIGMAN, *supra* note 125, at 150.

143. *Id.* at 151.

144. *Id.*

145. For instance, in Pennsylvania, unincorporated savings banks were taxed in the same manner as incorporated full-service banks. *Id.* at 149-50. The tax was based on a percentage of net earnings rather than on the amount of capital stock outstanding. *Id.*

146. Act of June 11, 1840, No. 232, 1840 Laws of Pennsylvania 612, 612; see SELIGMAN, *supra* note 125, at 166. It was not until the 1860s that the statute became a truly general tax on corporate dividends or income. See DELOS O. KINSMAN, *THE INCOME TAX IN THE*

incorporated institutions" in 1841, but it merely extended the general property tax to a corporation's capital stock.¹⁴⁷ These statutes, however, are notable more for their lack of imitators than for signaling a shift in the approach to the taxation of corporate income and assets.¹⁴⁸ Almost twenty-five years passed before other states followed Pennsylvania's lead.¹⁴⁹ The early taxation of the corporation does not therefore demonstrate a tendency to tax corporations differently on account of their special privileges and status.

B. The Democratization of the Corporation

Two related developments threatened the corporation's special status under the grant or concession theory. First, general incorporation statutes began to replace the special charter as the principal means of incorporating a business. Second, and perhaps because of the first development, individuals in manufacturing and other nonpublic enterprises began to select the corporate form to conduct business. In both cases, the result was to question the distinctive nature of the corporation. Neither of these developments, however, affected the taxation of the corporation.

1. General Incorporation and the Introduction of the Partnership Theory

Although the special charter may have been a necessary device to encourage development in early America, it became a symbol for something much worse in Jacksonian America.¹⁵⁰ In 1833, William

COMMONWEALTHS OF THE UNITED STATES 31 (1903).

147. Seligman, *supra* note 138, at 303; Act of Apr. 1, 1841, ch. 23, § 17, 1841 Md. Laws (1841).

148. Virginia enacted a two and a half percent tax on corporate dividends in 1843, but it was reduced in 1846 and subsequently eliminated altogether. Seligman, *supra* note 138, at 304.

149. *See id.* at 301-04. States may have chosen not to imitate Pennsylvania's corporate tax in part because of its relatively modest results. *See* T.K. Worthington, *Historical Sketch of the Finances of Pennsylvania*, in 2 PUBLICATIONS OF THE AMERICAN ECONOMIC ASSOCIATION 172-73 (1887) (noting that the measure in which the corporation taxes were enacted was expected raise, in the aggregate, no more than five or six hundred thousand dollars per year and in fact raised considerably less).

150. *See* HURST, *supra* note 105, at 30.

Gouge summarized the emerging sentiment by commenting that "[a]s the object of charters is to give to members of companies powers which they would not possess in their individual capacity, the very existence of moneyed corporations is incompatible with equality of rights."¹⁵¹ Critics of the special charter system objected both to the special charter itself and to the franchises or special privileges granted to those receiving a charter.¹⁵²

Many objected to the whole system of incorporating by the authority of a special charter. Because of the barriers to incorporation and the appearance of impropriety under a special charter system, special charters were charged with fostering the existence of a new aristocracy in America and corrupting state legislatures.¹⁵³ While such sentiments were intimately connected with Jacksonian Democratic politics, they resonated for many throughout the antebellum period. Amasa Walker, a Free Soiler and Republican, argued at the Massachusetts Constitutional Convention in 1853 that "this system of corporations is nothing more nor less than a moneyed feudalism."¹⁵⁴ Defenders answered charges by pointing to the need to encourage investment,¹⁵⁵ but the Jacksonians advocated the democratization, rather than the termination, of the process of incorporation. They argued that if the corporate entity was an appropriate vehicle for conducting business, it should be equally accessible to everyone.¹⁵⁶

151. WILLIAM M. GOUGE, *SHORT HISTORY OF BANKING IN THE UNITED STATES OF AMERICA* 41 (1833).

152. *Id.* at 31, 33.

153. See Note, *Incorporating the Republic: The Corporation in Ante Bellum Political Culture*, 102 HARV. L. REV. 1883, 1893 (1989) [hereinafter Note, *Incorporating the Republic*]; Note, *The Corporation and the Constitution: Economic Due Process and Corporate Speech*, 90 YALE L.J. 1833, 1844 (1981) [hereinafter Note, *The Corporation and the Constitution*].

154. ERIC FONER, *FREE SOIL, FREE LABOR, FREE MEN: THE IDEOLOGY OF THE REPUBLICAN PARTY BEFORE THE CIVIL WAR* 22 (1970).

155. See Note, *Incorporating the Republic*, *supra* note 153, at 1893-94.

156. See HURST, *supra* note 105, at 32; THEODORE SEDGWICK, *WHAT IS A MONOPOLY?* 13 (1835); Note, *The Corporation and the Constitution*, *supra* note 153, at 1844 n.62. This Jacksonian argument in favor of the democratization of the incorporation process stood in contrast to the Jeffersonian attack against the corporate entity itself. Political economist and noted Jeffersonian Thomas Cooper claimed that

these institutions are founded on the right claimed by government to confer privileges and immunities on one class of citizens, not only not enjoyed by the rest, but at the expense of the rest. . . . Generally in this country, it has glutted itself by incorporating banking companies, insurance companies, canal companies, and manufacturing companies of various descriptions. All these are

The special charter's grant of exclusive franchises further offended the prevailing egalitarian sentiment of Jacksonians.¹⁵⁷ Although a long tradition of opposition to special privileges had been brought over from England in the 1700s,¹⁵⁸ Andrew Jackson's campaign against the Second Bank of the United States in 1832 was a high point for this sentiment in America.¹⁵⁹ Jackson's substantive critique ostensibly related to other matters, but it was primarily a war against special privileges.¹⁶⁰ In Jackson's veto message on a bill to recharter the bank, he argued that "when the laws undertake to add to [the] natural and just advantages [possessed by men] artificial distinctions, to grant ... exclusive privileges, to make the rich richer and the potent more powerful, the humble members of society ... have a right to complain of the injustice of their Government."¹⁶¹ This was not merely a protest against the national chartering of corporations in general or of the bank in particular; rather, it was an attack on the system of granting exclusive privileges.

Particularly offensive to the Jacksonian vision of the independent, entrepreneurial common man was the special charter's conferral of monopoly privileges. As early as 1792, opposition to New Jersey's

increasing daily

THOMAS COOPER, LECTURES ON THE ELEMENTS OF POLITICAL ECONOMY 246 (2d ed. 1830); see also Hovenkamp, *supra* note 123, at 1634 (explaining the Jacksonian view of the corporation).

157. Jacksonians viewed equality of opportunity and open competition as the torchlights for an enlightened economy. See Note, *The Corporation and the Constitution*, *supra* note 153, at 1844 n.62.

158. See HENDERSON, *supra* note 105, at 19 ("The identification of incorporation with the grant of special and exclusive privileges or monopolies, and the fear that the corporation would infringe on the 'natural rights' of citizens, was the chief source of the early opposition to corporations."); LIVERMORE, *supra* note 98, at 247 ("As early as 1784 the attitude erroneously identified by historians as Jacksonian was clearly existent ..."); Note, *Incorporating the Republic*, *supra* note 153, at 1890 ("[T]here was a tradition of statutory and common law hostility to granting trading companies and craft guilds special privileges to carry on particular trades.").

159. See JAMES C. CURTIS, ANDREW JACKSON AND THE SEARCH FOR VINDICATION 114, 130 (1976).

160. Jackson's other criticisms of the bank related to its excessive issuances of paper money and its power to speculate and thereby create or exacerbate a panic. *Id.* at 112-15; HURST, *supra* note 105, at 116.

161. Theodore H. Davis, Jr., Comment, *Corporate Privileges for the Public Benefit: The Progressive Federal Incorporation Movement and the Modern Regulatory State*, 77 VA. L. REV. 603, 611 (1991) (quoting Jackson's veto message concerning the bill to recharter the national bank).

grant of a charter to one of the period's first manufacturing corporations was based on the grounds that "no citizen will think of giving seven years of the prime of his life to acquire the knowledge of any profession in which he may be supplanted by a junto of monied men, under the immediate patronage and protection of the Government."¹⁶² By the 1830s, the rhetoric had strengthened, as illustrated by the following attack on the corporate charter system:

Every corporate grant is directly in the teeth of the doctrine of equal rights, for it gives to one set of men the exercise of privileges which the main body can never enjoy. Every such grant is equally adverse to the fundamental maxim of free trade, for it carries on its face that none but the corporators are free to carry on the trade in question, with the advantages which the charter confers.¹⁶³

In response to such concerns, Jackson's Attorney General, Roger Taney, concluded that states had no legal power to grant monopolies.¹⁶⁴ After his appointment to Chief Justice of the Supreme Court, Taney provided support for this position in *Charles River Bridge v. Warren Bridge*.¹⁶⁵ Holding contrary to the accepted wisdom,¹⁶⁶ Taney wrote for the majority that a corporate charter did not imply the grant of a monopoly or other special privilege, and therefore, the legislature was not prohibited from granting a charter to a rival bridge corporation.¹⁶⁷ Even Justice Charles Story, in dissent, agreed that not "every grant to a corporation becomes, ipso

162. GEORGE LOGAN [A FARMER], FIVE LETTERS ADDRESSED TO THE YEOMANRY OF THE UNITED STATES 20 (1792). Logan called the charter "one of the most unjust and arbitrary laws to be enacted by the Commonwealth of New Jersey that ever disgraced the government of a free people—A law granting to a few wealthy men the exclusive jurisdiction of six miles square, and a variety of unconstitutional privileges, highly injurious to the citizens of that state." *Id.* at 10; see also JOSEPH STANCLIFF DAVIS, 1 ESSAYS IN THE EARLIER HISTORY OF AMERICAN CORPORATIONS 349 (1965) (discussing New Jersey's chartering of *The Society for Establishing Useful Manufactures*).

163. SEDGWICK, *supra* note 156, at 13.

164. Hovenkamp, *supra* note 123, at 1615.

165. 36 U.S. (11 Pet.) 420 (1837).

166. See HUGH RUSSELL FRASER, DEMOCRACY IN THE MAKING: THE JACKSON-TYLER ERA 55 (photo. reprint 1969) (1938) (depicting Jackson's measures to prevent the formation of monopolies, particularly the Second Bank of the United States).

167. *Charles River Bridge*, 36 U.S. at 536.

facto, a monopoly or exclusive privilege."¹⁶⁸ The decision reflected the Jacksonian desire to promote equal competition among individual businesses.

The cumulative effect of this criticism of the special charter system was to spur the development of general incorporation statutes.¹⁶⁹ Although early statutes were enacted for a variety of reasons,¹⁷⁰ general incorporation statutes for business corporations were primarily designed to make the corporate form available to a wider segment of the population.¹⁷¹ Connecticut passed one of the first truly general incorporation acts in 1837 and twenty-four of the thirty-eight existing states followed suit in the 1840s and 1850s.¹⁷² By 1886, one commentator declared that a general incorporation law

168. *Id.* at 638 (Story, J., dissenting).

169. See HERBERT HOVENKAMP, *ENTERPRISE AND AMERICAN LAW 1836-1937*, at 2 (1991); Hamill, *supra* note 113, at 101. On the other hand, Shaw Livermore argued that although the public campaign for general incorporation laws did emphasize the political opposition to special privileges, the result was the effect of an evolutionary process in the needs of the business organization. See LIVERMORE, *supra* note 98, at 295-96.

170. The earliest general incorporation statutes were more the result of the pressures on state legislatures from the increasing applications for special charters during the last two decades of the eighteenth century than from an egalitarian spirit. In 1800, New York's governor lamented the legislature's preoccupation with the consideration of applications for special charters at the expense of other business. RONALD E. SEAVOY, *THE ORIGINS OF THE AMERICAN BUSINESS CORPORATION, 1784-1855*, at 40 (1982). In 1806, a subsequent New York Governor repeated the earlier charge, suggesting that the legislature could avoid the problem "by establishing general principles on which all such companies shall in the future be incorporated." *Id.* at 41 (quoting Governor Morgan Lewis). In 1807, New York adopted a general regulatory statute for turnpikes and in 1811, New York passed a general law for the formation of certain types of manufacturing corporations. See N.Y. LAWS ch. 67, 111 (1811); *Louis K. Liggett Co. v. Lee*, 288 U.S. 517, 548 n.2 (1933) (Brandeis, J., dissenting); MACHEN, *supra* note 94, § 15; SEAVOY, *supra*, at 40; Note, *Incorporating the Republic*, *supra* note 153, at 1898.

Much of the later force behind the general incorporation movement, however, was the desire to equalize the chartering process. Although one approach would have been to cut off special charters without instituting a general method of incorporating, the effect of this "would have been to intensify the very features of monopoly and exclusive privilege which were the targets of Jacksonian attack. The logical outcome of egalitarianism was incorporation equally available to all: not fewer corporations, but more." Davis, *supra* note 161, at 611 n.36 (citation omitted).

171. According to Joseph Davis, even early general incorporation statutes for nonbusiness corporations such as ecclesiastical, educational, and literary entities were enacted out of "a strong and growing prejudice in favor of equality." DAVIS, *supra* note 162, at 610.

172. Act of June 10, 1837, ch. 63, 1837 Conn. Pub. Acts 49 (permitting incorporation of "any . . . lawful business"); Hamill, *supra* note 113, at 101-02.

"is now in force in some form or other in almost every State of the Union."¹⁷³

At first, such statutes existed simultaneously with the special charter system and contained many restrictions and limitations on permitted purposes, maximum authorized capital, duration, maximum indebtedness, and other powers.¹⁷⁴ Because of the ability to secure a charter on more favorable terms than under the general statute, however, many larger organizations still applied for and received such charters through special enactments.¹⁷⁵ This created a dual regime that was not unlike the system prior to the enactment of the general incorporation statutes. Several states sought to limit such special charters to avoid what Justice Brandeis referred to as "the scandals and favoritism incident to special incorporation."¹⁷⁶

In 1821, New York amended its constitution to require two-thirds approval from each branch of the legislature for any act "creating, continuing, altering, or renewing any body politic or corporate."¹⁷⁷ In the very next session, however, special charters were issued to thirty-nine New York corporations, suggesting more drastic measures were necessary.¹⁷⁸ The solution was to ban the issuance of such special charters altogether, which New York did by amend-

173. *General Corporation Acts: Their Origin*, 20 AM. L. REV. 757, 758 (1886) (quoting Edward Everett Hale).

174. HENN, *supra* note 112, at 17; HURST, *supra* note 105, at 33; Hamill, *supra* note 113, at 107, 122.

175. FRIEDMAN, *supra* note 56, at 195. For example, in Wisconsin between 1848 and 1871 corporations formed by special charter outnumbered corporations formed pursuant to the general incorporation statute by nearly eight to one. Davis, *supra* note 161, at 613 n.46.

176. *Louis K. Liggett Co. v. Lee*, 288 U.S. 517, 549 (Brandeis, J., dissenting). In New Jersey, the governor attempted to veto several special charters issued to manufacturing companies in the early 1850s after the adoption of a general incorporation act, but was unsuccessful. JOHN W. CADMAN, JR., *THE CORPORATION IN NEW JERSEY: BUSINESS AND POLITICS 1791-1875*, at 33 (1949). Hurst reports that in fact such favoritism did not occur, at least with respect to the ultimate question of gaining a charter. HURST, *supra* note 105, at 136 ("Legislative journals show that substantially all who sought incorporation obtained it Most variations in charter texts were variations of operational arrangements conveying no implication of sinister ends against public interest."). As Hurst admits, however, "the major incidents did not concern the grant of corporate status but the grant of other franchises enabling the grantees to engage in some action barred to the general public or to be free of legal burdens which would attach to the general public." *Id.* at 137.

177. *Liggett*, 288 U.S. at 548 n.3 (Brandeis, J., dissenting) (quoting the law granting the charters). Similar provisions were included in the Delaware Constitution of 1831, the Florida Constitution of 1838, and the Michigan Constitution of 1835. *Id.*

178. ANGELL & AMES, *supra* note 97, § 65, at 48.

ing its constitution in 1846.¹⁷⁹ One year earlier, Louisiana had inserted a clause into its constitution providing that "[c]orporations shall not be created in this State by special laws except for political or municipal purposes"—a provision which Iowa copied in 1846.¹⁸⁰ In fact, almost every state constitutional convention held after 1840 considered provisions limiting the issuance of special charters as states tried to unburden themselves from the fiscal ruin of excessive subsidization.¹⁸¹ While there was still resistance to general incorporation in some states, most notably New Jersey, the pressures to end special chartering eventually prevailed in the latter part of the nineteenth century.¹⁸² By 1880, twenty-seven states had adopted constitutional provisions prohibiting the issuance of special charters, and by 1913, all but four of the states had adopted such provisions.¹⁸³

As general incorporation statutes became increasingly more liberal, the corporation became the vehicle of choice for nonpublic enterprises. Beginning in the 1830s, manufacturing company incorporations began to catch up with transportation and other quasipublic incorporations.¹⁸⁴ In New Jersey, for example,

179. *Id.*

180. FRIEDMAN, *supra* note 56, at 196.

181. SEAVOY, *supra* note 170, at 180; Davis, *supra* note 161, at 618-19. According to Ronald Seavoy, the primary impetus for New York's constitutional amendment in 1846 was the massive public debt accruing under the weight of the legislature's very generous and subsidy-laden special charter system. SEAVOY, *supra* note 170, at 177. In the wake of the financial crisis of 1837-1844, states could no longer stand to bear this burden. *Id.* at 180.

182. See CADMAN, *supra* note 176, at 437. According to one study, "not until about 1875 had constitutional provisions requiring incorporation under general laws become so numerous that special charters might be considered a thing of the past for most fields of enterprise in most states of the Union." EVANS, *supra* note 120, at 10.

183. The four remaining states were Connecticut, Massachusetts, New Hampshire, and Rhode Island. EVANS, *supra* note 120, at 11 tbl. 5; Davis, *supra* note 161, at 613 n.47. Susan Pace Hamill has recently conducted a study that disputes the data from earlier studies regarding the precise timing of the adoption of constitutional prohibitions on special chartering. See Hamill, *supra* note 113, at 121-28. Hamill agrees, however, that "[f]rom 1904 until 1915, the practice of incorporation by special charter entered into a phase marked by substantial and consistent decline. . . . By 1916, special chartering neared complete insignificance." *Id.* at 135-36; see also Henry N. Butler, *Nineteenth-Century Jurisdictional Competition in the Granting of Corporate Privileges*, 14 J. LEG. STUD. 129, 146-61 (1985) (providing a public choice theory-based explanation for the endurance of special charters until the era of interjurisdictional competition).

