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THE "CORPORATION" IN THE CORPORATE INCOME TAX: SEPARATE ENTITY OR SHAREHOLDER PROXY?

STEVEN A. BANK*

The United States has long operated under a dual system of business taxation. Corporations are treated as separate taxable entities while partnerships are ignored for most purposes. Thus, 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 – but income from businesses operating in partnership form 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]

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[1] I.R.C. § 11 (West 2000) (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] It is considered inequitable because the double tax on corporate income 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* Katherine Pratt, *The Debt-Equity Distinction in a Second-Best World*, 53 VAND. L. REV. 1055, 1098-1100 (2000); Michael J. Graetz & Alvin C. Warren, Jr., *Integration of Corporate and Individual Income Taxes: An Introduction*, 85 TAX NOTES 1767, 1768 (1999); Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 YALE L.J. 325, 326-27 (1995); CHARLES E. MCLURE, JR., MUST CORPORATE INCOME BE TAXED TWICE? 2-3 (1979).

[3] Several partial integration methods were attempted prior to the 1986 Act, 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, 288-297

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" that was 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. Thus, observers suggest that the 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 was, like a partnership, 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 advent of the large corporation. Academic theorists began to agonize over the legal personality of the

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(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) (exempting certain electing small business corporations, or "S corporations" from the corporate income tax).

[4] Act of Aug. 27, 1894, ch. 349, § 27, 28 Stat. 509, 553. The income tax portion of the Act was later declared unconstitutional as an unapportioned direct tax. *See* Pollock v. Farmers' Loan & Trust Co., 158 U.S. 601 (1895). *See* Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 86 IND. L.J. 53, 86 (1990) ("The first federal income tax statute to clearly tax corporations was the 1894 Act."). *See also* Emil 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."); 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).

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

[6] Under the Act of 1864, investors were directly taxed on their undivided share of a business' gains and profits regardless of the form of organization. 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. Thus, the Act deliberately avoided double taxation and ostensibly did not distinguish between corporations and partnerships in the taxation of investments.

The entity v. aggregate debate continues today in the treatment of partnerships for tax purposes. *See* BABETTE B. BARTON ET AL., TAXATION OF BUSINESS ENTERPRISES 885 (1998).

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 that led to the adoption of a corporate income tax in 1894[9] 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. Even if it was an accurate description of the origins of the corporate income tax, it does not explain the absence of double taxation during the early years of the corporate income tax. In fact, Congress clearly intended to avoid double taxation when it enacted the corporate tax provisions in 1864 and 1894. Thus, if entity theory is useful at all, it is only insofar as it explains the decision to distinguish between corporations and partnerships for tax purposes. The corporation,

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[7] See MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW 1870-1960 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 ("[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.").

[9] *See, e.g.*, Pratt, *supra* note 2, at 1057 ("the corporate tax came into existence and was influenced by turn-of-the-century theories of the firm."); AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT – REPORTER'S STUDY OF TAXATION OF PRIVATE BUSINESS ENTERPRISES 35-36 (1999) ("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."); 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."). *Cf.* WESTIN, *supra* note 7, at 649 ("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."); 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.").

[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. at 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

however, was viewed as a separate entity, capable of being taxed on its income on the same basis as an individual, throughout the nineteenth century. This was especially true during the Civil War and Reconstruction when the 1864 Act was in effect. States had 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] Moreover, the aggregate theory of the corporation was never discussed until well after the Civil War income tax acts were adopted. Although Congressional debates over the 1894 Act were animated by discussions regarding the nature of the corporation,[12] 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] Thus, there is little basis for the notion that the adoption of a corporate income tax 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, then, were they taxed? This Article will establish that the corporate income tax was originally adopted as a substitute, or "proxy," for taxing the 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 income from wealthy individuals. Because of its regular and open distribution of dividends, the

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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] *See* Van Allen v. Commissioner, 70 U.S. (3 Wall.) 573 (1865); People v. Commissioner, 71 U.S. (4 Wall.) 244 (1866).

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

[13] The entity theory discussion occurred during debates over whether a corporation should be entitled to the same $4,000 exemption provided to individuals under the 1894 Act. Act of Aug. 27, 1894, ch. 349, § 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.

corporation was an obvious target for an expansion of the 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.

This enforcement rationale both undercuts the traditional entity theory explanation for double taxation and provides a basis for distinguishing among various proposals to integrate the corporate and shareholder taxes.[14] Absent an independent policy reason for taxing at the corporate level, integration efforts should move beyond merely determining the best way to reduce or eliminate the effects of double taxation. Reformers should instead consider the extent to which corporate-level taxation is still necessary to support the individual income tax. Part I compares the federal taxation of business income during the 1860s and the 1890s and beyond and highlights the continuing efforts 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 the differences in the treatment of corporations under the 1864 and 1894 Acts as arising from 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 brief comment on the relevance of this argument for recent reform efforts.

[14] *See generally* AMERICAN LAW INSTITUTE, *supra* note 9, at 57-65; AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT – INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES – REPORTER'S STUDY OF CORPORATE TAX INTEGRATION (1993); U.S. DEP'T OF TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE (1992).

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,[15] a federal income tax was first collected in 1862.[16] The 1862 Act imposed a tax of 3% on all income between $600 and $10,000 and a 5% tax on incomes in excess of $10,000.[17] 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 3% 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.[18] Despite the inclusion of these provisions under a separate section, they were generally regarded as a part of the income tax.[19]

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

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[15] Pre-war 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.

[16] The first federal income tax was actually adopted in 1861. Act of August 5, 1861, ch. 45, 12 Stat. 292, 309. Salmon Chase, Lincoln's Treasury Secretary at the beginning of the Civil War, made no effort to assess or collect any taxes under the Act and thus rendered it a dead letter. *See* Steven A. Bank, *Origins of a Flat Tax*, 73 DENV. U. L. REV. 329, 345 (1995).

[17] Act of July 1, 1862, ch. 119, § 90, 12 Stat. 432, 473.

[18] Id. at §§ 81, 82, 12 Stat. at 469-470.

[19] Joseph A. Hill, *The Civil War Income Tax*, Q. J. ECON. 416, 427 (July 1894). Sections 89-93 were listed under the heading "Income Duty," while the dividend and interest taxes were included under the headings

concerns about the general income tax was that it assessed wealth that was already taxed by another jurisdiction.[20] One Representative, in protesting a related provision, typified these concerns when he declared "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."[21] Others confirmed this statement, calling double taxation "not just" and proposing amendments to avoid this result wherever appropriate.[22]

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 income the receipt of dividends and interest from corporations already taxed under the Act.[23] 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.[24] While the latter problem was

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"Railroad Bonds" and "Banks, Trust Companies, Savings Institutions, and Insurance Companies." *See* 12 Stat. at 469-75.

[20] CONG. GLOBE, 37th Cong., 2d Sess. 1196 (1862) (statement of Sen. Morrill) ("The income duty is one, perhaps, of the least defensible that, on the whole, 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.").

[21] 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).

[22] 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 (proposed integration scheme offered by Sen. Howe).

[23] Id. at § 91, 12 Stat. at 473-74.

[24] The lack of an exemption produced some inequities. Hill, *supra* note 18, at 427-28. Thus, individuals with incomes in excess of $10,000 would be taxed at 3% on dividends or interest from railroads and other such corporations, but at 5% on all other income. Conversely, individuals not subject to the income tax because their income was less than $600 would still pay at a 3% 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

controversial,[25] albeit rare in occurrence,[26] 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 2% tax on individuals with income in excess of $10,000 who received dividends and interest from taxable corporations.[27]

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 3% tax on the gross amount of their receipts.[28] The provision, however, applied regardless of whether the business was incorporated.[29] It also explicitly permitted the affected company to pass on the amount of the tax to their customers in the form of higher fares.[30] 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 like a proxy tax

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corporations on dividends and interest as an administrative problem. *See* HARRY EDWIN SMITH, THE UNITED STATES FEDERAL INTERNAL TAX HISTORY FROM 1861 TO 1871 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.").

[25] *See* HAROLD Q. LANGENDERFER, II THE FEDERAL INCOME TAX 1861-1872 508-09 (1954, Arno ed. 1980).

[26] *See* ROBERT STANLEY, DIMENSIONS OF LAW IN THE SERVICE OF ORDER: ORIGINS OF THE FEDERAL INCOME TAX 1861-1913 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).

[27] 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 5% taxpayers at a 3% rate on corporate income, but it did not address the reverse problem of taxing 0% taxpayers at a 3% rate. *See* SIDNEY RATNER, TAXATION AND DEMOCRACY IN AMERICA 75 (1980).

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

[29] Id.

[30] Id. ("*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").

because shareholders were entitled to exempt from income the receipt of dividends from corporations subject to the gross receipts tax.[31]

2. 1864 Act

Between 1862 and 1864, the country's financial position worsened and the public debt grew to over $1 billion.[32] Revenue from the 1862 Act had been disappointingly low;[33] thus, Congress focused more of its efforts on the income tax in hopes of bolstering its financial condition.[34] Under the 1864 Act,[35] Congress increased the individual income tax rate to 5% on incomes between $600 and $5,000, 7.5% on incomes between $5,000 and $10,000, and 10% on incomes in excess of $10,000.[36] 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 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."[37] The Commissioner interpreted this latter phrase to permit the taxation of shareholders on the undivided profits of a corporation,[38] but soon after the 1864 Act was