184. Initially, legislatures expected that even manufacturing corporations should be at least tinged with the public interest. See EVANS, *supra* note 120, at 20 (citing the example of the first manufacturing business incorporated in New Jersey, "The Society for Establishing

manufacturing and mining incorporations accounted for thirty-two percent of all incorporations between 1820 and 1844, and in Wisconsin, such charters overtook quasipublic charters between 1848 and 1871.¹⁸⁵ This is not to suggest, however, that the progress toward general business incorporation was steady or uniform. In Pittsburgh, for instance, none of the 161 manufacturing businesses in operation in 1860 was incorporated, even though Pennsylvania had adopted its first general incorporation statute for certain manufacturing enterprises in 1836.¹⁸⁶ In Massachusetts, only 520 of the approximately 11,000 manufacturing businesses in existence were incorporated by 1878, although it is perhaps more significant that those businesses that had incorporated were responsible for over one-third of the commonwealth's manufacturing output.¹⁸⁷ It is safe to say that by the late 1880s, state incorporation laws primarily served the general business enterprise.¹⁸⁸

Eventually, the spread of corporations to nonpublic enterprises and the adoption of general incorporation statutes suggested a conceptual shift in the nature of the corporation. On one hand, the enactment of a system of general incorporation by statute rather than as a matter of right emphasized the continuing vitality of the grant/concession theory, albeit in a somewhat diluted form.¹⁸⁹ On the other hand, the right to freely incorporate seemed to necessitate a search for a theory that recognized the general business corporation's equality with other business associations.¹⁹⁰ As early

Useful Manufactures"). Eventually, however, the private character of these corporations was allowed to dominate. *Id.*

185. See HURST, *supra* note 105, at 18. There was a sharp increase in the number of manufacturing corporations in New Jersey between 1825 and 1834, and manufacturing and mining corporations outnumbered quasipublic transportation corporations for the first time between 1825 and 1829. CADMAN, *supra* note 176, at 425.

186. HEILBRONER & SINGER, *supra* note 119, at 189; E. Merrick Dodd, Jr., *American Business Association Law a Hundred Years Ago and Today*, in LAW: A CENTURY OF PROGRESS 1835-1935, at 254, 289 n.85 (1937) (discussing Act of June 16, 1836, relating to corporations formed to manufacture iron by means of coke).

187. HEILBRONER & SINGER, *supra* note 119, at 189.

188. Donald E. Schwartz, *Federal Chartering of Corporations: An Introduction*, 61 GEO. L.J. 71, 77 (1972).

189. HURST, *supra* note 105, at 113 (noting the banning of special charters "was coupled with explicit or clearly implied reconfirmation of legislative authority to determine general policy on the availability of incorporation").

190. See Eben Moglen, *The Transformation of Morton Horwitz*, 93 COLUM. L. REV. 1042, 1047 (1993) (reviewing HORWITZ, *supra* n. 7).

as 1806, the New York Council of Revision, in an unsuccessful veto of a bill which gave turnpike commissioners certain powers over toll roads, reasoned along partnership theory lines that "the rights vested in the stockholders of a turnpike company, incorporated by law, are as sacred and as much entitled to protection as any other private rights."¹⁹¹ It was not until the 1870s and 1880s, however, that scholars began to view the corporation as an aggregate of its individual stockholders, much like a partnership.

According to several modern observers, this movement had its roots in the writings of Victor Morawetz, a well-known author who later became a member of New York's Cravath law firm.¹⁹² In the first edition of his *Treatise on the Law of Private Corporations*, Morawetz noted that "the existence of a corporation independently of its shareholders is a fiction ... the rights and duties of an incorporated association are in reality the rights and duties of the persons who compose it, and not of an imaginary being."¹⁹³ Another contemporary observer, Henry Taylor, concurred with Morawetz, writing that the corporation "is a conception, which if it amounts to anything, is but a stumbling-block in the advance of corporation law towards the discrimination of the real rights of actual men and women."¹⁹⁴ With the standardization of corporation charters and the de-emphasis of special privileges, the law could look beyond the corporate form to what William Bratton described as the "creative energy of the individuals conducting it."¹⁹⁵

191. HORWITZ, *supra* note 123, at 308 n.6 (quoting the New York Council of Revision). The legislature overrode the Council's veto. *Id.*

192. See HORWITZ, *supra* note 7, at 90; Mark, *supra* note 98, at 1457.

193. MORAWETZ, *supra* note 93, § 1, at 3. Morton Horwitz explained that Morawetz's effort to disaggregate the corporation into freely contracting individuals must have seemed at the time the only entirely logical conclusion to draw in light of the triumph of general incorporation law. It not only dispensed with an increasingly fictional conception of the law as a creature of the state, it also made it possible to fit corporation law into the new dominant individualistic mode of private contract law.

HORWITZ, *supra* note 7, at 90.

194. HENRY O. TAYLOR, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS HAVING CAPITAL STOCK § 51 (2d ed. 1888).

195. William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471, 1486 (1989).

2. *The Taxation of Corporate Wealth*

Given the advent of general incorporation statutes and the blurring of the legal or practical distinction between the corporation and the partnership, the Civil War tax experience might be viewed as evidence of the acceptance of the aggregate theory of the corporation for tax purposes. Under the Revenue Act of 1864, corporations and partnerships were explicitly subject to the same pass-through system of taxation. Shareholders were taxed on the undivided profits of a corporation just as partners were taxed on the undistributed profits of the partnership.¹⁹⁶

Notwithstanding the pass-through scheme, several factors belie the notion that this enactment reflected an increasing acceptance of the aggregate theory of the corporation. At the federal level, Congress taxed the corporation as a separate entity in several provisions of the 1864 Act. As discussed earlier,¹⁹⁷ corporations in the banking and insurance industries were subject to a five percent tax on dividends issued to stockholders and on all undistributed sums added to surplus or contingent funds.¹⁹⁸ Corporations in the transportation field were subject to a five percent tax on dividends and interest paid on bonded indebtedness.¹⁹⁹ Additionally, the gross receipts taxes imposed under both the 1862 and 1864 Acts were direct taxes against corporations in the specified industries.²⁰⁰

Corporations, partnerships, and persons were each treated as separate taxable actors for purposes of the tax.²⁰¹ Although some of these provisions have been called mere withholding mechanisms for the taxes on individuals,²⁰² they were imposed upon corporations

196. See *supra* notes 36-39 and accompanying text.

197. See *supra* text accompanying notes 40-42.

198. Act of June 30, 1864, ch. 173, § 120, 13 Stat. 223, 283-84.

199. *Id.* § 122.

200. See *id.* § 103; Act of July 1, 1862, ch. 119, § 80, 12 Stat. 432, 468-69.

201. *E.g.*, § 80, 12 Stat. at 468 (imposing the gross receipts tax on "any person or persons, firms, companies, or corporations, owning" railroads or steamboats).

202. See FREDERIC C. HOWE, *TAXATION AND TAXES IN THE UNITED STATES UNDER THE INTERNAL REVENUE SYSTEM 1791-1895*, at 96-97 (1896). Congress specifically provided that those businesses subject to the gross receipts tax "shall have the right to add the duty or tax ... to their rates of fare." § 80, 12 Stat. at 468-69. The same proviso was included in the 1864 Act. See § 103, 13 Stat. at 276. As Senator Sherman later pointed out, "[w]e are levying taxes on the citizens through the corporations. We make these corporations merely agents of ours to collect the tax from individuals." CONG. GLOBE, 38th Cong., 1st Sess. 2499 (1864). "It is not

directly, and often the corporation paid them without explicitly passing on the cost and without the availability of a shareholder level credit. For instance, corporations were permitted to deduct and withhold a portion of each dividend to pay the tax,²⁰³ but were not required to do so. In fact, most did not do so, choosing instead to pay the tax without diminishing the payments to security holders.²⁰⁴ Although shareholders were entitled to deduct from income dividends and interest derived from corporations that had already paid the tax due on such items,²⁰⁵ they were not entitled to deduct from income or receive a credit for taxes paid by the corporation itself.²⁰⁶ Finally, some corporations were subject to a tax on undistributed profits, thus reinforcing the entity-level nature of the tax. Because of the apparent concern that banks might fail to either issue dividends or make additions to surplus and thereby avoid the dividends tax, those failing to make such distributions at least once every six months were explicitly subject to a five percent tax on all accrued or earned profits.²⁰⁷ Consequently, the tax treatment of the corporation only dimly reflects the aggregate or partnership theory, if at all.

a tax assessed upon the gas company," Senator Sherman continued, "so much as upon the consumption of gas; it is a tax assessed on the consumer, and we allow the gas company to collect from the consumer of the gas the tax we choose to impose." *Id.* For further discussion on this provision, see CONG. GLOBE, 38th Cong., 1st Sess. 1917-18 (1864); CONG. GLOBE, 37th Cong., 2d Sess. 1196, 1482, 1484, 2331-33, 2346 (1862). Even in industries such as insurance, where permission to pass on the tax was not made explicit, most assumed that the cost would be borne by the customers anyway. See, e.g., CONG. GLOBE, 37th Cong., 2d Sess. 2334 (1862) (statement of Sen. Sherman) ("When a person applies for an insurance, if he pays fifty dollars for his insurance, a tax would be added equivalent to \$1.50, and that would be paid by the insured. It is not paid by the insurance company."); *id.* at 2346 (statement of Sen. Fessenden) ("[The insurance companies] said it [the gross receipts tax] would come hard on those who were insured, because they must pay it, and not the companies.").

203. §§ 120, 122, 13 Stat. at 283-84.

204. Edwin R. A. Seligman, *The Income Tax*, 9 POL. SCI. Q. 610, 628-29 (1894) (noting that "corporations were not compelled to deduct the tax from the dividend or interest of each security holder, and as a matter of fact they generally assumed the tax themselves without withholding it from the bondholder. It became to that extent a tax on the corporation, not on the bondholder."). Even in the gross receipts tax, where corporations were given explicit permission to pass off the cost, they may not have done so. See Kornhauser, *supra* note 4, at 83 n.108.

205. § 117, 13 Stat. at 281.

206. See BOUTWELL, *supra* note 26, at 305 (Ruling No. 29).

207. § 121, 13 Stat. at 284.

Developments at the state level were also starkly contrary to a partnership conception of the corporation. During this same period, several states were beginning to follow Pennsylvania's lead and impose taxes on corporations directly.²⁰⁸ Alabama and Virginia, for instance, both imposed taxes on the capital stock and dividends of all domestic corporations, with Alabama enacting an income tax in 1867 that was later held to apply to corporations.²⁰⁹ The most prominent example, however, is in Massachusetts. In 1863, Massachusetts enacted a tax on corporate dividends paid to non-resident stockholders.²¹⁰ After this was declared unconstitutional,²¹¹ the legislature elected to tax the corporation directly. Under an Act approved May 11, 1864, corporations were taxed on the market value of their capital stock after deducting the value of their real estate and machinery, which was already subject to local taxation.²¹² The proportion of the tax corresponding to stock owned by Massachusetts residents was credited and paid to the municipalities in which those shareholders resided.²¹³ The state effectively retained only the value of the capital stock attributable to nonresidents. In one sense, the new law merely centralized the administration of the local shareholder tax that had been previously held to be unconstitutional.²¹⁴ As one commentator described it though, "[t]he

208. Seligman, *supra* note 138, at 303-05 (citing the examples of Alabama, Illinois, Maryland, Massachusetts, New Jersey, and Virginia).

209. *Id.*; ALA. CODE § 1(1) (1867) (stating that "the word 'person' includes a corporation as well as a natural person"); Ala. Laws of Feb. 19, 1867, § 3 (imposing an income tax on persons, which was later held to include corporations); Ala. Laws of Feb. 22, 1866, § 2, ¶ 4 (imposing a one-half percent tax "[o]n the capital stock actually paid in of all incorporated companies created under any law of this State, whether general or special (except railroads) and not exempted by their charter from such tax; except any portion that may be invested in property and taxed otherwise as property"); *id.* at ¶ 15 (imposing a tax "[o]n all dividends declared, or earned and not dividend, by incorporated companies created under the laws of this State, (except railroads) to be assessed to and paid by the companies earning or declaring the same"); Board of Revenue v. Montgomery County Gas-Light Co., 64 Ala. 269, 277 (1879) (applying income tax to corporation). None of these measures ever raised substantial sums because of certain exceptions and a lack of enforcement. See Seligman, *supra* note 138, at 304.

210. 1863 Mass. Acts ch. 236.

211. *Oliver v. Washington Mills*, 93 Mass. (1 Allen) 268, 275 (1865) (holding that the tax violated the apportionment clause of the commonwealth's constitution).

212. 1864 Mass. Acts ch. 208, § 5; HARRY G. FRIEDMAN, *THE TAXATION OF CORPORATIONS IN MASSACHUSETTS* 47 (1907).

213. 1864 Mass. Acts ch. 208, § 8.

214. This, in itself, was no small feat. One commentator later noted that "[t]he distinctive feature of the system of taxation of corporate property in Massachusetts is that it is

change involved . . . an important departure in principle, for it really meant the taxation of corporations in place of individuals."²¹⁵ In 1865, the state underscored the entity-level nature of the tax by calling it "a tax upon its corporate franchise" ²¹⁶

The Confederacy's adoption of a corporate income tax measure during the Civil War is further evidence that the corporation was considered an appropriate taxable unit during this period. Initially, the Confederacy relied on a direct tax on real and personal property.²¹⁷ Because the government lacked the administrative apparatus to administer such a tax, however, collection was left to the individual states with predictably unsatisfactory results.²¹⁸ After a disastrous experiment with loan financing and eventually resorting to printing paper currency to pay its bills,²¹⁹ the Confederate government resorted to an income tax in 1863.²²⁰ As part of the income tax, all corporations were required to reserve one-tenth of annual earnings set apart for dividends and reserves.²²¹ When this amount exceeded ten percent of the paid capital stock,

administered wholly or in part by officers of the State, instead of by local officers It is unique in the tax experience of the States of the Union." GEORGE CLAPPERTON, *TAXATION OF CORPORATIONS: REPORT ON SYSTEMS EMPLOYED IN VARIOUS STATES* 14 (1901) (quote unattributed).

215. FRIEDMAN, *supra* note 212, at 46.

216. 1865 Mass. Acts ch. 283, § 5.

217. RATNER, *supra* note 26, at 102; SELIGMAN, *supra* note 46, at 482.

218. SELIGMAN, *supra* note 46, at 482. Only \$20 million was collected during its two years of operation and the great bulk of it was financed by the states themselves. KENNAN, *supra* note 62, at 269; RATNER, *supra* note 26, at 102-03; EMORY M. THOMAS, *THE CONFEDERATE NATION: 1861-1865*, at 137 (1979) ("[S]tate governments undertook to pay the levies for their citizens—largely in unsupported state currency.").

219. See RANDOLPH E. PAUL, *TAXATION IN THE UNITED STATES* 19 (1954) ("This step plunged the Confederacy into the adventure of creating wealth out of nothing by 'magic revolutions of the printing press' The Confederate Treasury became the greatest money factory in the world.") (quoting G.C. Eggleston); SELIGMAN, *supra* note 46, at 483-84 (stating that the experiment with loans was no more successful than that with direct tax); THOMAS, *supra* note 218, at 137-38 (observing that the "folly of unsupported money" could do little to bring in tax); J.C. Schwab, *The Finances of the Confederate States*, 7 POL. SCI. Q. 38, 39 (1892) (noting that loan financing amounted to more than ninety percent of total revenues during the first few years of the war). By January 1, 1864, the inflation rate was over six hundred percent. THOMAS, *supra* note 218, at 197.

220. SELIGMAN, *supra* note 46, at 486; THOMAS, *supra* note 218, at 198. By 1864, the war taxes raised almost eleven percent of the Confederacy's total revenues, a figure that compares favorably with the fifteen percent raised by taxation in the North during the same period. See Schwab, *supra* note 219, at 41.

221. SELIGMAN, *supra* note 46, at 487.

the government imposed a 12.5% tax and when it exceeded twenty percent of paid capital stock, the tax rate increased to 16.66%.²²² This provision did not result in double taxation because stockholders were permitted to exempt from income all dividends received from such corporations.²²³

When this income tax measure failed to satisfy the Confederacy's growing revenue needs, the Commissioner of Taxes recommended a further increase in the rates. This specifically included an attempt to increase the tax on corporate profits. In a report issued in November of 1863, the Commissioner suggested a tax of fifty percent on the profits of all corporations beyond that necessary to support a dividend of twenty-five percent to their stockholders.²²⁴ According to the Commissioner, "[w]hile three fourths, perhaps, of the men of the Confederacy have dedicated their lives or fortunes, in many instances both, to their country's cause, the remaining fraction have no moral right to amass fortunes at their expense."²²⁵ This plea got the government's attention, and on February 17, 1864, the Confederacy enacted a more draconian income tax act.²²⁶ In this measure, however, the Confederacy broadened the provision from a tax on corporations to a tax on all businesses. A tax of twenty-five percent was imposed on any business's profits in excess of that necessary to support a twenty-five percent dividend.²²⁷ This treatment was continued in a last ditch income tax enacted in the waning hours of the Confederacy, but surrender occurred before it was ever implemented.²²⁸ The Confederacy's tax strategy understandably was guided by the need for revenue rather than the dictates of theory.

Finally, during the same period in which all of these statutory provisions were enacted, the Supreme Court issued its own entity theory-based view of the corporation in *Van Allen v.*

222. *Id.*

223. *Id.*

224. *Id.* at 489-90 (quoting REPORT OF THE COMMISSIONER OF TAXES ACCOMPANYING THE REPORT OF THE SECRETARY OF THE TREASURY 2 (1863)).

225. RATNER, *supra* note 26, at 105 (quoting REPORT OF THE COMMISSIONER OF TAXES ACCOMPANYING THE REPORT OF THE SECRETARY OF THE TREASURY 2 (1863)).

226. SELIGMAN, *supra* note 46, at 490-91; THOMAS, *supra* note 218, at 264.

227. RATNER, *supra* note 26, at 106.

228. *Id.* at 107; PAUL, *supra* note 219, at 22.