[31] Id. § 91, 12 Stat. at 473-74.
[32] RATNER, *supra* note 26, at 80; LANGENDERFER, *supra* note 24, at 451-52.
[33] RATNER, *supra* note 26, at 82.
[34] *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.").
[35] Act of June 30, 1864, ch. 173, §§ 116-123, 13 Stat. 223, 281-85.
[36] Id. at § 116, 13 Stat. at 281. Before the 1864 Act went into effect, however, Congress eliminated the 7.5% bracket and imposed a 10% tax on all incomes in excess of $5,000 in an effort to further increase revenues. Act of March 3, 1865, ch. 78, 13 Stat. 469; Taylor, *supra* note 3, at 262; Hill, *supra* note 18, at 425. Apparently, the need arose because new estimates suggested that the receipts from the 1864 Act would fall far short of the predictions when the bill was introduced. *See* STANLEY, *supra* note 25, at 35.
[37] Act of June 30, 1864 at § 117, 13 Stat. at 282.
[38] *See* DIGEST OF DECISIONS AND REGULATIONS MADE BY THE COMMISSIONER OF INTERNAL REVENUE, 1864-1898 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

adopted this reading of the statute was challenged in court. Eventually, the Supreme Court considered the issue in *Collector v. Hubbard.*[39] The Court agreed, albeit in dicta, that the "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.[40] Thus, regardless of a business' form of organization, its owners were taxed on a conduit basis.

In the 1864 Act, Congress had deviated from the pure conduit approach with respect to the "taxable" businesses assessed under the 1862 Act. These included banks, trust companies, savings institutions, and insurance, railroad, canal, turnpike, canal navigation, and slackwater companies.[41] Such businesses were subject to a tax of 5% on all dividends as well as "all undistributed sums, or sums made or added during the year to their surplus or contingent funds."[42] Additionally, certain businesses were subject to a tax of 5% on interest paid pursuant to bonded indebtedness.[43]

Despite the increased pressure to raise revenue, Congress sought to avoid imposing double taxation.[44] As with the 1862 Act, several measures were enacted with

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

[39] 79 U.S. (12 Wall.) 1 (1870).

[40] Id. at 16-18 (dicta). The Court struck down the challenge on the grounds that it was barred on jurisdictional grounds. Id. at 14-15.

[41] Act of June 30, 1864, ch. 173, §§ 120-122, 13 Stat. at 283-85. While 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.

[42] Id. at § 120, 13 Stat. at 283.

[43] Id. at § 122, 13 Stat. at 284. 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).

[44] 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)

this goal in mind. At the company level, taxable businesses were permitted to deduct amounts previously taxed, such as undistributed sums, from the tax due on the dividend.[45] At the investor level, investors were permitted to exclude dividends and interest received from taxable businesses.[46] 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 5% 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 10% 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 5% tax on all income, including income from dividends and interest.[47] 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.[48] While some have suggested that this failure to adjust the business rates may have been merely an oversight,[49] more likely it was the administrative difficulties of imposing a graduated tax at the business level that accounts for the disconnect.[50]

(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).

[45] Id. at § 121, 13 Stat. at 284.

[46] Id. at § 117, 13 Stat. at 281.

[47] EDWIN R.A. SELIGMAN, THE INCOME TAX 440 (1911).

[48] Id. at 441; Taylor, *supra* note 3, at 264.

[49] *See* Taylor, *supra* note 3, at 264.

[50] *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."); Langenderfer, *supra* note 24, at 475 (Discussing the same provision under the 1865 Act, stated 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.").

The 1864 Act, as amended, remained in effect until the end of Reconstruction in 1872.[51] Some thought the income tax should be retained as part of a general overhaul of the federal revenue system.[52] 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.[53] 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.[54] After receiving a short reprieve, the income tax ultimately expired after 1872.[55] Financial prosperity and the declining national debt combined to drain the income tax of its original wartime imperative.[56]

B. 1894 Act

Although political support for an income tax continued after the end of Reconstruction,[57] it was not successfully revived until after the Panic of 1893.[58] The high rates instituted by the McKinley tariff in 1890 had already focused attention on the inequity of the current revenue system.[59] Coupled with the unrest occasioned by the

[51] *See* Jeffrey L. Kwall, *The Uncertain Case Against the Double Taxation of Corporate Income*, 68 N.C. L. REV. 613, 618 n.23 (1990).
[52] *See, e.g.*, JOHN SHERMAN, SELECTED SPEECHES AND REPORTS ON FINANCE AND TAXATION, FROM 1859 TO 1878 319 (1879) ("the 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. *See* SELIGMAN, *supra* note 46, at 456.
[53] Id. at 7-8; RATNER, *supra* note 26, at 121-27; STANLEY, *supra* note 25, at 45.
[54] *See* ROY G. BLAKEY & GLADYS C. BLAKEY, THE FEDERAL INCOME TAX 7 (1940).
[55] *See* Ratner, *supra* note 26, at 126-27; Kwall, *supra* note 50, at 618 n.23.
[56] *See* STANLEY, *supra* note 25, at 54.
[57] *See* 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); WITTE, *supra* note 14, at 70. Fourteen different income tax bills were introduced into 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.
[58] WITTE, *supra* note 14, at 70.
[59] WITTE, *supra* note 14, at 70; Baack & Ray, *supra* note 56, at 609.