Commissioner.²²⁹ In *Van Allen*, the Court addressed whether a state could tax a bank's stockholders on the shares of stock held by them, even though the bank's capital was invested solely in tax-exempt United States securities.²³⁰ The stockholders argued that the tax effectively was against the bank's capital itself, thus violating the prohibition against state taxation of U.S. securities.²³¹ The Court rejected this argument, concluding that the shares did not represent an ownership interest in the underlying property.²³²

Quoting from a British authority, the Court noted that "[t]he individual members of the corporation are no doubt interested in one sense in the property of the corporation, as they may derive individual benefits from its increase, or loss from its decrease; but in no legal sense are the individual members the owners."²³³ The Court thus rejected a partnership conception of the corporation, stating that "[t]he corporation is the legal owner of all of the property of the bank . . . and . . . can deal with the corporate property as absolutely as a private individual can deal with his own."²³⁴ This widely anticipated decision attracted much attention,²³⁵ and was cited in cases throughout the latter part of the nineteenth century to support the notion that taxation of both the stock and the property of a corporation was neither illegal nor double taxation.²³⁶

229. 70 U.S. (3 Wall.) 573 (1865).

230. *Id.* at 581-82.

231. *Id.* at 583.

232. *Id.* at 584.

233. *Id.* (quoting *Queen v. Arnoud*, 9 Adolphus & Ellis, New Series, 806).

234. *Id.* at 584. The Court ultimately sided with the taxpayers because the New York statute failed to tax shares in national banking associations on par with its taxation of shares in state chartered banks. *Id.* at 581. New York then amended its statute, which the Court later upheld relying on its reasoning in *Van Allen*. *People v. Comm'rs*, 71 U.S. (4 Wall.) 244 (1866).

235. *E.g.*, *Bank Items—New Jersey*, 20 BANKERS' MAG. & STAT. REG. 589 (Jan. 1866); *Bank Items—Supreme Court Decision*, 20 BANKERS' MAG. & STAT. REG. 900 (May 1866); *Law Reports—United States Supreme Court*, N.Y. TIMES, Apr. 19, 1866, at 2; *The Taxation of Shareholders in National Banks, By States*, 20 BANKERS' MAG. & STAT. REG. 449 (Dec. 1865).

236. *See, e.g.*, *Shelby County v. Union & Planters' Bank*, 161 U.S. 149, 159 (1896); *Bank of Commerce v. Tennessee*, 161 U.S. 134, 146 (1896); *Gibbons v. Mahon*, 136 U.S. 549, 557 (1890); *New Orleans v. Houston*, 119 U.S. 265, 277 (1886); *Tennessee v. Whitworth*, 117 U.S. 129, 136-37 (1886); *Bradley v. Illinois*, 71 U.S. (4 Wall.) 459 (1866); *Mercantile Nat'l Bank v. City of New York*, 28 F. 776, 784 (S.D.N.Y. 1886); *Covington City Nat'l Bank v. City of Covington*, 21 F. 484, 491 (C.C.D. Ky. 1884); *Exchange Nat'l Bank v. Miller*, 19 F. 372, 379 (S.D. Ohio 1884); *Albany City Nat'l Bank v. Maher*, 6 F. 417, 420 (N.D.N.Y. 1881); *Batterson v. Town of Hartford*, 50 Conn. 558, 560 (1883); *Exchange Bank v. Macon Constr. Co.*, 97 Ga.

C. The Advent of the Large Corporation

If the middle period of the nineteenth century is considered important for the spread of the corporate form, the latter part of the nineteenth century is significant for the advent of the megacorporation. The increasing size and complexity of the new corporation defied the partnership or aggregate view of the corporation.

1. Natural Entity Theory and the Advent of the Big Corporation

As the general incorporation movement made the process of securing a charter more readily available, businesses increasingly took advantage of the corporate form. While earlier businesses were motivated to seek a corporate charter because of the quasipublic nature of their activities, the corporate form was particularly attractive in the latter half of the nineteenth century for capital-intensive businesses in search of a way to bring on new investors.²³⁷ Corporations offered limited liability, thereby reducing the personal financial risks of the owners.²³⁸ As business enterprises expanded

1, 6 (1895); *Wright v. Stiltz*, 27 Ind. 338, 341 (1866); *Frazer v. Seibern*, 16 Ohio St. 614, 620 (1866).

237. As Adolph Berle and Gardiner Means described and explained:

It came first in the fields of public utilities, common carriers, banks and insurance companies (which even in the 1840's were conceded to perform public functions) and last in the areas of personal service and agriculture;—early, with the high fixed capital costs in railways and mines; late, in mercantile pursuits where capital consists to such a large extent of stock on hand.

BERLE & MEANS, *supra* note 104, at 17 (footnotes omitted). Another rationale for the formation of companies was that:

Many enterprises, not in their nature public, and many industries most important to the development and well being of a people, require too large an outlay of capital, to be within the means of any individual or partnership in a new country. Such enterprises . . . must be undertaken by organizations in which capital is contributed by many persons, and in small sums placed substantially at the risk of the business.

Reform of Corporations, 32 BANKER'S MAG. & STAT. REG. 184, 188-89 (1877).

238. HEILBRONER & SINGER, *supra* note 119, at 189. One contemporary lawyer noted at a bar association meeting that

individuals desire to form business corporations . . . [because] small amounts of capital, held in many different hands, may be combined so as to form an aggregate large enough to carry on business operations which otherwise would not be carried on at all; both because these individuals could never be brought

their markets and became increasingly more speculative, investors demanded what was once thought to be the unnecessary feature of limited liability.²³⁹ Furthermore, stock ownership was preferable for investors seeking the enhanced liquidity available in corporate ownership.²⁴⁰ This was not so much because there was a ready market for corporate stock, as a truly public stock market did not develop until early in the twentieth century,²⁴¹ but rather because a certificate of stock could be transferred more conveniently than a partnership interest.²⁴²

The increasing attractiveness and accessibility of the corporate form led to an explosion in the number of corporations in the post-war period.²⁴³ In Massachusetts, for example, the Secretary of the

together as partners, and also because while each shareholder is willing to risk in that enterprise the amount he invests in corporate stock, he is not willing to incur any further liability.

General Corporation Acts: Their Origin, *supra* note 173, at 758-59 (quoting Henry Hitchcock).

239. Ronald E. Seavoy, *The Public Service Origins of the American Business Corporation*, 52 BUS. HIST. REV. 30, 58 (1978). It was not until after the War of 1812 that businesses began to seek limited liability protection for their investors. See LIVERMORE, *supra* note 98, at 236. Shareholders were not always provided limited liability under their corporation's charter or the general incorporation statute. For instance, until 1830, Massachusetts imposed unlimited liability on manufacturing enterprises seeking to incorporate. Dodd, *supra* note 186, at 267-68; see also Goebel, *supra* note 108, at xxii-xxiii (noting that limited liability was not an automatic feature of corporate charters).

240. Seavoy, *supra* note 239, at 58.

241. JONATHAN BARRON BASKIN & PAUL J. MIRANTI, JR., A HISTORY OF CORPORATE FINANCE 177 (1997) ("The rise of large-scale public markets for common stocks was very much a post-World War I phenomenon."). This is not to suggest that there was no market for corporate stocks, since the New York Stock Exchange experienced one of its most significant periods of growth during the 1870s and 1880s, doubling its volume and the value of traded shares. CHARLES R. GEISST, WALL STREET: A HISTORY 101 (1997).

242. See BASKIN & MIRANTI, *supra* note 241, at 177 ("Earlier, equity shares were a convenient way to transfer ownership between limited circles of business associates, rather than instruments to support broad public dealings."). Corporate stock's liquidity advantage may have been a vestige of the Bubble Act's prohibition on the transfer of the shares of anything but a corporation. See LIVERMORE, *supra* note 98, at 63-65 n.65. Although the Supreme Court confirmed as early as 1827 that partnership interests were freely transferable if permitted by the partnership agreement, *Alvord v. Smith*, 22 Mass. (5 Pick.) 232 (1827), it was not until 1843 that England reversed its stance on this issue. See LIVERMORE, *supra* note 98, at 63-65 n.65.

243. See COLEMAN, *supra* note 105, at 30; EVANS, *supra* note 120, at 31. In some jurisdictions, this push to incorporate preceded the Civil War. An Illinois jurist noted in 1857 that "more corporations were created by the legislature of Illinois at its last session than existed in the whole civilized world at the commencement of the present century." ARTHUR SELWYN MILLER, THE MODERN CORPORATE STATE: PRIVATE GOVERNMENTS AND THE AMERICAN CONSTITUTION 39 (1976).

Commonwealth reported to the legislature that the rise in corporate charters issued under the general incorporation law in 1864 indicated "prosperity in manufacturing and mining interests, and an appreciation by capitalists of the facilities afforded by standing laws for the establishment of corporate bodies without the delay involved in obtaining special charters."²⁴⁴ In Michigan, the number of corporations rose from less than 100 in 1850 to approximately 8000 in 1894.²⁴⁵ Moreover, the rush to incorporate was not limited to individual jurisdictions and industries. In its 1869 decision in *Paul v. Virginia*,²⁴⁶ the Supreme Court commented that

[a]t the present day corporations are multiplied to an almost indefinite extent. There is scarcely a business pursued requiring the expenditure of large capital, or the union of large numbers, that is not carried on by corporations. It is not too much to say that the wealth and business of the country are to a great extent controlled by them.²⁴⁷

Although the number of new incorporations steadied as the economy readjusted, a new spurt of incorporation took place in the 1880s and finally stabilized in the early 1890s.²⁴⁸

Even more significant than the increased incorporation was the introduction of the large corporation. The early American business corporation shared more in common with the partnership than a true corporate organization.²⁴⁹ The number of stockholders was usually fairly small and each stockholder was intimately involved in the daily operations of the business.²⁵⁰ Before the 1880s, even the

244. EVANS, *supra* note 120, at 75. The number of corporate charters issued by Massachusetts in 1864 was more than triple the number issued in 1863. *Id.* at 119 tbl.

245. See John P. Davis, *The Nature of Corporations*, 12 POL. SCI. Q. 273, 273 n.1 (1897) (quoting Address of President Alfred Russell at Jackson, Michigan, March, 1894, on "Corporations in Michigan," *Publ'ns of Mich. Pol. Sci. Ass'n*, No. 2, 97).

246. 75 U.S. (8 Wall.) 168 (1869).

247. *Id.* at 181-82.

248. See EVANS, *supra* note 120, at 31.

249. See LIVERMORE, *supra* note 98, at 2 n.2 (distinguishing between partnership-like corporations involving owner-managers and "true corporate bodies" involving owner-outsiders).

250. With few employees and only one location, manufacturing enterprises required little in the way of oversight or administration. An owner could personally oversee operations without much difficulty. GLENN PORTER, *THE RISE OF BIG BUSINESS 1860-1910*, at 17-18 (1973).

largest factories employed no more than a few hundred workers, and even these larger enterprises were still predominately family-owned.²⁵¹ By contrast, the business corporation of the latter half of the nineteenth century grew in size and complexity.²⁵² Each of the large railroads employed more than 100,000 workers by 1890²⁵³ and the common stock of many of the largest corporations was publicly traded.²⁵⁴ The single-plant, one-function enterprise was replaced by a multifaceted and vertically integrated operation spread over several locations, often in different states.²⁵⁵ As one modern observer explains, these new "supercorporations" were "a genus apart from the small, localized, family-owned companies that characterized the early years of the republic."²⁵⁶ Corporations were becoming "large-scale, hierarchical business enterprises."²⁵⁷ Control increasingly became centralized in a small core of professional managers, most of whom owned little if any stock in the corporation.²⁵⁸

Paralleling this increase in the size and complexity of the corporation was the decline of the partnership or aggregate theory among legal scholars of the late nineteenth century.²⁵⁹ As Morton Horwitz noted, "the picture of the corporation as a contract among individual share holders was itself becoming a nostalgic fantasy at the very moment the partnership view was most forcefully

251. BASKIN & MIRANTI, *supra* note 241, at 193; THOMAS K. McCRAW, *PROPHETS OF REGULATION* 64 (1984). The exception was in the railroad industry. For example, although the three mills run by the Pepperell Manufacturing Company in Maine employed an average of about 800 workers during the 1850s, the New York & Erie Railroad had more than 4000 employees. By the 1880s, the Pennsylvania Railroad employed almost 50,000 workers. Alfred Chandler, *The Organization of Manufacturing and Transportation*, in *THE ESSENTIAL ALFRED CHANDLER: ESSAYS TOWARD A HISTORICAL THEORY OF BIG BUSINESS* 208-09 (Thomas K. McCraw ed., 1988).

252. C.K. YEARLEY, *THE MONEY MACHINES: THE BREAKDOWN AND REFORM OF GOVERNMENTAL AND PARTY FINANCE IN THE NORTH, 1860-1920*, at 218 (1970).

253. Chandler, *supra* note 251, at 641.

254. BASKIN & MIRANTI, *supra* note 241, at 193. According to one contemporary observer, publicly traded corporations held nearly one-quarter of the country's wealth. ARTHUR T. HADLEY, *RAILROAD TRANSPORTATION, ITS HISTORY & LAWS* 42 (1885).

255. JOHN O'SULLIVAN & EDWARD F. KEUCHEL, *AMERICAN ECONOMIC HISTORY: FROM ABUNDANCE TO CONSTRAINT* 108 (1981); see PORTER, *supra* note 250, at 18.

256. MILLER, *supra* note 243, at 50.

257. BASKIN & MIRANTI, *supra* note 241, at 167.

258. *Id.* at 168; ALFRED D. CHANDLER, JR., *THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS* 491-92 (1977); PORTER, *supra* note 250, at 21.

259. HORWITZ, *supra* note 7, at 92-93; Bratton, *supra* note 195, at 1490.

put forth."²⁶⁰ With the success of managers in the operation of large-scale, oligarchic enterprises, and the increasing passivity of shareholders, it was difficult for theorists to assert that the corporation was nothing more than the sum of its individual members.²⁶¹

At the same time that the partnership theory's value was declining as a descriptive tool, the nascent real or natural entity theory began to influence the academic understanding of the corporation.²⁶² Whereas the aggregate theory trumpeted the role of the individual in the development of the corporation, the natural entity theory viewed the corporation as greater than the sum of its parts. One contemporary observer noted that a large corporation's power and influence "is far greater than that of any individual, and ... the persons composing it could exert but a small part of this influence were it not for the unification accomplished by the distinct corporate life."²⁶³ This theory appeared to draw upon and to corroborate the claims of contemporary sociologists such as Frenchman Emile Durkheim and others that group behavior must be evaluated as a real, independent phenomenon that could not be reduced to the wills of individual actors.²⁶⁴ As Arthur Machen

260. HORWITZ, *supra* note 7, at 92. The same disconnect between theory and reality occurred in England. One commentator noted that

[h]oary ideas of partnership continued to confuse thinking with regard to corporate enterprise. Partnership law ... was a barrier to a clear view of the essential change which had taken place in the position of the investor. The typical shareholder ... was no longer an entrepreneur in the full sense of the word.

BISHOP CARLETON HUNT, *THE DEVELOPMENT OF THE BUSINESS CORPORATION IN ENGLAND, 1800-1867*, at 129-30 (1936).

261. HORWITZ, *supra* note 7, at 93; Bratton, *supra* note 195, at 1490.

262. The theory traced its roots back to 1881. In that year, philosopher Otto von Gierke first published his study of the history of associations in Germany, a study focusing on medieval communalism and the work of the German jurist, Johannes Althusius, and his theory of the state as a hierarchy of constituent, purposive groups acting as psychic organisms. See HORWITZ, *supra* note 7, at 71 (citing OTTO GIERKE, *DIE STAATS-UND KORPORATIONSLEHRE DES ALTERTHUMS UND DES MITTELALTERS UND IHRE AUFNAHME IN DEUTSCHLAND*, in 3 *DAS DEUTSCHE GENOSSENSCHAFTSRECHT* (1881)); Dewey, *supra* note 94, at 670.

263. Dwight Arven Jones, *A Corporation as "a Distinct Entity,"* 2 *THE COUNSELLOR* 78, 78 (1892).

264. Hager, *supra* note 98, at 581; see also LEON BRAMSON, *THE POLITICAL CONTEXT OF SOCIOLOGY* 14 (1961) (describing "Durkheim's claim for the metaphysical reality of the group"). Moreover, it was a theory that was not inconsistent with the developing judicial conception of the corporation. In *Graham v. La Crosse and Milwaukee R.R. Co.*, for instance,

described it, "[t]his personality is neither fictitious, nor artificial, nor created by the state, but both real and natural, recognized but not created by the law. When a company is formed by the union of natural persons, a new real person, a real corporate 'organism,' is brought into being."²⁶⁵ As a natural entity, the corporation was ostensibly both entitled and subject to the same treatment as an individual.²⁶⁶

2. *The Taxation of the Corporation During the Dominance of the Real Entity Theory*

Supporters of the entity theory explanation for the origins of the corporate income tax rely principally upon two features of the legislative history of the 1894 Act to establish the theory's practical application. First, the Senate version of the bill, which was ultimately adopted, reflected more of a natural entity theory view of the corporation than did the House bill.²⁶⁷ The House proposed to

the Court declared that "[a] corporation is a distinct entity. . . . [I]t is as distinct a being as an individual is" 102 U.S. 148, 160-61 (1880).

265. Machen, *supra* note 96, at 256. Some contemporary theorists carried this "natural organism" analogy to excess, describing a corporation's functions in terms of organs and attributing gender to different types of entities. An entity such as the church was considered feminine while the business corporation or the State itself was considered masculine, a concept which led one philosopher to raise the question of a corporation's ability to marry an individual. *See id.* at n.6.

Frederic Maitland sought to definitively answer De Vareilles-Sommieres' rhetorical questions by declaring that the real entity theory did not suggest that a corporation could do everything a man could do:

The corporation is (forgive this compound adjective) a right-and-duty-bearing unit. Not all the legal propositions that are true of a man will be true of a corporation. For example, it can neither marry nor be given in marriage; but in a vast number of cases you can make a legal statement about *x* and *y* which will hold good whether these symbols stand for two men or for two corporations, or for a corporation or a man.

Dewey, *supra* note 94, at 656 (quoting 3 FREDERIC WILLIAM MAITLAND, COLLECTED PAPERS 307 (1911)).

266. *See* Jones, *supra* note 263, at 80. One author notes:

[A corporation's] [r]ights are in no sense predicated of these agents or any of the various persons or aggregations of persons who may be said to compose the artificial person, but of it under its own name; the artificial person being under its own name the subject of such rights, duties and penalties, and in truth and fact, just as much a person in contemplation of law as they.

Henry Winslow Williams, *An Inquiry Into the Nature and Law of Corporations—Part I*, 38 AM. L. REG. 1, 8-9 (1899).

267. *See* Kornhauser, *supra* note 4, at 87.

tax the dividends and undistributed net income of all "corporations or associations organized for profit by virtue of the laws of the United States or of any State or Territory, by means of which the liability of the individual stockholders is in anywise limited."²⁶⁸ By contrast, the Senate version altered this language, imposing a tax on the net profits or income of all "corporations, companies, or associations doing business for profit in the United States, no matter how created and organized, but not including partnerships."²⁶⁹ The House version reflects the grant or concession theory's emphasis on the corporation's special privilege of limited liability, while the Senate version taxes all corporations regardless of their individual attributes. The enactment of the latter version thus appears to lend credence to a natural entity rather than an artificial entity or grant/concession theory explanation.²⁷⁰

One possible rebuttal to this argument is that the 1894 Act permitted shareholders to exclude from income those dividends received from corporations already taxed under the Act.²⁷¹ The ostensible justification for this exclusion was to avoid double taxation of corporate income.²⁷² One contemporary observer explained that "the shareholder is himself a component of the corporate person, and his dividends a portion of the net income of the corporation. ... [To tax both] can not be considered otherwise than as double taxation of the most positive sort."²⁷³ This, however,

268. 26 CONG. REC. 6831 (1894).

269. Act of Aug. 27, 1894, ch. 349, § 31, 28 Stat. 509, 556. The original Senate proposal did not include the last phrase—"but not including partnerships." 26 CONG. REC. 6831 (1894). This language was added after discussion on the question whether the Finance Committee intended to exclude partnerships, and Senator Hoar of Massachusetts suggested that the initial language was insufficient to indicate this intent. *Id.* at 6832-35, 6877.

270. See Kornhauser, *supra* note 4, at 87 ("The Senate language, ultimately adopted, seems to rely on a natural entity theory in contrast with the House's version which fits an artificial entity theory.") (footnote omitted).

271. The 1894 Act included the following provision:

Provided also, That in computing the income of any person, corporation, company, or association there shall not be included the amount received from any corporation, company, or association as dividends upon the stock of such corporation, company, or association if the tax of two per centum has been paid upon its net profits by said corporation, company, or association as required by this Act.

§ 28, 28 Stat. at 554.

272. See WALKER, *supra* note 73, at 65-66.

273. *Id.* at 64.

was based on an aggregate view of the corporation.²⁷⁴ If the corporation were truly viewed as a natural entity standing on par with any individual, then there would be less reason to connect the corporation's taxation with the taxation of its stockholders.²⁷⁵ Thus, the integration of the corporate and shareholder income taxes potentially points toward an aggregate conception of the corporation.

The second feature of the legislative history that is cited in support of an entity theory explanation is the debate over an exemption for corporations.²⁷⁶ Individuals were taxed only on the amount of income in excess of \$4000.²⁷⁷ Corporations, however, were permitted no such exemption under either the House or Senate versions of the bill. This meant that integration of corporate-shareholder income taxes was only partial. Corporations were subject to the income tax even if they had income of less than \$4000 per year. A shareholder's income from dividends was indirectly subject to a tax even if the shareholder's income was otherwise below the exemption amount and, therefore, normally nontaxable.²⁷⁸

Commentators have scrutinized the debates over the lack of a corporate exemption because of the entity theory undertones.²⁷⁹ The argument in favor of an exemption was itself based on a partnership theory of the corporation. As one exemption proponent explained,

274. *See id.* Walker indicated:

The circumstances ... are really the same, in this respect, as that of a private partnership. No one would assert that a partnership should be taxed on its property in the name of the firm, and that each partner should also be liable individually for what he has already paid taxes on, jointly with his associates.

Id.

275. Such a connection would likely be made on alternative grounds, such as the efficiency-related concern of subjecting corporate and noncorporate income to the same tax burden.

276. *See* AMERICAN LAW INSTITUTE, *supra* note 9, at 38; Kornhauser, *supra* note 4, at 88.

277. Act of Aug. 27, 1894, ch. 349, § 27, 28 Stat. 509, 553.

278. *See* 26 CONG. REC. 6865 (1894) (statement of Sen. Hill) (explaining that if an individual makes a \$3000 profit from a \$5000 investment in a partnership, "that profit of \$3,000 is not taxed, as the individual is entitled to an exemption of \$4,000, but if I place that \$5,000 as an investment in a corporation, before a dividend comes to me from that corporation the tax is already taken out in advance").

279. *See, e.g.,* Kornhauser, *supra* note 4, at 88. This view may be buttressed, in part, by the lack of entity theory undertones in a similar debate over a corporate exemption in the 1864 Act. *See* LANGENDERFER, *supra* note 24, at 508-09 (describing debate over a proposal to permit shareholders with annual incomes below \$1000 to receive a refund for amounts withheld from dividends).

"corporations are but aggregations of the capital of individuals for joint profit, with joint liability and joint loss, conveniently divided into shares for the purposes of distribution and management."²⁸⁰ Another proponent echoed this sentiment, pointing out that "[a] corporation is simply an aggregation of individuals. Many of the corporations that have been chartered under the various State governments are simply cocoperative associations."²⁸¹ Given this shareholder-centered view of the corporation, the natural question was "why levy this tax upon this class of citizens having income less than \$4,000 who happen to be shareholders in corporations?"²⁸² Senator George Graham Vest of Missouri, the principal draftsman of the corporate income tax provision and the spokesman for the Senate Finance Committee on the issue,²⁸³ defended the lack of an exemption by explaining:

We do not deal with the stockholders. We deal with a corporation as a legal being, doing business, artificially created, receiving protection upon its property from the General Government like citizens receive protection upon theirs. If it consumed clothing and food and paid the internal-revenue tax and the tariff import tax as does the individual, then the exemption should apply.²⁸⁴

280. 26 CONG. REC. 6874 (1894) (statement of Sen. Higgins).

281. *Id.* at 6876 (statement of Sen. Aldrich).

282. *Id.* at 6874 (statement of Sen. Higgins); *see also id.* at 6868 (statement of Sen. Allison) ("What is the proposition as to taxing these corporations? They are entities in one sense, but they are composed of individuals who own the shares, and who would be taxed on these shares without [the proposed exemption], and who are now exempted if their income exceeds \$4,000.").

283. *See* MANUEL IRWIN KUHR, *THE SPEAKING CAREER OF GEORGE GRAHAM VEST* 313-14 (1963) (unpublished Ph.D. dissertation, University of Missouri) (on file with author).

284. 26 CONG. REC. 6866 (1894) (statement of Sen. Vest). Senator Vest went on to explain: My argument this morning was to show that we treated a corporation as a legal entity, that we had nothing to do with stockholders, that we treated corporations exactly as we treated individuals, except that we give them no exemptions . . . Senators talk to me now about the stockholder being different from a corporation. We know nothing about the stockholder. We deal with the corporation as an entity, and that is the whole of the argument, whether good or bad.

Id. at 6879. Earlier, Senator Vest addressed the consumption argument by stating: [I]t was assumed in the House of Representatives, and we adopt now the same exemption, that the consumption of a man, say, with six or seven in his family in the course of the year will amount to about the sum which we have exempted.

This suggested that the majority viewed the corporation as a separate entity but found no justification for providing it with relief from the full measure of taxation. Given that this latter argument ultimately carried the day, modern observers have concluded that legislators not only were aware that the 1894 Act for the first time targeted corporations directly, but also were motivated to do so because of the ascendancy of the natural entity theory.²⁸⁵

Such a conclusion gives too much weight to the debates and the exemption issue itself. The shape of the income tax bill "was determined by caucus debate, committee conference, and private conversation. ... [P]ublic debate had little influence, and even lengthy speaking for the record was superfluous."²⁸⁶ The bill's sponsors clearly had little interest in extending the debate.²⁸⁷ As a consequence, the rationales offered hardly provided solid evidence of their theory of the corporation or their rationale for the corporate tax. Some arguments, such as the fact that the exemption was provided to individuals to offset the consumption taxes that a corporation did not have to pay,²⁸⁸ could be construed as supporting a natural entity theory view of the corporation. Other arguments, however, such as the fact that corporations received privileges unavailable to individuals,²⁸⁹ were based on a grant or concession

Does that rule apply to corporations? Does the corporation eat anything? Does it drink anything?

Id. at 6866.

285. See AMERICAN LAW INSTITUTE, *supra* note 9, at 36-39.

286. KUHR, *supra* note 283, at 309; see also 26 CONG. REC. 6882 (1894) (statement of Sen. Hoar) (accusing the Democrats of putting "voting in the Senate into a trust, which has two or three managers").

287. See Kuhr, *supra* note 283, at 310 ("It was the intention of the Democrats to speed the bill along by refraining from debate, except for concise explanations of their changes...").

288. See, e.g., 26 CONG. REC. 6867 (1894) (statement of Sen. Vest) ("We are told now that liberty lies bleeding in the streets unless this exemption of \$4,000, amounting to a tax of \$80 a year, is given to corporations, who eat nothing, drink nothing, [and] buy no clothes..."); *id.* at 6868 (statement of Sen. Vest) ("I believe the bill is right as it is now, and that the corporations ought to be made to pay, as they pay no tax upon consumption, without the exemptions.").

289. Representative McMillan summarized the concession theory, stating:

The corporation pays upon all its net income. And why? We will give you our reasons for it. Here are artificial parties; here are creatures of the law that have peculiar privileges. They have in some instances the right of eminent domain; they have the right to sue and be sued as individuals. ... They have the right to be exempt from personal liability. As the Government has to keep its courts in existence for the benefit of many of these corporations, as all or a majority of

theory that supposedly lost its force amidst the spread of general incorporation statutes.²⁹⁰ Still other arguments, such as the difficulty of administering a more broadly applicable individual exemption,²⁹¹ were unrelated to the entity theory rationale. Not surprisingly, the spokesmen for the Senate Finance and House Ways and Means committees ultimately hid behind the decision of their respective committees when their arguments proved unpersuasive.²⁹²

Perhaps more revealing than the debate was the Senate vote on two of the most promising, and seriously considered, of the various amendments introduced in an attempt to resolve the exemption issue.²⁹³ One proposed amendment provided a \$4000 exemption for corporations and the other exempted from the corporate tax the share of dividends owed to individuals with total incomes below the

them are presumed to be founded upon surplus, we have thought that an exception might be made in their case, and that the exemption need not apply; therefore, the net income of the corporation would be liable.

26 CONG. REC. 420 (1894) (statement of Rep. McMillin).

290. Moreover, the bill's opponents were quick to discount these privilege arguments on the grounds that it was the state, rather than the federal government, that provided the privilege in the first place. Tunell, *supra* note 60, at 335 n.2.

291. See, e.g., 26 CONG. REC. 6867 (1894) (statement of Sen. Vest) (commenting on an amendment that would allow corporations to deduct each shareholder's dividends from their income to the extent they did not exceed the \$4000 exemption amount when combined with all of the shareholder's other sources of income).

292. Representative McMillin relied upon the committee's decision when he stated: [I]f the committee should conclude that injustice has been done here it can be remedied. We have given the subject the best thought we could and have concluded that that was right. If on the contrary there should be an exemption in favor of a corporation, as of an individual, you can make it by applying the exemption to the corporation as well as the individual. That will be for the Committee of the Whole to determine when they come to consider the bill by sections.

26 CONG. REC. 420 (1894) (statement of Rep. McMillin). Senator Vest also sought refuge in the committee:

I am here as the organ of the committee. I have no personal discretion in the matter. ... all this matter can be adjusted in conference. It does not facilitate the passage of the bill to accept any amendment because the amendments seem to increase and feed upon what is given.

Id. at 6883 (statement of Sen. Vest)

293. Several less serious amendments were offered but they were defeated fairly handily, in part because they were awkwardly worded or difficult to administer. See *id.* at 6867 (discussing a variant on the \$4000 exemption); *id.* at 6868 (exempting all corporations with a capital of less than \$100,000 from the tax altogether); *id.* at 6875 (discussing a \$3000 exemption); *id.* at 6878 (discussing a \$1000 exemption).

\$4000 exemption.²⁹⁴ The former appeared to support an entity view and the latter appeared to support an aggregate view of the corporation. Despite such stark contrast in their apparent theoretical underpinnings, both amendments were defeated by relatively slim margins. The corporate exemption amendment was defeated by a 30-to-28 vote while the individual exemption amendment, despite its well-discussed administrative difficulties,²⁹⁵ was defeated by a 31-to-24 vote.²⁹⁶ This suggests the exemption issue was both less significant and closer to resolution than others have implied.

The exemption issue was thought to be of low significance because few honestly believed that many taxpayers would suffer from the failure to track the exemption to cover corporate profits. Taxpayers with income below \$4000 were unlikely to hold much stock in corporations. As one senator exclaimed, "there is a good deal of nonsense" in the notion that the "poor people of the country" own the railroads and banks.²⁹⁷ At the same time, the exemption

294. The provision was explained to mean that:

The amount of any dividends paid to a single stockholder not exceeding \$4,000 annually may be deducted by corporations, companies, or associations, not including partnerships, from any amounts upon which they would otherwise be compelled to pay, the tax herein provided for; but the amount of such dividends so received by such single stockholder shall be included in estimating any income he may have in excess of \$4,000, and in that event it shall bear its proportion of the tax herein provided for.

26 CONG. REC. 6867 (1894); *id.* at 6883 ("[T]here shall be levied and collected, except as herein otherwise provided, a tax of 2 per cent annually on the net profits or income above \$4,000 and above actual operating and business expenses.").

295. One senator voiced several concerns and asked:

How is the corporation to settle with each individual stockholder in making up its net profits for the year? It does its business as an entirety. It makes so much money or it loses so much money. It is to pay the tax upon its net profits. Now, if that amendment should be adopted it would be requisite for the corporation, before it ascertains what its net profits are, to set aside certain amounts of money, not to be taken any account of in its business at all. How is this to be done?

Id. at 6867-68 (statement of Sen. Vest).

296. *Id.* at 6882 (reporting the defeat of the individual exemption amendment); *id.* at 6883 (reporting the defeat of the corporate exemption amendment).

297. *Id.* at 6869 (statement of Sen. Teller). Similar statements were made in the House. Representative John Sharp Williams, a staunch defender of the income tax bill, protested that everyone knows "that it is not the widows and orphans of this country who own the banks and railroad companies and the insurance companies of the United States. There may be some widows and orphans who have such investments, but they are widows and orphans of large estates." *Id.* at 1739 (statement of Rep. Williams).

amendment was close to passage because some of the Republican and other minority party senators who voted in favor of keeping the income tax also voted for one or both exemption amendments.²⁹⁸ After extensive caucus debate, the Democrats, with one exception,²⁹⁹ agreed to vote in a block on all issues related to the income tax.³⁰⁰ Their failure to support an exemption, therefore, was probably more the result of party loyalty than a tacit acceptance of any of the entity-theory principles expressed during the debates.

Ultimately, the flaw in the entity-theory explanation, and its variants,³⁰¹ is one of perspective. By focusing on the 1894 Act to discern the influence of entity theory on the origins of the corporate income tax, commentators have obscured the role played by the taxation of corporations on both the state and federal level from the Civil War through the 1890s. This history, as much as the

Some senators may have also believed that the Internal Revenue Service would in practice alleviate the "injustice" in their collections from individuals. During the Civil War and Reconstruction, the Service directed its collectors to obtain the extra amount due from shareholders whose income tax rates exceeded the tax imposed on corporations. *See supra* text accompanying note 26. The difference under the 1894 Act, however, was that the Service would have had to provide a refund to remedy the injustice, a practice not likely to be initiated without express authorization.

298. Senators voting to keep the income tax and to pass both exemption amendments were John Mitchell (R. Or.) and Thomas Power (R. Mont.). Senators voting to keep the income tax and the corporate exemption only included James Kyle (Ind. S.D.), William Peffer (Pop. Kans.), and Henry Teller (R. Colo.). *Compare* 26 CONG. REC. 6882-83 (1894) (corporate and individual exemption votes), *with* 26 CONG. REC. 6934 (1894) (income tax vote). *See also* BIOGRAPHICAL DIRECTORY OF THE AMERICAN CONGRESS 1774-1971, at 254-58 (1971) (party affiliations).

299. Senator David Hill of New York was the lone Democrat dissenter on the income tax. KUHR, *supra* note 283, at 311.

300. *Id.*

301. One possible alternative explanation is that corporations were considered artificial entities in 1864 and natural entities in 1894. *Cf.* Kornhauser, *supra* note 4, at 85-86 (discussing the Court's simultaneous recognition of the corporation as a separate entity and permission to tax a corporation's undivided profits in *Collector v. Hubbard*). In the former case, the corporation would be an entity only for certain state purposes, and not for purposes of federal taxation. In the latter case, the corporation would be treated on par with the individual for federal tax purposes. Notwithstanding that the corporation was taxed on par with individuals during the height of the grant/concession period in the beginning of the nineteenth century, see *supra* text accompanying notes 124-49, even Kornhauser concedes that both the House version, which evidenced an artificial entity approach, and the Senate version, which evidenced a natural entity approach, supported the direct, rather than the pass-through taxation of the corporation. Kornhauser, *supra* note 4, at 87.

legislative history of the 1894 Act itself, sheds significant light on the true nature of the original corporate income tax.

III. A SHAREHOLDER-CENTERED EXPLANATION FOR THE CORPORATE INCOME TAX

One of the principal problems with the traditional explanation for Congress' change in approach is that it assumes the 1894 Act's corporate income tax was actually a radical departure from the Civil War tax. It is true that both the House and Senate bills in 1894 changed several features in the 1864 Act's scheme for the taxation of corporate income. For instance, the 1894 House bill applied the tax to corporations rather than certain industries and made a dividend tax coupled with a corporate undistributed profits tax its centerpiece, thus abandoning the 1864 Act's tax on shareholders' undivided profits. The 1894 Senate bill discarded the dividend tax used in both the 1864 Act and the House bill in favor of a corporate income tax. The following examination of each of these changes and the underlying history suggests, however, that the 1894 Act's taxation of corporate income is a great deal closer to the 1864 Act's approach than most observers assert. In both cases, Congress sought to tax the investor. The only difference was that by 1894 Congress recognized the benefits of distinguishing between the corporation and the partnership in taxing increasingly elusive intangible wealth.