Panic's economic dislocation,[60] 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.[61] After much political wrangling, including an attempt to separate the income tax provision from the larger tariff bill,[62] the 1894 Act was passed by Congress and became law.[63]

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 $4,000 were taxed at a rate of two percent per year.[64] As the high exemption suggests, however, the tax was still primarily aimed at the wealthiest segment of society.[65] 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.[66] The innovation

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[60] WITTE, *supra* note 14, at 70; RATNER, *supra* note 26, at 170.
[61] 26 CONG. REC. 1594 (1894); id. app. At 411-13 (Jan. 29, 1894) (statement of Rep. Benton McMillin) (D-Tenn.); 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).
[62] RATNER, *supra* note 26, at 173; STANLEY, *supra* note 25, at 113.
[63] See Tariff Act of 1894, ch. 349, 28 Stat. 509. The Act passed over the objections and without the signature of President Grover Cleveland. *See* Taylor, *supra* note 3, at 268; KOSSUTH KENT KENNAN, INCOME TAXATION 259 (1910). 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. However, he kept Congress in session the required ten days so that the measure became law without his signature.").
[64] Tariff Act of 1894, ch. 349, § 27, 28 Stat. 509, 553.
[65] *See* Taylor, *supra* note 3, at 268. The tax was expected to affect no more than .1% of the population. STANLEY, *supra* note 25, at 133, Table 3-7.
[66] Section 59 of the House Bill provided, in relevant part,

> [t]hat 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,

was to extend this tax to cover all corporations or limited liability 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 whatever.[67]

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.[68]

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.[69] Thus, in contrast to the 1864 Act, 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.[70] Ultimately, the Senate version of the

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> 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).
[67] Id.
[68] Id.
[69] 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.
[70] *See* 26 Cong. Rec. 6621 (statement of Sen. Hill) (questioning the constitutionality or prudence of taxing certain public or quasi-public corporations).

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."[71]

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."[72] Another demanded that "[t]he folly, injustice, and demoralization which go with our present attempts at double taxation are first to be assailed."[73] Other sources, while treating the subject more even handedly, were similarly consumed with double taxation.[74]

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[71] Act of 1894, ch. 349, at § 32, 28 Stat. at 556. In full, the statute provided as follows:

> 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 indebtedness of all banks, banking institutions, trust companies, savings institutions, fire, marine, life, and other insurance companies, railroads, 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.

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

[73] J.P. QUINCY, DOUBLE TAXATION IN MASSACHUSETTS 4 (1889).

[74] *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) ("the problems that hinge about this particular subject [double taxation] are so especially important in the United States as to demand the most serious attention.").

Double taxation concerns dominated consideration over the corporate income tax provisions of the 1894 Act. One Senator asked 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."[75] Members of Congress were quick to point out that the corporate income tax was deliberately structured so that it would complement rather than overlap with the individual income tax.[76] Section 28 of the Act excluded from income dividends received from entities already taxed under the Act.[77] As under the 1864 Act, however, this was only a partial solution because the entity-level tax could not be avoided by reason of the individual-level $4,000 exemption.[78] Thus, for shareholders with incomes below the exemption level, the tax on corporate income 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. While 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 truly "corporate" income tax. This innovation in federal income taxation was not implemented, however, because of a challenge to the constitutionality of the 1894 Act. Almost immediately after the Act took effect on January 1, 1985, two shareholder suits were filed in federal court in New York to prevent

[75] 26 CONG. REC. 6876 (1894) (statement of Sen. Dolph).
[76] *See* id. (statement of Sen. Hill).
[77] Id. at § 28, 28 Stat. at 554.
[78] *See* Taylor, *supra* note 3, at 269.

their respective corporations from paying the tax.[79] Eventually, the Court in *Pollock v. Farmers' Loan & Trust Co.* declared the income tax unconstitutional as an unapportioned direct tax.[80] Arguably, the Court could have concluded that the corporate income tax provision was permissible, while still striking down the individual income tax.[81] On rehearing, however, the Court emphasized that notwithstanding the existence of certain potentially valid provisions, the income measure was void *in toto*.[82]

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,[83] Congress passed a corporate excise tax as part of the Payne-Aldrich Tariff Act.[84] Although styled as an "excise tax," it was effectively an income tax because the excise was measured by a corporation's net income. Since it was not accompanied by an individual income tax, however, the double tax risk minimized. Upon ratification of the Sixteenth Amendment, a corporate income tax was once again adopted as part of individual income tax imposed under the Revenue Act of 1913.[85] 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

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[79] The cases were consolidated before the Supreme Court under the name Pollock v. American 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.

[80] 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. The rule of apportionment, a compromise bome 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).

[81] *See* Taylor, *supra* note 3, at 271-72.