A. The Increasing Focus on Corporate Wealth

The first apparent change was to add a general tax on corporations. In the 1864 Act, Congress imposed a tax on businesses, but it appeared to target certain industries rather than forms of organization. In addition to defining "income" to include the undivided "gains and profits of all companies, whether incorporated or partnership,"³⁰² Congress imposed a five percent tax on all dividends and undistributed sums of companies in the transportation, banking, and insurance industries.³⁰³ In contrast,

302. Act of June 30, 1864, ch. 173, § 117, 13 Stat. 223, 282.

303. *Id.* § 120-22.

the 1894 House bill proposed a two percent tax on the dividends and undistributed sums of "corporations or associations organized for profit by virtue of the laws of the United States or of any State or Territory, by means of which the liability of the individual stockholders is in anywise limited."³⁰⁴

Modern observers, in declaring that "[t]he 1894 Act ... marked the first time in this country's revenue history that the law distinguished corporations from other types of business organizations for tax purposes," imply that the 1894 Act was a radical shift in approach.³⁰⁵ This conclusion, however, is based on a limited review of federal rather than state revenue law. The growth of intangible wealth during the latter half of the nineteenth century led states to direct their attention to the sources of such wealth, which in turn led taxing authorities to enact statutes directed, first, at certain industries and, eventually, at corporations in general. Viewed in this light, the shift from the 1864 Act to the 1894 Act was a much more gradual process than commonly has been assumed and the similarities between the two Acts more striking.

1. *Property Taxation and "New" Wealth*

One corollary of the dramatic increase in the number and size of corporations in the latter half of the nineteenth century was a dramatic increase in the country's intangible wealth. Prior to the Civil War, most of the country's wealth was in tangible form—real property or personalty, such as the harvest reaped from an individual's farm—and thus could be easily identified.³⁰⁶ This situation, however, quickly changed. Within two decades after the end of the Civil War, "the bulk of Northern property had assumed new shapes: machinery, credits, securities, mortgages, savings, exchange values, 'going-concerns,' and personal possessions. If much of this wealth was tangible, just as the 'old wealth' had been, much more of it was intangible, hard to locate, hard to value."³⁰⁷

304. 26 CONG. REC. 6831 (1894).

305. Patrick E. Hobbs, *Entity Classification: The One Hundred-Year Debate*, 44 CATH. U. L. REV. 437, 438 (1995).

306. See YEARLEY, *supra* note 252, at 39.

307. *Id.*; see also RICHARD T. ELY, *TAXATION IN AMERICAN STATES AND CITIES* 143 (1888) (estimating that the value of all personal property in the country was at least equal to and

The increase in the value of intangible property was primarily attributable to the growth of the corporation.³⁰⁸ While some intangible wealth surely was held in partnership form, corporate investments accounted for the vast majority of such wealth. As one state tax commission concluded, "[t]he wealth of the country in personalty consists largely of investments in corporate securities, stocks, and bonds in railroad and other corporations."³⁰⁹ Perhaps most importantly, contemporary legislatures *believed* that the "new" wealth was primarily corporate. As Clifton Yearley explained:

By the end of the last century, land was believed much less valuable than formerly and despite the possibilities of raised assessments, it appeared to be a shrinking reservoir from which to siphon taxes. On the other hand, corporate wealth was taken to be prodigiously valuable, more than anyone had ever dreamed.³¹⁰

The new wealth posed considerable difficulties for existing state and local property tax systems. Because of the real property orientation of the prevailing tax systems, holders of intangible property were accused of not bearing their fair share of the burden.³¹¹ In 1860, the president of the American Statistical Association noted that there is "*a very prevalent opinion* that some

perhaps as much as double the value of all real property based on figures for England in 1869).

308. See Seligman, *supra* note 138, at 269 ("In all ages and in all countries it has been found almost impossible to reach intangible personalty. What has always been a difficult task has become immensely complicated to-day through the growth of the modern corporation.").

309. Roswell C. McCrea, *A Suggestion on the Taxation of Corporations*, 19 Q. J. ECON. 492, 493 n.1 (1905) (quoting REPORT OF THE WISCONSIN STATE TAX COMMISSION (1903)).

310. YEARLEY, *supra* note 252, at 197.

311. As one report of the period put it:

[T]he profits of large numbers of the citizens of the State who have moneyed and business operations are untaxed. The citizen who buys and sells real estate—who deals in stocks and securities—who speculates in grain or the necessities of life, is not called upon to contribute one penny for the support of the government.

Report of John A. Wright, in REPORT OF THE REVENUE COMMISSION APPOINTED BY THE ACT OF THE LEGISLATURE OF PENNSYLVANIA, MAY 25, 1889, 38, 128 (1890); see also Sumner Benson, *A History of the General Property Tax*, in GEORGE C. S. BENSON ET AL., THE AMERICAN PROPERTY TAX: ITS HISTORY, ADMINISTRATION, AND ECONOMIC IMPACT 52 (1965); ELY, *supra* note 307, at 140 ("Some way must be contrived to make owners of these new kinds of property, who include most of our wealthiest citizens, pay their due share of taxes.").

of the more wealthy citizens, much of whose property is invisible ... do not bear their due proportion of the public burdens. ... [While, at the same time,] real estate ... cannot escape the observation of public officers, and these are fully taxed."³¹² State legislatures, dominated by farmers eager to equalize the burden,³¹³ aggressively instituted commissions to study the problem and enacted statutes designed to reach intangible property.³¹⁴

The problem was that the general property tax was ill-suited to the task of collecting on wealth that could not be seen or touched.³¹⁵ As Professor Henry Carter Adams reported at the time, "[t]he development of the corporation and the increase of incorporeal property which comes with the increase of interdependence in industrial matters have destroyed the conditions under which a general property tax can work in a satisfactory manner."³¹⁶ Tax evasion was rampant because individuals were trusted with the responsibility of reporting the value of their assets and collectors were forced to rely on mere "conjecture."³¹⁷ In New York City, for

312. Edward Jarvis, *On the System of Taxation prevailing in the United States, and especially in Massachusetts*, 23 J. STAT. SOC'Y OF LONDON 370, 376 (1860).

313. ELY, *supra* note 307, at 144; YEARLEY, *supra* note 252, at 39-41. Yearley, quoting from an 1881 article in *The Nation*, noted that, "[a] few farmers themselves acknowledged that 'it was entirely by their vote that the existing system [was] ... maintained,' thanks to a 'political influence vastly out of proportion to their numbers' and a burning 'hope of getting at the rich bondholders and goldbugs somehow.'" *Id.* at 41 (brackets and ellipses in original).

314. See, e.g., CADMAN, *supra* note 176, at 404 ("In recognition of the increasing importance of intangible wealth, an amendment to the [New Jersey] general tax law was passed in 1851 for the purpose of reaching the owners of intangible property."); Report of John A. Wright, *supra* note 311, at 123 ("The great increase in the value of personal property since that date [1861] has been an incentive to Legislatures to tax capital in the various forms in which it is represented in personal property. All the States have endeavored to reach personal property, and this has been eminently true" of Pennsylvania.).

315. See ELY, *supra* note 307, at 141 ("The existing method of assessing and taxing property was better adapted to the first half of the nineteenth century than to the second half, because taxation was less important, and also because property could more readily be found."); FRIEDMAN, *supra* note 212, at 28 ("It was progressively more difficult under the general property tax to reach much more than tangible property.").

316. Henry C. Adams, *Suggestions for a System of Taxation*, in PUBLICATIONS MICH. POL. SCI. ASS'N 49, 55 (May 1894); see also CLAPPERTON, *supra* note 214, at 8 ("The inadequacy, under existing economic conditions, of the general property tax, so called, and its utter failure, even under the most rigorous and effective administrative methods that have been devised, to reach for taxation property of a corporate and intangible character, are recognized in all the States named.").

317. Jarvis, *supra* note 312, at 375. Part of the evasion may also have been attributable to a sort of race-to-the-bottom among elected tax assessors seeking to curry favor with their

instance, only 8900 individuals out of a total population of one million in 1875 conceded liability for personal property despite conservative estimates that set the total value of all such property at two billion dollars.³¹⁸ A report from the Ohio Tax Commission commented that "fully one-half of the property of a modern State exists in intangible forms: of this all but a mere bagatelle escapes taxation entirely, when the attempt is made to reach it in the form of property."³¹⁹ Perhaps the most revealing statistic is that from 1860 to 1880, a period in which the assessed valuation of real estate grew from just under \$7 million to just over \$13 million, the assessed value of personal property declined by more than \$1.2 million.³²⁰ Few believed the decline was attributable to an actual drop in asset value.³²¹

2. *Tax Evasion and Anticorporate Sentiment*

Although tax evasion involving intangible assets was widespread across different classes of taxpayers and categories of property, corporate shareholders were foremost on every legislator's "Most Wanted" list for such abuse. Investors often either failed to list corporate securities among their assets, or, if listed, the value of such securities was seriously understated. The latter problem may have been due to the difficulty of arriving at an accurate value in the absence of public markets,³²² but tax evasion was rampant even

citizenry and produce the lowest possible tax burden relative to other areas of the state. See QUINCY, *supra* note 72, at 6 ("The Confederate Treasury became the greatest money factory in the world."); Adams, *supra* note 316, at 55-56 (same).

318. YEARLEY, *supra* note 252, at 42-43.

319. Charles F. Dunbar, *The New Income Tax*, 9 Q. J. ECON. 26, 35-36 (1895) (quoting REPORT OF THE TAX COMMISSION OF OHIO OF 1893, at 42).

320. Adams, *supra* note 316, at 56 (citation omitted).

321. See, e.g., Benson, *supra* note 311, at 53 (noting that "the absolute decline in personal property assessment and the relative decline in the role of personal property were clear signs that assessment practice did not reflect changes in the national economy" and concluding that "[c]learly, many citizens, when faced with a tax list on which they were to report all their personal property, simply did not display the same spirit of idealism that had prompted the adoption of general property tax requirements"); James A. Briggs, Letter to the Editor, *Taxation and Assessment in the State of New York*, N.Y. TIMES, Mar. 18, 1882, at 2 ("There is no doubt that there has been a very large increase of taxable personal property in this State since 1858. And yet there has been a large decrease in the assessed valuations . . .").

322. A *Newark Daily Advertiser* editorial commented that the value "of personals is so doubtful that their owner rarely knows with any exactness how much he is worth, and he has

when the securities were publicly traded. In California, for instance, the total value of all taxable securities quoted on the San Francisco Exchange was in excess of \$110 million, but less than \$8.5 million of that value was reported on tax returns.³²³ This pattern of underreporting was also evident in Pennsylvania, where the state tax commission admitted that the amount of tax received from personal property was "far below the holdings of bonds and stocks by citizens of the State."³²⁴ Ultimately, Professor Adams concluded, "[w]hen one observes the character of [stocks and bonds] and the ease with which [their value] is concealed, it is clear that an attempt to apply the theory of the general property tax to corporations must result in the evasion of taxation by a considerable portion of this property."³²⁵

In states where the tax primarily targeted the source of corporate wealth rather than the investor, the corporation was accused of not paying its fair share.³²⁶ In part, this was less a matter of tax evasion than the product of the generous tax exemptions provided under federal, state, and local law.³²⁷ Cynical observers, however, saw little difference between these exemptions and outright tax fraud. Corporations had merely cloaked their fraud in the color of law by purchasing such exemptions from corrupt legislators.³²⁸ The general view, expressed by one editorialist, was that the corporation "pays for its law by the year" and thereby has "succeeded very largely in shaping legislation to suit their purposes."³²⁹ It did not take a wild-eyed radical to see that "[l]egislatures had been bought like cattle

an excuse in that for underestimate." Editorial, *Taxes on Corporations*, NEWARK DAILY ADVERTISER, Feb. 18, 1870, at 1.

323. YEARLEY, *supra* note 252, at 58.

324. Report of John A. Wright, *supra* note 311, at 132.

325. HENRY CARTER ADAMS, *THE SCIENCE OF FINANCE: AN INVESTIGATION OF PUBLIC EXPENDITURES AND PUBLIC REVENUES* 382 (1898).

326. See YEARLEY, *supra* note 252, at 59 ("It was a popular prejudice that corporations were guilty of extensive evasion, a prejudice all the more bitter to those who entertained it because of the fiscal advantages which they realized governments had extended these businesses.").

327. *Id.* In 1882, newspaper headlines cried foul at a provision that would exempt elevated railroad corporations from certain taxes. See, e.g., *Trying to Evade Taxes—The Elevated Railroads Endeavoring to Cheat the City*, N.Y. TIMES, Apr. 12, 1882, at 2.

328. See JAMES H. COLEMAN, *LETTERS & C. ON CORPORATIONS AND TAXATION* 2 (n.d.) (approx. 1880) (citing correspondence of the *New York Daily Graphic*, Dec. 23, 1878).

329. Editorial, *Corporate Wealth*, N.Y. TIMES, Jan. 15, 1882, at 6.

and sheep, though hardly for so little money."³³⁰ Perhaps recognizing the truth of these charges, states sought to insulate themselves from temptation. Pennsylvania, for example, enacted a constitutional provision barring the legislature from ever surrendering its right to tax corporations.³³¹ Although some of these legislatively bestowed tax advantages were counterbalanced by the inefficiencies of local property tax administration,³³² they nevertheless provided support for charges that corporate wealth failed to bear its fair share of the tax burden.

Further fueling popular prejudice against the corporation was the fact that corporations appeared to engage in more than their fair share of actual tax evasion.³³³ In one well-reported example, Cornelius Vanderbilt's New York Central Railroad, which claimed in its financial documents to have capital of \$143 million, paid taxes on only \$22 million of it by double deducting its indebtedness.³³⁴ In another case, the Western Union Telegraph Company, claiming that its wires and telegraph poles were not taxable as real estate, paid taxes on a capital of \$1.8 million despite distributing dividends on a capital of \$47 million.³³⁵ These were hardly isolated examples. "[C]rooked accounts, dishonest bonding, under-assessment, phony

330. YEARLEY, *supra* note 252, at 61 (paraphrasing Rev. Henry Ward Beecher).

331. JOHN F. WHITWORTH, TAXATION OF FOREIGN AND DOMESTIC CORPORATIONS, JOINT STOCK ASSOCIATIONS AND LIMITED PARTNERSHIPS IN PENNSYLVANIA 53 (1901).

332. See YEARLEY, *supra* note 252, at 80 ("Corporate properties ... were frequently victimized or faced with victimization by inequities in the operations of the general property tax. Advantages won by particular corporations from governments, or awarded to them by governments, were sometimes heavily counterbalanced by inequities.")

One author of the time described the imperfections as follows:

The multiplicity and lack of homogeneity of existing systems of taxation are the causes of their greatest imperfections; and this lack of homogeneity and the conflicts resulting therefrom especially affect corporations, of which many large ones, both private and public, ramify through several States, holding property and doing business in each, and thus becoming subject to the tax laws of each.

Edward C. Moore, Jr., *Corporate Taxation*, 18 AM. L. REV. 750, 752 (1884). As Yearley explains, such inequities "might suggest nuances in the usual picture of corporate offenders against society, or might at least provide another explanation of why some were driven to offenses." YEARLEY, *supra* note 252, at 80-81.

333. YEARLEY, *supra* note 252, at 60-61.

334. *Id.* at 62; COLEMAN, *supra* note 328, at 7. The railroad, apparently in violation of New York judicial decisions barring the practice, treated debt as diminishing the value of its capital stock and then deducted the debt from the already diminished valuations. YEARLEY, *supra* note 252, at 62.

335. COLEMAN, *supra* note 328, at 9.

indebtedness, the juggling of domiciles, collusion with public officials, or bribing them were all part of the arsenal of corporate tax dodgers.³³⁶ Because of the high-profile nature of the corporation and its abuses, it is perhaps not surprising that one commentator reported in 1884 that "there is a wide-spread feeling that corporate bodies are natural enemies of the people."³³⁷ It became popular to call on state legislatures to collect all of their revenues from corporations.³³⁸

3. *State Targeting of Corporations for Special Taxation*

The combination of this anticorporate sentiment and the failings of the general property tax led state after state to search for alternative methods of taxing the corporation.³³⁹ The first method chosen—and the one reflected in the 1864 Act—was targeting corporation-dominated industries imposing taxes designed to reach wealth missed by the general property tax.³⁴⁰ Thus, states enacted taxes narrowly tailored to reach the assets of banks, insurance companies, railroads, and other transportation and transmission

336. YEARLEY, *supra* note 252, at 63.

337. Moore, *supra* note 332, at 751; *see also* *Current Events—The Growth of Corporate Organization*, 20 CENT. L.J. 481, 482 (1885) ("[T]he prejudice against corporations has become so violent that the name corporation has almost become synonymous with monopoly.").

338. *See, e.g.*, Bolton Hall, Essay 1, in *EQUITABLE TAXATION* 58 (1892) (describing the governor of New York's expression of hope that all expenses could be met through the taxation of corporations); YEARLEY, *supra* note 252, at 60 ("Demagogues," insisted E.L. Godkin in 1879, "are constantly bringing forward schemes to relieve the whole people from public burdens by taxing corporations."); Adams, *supra* note 316, at 58-59 ("[T]he chief source of revenue to the states should be from the corporation tax. . . . [Because] the states do not expend more than \$140,000,000 annually, their demands could be easily met by a corporation tax.").

339. *See* ADAMS, *supra* note 325, at 382 ("In order to overcome this difficulty [tax evasion], as also to evade the theoretic criticisms as applied to personal property, there is an observed tendency in recent revenue reforms toward the development of special methods of taxing corporate property."); YEARLEY, *supra* note 252, at 197 ("Legislation by the states to exploit corporate wealth as a major source of public revenue, though little publicized, represented one of the chief reform efforts of the last third of the nineteenth century."); Adams, *supra* note 316, at 57 ("It was in recognition of the fact that the general property tax worked a great injustice that legislators have in recent years attempted to supplement it by the corporation tax.").

340. *See* SELIGMAN, *supra* note 125, at 143; *see also* FRANK I. HERRIOTT, AN INTRODUCTION TO THE HISTORY OF CORPORATION TAXES IN IOWA 4a (1902) (noting that initially, "[o]ne class of corporations would receive attention and then another. One method of assessment would be taken with one class and another basis with another class."). This classification movement extended beyond corporations, covering all forms of tangible and intangible property. *See* Benson, *supra* note 311, at 63.

companies.³⁴¹ The taxes generally targeted capital stock, surplus, franchise, gross receipts, dividends, or net profits, or some combination of the above, depending upon the characteristics of the individual industry.³⁴² This special system of corporate taxation was primarily justified on the ground that there were "certain classes of corporations which, from their nature, could not conform to general laws."³⁴³ As one contemporary commentator observed, the general property tax's "complete failure" to reach companies in the banking, Pullman car, telephone, telegraph and insurance industries, among others, resulted in "the adoption of separate and distinct systems for their taxation."³⁴⁴ By contrast, corporations in other industries were not subject to special taxation because conventional methods were relatively more successful.³⁴⁵

The problem with this industry-specific system of corporate taxation was that corporations soon began to dominate virtually all

341. SELIGMAN, *supra* note 125, at 143-66 (discussing various attempts to target each industry with something other than the general property tax). In New Jersey, for example, there were:

[C]ertain types of business corporations that were singled out during the first half of the nineteenth century for special treatment in the matter of taxation. The principal representatives of the groups to which special rules of taxation were applied were commercial banks, insurance companies, canal and railroad corporations, and a few early telegraph companies.

CADMAN, *supra* note 176, at 389. Not surprisingly, the majority of businesses incorporated during this period were operating in one of these industries. See HURST, *supra* note 105, at 17 (listing percentages of second charters given for these business types).

342. HURST, *supra* note 105, at 17; see also FRIEDMAN, *supra* note 212, at 28-32 (describing Massachusetts' tax on savings banks as an excise on the privilege of operating in corporate form).

343. Moore, *supra* note 332, at 754.

344. Walter E. Weyl, in *EQUITABLE TAXATION* 21 (1892) (Weyl, a nineteen-year old Wharton student, was the first prize winner in an 1891 essay contest sponsored by the journal *Public Opinion* whose prize-winning essays were reprinted in this volume.). An 1893 report of the Ohio Tax Commission, in advocating a franchise tax based upon gross receipts, elaborated on the problems of taxing specific industries under the general property tax:

An express company may own nothing within the State beyond a few horses and wagons and trucks; a telephone company or telegraph company owns a few miles of wire, which is worthless except as a source of revenue, and a number of instruments of small value . . . It is apparent that in all of these cases the property owned is no index whatever of the ability to aid in bearing the burdens of the State.

WALKER, *supra* note 73, at 73 n.1 (quoting OHIO TAX COMMISSION 48, 60 (1893)).

345. See ADAMS, *supra* note 325, at 449-50.

industries.³⁴⁶ The taxation of corporations in some industries, but not in others, became increasingly untenable.³⁴⁷ In effect, the industry-based exception was swallowing the general rule that corporations should be treated the same as individuals for tax purposes. Thus, states increasingly shifted their focus from taxation of industries to taxation of corporations.³⁴⁸ Industry-specific taxes were not eliminated; instead, they were supplemented with a general system of corporate taxation intended to more fairly allocate the burden of taxation. In 1869, New Jersey's Governor used his inaugural address to call for the adoption of a tax "based on the 'profits or dividends' of all the corporations chartered" by the state.³⁴⁹ According to the Governor, only a few corporations, and some of them neither rich nor profitable, contributed all of the expenses of the state.³⁵⁰ The corporate tax was designed "to include all, or at least many more corporations in the operation of the law, thus increasing the sources of revenue and equalizing the burdens."³⁵¹ Although New Jersey's general corporate tax subsequently died for lack of enforcement,³⁵² other states were motivated by similar concerns. Both Massachusetts' general corporate tax, enacted in 1864 and New York's general corporate tax, enacted in 1880, were taxes on all corporate franchises except

346. See Adams, *supra* 316, at 65 (statement of Mr. Cutcheon during discussion of Adams' paper).

347. See YEARLEY, *supra* note 252, at 209-10 (citing the example of Pennsylvania's failure to tax corporations in a new type of industry—the building and loan association—simply because of the practice of naming the industries to which the tax applied and thereby exempting all other industries to arise after the adoption of the statute).

348. The pattern for taxing industries rather than corporations has been described as follows:

By 1903 ... seventeen of the twenty states of the iron rectangle reached the capital stock of corporations under provisions of the general property tax as *specially* administered for certain classes of corporations. Under special definitions of personal property, moreover, eight of the twenty states, including New York, Michigan, Indiana, and Illinois levied taxation on corporate franchises. But the most impressive shift away from the policies of the preceding generation could be traced in the fact that seventeen states of the Northern tier had inaugurated extensive systems of distinct corporate taxation, some general, some special.

Id. at 207.

349. CADMAN, *supra* note 176, at 409-10.

350. Editorial, *Taxes on Corporations*, NEWARK DAILY ADVERTISER, Feb. 18, 1870, at 1.

351. *Id.*

352. CADMAN, *supra* note 176, at 414. It was eventually revived in the 1880s. *Id.* at 415-16.

those in industries governed by other provisions.³⁵³ Similarly, a special revenue commission in Iowa recommended to the Legislature in 1893 that, in addition to reforming its taxation of corporations in specific industries, it adopt a general corporation tax for "ordinary business corporations."³⁵⁴ The corporation tax became not merely a Band-Aid to cover the gaps in the traditional property tax's reach, but a separate form of taxation altogether.

Paralleling the advent of the general corporation tax was a growing recognition of the failings of property-based systems of corporate taxation such as the tax on a corporation's capital stock. The problem was that a corporation's capital stock was not very reliably correlated with its ability to pay. Where the tax was based on the amount of capital stock outstanding at the time of incorporation, corporations could easily reduce their burden by deliberately establishing a low capitalization. In one typical example, an Indiana railroad whose stock was worth at least \$3 million set its capital stock at a mere \$50,000 because state law imposed a tax based on a percentage of the capital stock at the time of incorporation.³⁵⁵ As a local commentator noted in discussing the situation, "[t]he law as framed admits of evasions but how can such a result be avoided under the law? You can not compel a corporation to have a certain amount of capital stock."³⁵⁶ Moreover, capital stock was a measure of equity, rather than debt, contributions to the corporation. Thus, as Edwin Seligman pointed out, a "heavily bonded corporation would ... entirely escape taxation; because in such cases—and they are the great majority—the capital stock alone would not represent the value of the property."³⁵⁷ Because of such problems, states increasingly resorted to corporate taxes based upon earnings, business transacted, dividends, and profits or income.³⁵⁸ The trend was away

353. Seligman, *supra* note 138, at 301-02.

354. HERRIOTT, *supra* note 340, at 24. Critics opposed the then-novel method of taxing corporations on the market value of their capital stock. *Id.* at 26. The recommendation was eventually adopted in 1897. *Id.*

355. JACOB P. DUNN, *THE NEW TAX LAW OF INDIANA AND THE SCIENCE OF TAXATION* 51 (1892).

356. *Id.*

357. SELIGMAN, *supra* note 125, at 193.

358. Seligman, *supra* note 138, at 271-73.

from taxation of corporate property and toward the taxation of corporate income.

The corporate income tax, therefore, arose in part because of the traditional property tax's failure to reach intangible wealth. In effect, it was a substitute for an individual property tax on corporate investments. Professor Adams explained that since it is "impossible to secure payment from [stocks, bonds, shares, and other forms of personal property] by tracing it to individual proprietors, the tax is levied upon the corporation, which from its nature must have a legal situs and maintain a current record of its property and earnings."³⁵⁹ Although states also might have attempted to resolve this quandary by resorting to individual income taxation, corporate taxation appeared to present a much more palatable alternative.³⁶⁰

4. *Federal Taxation of Corporations*

The federal experiment with a corporate tax during the nineteenth century both was inspired by the state movement to supplement the traditional property tax with a tax on corporations and motivated by some of the same concerns about the taxation of intangible wealth. Throughout the debates over taxation during the Civil War and Reconstruction, congressional leaders expressed a desire to shift some of the burden of taxation to the stockholders of the country. When Thaddeus Stevens initially proposed a direct tax on land in 1861, opponents cried they would not support a bill "that would allow a man, a millionaire, who has put his entire property into stock, to be exempt from taxation, while a farmer who lives by his side must pay a tax."³⁶¹ When the property tax was rejected, both on policy and constitutional grounds,³⁶² the only existent

359. ADAMS, *supra* note 325, at 441-42.

360. YEARLEY, *supra* note 252, at 226.

361. CONG. GLOBE, 37th Cong., 1st Sess. 306 (1861) (statement of Rep. Colfax). When the issue was revived again in 1864, opponents maintained that "you must assess taxes not upon land alone but upon every description of property real and personal, and consequently the owners of personal estate that amounts to such a large proportion of the aggregate wealth of the United States ought not to be wholly exempt from the direct tax. . . ." CONG. GLOBE, 38th Cong., 1st Sess. 2631 (1864) (statement of Sen. Davis). The senator went on to indicate: "In Massachusetts, and in the eastern States generally, there is a large aggregation of capital that does not exist in the form of real estate; it exists in stocks; bank stocks, manufacturing stocks, canal stocks, and railroad stocks, and in other forms." *Id.*

362. RATNER, *supra* note 26, at 64-65.

alternatives were the consumption-based tariff and excises taxes. As one senator remarked, "I am not for any greater burden on the consumption of this country than it bears now. I want wealth and improper indulgences to pay the rest."³⁶³ Similar sentiments were expressed during the debates over the 1894 Act. Senator Hill from New York, while questioning the income tax's fitness for this purpose, acknowledged that "[i]t is said that the wealthy men of the country have their money so invested that they can not be reached by other methods or systems of taxation, and that the object of the income-tax provision is to reach that class of people."³⁶⁴ The adoption of an income tax during the Civil War and in 1894, including the taxes directed at corporate income, responded to these concerns.³⁶⁵

The industry-specific focus of the 1864 Act was a reflection of the state trend to tax industries in which the evasion of the property tax was the greatest. It was still, however, considered a tax on corporations. As one senator later recounted, the "original object" of the Civil War era dividend tax provisions

was to require the great corporations of the United States to pay the incomes for the beneficiaries [I]n the sections of the original acts and the amendments every corporation was named; that is, the character of the corporation was named, and there were but two kinds of corporations in our income-tax law originally.³⁶⁶

These two kinds of corporations included "moneyed corporations" such as banks and insurance companies, and "transportation companies."³⁶⁷ As one observer confirmed, this "legislation but followed the approved practices of the States in selecting such a method of reaching this form of property."³⁶⁸ The intent was to focus on the industries in which the largest corporations operated and leave shareholders in corporations where the traditional methods of

363. CONG. GLOBE, 37th Cong., 2d Sess. 2350 (1862) (statement of Sen. Simmons).

364. 26 CONG. REC. 6804 (1894) (statement of Sen. Hill).

365. RATNER, *supra* note 26, at 67 (discussing, in particular, the adoption of an income tax in 1861).

366. 26 CONG. REC. 6832 (1894) (statement of Sen. Allison).

367. *Id.*

368. HOWE, *supra* note 202, at 103.

taxation were adequate to be covered by the general income tax provisions.³⁶⁹

The increasing state reliance on general, rather than industry-based, corporate taxes during the latter half of the nineteenth century served as a model for federal government efforts during the 1890s. In fact, the House bill was effectively modeled after the general corporation tax in Pennsylvania. As Senator Vest noted, the House bill "adopted the system as to its details which was in the old law of 1864 and which is found in the law of Pennsylvania to-day."³⁷⁰ Pennsylvania's law was the first to impose a tax on corporations rather than industries and was the basis for later general corporation taxes such as the one enacted in New York in 1880.³⁷¹ Moreover, just like the trend to adopt general corporation taxes at the state level, the 1894 House bill did not completely abandon the previous focus on specific industries. The two percent tax was specifically applied to banks, insurance companies, railroads and other transportation companies, and gas, electric, and water companies, in addition to all other corporations.³⁷² Application of the tax to corporations rather than specific industries was, therefore, a product of the spread of the corporation to all industries. In both the general and industry-specific taxes, the target was the corporation rather than the partnership.

B. The Rising Popularity of Stoppage-at-the-Source Methods of Taxation

The second difference between the 1864 Act and the 1894 House bill is that the House bill relied exclusively on a corporate dividends/undistributed profits tax to reach the income from corporate investments. In the 1864 Act, Congress employed a two-

369. See 26 CONG. REC. 6832 (1894) (statement of Sen. Allison) ("All the small corporations of the country were left to the original operation of the income tax; their dividends were paid, if dividends were declared, and carried in the income statements and returns of the individual members of those corporations.").

370. *Id.* at 6866 (statement of Sen. Vest).

371. See SELIGMAN, *supra* note 125, at 166 (stating that Pennsylvania enacted a general corporate tax in 1840, which provided that "banks and all corporations whatever" shall be subject to the tax); *id.* at 170 (describing New York's general corporation tax and noting that it "was based on the Pennsylvania act").

372. 26 CONG. REC. 6831 (1894).

pronged approach to the taxation of corporate income. First, "income" was defined to include both the dividends received and an individual's share of the undivided profits of a corporation.³⁷³ Second, shareholders of corporations in certain specified industries were subject to a dividends tax rather than the undivided profits tax. Under the dividends tax, these corporations were directed to withhold five percent of all dividends paid and remit this amount to the government in payment of the tax due.³⁷⁴ All undistributed sums or sums added to surplus or contingent funds were also subject to a five percent tax.³⁷⁵

The 1894 House bill abandoned the 1864 Act's pass-through method of taxing corporate income, but retained the dividends tax. As most observers acknowledged,³⁷⁶ the dividends tax was a shareholder provision imposed at the corporate level to aid collection efforts. While it is true that the corporate undistributed profits tax was a direct tax on the corporation, it essentially served as an enforcement mechanism for the dividends tax. If shareholders tried to avoid taxation by causing their corporation to refrain from issuing dividends,³⁷⁷ the undistributed profits tax would reach the retained funds.³⁷⁸ In light of the general difficulties with enforcing previous tax acts and the growing complexity of the corporation, it is not surprising that the 1894 House bill dropped the pure conduit approach and increased reliance on stoppage-at-the-source methods

373. Act of June 30, 1864, ch. 173, § 117, 13 Stat. 223, 282.

374. *Id.* §§ 120-122.

375. *Id.* § 120.

376. See, e.g., Hill, *supra* note 18, at 427 (describing the same provision in the 1862 Act: "This tax, therefore, was essentially a part of the income tax, and was so regarded, being in effect an assessment on the income of the stockholder or bondholder, who received his interest or dividends diminished by the amount of the tax.").

377. Some commentators discounted this concern, usually by neglecting to take into account the value of tax deferral. See Moore, *supra* note 332, at 764 (suggesting that this phenomenon is less of a problem than it might be otherwise because of the taxation upon eventual distribution).

378. In fact, the shareholder undivided profits provision was effectively designed to address the same concern. As one scholar noted:

[I]t has been contended that this tax fails to reach the profits which are not divided but which are simply put into a reserve fund; and some commonwealths have even sought to obviate the supposed difficulty by providing that the tax should apply to the dividends, whether declared or merely earned and not divided.

SELIGMAN, *supra* note 125, at 197.

of collection. Rather than reflecting a change in the understanding of the corporation vis-à-vis the partnership, though, it reflected an effort to alleviate some of the administrative burdens of the income tax.

1. *Difficulties Enforcing the Income Tax*

Tax evasion was so prevalent toward the end of the nineteenth century that it "was often perpetrated openly and defiantly."³⁷⁹ It was normal for returns to be tainted by fraud on the part of the assessors or the taxpayers or both.³⁸⁰ Elliot Brownlee described this phenomenon as "[t]ax resistance," rather than tax evasion, because it represented the combination of an antigovernment political ideology and a successful economy in which government spending only minimally appeared to aid the accumulation of economic fortunes.³⁸¹ As the president of the Pennsylvania Tax Conference declared, "I believe one of the articles of faith of humanity is to beat the tax collector."³⁸² Taxpayers live up to this article of faith, he lamented, "with religious zeal."³⁸³

One of the problems was that there were few mechanisms available to reliably ensure the collection of taxes. Under a self-assessment system, the principal enforcement method was to require the taxpayer to swear to the accuracy of his return by signing an oath.³⁸⁴ In most cases, however, this had only a minimal effect.³⁸⁵ Taxpayers with a conscience resorted to tactics short of outright lying, including failing to sign the oath or having someone else sign for them, but evasion continued virtually unabated.³⁸⁶ According to one observer, "honorable citizens" looked at their tax obligation as akin to "a Sunday-school donation."³⁸⁷ While tax

379. YEARLEY, *supra* note 252, at 43.

380. *Id.* at 41.

381. W. Elliot Brownlee, *The Transformation of the Tax System and the Experts, 1870-1930*, 32 NAT'L TAX J. 47, 47 (Supp. 1979).

382. YEARLEY, *supra* note 252, at 39.

383. *Id.*

384. *Id.* at 41.

385. One expert concluded that returns accompanied by sworn oaths increased the average estimate by ten to fifteen percent, but still fell far short of ensuring fair and complete reporting. *Id.* at 42.

386. *Id.* at 41-42.

387. Seligman, *supra* note 204, at 646. One contemporary commentator reported that

collectors and local assessors ostensibly served as a reality check for false returns, political pressures often overwhelmed truly honest law enforcement.³⁸⁸ As Professor Adams complained, accurate assessment "is impossible so long as assessors are elected by the people whose property they assess."³⁸⁹ To combat this problem, some cities resorted to the use of "inquisitors," or private collectors who received a percentage of any property or income they added to the tax rolls, but such mercenaries were either unduly expensive or themselves corrupt.³⁹⁰ Even in those jurisdictions where tax evasion was strictly limited, wealthy individuals simply moved their intangible assets and other personalty to "tax haven" jurisdictions with friendly assessors.³⁹¹ In Massachusetts, for instance, a quarter of the value of the state's intangible wealth vanished from Boston and magically reappeared in a few taxpayer-friendly towns.³⁹² During the debates over the Civil War income tax, some members of Congress worried that an income tax would push wealthy taxpayers to shift their investments to nontaxable varieties or even encourage them to move abroad altogether.³⁹³

There was little hope that the federal government would have much more success enforcing an income tax than the states had in enforcing a property tax. As one contemporary observer explained,

"[m]ultiplying oaths and increasing penalties has proved utterly inadequate for the correction of the injustice of the present system and the consequent tendency toward the corruption of character. The very terrors of the Inquisition would scarcely avail." William Hamilton Cowles, in *EQUITABLE TAXATION* 83 (1892).

388. See *supra* note 317 and accompanying text (describing system of local assessment).

389. Adams, *supra* note 316, at 55.

390. YEARLEY, *supra* note 252, at 46-47.

391. *Id.* at 48-49.

392. *Id.* at 49.

393. One senator noted his concerns when he stated:

[T]he moment you carry that tax up to seven and a half per cent. or any other excessive rate, [the man of wealth] says, 'this is unjust; it is not right. I will transfer my income into some other shape, or I will place it where it will be beyond the reach of the government.' I have heard of several cases already where large incomes have been transferred abroad, and I believe the fact to be so.