[82] Pollock v. Farmers' Loan & Trust Co., 158 U.S. 601, 635-37 (1895).

[83] U.S. CONST. amend. XVI. *See* RATNER, *supra* note 26, at 292.

[84] Act of August 5, 1909, ch. 6, § 38, 36 Stat. 11, 112.

until the dividend exclusion was removed in 1936.[86] 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 not by a desire to double tax corporate income. 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. Thus, 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.

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 appears to be 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' owner for tax purposes, the 1894 Act taxed corporate, but not partnership, income at the entity level.

What accounted for this change? The traditional explanation is that it was in large part due to developments in the nature of the corporation and in our understanding of its

[85] *See* RATNER, *supra* note 26, at 335-36.
[86] *See* Kwall, *supra* note 50, at 619-20.

legal personality. A recent American Law Institute report on the Federal income taxation of private business enterprises reflects this traditional view.[87] According to the report, the "[entity] theory of business-organization personality influenced the income-tax rules that developed" for corporations and partnerships.[88] 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."[89] 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 began to diverge under state law. "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."[90] Thus, under the traditional view, the triumph of the entity conception of the corporation necessitated its taxation as a unit separate and distinct from the taxation of its owners.[91]

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

[87] *See* AMERICAN LAW INSTITUTE, *supra* note 9, at 36. *See also* George K. Yin, *The Future Taxation of Private Business Firms*, 4 FLA. TAX REV. 141, 145 (1999) (same).
[88] AMERICAN LAW INSTITUTE, *supra* note 9, at 37.
[89] Id. at 37; Yin, *supra* note 86, at 146.
[90] Id at 36 (*quoting* Kornhauser, *supra* note 4, at 57-62).
[91] *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.").

business enterprises would be subject to the corporate income tax.[92] 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."[93] Perhaps just as importantly, traditional entity theory appears to at least partially explain the continued popular and political support for the double taxation of corporate income.[94] One significant problem with the traditional entity theory explanation for the origins of the corporate tax, however, is that it is historically inaccurate. As is 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 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

[92] In 1997, Treasury adopted the check-the-box regulations, which permit business enterprises to elect their tax classification under the Code. See 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 and End to the Anachronistic Reliance on State Corporation Laws*, 77 N. C. L. REV. 1307, 1364-1367 (1999).

[93] Mortimer Caplin, *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).

[94] *See* Arlen & Weiss, *supra* note 2, at 331 ("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."); 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."); William A. Klein, *Income Taxation and Legal Entities*, 20 UCLA L. REV. 13, 54 (1972)

individuals.[95] During the Medieval Period, this concept was readily used to describe villages, towns, churches, and trade guilds.[96] While such groups admittedly only existed 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.[97] As Professor Arthur Machen explained, "any group whose membership is changing is necessarily an entity separate and distinct from the constituent members."[98] 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.[99]

An artificial entity transcends this descriptive quality and becomes real to the extent an authority recognizes it as such. The 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.[100] 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

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(the personification of the corporation was "a significant element in the public's support of the law imposing the [corporate income] tax.").

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

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

[97] *See* MORAWETZ, *supra* note 94, at § 1, 2-3.

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

[99] Id. at 257; JOSEPH K. ANGELL & SAMUEL AMES, TREATISE ON THE LAW OF PRIVATE CORPORATIONS AGGREGATE § 6, at 4 (9th ed. 1871).

[100] Dewey, *supra* note 95, at 665-66; SHAW LIVERMORE, EARLY AMERICAN LAND COMPANIES: THEIR INFLUENCE ON CORPORATE DEVELOPMENT 11 n. 4 (1939); Mark M. Hager, *Bodies Politic: The Progressive History of Organizational "Real Entity" Theory*, 50 U. PITT. L. REV. 575, 588 (1989); Gregory M. Mark, Comment, *The Personification of the Business Corporation in American Law*, 54 U. CHI. L. REV. 1441, 1469 (1987).

individuals the right to create lesser entities or associations.[101] Thus, an entity only existed 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.[102] 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."[103] This strategy sought to justify the supremacy of the Church and the State by marginalizing non-approved 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."[104] 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."[105] The corporation was thus considered a "franchise" or privilege to establish an independent legal person.[106] 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

[101] Mark, *supra* note 99, at 1469.
[102] See Dewey, *supra* note 95, at 667.
[103] Id. at 666.
[104] ERNEST FREUND, STANDARDS IN AMERICAN LEGISLATION 39 (1917).
[105] 1 WILLIAM BLACKSTONE, COMMENTARIES *472.
[106] ADOLF A. BERLE, JR. & GARDINER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 128 (1932).

was necessary to enlist the corporation as an arm of the Crown, especially in the case of corporations engaged in foreign trade: "[t]he 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."[107] While royal charters were arguably sought for private benefit by trade guilds such as the weavers, goldsmiths, haberdashers, fishmongers, vintners, and merchant tailors,[108] 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.[109]

Not surprisingly, the grant or concession view of the corporation found new strength amidst the grab for power in America.[110] 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."[111] In some cases, these local chartering bodies exercised their authority through a delegation of the Crown's prerogative,[112] but when

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[107] JAMES WILLARD HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES 1780-1970 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).