CONG. GLOBE, 37th Cong., 2d Sess. 2486 (1862) (statement of Sen. Chandler); see also CONG. GLOBE, 38th Cong., 1st Sess. 1940 (1864) (statement of Rep. Morrill) ("I believe the result of this differential system of duties upon men of large wealth will be to make them go abroad in order to escape the taxation. On the boundary line of my own State I fear it may be so.").

[t]he dependence for the disclosure of income in general is on the same average degree of honest compliance with law, which has hitherto proved insufficient for the success of State taxation *in pari materia*. What reason is there for expecting any better result under the act of 1894 than has been secured under a multitude of State laws?³⁹⁴

The Civil War experience with an income tax served to underscore this point. Although the income tax was generally more successful than the state property tax,³⁹⁵ it fell far short of achieving its full potential. One observer reported that "not more than one-tenth of the actual taxable income of the country was reached" by the income tax.³⁹⁶ This was especially true after the end of the war when "the payment of the tax did not appeal so strongly to the patriotic motives of the citizens."³⁹⁷

One of the principal complaints levied against the Civil War income tax was that it was inquisitorial.³⁹⁸ David Wells, a Commissioner of Internal Revenue during the first income tax, opined that the problem was that a tax return

necessarily disclosing to a greater or less degree his financial condition to his business competitors and to a curious, gossiping

394. Dunbar, *supra* note 319, at 36. David Wells, the Commissioner of Internal Revenue at the time, complained that "not even the exhibits of the Patent Office showed the ingenuity of Americans as well as their methods of evading taxes." PAUL, *supra* note 219, at 28 (paraphrasing Wells).

395. See Seligman, *supra* note 204, at 636-37 (comparing the income tax collections in 1865 in New York with the property tax collections for the same year and concluding that "[t]he income tax yielded one-third as much again as a corresponding property tax").

396. KENNAN, *supra* note 62, at 256.

397. SELIGMAN, *supra* note 46, at 471. Many individuals simply did not file returns. As one observer noted:

In 1866 there was a marked falling off in the returns. . . . It may well be, then, that there was, in fact, less income to be assessed in 1886 [sic] than there had been the year before. At the same time it is probable that the tendency to evade the tax and make incomplete returns of income was becoming stronger and more generally operative.

Hill, *supra* note 18, at 444-45. By 1872, the number of returns filed annually had fallen to only 72,000—from the already short 1866 level of 460,000. YEARLY, *supra* note 252, at 228.

398. See, e.g., CONG. GLOBE, 42d Cong., 2d Sess. 1737 (1872) (statement of Rep. Rice) (denouncing "[t]he cries of 'espionage' and 'inquisitorial' that have been rung, with all their changes, from 1863 to the present" because they applied equally to many existing forms of taxation); CONG. GLOBE, 41st Cong., 3rd Sess. 720 (1871) (statement of Sen. Scott) (characterizing the income tax as "unjust, unequal, inquisitorial, and unconstitutional").

public, no man will willingly make; and he naturally regards it as in the nature of an outrage on the part of a government that seeks to compel him to do it.³⁹⁹

"Hence," Wells continued, "the successful administration of an income tax involves and requires the use of arbitrary and inquisitorial methods and agencies which, perfectly consistent with a despotism, are entirely antagonistic to and incompatible with the principles and maintenance of a free government."⁴⁰⁰ One such "arbitrary and inquisitorial method" was to publish a list of taxpayers and their self-reported incomes in the local newspapers in the hopes of securing more accurate returns.⁴⁰¹ Another was the practice of having an assessor complete the taxpayer's return through a series of inquiries into all aspects of the taxpayer's personal and financial affairs.⁴⁰² Not surprisingly, these methods were a lightning rod for critics of the income tax.⁴⁰³ Representative Benjamin Butler of Massachusetts claimed that the government "undertakes by inquisition in collecting [the income tax] to treat every man in the country as a rogue and rascal most likely to evade the tax, and thereby succeeds only in compelling the conscientious, the honest and the just men to pay . . ."⁴⁰⁴

2. *The Declining Utility of Pass-Through Taxation*

Enforcement of the income tax during the Civil War and Reconstruction was not aided by the fact that Congress defined income in the 1864 Act to include the undivided profits of a

399. David A. Wells, *An Income Tax: Is It Desirable*, 17 FORUM 1, 3 (1893).

400. *Id.*

401. One author has explained this idea more fully, stating:

[I]n the absence of any express legislative prohibition of publicity, and under the pressure of newspaper enterprise, the custom was soon established of publishing full lists of tax-payers and their incomes. In support of this practice it was urged that its effect was to increase the assessment and secure more complete returns.

Hill, *supra* note 18, at 436; see also Wells, *supra* note 399, at 8 ("[O]ne commissioner of Internal Revenue instructed his officials to have them published in the pages of local papers, 'in order,' as he said, 'that the amplest opportunity may be given for the detection of any fraudulent returns that may have been made.'").

402. LANGENDERFER, *supra* note 24, at 751, 782-83.

403. *Id.*; Wells, *supra* note 399, at 8.

404. PAUL, *supra* note 219, at 24 (quoting Rep. Butler).

corporation. This is not surprising because a similar provision was used by several states during this period, either to enforce a dividends tax or in the definition of income, with unsatisfactory results.⁴⁰⁵ In Virginia, for instance, "income" was defined in 1870 to include "the share of the gains and profits of all companies, whether incorporated or partnership, of any person who would be entitled to the same if divided, whether said profits were divided or not."⁴⁰⁶ Despite this expansive definition, Virginia's income tax only contributed \$33,140 of the state's total revenues of \$2,268,000 in 1873.⁴⁰⁷ By the end of the century, many of the states taxing corporate profits, and virtually all of the European nations, chose to impose some form of an income tax at the corporate level.⁴⁰⁸

Part of the impetus behind the trend away from a shareholder undivided profits tax was the difficulty of tracking a taxpayer's share of undivided profits under turn-of-the-century accounting systems. As Professor William Hewett later pointed out, "[t]he measurement for tax purposes of such items as undivided profits ... would require a very high degree of perfection and uniformity in accounting practice."⁴⁰⁹ This level of sophistication in accounting practices was not present in the 1920s, let alone the 1860s.⁴¹⁰ In fact, one of the principle justifications for the failure to apply either an exemption or proportional rates to the dividends tax during the Civil War and Reconstruction was the difficulty of administering such a system.⁴¹¹ Similarly, during the 1894 Senate debates over the lack of a corporate exemption, Senator Vest rejected a proposal to apply the exemption on a shareholder-by-shareholder basis because of its administrative difficulty. As Vest asked, "How is the corporation to settle with each individual stockholder in making up

405. See SELIGMAN, *supra* note 125, at 197 ("[S]ome commonwealths have even sought to obviate the supposed difficulty by providing that the tax should apply to the dividends, whether declared or merely earned and not divided.").

406. KINSMAN, *supra* note 146, at 50-51 (quoting 1869-70 Va. Acts ch. 189, § 16).

407. *Id.* at 56.

408. See SELIGMAN, *supra* note 125, at 198-99.

409. WILLIAM WALLACE HEWETT, *THE DEFINITION OF INCOME AND ITS APPLICATION IN FEDERAL TAXATION* 81 (1925).

410. See *id.* (commenting on "the relatively unsatisfactory nature of accounting practice in its present stage of development"); Robert Murray Haig, *The Concept of Income—Economic and Legal Aspects*, in *THE FEDERAL INCOME TAX* 1, 18 (Robert M. Haig ed., 1921) (lamenting the "wide gap which stretches between theory and practice in the field of accounting").

411. See LANGENDERFER, *supra* note 24, at 508-09; SELIGMAN, *supra* note 46, at 444.

its net profits for the year? . . . It seems to me it makes intricate and complex the business of all these corporations, and opens the door to great indirection, if not to fraud."⁴¹² The shareholder undivided profits tax posed some of the same problems, leading Hewett to note that although the provision was "carried out in practice as fairly as the collectors found it possible . . . it proved to be a rather onerous task."⁴¹³

3. *The Corporate/Partnership Divide on Stoppage-at-the-Source*

In contrast to the general operation of the Civil War income and undivided profits taxes, the dividends tax had proven relatively efficient and uncontroversial. One representative boasted in the *Congressional Globe* that the "tax is collected from corporations, such as railroads and manufacturing companies, in a single sum and in large amounts, with comparatively little or no cost."⁴¹⁴ While this may have been a bit of an overstatement, it was not far from the truth. One of the principal advantages in taxing income at the source was that it potentially removed much of the tax evasion motive from the equation. "The companies or persons paying the rent, interest, or dividends which are to be taxed, independently of their openness to inspection, are not actuated by the same motives as the individual who is called upon to return the amount of his income."⁴¹⁵

The success of the Civil War dividends tax was due largely to the fact that businesses in the targeted industries generally operated in corporate form. Unlike partnership distributions of earnings, corporate dividends were visible and easy to track. Partnerships divided their earnings on an irregular basis and without formal notice.⁴¹⁶ Generally, partners were entitled to draw upon part-

412. 26 CONG. REC. 6867-68 (1894) (statement of Sen. Vest).

413. HEWETT, *supra* note 409, at 41.

414. CONG. GLOBE, 42d Cong., 2d Sess. 1736 (1872) (statement of Rep. Rice).

415. Dunbar, *supra* note 319, at 38; *see also* Moore, *supra* note 332, at 762 (arguing that assessing "all corporate taxes to the corporation instead of to its shareholders, certainly appears to be the better method. It is simpler, both to understand and to apply; it does not give such opportunities for evasion of taxes, and it does not necessitate so many special exceptions and provisions.").

416. *See* THEOPHILUS PARSONS, LAWS OF BUSINESS FOR ALL THE STATES OF THE UNION WITH

nership earnings in advance of such divisions of profit.⁴¹⁷ In contrast, under state corporation law, dividends had to be formally declared by the officers of the corporation.⁴¹⁸ The officers recorded the declaration of dividends by including them in the minutes of the board of directors and a notice was frequently published in a financial newspaper or trade journal.⁴¹⁹ By taxing corporate dividends, rather than partnership earnings, the most inquisitorial aspects of the income tax were avoided. Thomas Cooley, in his *Treatise on the Law of Taxation*, explained that “[t]axes on [d]ividends are more easily collected and do not usually involve inquisitorial proceedings. Dividends come from corporations whose proceedings are usually semi-public, and while the privacy of individuals is not invaded, neither are the demands of the government liable to serious evasions.”⁴²⁰ Representative Wilson saw this as one of the chief benefits of a federal income tax on corporations, noting that “the ascertainment of those earnings would generally be easy and reasonably accurate, and free from the

FORMS AND DIRECTIONS FOR ALL TRANSACTIONS 232-33 (1874) (stating that a common form of partnership agreement provided “that all such gain, profit, and increase, as shall come, grow, or arise, for or by reason of the said trade, or business as aforesaid, shall be from time to time, during the said term, equally and proportionably divided between them the said copartners, share and share alike”).

417. *Id.* at 233 (quoting from a clause often added to the traditional partnership agreement: “That it shall be lawful for each of them to take out of the cash of the joint stock the sum of _____ quarterly, to his own use, the same to be charged on account . . .”).

418. See *Lockhart v. Van Alstyne*, 31 Mich. 76, 78 (1875) (“A right to a dividend from the profits of a corporation is no debt until the dividend is declared.”); H.W.R., *Dividends*, 9 CENT. L.J. 161, 163 (1879) (“The right of a stockholder to share in the surplus of profits is in the nature of an inchoate right, until a distribution or dividend has been actually declared by the proper officers of the corporation.”). This rule originated as part of the desire to protect against the impairment of capital and the accompanying demise of the premises of the grant of limited liability. Donald Kehl, *The Origin and Early Development of American Dividend Law*, 53 HARV. L. REV. 36, 41 (1939).

419. See, e.g., 40 COM. & FIN. CHRON. & HUNT’S MERCHANT MAG. 59 (1885) (publishing the Annual Report for the Buffalo, New York & Philadelphia Railroad, including a description of dividends paid); *id.* at 19 (listing a compilation of recent dividends announced by corporations in the railroad, banking, insurance, and other miscellaneous industries); 22 COMM. & FIN. CHRON. & HUNT’S MERCHANT MAG. 41 (1876) (publishing the Annual Report for New York Central & Hudson Railroad, including a description of dividends paid); *id.* at 11 (listing a compilation of recent dividends announced by corporations in the railroad, banking, and insurance industries).

420. THOMAS M. COOLEY, A TREATISE ON THE LAW OF TAXATION 22 (1876).

offensive inquisition so much declaimed against in the case of the individual."⁴²¹

Other countries contemporaneously recognized the advantage of using stoppage-at-the-source methods for taxing corporate, but not partnership, investments. In France, for example, the government replaced a general income tax with taxes tied to the presence of the indicia of income such as the receipt of interest or dividends on corporate securities.⁴²² To avoid the potential introduction of the "personal inquisitorial features" associated with a general income tax, the French dividends tax was not applied to "associations of partnership, nor private obligations or mortgages."⁴²³ Thus, the corporation, rather than the partnership or some other noncorporate entity, was a uniquely appropriate target for the imposition of stoppage-at-the-source principles.

The unique advantages of a corporate tax were so well appreciated that the original proposals for a new source of federal revenue at the end of the nineteenth century, much like the state movement to replace property taxes with a tax on corporations, envisioned a tax on income from corporate investments only. In his State of the Union address in 1893, President Grover Cleveland endorsed a House Ways and Means Committee recommendation that Congress adopt "a small tax upon incomes derived from certain corporate investments."⁴²⁴ Soon after, Treasury Secretary John Carlisle echoed this recommendation in his address to Congress, proposing a tax on incomes "derived from investments in stocks and bonds of corporations and joint stock companies" as one manner of "most conveniently and justly" making up the shortfall from tariff reform.⁴²⁵ Representative William Wilson, the Chair of the Ways and Means Committee, also jumped onto the emerging bandwagon with the publication of his article, *The Income Tax on Corporations*, in January of 1894.⁴²⁶ In it, he lamented the already high consumption taxes on the poor, noting that "[t]he balance of taxation

421. William L. Wilson, *The Income Tax on Corporations*, 158 N. AM. REV. 1, 7 (1894).

422. Wells, *supra* note 399, at 4-5.

423. *Id.*; see also SELIGMAN, *supra* note 125, at 203.

424. GROVER CLEVELAND, *First Annual Message*, in 9 A COMPILATION OF THE MESSAGES AND PAPERS OF THE PRESIDENTS, 1789-1897, at 434, 460 (1899).

425. RATNER, *supra* note 26, at 174 (citation omitted).

426. Wilson, *supra* note 421.

ought to be weighted by some taxes drawn from the property of the country."⁴²⁷ Wilson suggested that this could be accomplished while still producing "a revenue sufficient to cover a large part of the gap now opening between receipts and expenditures" by imposing a small tax on "the incomes or earnings of corporations."⁴²⁸ Perhaps in recognition of the fact that a corporate tax does not effectively reach a shareholder's ability to pay except as part of a comprehensive income tax scheme,⁴²⁹ the tax on income from corporate investments was eventually expanded to include an individual income tax in the 1894 Act.⁴³⁰ Although the 1894 Act eliminated the return requirement only for those individuals with nondividend income of less than \$3500,⁴³¹ the corporate tax combined with other measures to help reduce the concerns about the inquisitorial nature of the income tax.⁴³²

C. *Simplifying the Tax on Corporate Wealth*

The last major change to the 1864 Act structure for the taxation of corporate income occurred in the Senate. As drafted by the Senate Finance Committee, the bill dropped the dividends/undistributed profits tax scheme in favor of a direct tax on the net profits or income of corporations.⁴³³ This language ultimately became part of the 1894 Act as passed and is considered a substantial departure from the 1864 Act.⁴³⁴ The reason that the 1894 Act's corporate income tax is considered a radical change, however, is because it is compared to the 1864 Act's shareholder undivided profits tax rather than the dividends/undistributed profits tax contained in the 1864 Act and the 1894 House bill. When this latter comparison is made,

427. *Id.* at 7.

428. *Id.*

429. McCrea, *supra* note 309, at 493-94.

430. RATNER, *supra* note 26, at 174-75.

431. See Dunbar, *supra* note 319, at 41 (noting that the corporate tax did not exempt a considerable number of individuals from filing a return).

432. *Id.* (citing the desire for "the increased facility of collection" as one of the principal grounds for the adoption of the tax); see also Seligman, *supra* note 204, at 624 (one such measure was a provision barring the publication or disclosure of any information obtained from the returns).

433. 26 CONG. REC. 6831 (1894).

434. Tariff Act of 1894, ch. 349, § 32, 28 Stat. 509, 556; Yin, *supra* note 86, at 146 (discussing divergence from 1864 Act).

the corporate income tax becomes a natural progression in the quest to reach shareholder income.

It is not entirely accurate to portray the 1894 Senate bill and the final Act as the first federal measures to target corporate income directly. The 1864 Act's dividend tax directly targeted the undistributed profits and sums added to surplus of companies in specified industries. Given that the use of industry classifications was considered to be a method of targeting corporations,⁴³⁵ the undistributed profits tax was in effect a direct tax on corporations. Furthermore, the 1894 House bill's undistributed profits tax was even more clearly a direct tax on corporations since it applied to corporations generally. Despite this reality, however, contemporary observers did not view the undistributed profits component of the dividends tax as imposing a corporate income tax. As Joseph Hill pointed out, the dividends/undistributed profits tax "was essentially a part of the income tax, and was so regarded, being in effect an assessment on the income of the stockholder or bondholder, who received his interest or dividends diminished by the amount of the tax."⁴³⁶ From the perspective of the modern reader, the failure to recognize the undistributed profits portion of the dividends tax as a direct tax on the corporation appears to be a disconnect between perception and reality.⁴³⁷

From the perspective of the contemporary observer of corporate dividend practices, however, the apparent disconnect disappears. Today, most corporations distribute no more than half of their net earnings in the form of dividends and many fail to pay any dividends at all.⁴³⁸ By contrast, nineteenth-century corporations and their shareholders and bondholders considered dividends to be nearly essential. With illiquid or nonexistent markets, dividends served the important functions of setting a market valuation and

435. See *supra* text accompanying notes 339-45.

436. Hill, *supra* note 18, at 427.

437. To put it more precisely, it appears to be a disconnect between perception and reality to call the corporate income tax a tax on corporations, but not call the undistributed profits tax a tax on corporations. It is true that economists might conclude that neither constitutes a tax on corporations.