[108] HURST, *supra* note 106, at 3.

[109] *See* Samuel Williston, *History of the Law of the Business Corporations Before 1800*, 2 HARV. L. REV. 105, 108-09 (1888) (The guilds or companies "made by-laws governing their respective trades, which were not simply 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.").

[110] *See* Julius Goebel, Jr., *Editor's Introduction*, *in* LIVERMORE, *supra* note 99, at x-xiii, xxv.

[111] MACHEN, *supra* note 95, at § 2; HURST, *supra* note 106, at 15.

[112] 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 (Yale Law Faculty, eds., 1901).

English rule ended, any prerogative ended as well.[113] The newly formed states hurried to establish their claims to authority by filling this void.[114] 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.[115]

As in England, the American corporation was viewed as a creation of the state by virtue of its grant of a corporate charter. Chief Justice Marshall described the corporation in his 1819 opinion in the *Dartmouth College* case by borrowing heavily from Blackstone and other English legal theorists:[116] "[a] corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of the law, it possesses only those properties which the charter of its creation confers upon it, either expressly or as incident to its very existence."[117] Reinforcing this grant or concession theory of the corporation was the fact that special charters were often reserved for those activities promoting the public good. Although the demand for corporate charters in

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[113] MACHEN, *supra* note 95, at § 2.

[114] Under the Articles of Incorporation, 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 the fear that it would permit Congress to create national monopolies. Id.; HENDERSON, *supra* note 106, at 19-20.
Even 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* note 113, at 16 n.4.

[115] 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); FRIEDMAN, *supra* note 56, at 188; HAROLD F. LUSK, BUSINESS LAW: PRINCIPLES AND CASES 694 (1946).

[116] HURST, *supra* note 106, at 9.

[117] Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518, 636 (1819). 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. *See* David Graver, Comment, *Personal Bodies: A Corporeal Theory of Corporate Personhood*, 6 U. CHI. L. SCH. ROUNDTABLE 235, 237-38 (1999).

America was exceedingly light prior to 1780,[118] corporations receiving charters during the burst of activity prior to the turn of the century were overwhelmingly "quasi-public"[119] in operation. According to Willard Hurst, "[o]f the 217 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."[120] This bias in favor of quasi-public 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.[121] One Virginia Supreme Court Justice wrote in 1809 that special acts of incorporation "ought never to be passed, but in consideration of services to

[118] HURST, *supra* note 106, at 7; MACHEN, *supra* note 95, at § 14; LIVERMORE, *supra* note 99, at 61. 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 106, at 8; HENN, *supra* note 113, at 14-16. In the Bubble Act, adopted by Parliament after the "bubble" burst on the 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.

[119] Or, as Shaw Livermore describes them, "semi-political." *See* LIVERMORE, *supra* note 99, at xxvii.

[120] HURST, *supra* note 106, at 17; Baldwin, *supra* note 111, at 276 ("of the charters granted prior to 1800 for moneyed corporations, two-thirds were of a quasi-public character"). *See also* 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."); BERLE & MEANS, *supra* note 105, 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."). 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) ("by contrast to English and Continental experience, the less advanced economy of the United States produced almost 350 business corporations between 1783 and 1801"), but the discrepancy may be due to the fact that these latter numbers do not distinguish between quasi-public businesses and general businesses. *See* Hamill, *supra* note 114, at 93 n. 51 ("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 private corporations to resemble more closely towns' public bodies rather than private competitive businesses.").

[121] ANGELL & AMES, *supra* note 98, § 13 at 7; GEORGE HEBERTON EVANS, JR., BUSINESS INCORPORATIONS IN THE UNITED STATES 1800-1943 21 (1948).

be rendered to the public."[122] To satisfy this requirement, many early special charters declared the public usefulness of their enterprise in the preamble.[123] 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.[124]

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.[125] In reality, however, 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.[126] Legislators appeared to assume that there was little reason to distinguish between corporate and non-corporate property since property taxation itself did not depend upon the status of the holder.[127] Obviously, this assumption was not always a valid one. In Massachusetts, for example, a manufacturing corporation

[122] Currie's Admin. V. Mutual Ass'n. Soc., 14 Va. (4 Hen. & M.) 315, 347-48 (Va. 1809).
[123] *See* EVANS, *supra* note 120, at 21 n. 21.
[124] MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW 1780-1860 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 that "[a] private corporation created by the legislature may lose its franchises by a misuser or a nonuser of them; and they may be resumed by the government upon a quo warranto action 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, 51 (1815).
[125] *See* Pratt, *supra* note 2, at 1097 (noting that corporate taxation was sometimes justified as payment for the special privileges of operating as an artificial entity).
[126] EDWIN R.A. SELIGMAN, ESSAYS IN TAXATION 138 (1895).

resisted the application of a tax assessed in 1817 for the support of the church parish in which the corporation's plant was located.[128] The attorney for the corporation argued that since "corporations have no souls" for the parish to save, the tax cannot possibly apply to them.[129] In rejecting this argument, the court not only noted that a tax is not like a fee which may be charged only to those who benefit from it, but 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."[130] 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.[131] Thus, the tax could not possibly serve to protect the property of a non-resident or non-parish affiliated owner. When the parish tax was imposed against a manufacturing corporation in 1830,[132] the corporation's attorneys argued that since none of the shareholders belonged to the parish in which the property was located, the property should be exempt from the tax.[133] 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.[134] Since the corporation itself did not belong to any other religious society, the exemption did not apply. Perhaps recognizing the awkward nature of this logic, though, the court noted in a footnote that the Legislature had, in the

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[127] Id.
[128] Amesbury Nail Factory Co. v. Weed, 17 Mass. 53 (1820).
[129] Id. at 53-54.
[130] Id. at 55.
[131] Mass. Gen. L. ch. 106, § 3 (1823).
[132] Goodell Mfg. Co. v. Trask, 28 Mass. (11 Pick.) 514 (1831).
[133] Id. at 515. In fact, each of the shareholders belonged to different religious denominations altogether. Id. at 516.
[134] Id. at 517.

interim, enacted a statute providing that "no corporation shall be taxed for any parochial purpose."[135]

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.[136] 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."[137] There were special provisions providing for a corporation's payment of the tax,[138] 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.[139] In fact, several states adopted constitutional provisions mandating that corporations be taxed like individuals for property tax purposes.[140]

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

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[135] Id. at 518 n. 1.
[136] SELIGMAN, *supra* note 125, at 138.
[137] Act of April 23, 1823, Laws of New York § 14 (1823).
[138] Corporations were required to submit a list of its 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 at § 15.
[139] 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).

percent tax on the capital stock of banks and a one and a half percent tax on their total amount in circulation.[141] A few states followed suit, relying principally on the taxation of bank capital stock or dividends.[142] 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.[143] When other states imposed similar taxes on foreign insurance companies, Massachusetts enacted what came to be known as a "reciprocal act" in 1832.[144] This 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.[145] 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.[146]

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

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[140] States adopting constitutional provisions requiring that corporations be taxed like individuals included Alabama, Colorado, Florida, Iowa, Mississippi, Nevada, Ohio, and South Carolina. *See* id. at 273 n. 3.
[141] *See* Ga. Law of Dec. 4, 1805 at 20 ("there shall be a tax of two and a half per cent. levied and collected on the amount or capital of any bank or banks, office or offices of discount and deposit 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").
[142] *See, e.g.*, Pa. Session Laws, 1813-1814, ch. 98, § 10 ("each 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); 1830 Conn. Pub. Acts ch. 28, § 2 (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.
[143] *See* id. at 150.
[144] Id. at 151.
[145] Id.

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.[147] Maryland imposed a "tax on incorporated institutions" in 1841, but it merely extended the general property tax to a corporation's capital stock.[148] 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.[149] Almost twenty-five years passed before other states followed Pennsylvania's lead.[150] Thus, the early taxation of the corporation does not evidence 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 non-public enterprises began to select the corporate form to conduct business. In both cases, the

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[146] 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.

[147] Pa. Laws of 1840, n. 232, at 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 COMMONWEALTHS OF THE UNITED STATES 31 (1903).

[148] Seligman, *supra* note 138, at 303; *See* Md. Laws of 1841, ch. 23, § 17.

[149] Virginia enacted a two and a half per cent tax on corporate dividends in 1843, but it was reduced in 1846 and subsequently eliminated altogether. *See* Seligman, *supra* note 138, at 304.

[150] *See* Seligman, *supra* note 138, 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*, 2 PUBLICATIONS OF THE AM. ECON. ASS'N 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 thousand dollars a year and in fact raised considerably less).

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.[151] In 1833, William 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."[152] 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.[153]

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.[154] While such sentiments were intimately connected with Jacksonian Democratic politics, they resonated for many throughout the ante-bellum 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."[155] Defenders answered charges by

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[151] HURST, *supra* note 106, at 30.
[152] WILLIAM GOUGE, SHORT HISTORY OF PAPER MONEY AND BANKING IN THE UNITED STATES 17 (1835).
[153] Id. at 31, 33.
[154] *See* Note, *Incorporating the Republic: The Corporation in Ante-Bellum Political Culture*, 102 HARV. L. REV. 1883, 1893 (1989); Note, *The Corporation and the Constitution: Economic Due Process and Corporate Speech*, 90 YALE L.J. 1833, 1844 (1981).
[155] ERIC FONER, FREE SOIL, FREE LABOR, FREE MEN: THE IDEOLOGY OF THE REPUBLICAN PARTY BEFORE THE CIVIL WAR 22 (1970).

pointing to the need to encourage investments,[156] 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.[157]

The special charter's grant of exclusive franchises further offended the prevailing egalitarian sentiment of Jacksonians.[158] Although a long tradition of opposition to special privileges had been brought over from England in the 1700s,[159] Andrew Jackson's campaign against the Second Bank of the United States in 1832 was a high point for this sentiment in America.[160] Jackson's substantive critique ostensibly related to other matters, but it was primarily a war against special privileges.[161] In Jackson's veto message to 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

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[156] *See* Note, *supra* note 153, at 1893-94.