438. BASKIN & MIRANTI, *supra* note 241, at 18-19. In fact, "during most of this century, there was a strong tax inducement for corporations to adopt a 'no dividend' policy." ROBERT W. HAMILTON, *CASES AND MATERIALS ON CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED PARTNERSHIPS* 410 (5th ed. 1994).

providing investors with a source of liquidity comparable to debt instruments.⁴³⁹ Congress operated under the assumption that the vast majority of corporations distributed virtually all of their net earnings in the form of dividends.⁴⁴⁰

In an environment in which dividends represented substantially all of a corporation's net income, it is not surprising that the undistributed profits portion of the dividends tax was not viewed as a tax on the corporation. It was merely an enforcement mechanism for the dividends tax. As Senator Hill acknowledged during the debate over the lack of a corporate exemption, "nobody objects to the bill taxing the undivided surplus of corporations. If a corporation sees fit to accumulate a large surplus instead of dividing it among its stockholders, it can be reached by the bill and nobody objects to it."⁴⁴¹ The undistributed profits tax, therefore, was both easily avoided and unlikely to ever be applied. Corporations simply had to follow existing custom and distribute substantially all of their profits to shareholders.

The Senate bill's adoption of a corporate income tax was viewed as a measure simplifying, rather than replacing, the dividends/undistributed profits tax. Senator Vest, the person responsible for the new language, explained that

[i]nstead of making the corporation a collector simply for the Government, we have endeavored to simplify the bill and, in my judgment we have strengthened it, by putting the tax directly upon the corporation and then allowing the corporation to adjust its relations with its own stockholders as it sees proper.⁴⁴²

The Senate bill combined the separate dividend and undistributed profits tax provisions into one step.⁴⁴³ Levying a tax on the corporation directly left the dividend decision to the corporation and its stockholders and allowed the federal government to remain neutral on this score.⁴⁴⁴

439. BASKIN & MIRANTI, *supra* note 241, at 18-19.

440. See 26 CONG. REC. 6869 (1894) (statement of Sen. Allison).

441. *Id.* at 6873 (statement of Sen. Hill).

442. *Id.* at 6866 (statement of Sen. Vest).

443. *Id.* at 6880 (statement of Sen. Chandler) (asserting "the Senator from Missouri seems to have thought that he could roll all those sections into one" by imposing an income tax).

444. This decision was something that corporations and shareholders had already

As a practical matter, legislators still viewed the corporate income tax as the equivalent of a tax on shareholder income. Senator Allison agreed with the claim that a direct federal income tax on corporations was unprecedented,⁴⁴⁵ but contended that the Senate bill was little more than a dividend tax except that it “provides that these corporations shall also pay a tax upon surplus earned during the year.”⁴⁴⁶ This was of no practical import, however, because as the Senator explained, the tax on such surplus

will be an infinitesimal amount as respects all the great corporations and the little corporations of our country, because there is nothing carried to the surplus account except in the case of national banks, where they are obliged to carry a certain portion of their earnings to surplus from year to year and perhaps other banks and insurance companies. But as to the great body of the corporations of our country they make dividends covering practically [all] their earnings each year.⁴⁴⁷

Because of contemporary corporate dividend policies, the Senate bill was thought to be an attempt to streamline the House bill's dividend tax.⁴⁴⁸ In both cases, the corporate tax was part of an effort to reach shareholder income.

This shareholder-centered view of the corporate income tax also appeared to be in accord with contemporary economic thought on the question. Edwin Seligman reported in his essay *The Taxation of*

undertaken during the Civil War and Reconstruction when many corporations chose not to withhold the tax from dividends and instead paid it out of surplus. See Seligman, *supra* note 138, at 672 n.1.

445. Senator Allison acknowledged this point when he said:

We did not undertake to tax corporations as respects their income in 1864 or 1868. We simply used the corporations as instrumentalities on behalf of the Government to gather in the money. Instead of utilizing and using the collectors and deputy collectors of the country we required them to make return and pay the tax, and they in turn turned on their stockholders, and were authorized to deduct from bonds and from stock as well.

26 CONG. REC. 6869 (1894).

446. *Id.*

447. *Id.*

448. There were several potential problems with the bill's language, not including the failure to provide an exemption, which complicated the question of whether the Senate bill actually would reach the same result as the House bill. Foremost among these potential problems was the awkward definition of “net profits” as “income above ordinary working or operating expenses.” 26 CONG. REC. 6881 (1894) (statement of Sen. Chandler).

Corporations, first published in 1890, that "[i]t is generally assumed that the tax on the corporation is a tax on the shareholder or bondholder."⁴⁴⁹ Assuming that corporate income is part of a general scheme of income taxation, so that the tax impacts the value of all investments and not merely corporate securities, Seligman concluded that "the tax on the corporation is a tax on the investor. To tax both corporation and individuals on their income would hence really be double taxation."⁴⁵⁰ Although the courts often approached the question from the more legalistic entity theory perspective, with varying results,⁴⁵¹ economists and policymakers at the state and federal level tended to view a corporate tax as the economic equivalent of a tax upon the shareholders.⁴⁵²

Thus, far from representing radical change, contemporary observers saw the corporate income tax as a broadened version of the 1864 Act's dividend/undistributed profits tax. Even the fiercest opponents to the corporate income tax based their argument in part on its redundancy with the individual income tax.⁴⁵³ "I see no reason why there should be any special clause taxing the incomes of corporations," said one senator, because "everything that is income and the profit of a corporation is taxed by an individual income tax."⁴⁵⁴ The premises for this conclusion may have been

449. Seligman, *supra* note 138, at 671.

450. *Id.* at 673. This assessment survived the inspection of the proposals for a corporate tax. During the debates, Senator Gallinger offered an excerpt of an article from the *New York Tribune* in which the writer concluded that "[s]uch a tax on the earnings of corporations is, in fact, a tax on every stockholder of such corporations." 26 CONG. REC. 3894 (1894).

451. As one commentator of the era observed:

The judicial decisions are far from unanimous in declaring the taxation of shares and property to be double taxation, or in disallowing it. This may be explained, apart from the conservatism of most courts, to the fact that the older decisions often represent a period of financial development now passed, when the statutes also may have expressly required such double taxation.

WALKER, *supra* note 73, at 67.

452. *Id.* at 64-65.

453. 26 CONG. REC. 6880 (1894) (statement of Sen. Chandler) ("[N]ever, until the Senator from Missouri undertook the task, has there been any attempt to roll an income tax upon individuals and an income tax upon corporations into the same paragraph of the same bill of legislation.").

454. *Id.* at 6881.

questionable,⁴⁵⁵ but the conclusion itself discloses the shareholder, rather than corporate, focus of the first corporate income tax.

The focus on shareholder wealth in the 1894 Act continued in subsequent state and federal tax measures involving corporations. In 1903, the Wisconsin State Tax Commission reported that

[t]he wealth of the country in personalty consists largely of investments in corporate securities, stocks, and bonds in railroad and other corporations which are not and cannot be reached for taxation to the holders by the severest and most inquisitorial laws. The taxation of corporations as legal entities is the only recourse.⁴⁵⁶

In 1909, when President Taft proposed a federal excise tax on corporations that was measured by income, he admitted that it was a second-best alternative to the individual income tax barred by *Pollock*.⁴⁵⁷ Supporters of this proposal emphasized its ability "to

455. The failure to grant an exemption to corporations to match the one permitted for individuals served to disconnect the individual and corporate taxes. See Taylor, *supra* note 3, at 269 ("The only real problem with the statute's integration regime was its failure to provide any credit to individuals who received dividend income and who found themselves under the \$4,000 exemption.").

456. McCrea, *supra* note 309, at 493 n.1 (citation omitted).

457. 44 CONG. REC. 3344 (1909) (message from President Taft). Taft also spoke of "[a]nother merit" of the excise tax—"the federal supervision which must be exercised in order to make the law effective over the annual accounts and business transactions of all corporations." *Id.*

It is true that Taft suggested that such a tax was based on the grant or concession theory of the corporation, in that it was "an excise tax upon the privilege of doing business as an artificial entity and of freedom from a general partnership liability enjoyed by those who own the stock." 44 CONG. REC. 3344 (1909). This, however, was merely an attempt to conform to the Court's statements regarding the ability to use an excise tax on the privilege of doing business in lieu of an income tax. See *Spreckels Sugar Refining Co. v. McClain*, 192 U.S. 397, 413 (1903) (upholding a tax on the gross receipts of sugar refiners as a constitutional excise tax); *Pollock v. Farmer's Loan and Trust Co.*, 158 U.S. 601, 635-37 (1895) (noting that its decision striking down the 1894 income tax as unconstitutional did not mean that an excise tax on the privilege of doing business would be unconstitutional). Most commentators seemed to recognize the artificiality of the grant or concession period by this time. For example, one official report claimed that the reply to the grant or concession theory rationale for corporate taxation

is, substantially, that in these days corporations should be considered, not as abnormalities, but as normal and necessary forms for doing business . . . that hence in creating corporations a State should be considered as performing a duty rather than as granting a privilege. [T]he property and the business of corporations, except in so far as that property and that business differ from

reach the great accumulated wealth of the country, or its earnings, engaged in corporate enterprise."⁴⁵⁸ The focus did not fully shift to the corporation until 1936, when Congress included dividends in income while retaining the existing corporate income tax.⁴⁵⁹ Even this, however, was part of President Roosevelt's attempt to target the evasion of the individual income tax through the retention of corporate profits.⁴⁶⁰ Thus, the early history of the corporate income tax belies the traditional entity-theory explanation for its origins.

CONCLUSION

The early corporate income tax not only differs from our traditional entity theory-based notion of the first federal income tax on corporations, but it also differs greatly from the current system, which subjects corporate income to two layers of tax and thereby treats the corporation as a separate taxable entity. How did we stray so far from the corporate tax's roots as a more efficient means of reaching shareholder income? This question itself breaks down into two related questions. First, why did Congress repeal the exemption from the individual normal tax for dividends in the Revenue Act of 1936 and thereby fully subject corporate income to double taxation? Second, why does the separate corporate income tax persist despite the steady stream of proposals to integrate it with the shareholder income tax? While both of these questions are beyond the scope of this Article, they may shed light on the continuing implications of the entity-theory myth.

The latter question has received significantly more scholarly attention from modern observers than the former. While a variety of theories have been forwarded,⁴⁶¹ one possible explanation for the

those of natural persons, should be taxed with no exceptional machinery.

Report of the Commissioner of Corporations on the System of Taxing Manufacturing, Mercantile, Transportation, and Transmission Corporations in the States of Ohio, Indiana, Illinois, Michigan, and Wisconsin, in TAXATION OF CORPORATIONS: PART III—EASTERN CENTRAL STATES 3 (1911).

458. 44 CONG. REC. 3756 (1909) (statement of Sen. Newlands).

459. See Kwall, *supra* note 50, at 620. Previously, shareholders were entitled to exclude dividends from the base, or "normal," individual tax. *Id.* at 619.

460. *Id.* at 619-20.

461. See Arlen & Weiss, *supra* note 2, at 331-33 (listing possible explanations, including entity theory, the popular belief that the corporate tax is another tax on capital, and the belief

endurance of the separate corporate income tax is that the public may have so accepted the entity-theory myth that it has become a reality, at least in political terms. Popular opinion polls suggest that the public considers the corporation a separate taxable entity while at the same time rejecting the notion of double taxation.⁴⁶² This may explain why the government has been receptive to some complete or partial integration proposals, such as the shareholder credit, dividend deduction, and dividend exclusion methods,⁴⁶³ while rejecting as politically impossible more radical methods such as a mark-to-market system or a shareholder allocation approach similar to that used for partnerships.⁴⁶⁴ The former proposals would preserve the existing corporate income tax, even if only in limited form, while the latter proposals would blur or completely eliminate the line between the corporation and its shareholders for tax purposes.⁴⁶⁵ Under this view, entity theory may not have been responsible for the original corporate income tax, but it would be at least partially responsible for its continued existence.

Another possibility raised in a number of recent law review articles is that the persistence of the separate corporate income tax and the double taxation of corporate income is connected to the

that politicians like the corporate tax because it acts as a "hidden tax").

462. *Id.* at 333-34 (reporting that between sixty-five to eighty percent of those polled supported an increased corporate income tax while only twenty-nine to thirty-seven percent support double taxation); see also *supra* note 92 (discussing public views).

463. See generally U.S. DEPT OF TREASURY, *INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE* (1992) (describing potential integration proposals); AMERICAN LAW INSTITUTE, *FEDERAL INCOME TAX PROJECT—INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES—REPORTER'S STUDY OF CORPORATE TAX INTEGRATION* 3-4 (1999).

464. See Graetz & Warren, *supra* note 2, at 1769. For examples of the mark-to-market approach in which all shareholders, or shareholders in only public corporations, are taxed on the annual rise in value of their stock and the corporate tax is eliminated entirely or limited to public corporations, see Joseph M. Dodge, *A Combined Mark-To-Market and Pass-through Corporation-Shareholder Integration Proposal*, 50 TAX L. REV. 265 (1995) and Michael S. Knoll, *An Accretion Corporate Income Tax*, 49 STAN. L. REV. 1 (1996). The shareholder allocation method, in which each shareholder is allocated his or her pro rata share of the corporation's tax items for the year, is similar to the pass-through taxation applied to partnerships.

465. See, e.g., Dodge, *supra* note 464, at 290 (suggesting that the dividend deduction method "presupposes ... that the corporation is a meaningful taxable entity" while this Article's proposal would reject that orthodoxy).

problem of agency cost.⁴⁶⁶ In its strongest articulation, double taxation becomes an ally of corporate management because it helps persuade shareholders to allow managers to retain earnings and invest them free of substantial monitoring.⁴⁶⁷ Stated more moderately, fighting double taxation is of considerably lower value to managers than trying to secure research and investment credits.⁴⁶⁸ In either case, managers are much less inclined to lobby actively for the passage of one of the many integration proposals that have arisen over the years.⁴⁶⁹ Nor are they likely to attempt to counter the remnants of the entity-theory orthodoxy that may explain the public's continued support for the corporate income tax.⁴⁷⁰ The persistence of the classical system of corporation taxation therefore may be due to a combination of public approval and manager acquiescence.

The origin of double taxation has generated little modern inquiry,⁴⁷¹ but a preliminary review of the circumstances surrounding the repeal of the dividend exemption in 1936 suggests that it also

466. See, e.g., Arlen & Weiss, *supra* note 2, at 336; John K. McNulty, *Reform of the Individual Income Tax by Integration of the Corporate Income Tax*, 46 TAX NOTES 1445, 1446 (1990); James R. Repetti, *Corporate Governance and Stockholder Abdication: Missing Factors in Tax Policy Analysis*, 67 NOTRE DAME L. REV. 971, 1034 (1992); James R. Repetti, *The Misuse of Tax Incentives to Align Management-Shareholder Interests*, 19 CARDOZO L. REV. 697, 716 (1997); Herwig J. Schlunk, *The Zen of Corporate Capital Structure Neutrality*, 99 MICH. L. REV. 410, 411 n.8 (2000); Lee A. Sheppard, *Corporate Tax Integration: The Proper Way to Eliminate the Corporate Tax*, 27 TAX NOTES 637, 638-39 (1985); Alvin C. Warren, Jr., *Three Versions of Tax Reform*, 39 WM. & MARY L. REV. 157, 173 (1997).

467. See Arlen & Weiss, *supra* note 2, at 348-49 (describing this argument, which has come to be known as the "free cash flow" theory).

468. See *id.* at 336.

469. Over the years, at least four integration methods have received serious consideration: (1) The shareholder allocation method in which each shareholder is allocated his or her pro rata share of the corporation's tax items for the year; (2) the shareholder credit or dividend deduction methods, which involve either giving shareholders a credit for taxes paid by the corporation or giving the corporation a deduction for dividends paid; (3) the dividend exclusion method in which shareholders are entitled to exclude dividends from income; and (4) the partial or complete mark-to-market method in which all shareholders, or shareholders only in public corporations, are taxed on the annual rise in value of their stock and the corporate tax is eliminated entirely or limited to public corporations. See generally AMERICAN LAW INSTITUTE, *supra* note 463, at 3-4; Graetz & Warren, *supra* note 2, at 1769.

470. Arlen & Weiss, *supra* note 2, at 331.

471. For a brief attempt to describe what occurred in 1936, see Kwall, *supra* note 50, at 619-20.

may have arisen because of the agency cost problem.⁴⁷² The dividend exemption was removed as part of a plan to combat the corporate "hoarding" of earnings. Originally, President Roosevelt proposed replacing the corporate income tax with an undistributed profits tax and subjecting distributed income to the shareholder normal and surtax rates only.⁴⁷³ In response to corporate managers' complaints that the undistributed profits tax constituted an unwarranted intrusion into the operation of businesses and would fail as a revenue-raiser, Congress compromised by retaining both the corporate income tax and a more modest undistributed profits tax. Not coincidentally, opponents attempted to set the undistributed profits tax rate equal to the individual normal tax on dividends, thus counteracting the distributive pressure of the tax. In effect, managers appeared to be willing to trade double taxation for a reduction in the threat posed to them by the undistributed profits tax.

The agency cost explanation suggests that the entity-theory myth may have powerful allies. Corporate managers may help to prop up, or at least fail to reject, the entity-theory explanation because the existence of a separate corporate income tax furthers their own goals. Given the assumptions regarding dividend policies underlying the adoption of the corporate income tax,⁴⁷⁴ it should not be surprising that the manager-shareholder relationship has become critical. Senator Vest's original notion that the switch from a dividends/undistributed profits tax to a corporate income tax would "allow[] the corporation to adjust its relations with its own stockholders as it sees proper" worked well when virtually all earnings were distributed as dividends as a matter of business custom.⁴⁷⁵ Now that dividends are a matter of practical discretion for corporate management, especially a management that is increasingly separate from ownership, the corporation can be only vaguely described as a proxy for its shareholders. In this environ-

472. This is a brief summary of a much larger work currently in progress. See Steven A. Bank, *Corporate Managers and the Rise of Double Taxation* (work in progress) (copy on file with The William & Mary Law Review).

473. See MESSAGE FROM THE PRESIDENT OF THE UNITED STATES, H.R. DOC. NO. 418, at 3 (1936); see also Pratt, *supra* note 2, at 1115.

474. See *supra* text accompanying notes 439-41.

475. See *supra* note 442.

ment, reformers may have to do more than simply debunk the entity-theory myth in order to secure political support for their proposals. They may also have to bridge the gap between corporate managers and their shareholders with respect to the integration of the corporate and individual income taxes.