[157] *See* THEODORE SEDGWICK, WHAT IS A MONOPOLY? 13 (1835); HURST, *supra* note 106, at 32; Note, *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 encreasing [sic] daily." THOMAS COOPER, LECTURES ON THE ELEMENTS OF POLITICAL ECONOMY 206 (1826). *See also* Hovenkamp, *supra* note 123, at 1634.

[158] Jacksonians viewed equality of opportunity and open competition as the torchlights for an enlightened economy. *See* Note, *supra* note 153, at 1844, n.62.

[159] *See* Note, *supra* note 153, at 1890 ("there was a tradition of statutory and common law hostility to granting trading companies and craft guilds special privileges to carry on particular trades"); HENDERSON, *supra* note 106, 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 99, at 247 ("As early as 1784 the attitude erroneously identified by historians as Jacksonian was clearly existent").

[160] *See* JAMES C. CURTIS, ANDREW JACKSON AND THE SEARCH FOR VINDICATION 114, 130 (1976).

[161] 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. *See* id. at 112-115; HURST, *supra* note 106, at 116.

members of society . . . have a right to complain of the injustice of their Government."[162] This was not merely a protest against the national chartering of corporations in general 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 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."[163] 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.[164]

In response to such concerns, Jackson's attorney-general, Roger Taney, concluded that states had no legal power to grant monopolies.[165] After his appointment as Chief Justice of the Supreme Court, Taney provided support for this position in the 1837 *Charles River*

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[162] 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).
[163] GEORGE LOGAN, 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 S. DAVIS, I ESSAYS IN THE EARLIER HISTORY OF AMERICAN CORPORATIONS 349 (1965) (discussing New Jersey's chartering of The Society for establishing useful Manufactures).
[164] SEDGWICK, *supra* note 156, at 13.
[165] *See* Hovenkamp, *supra* note 123, at 1615.

Bridge case.[166] Holding contrary to the accepted wisdom,[167] 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.[168] Even Justice Charles Story, in dissent, agreed that not "every corporation becomes, *ipso facto,* a monopoly or exclusive privilege."[169] 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.[170] Although early statutes were enacted for a variety of reasons,[171] general incorporation statutes for business corporations were primarily designed to make the corporate form available to a wider

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[166] Charles River Bridge v. Warren Bridge, 36 U.S. (11 Pet.) 420 (1837).
[167] *See* HUGH RUSSELL FRASER, DEMOCRACY IN THE MAKING: THE JACKSON-TYLER ERA 55 (phot. Reprint 1969) (1938).
[168] Charles River Bridge, 36 U.S. at 536.
[169] Id. at 638 (Story, J., dissenting).
[170] *See* HERBERT HOVENKAMP, ENTERPRISE AND AMERICAN LAW 1836-1937 2 (1991); Hamill, *supra* note 114, at 101. On the other hand, Shaw Livermore argued that while 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. LIVERMORE, *supra* note 99, at 295-96.
[171] 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 18th 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 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; Davis, Jr., Comment, *supra* note 161, at 607. 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* SEAVOY, ID., at 41; 1811 N.Y. LAWS ch. 67, 111; Note, *supra* note 153, at 1898; MACHEN, *supra* note 95, at § 15; Louis K. Liggett Co. v. Lee, 288 U.S. 517, 548 n.2 (Brandeis, J., dissenting).
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 Jr., Comment, *supra* note 161, at 611 n. 36.

segment of the population.[172] 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.[173] By 1886, one commentator declared that a general incorporation law "is now in force in some form or other in almost every State of the Union."[174] 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.[175] 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.[176] 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."[177] In 1821, New York amended its constitution to

[172] According to Joseph Davis, even early general incorporation statutes for non-business corporations such as ecclesiastical, educational and literary entities were enacted out of "a strong and growing prejudice in favor of equality." JOSEPH S. DAVIS, II ESSAYS IN THE EARLIER HISTORY OF AMERICAN CORPORATIONS (1917).

[173] Act of June 10, 1837, ch. 63, 1837 Conn. Pub. Acts 49 (permitting incorporation of "any . . . lawful business"); *See* Hamill, *supra* note 114, at 101-02.

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

[175] HURST, *supra* note 106, at 33; Hamill, *supra* note 114, at 107, 122; HENN, *supra* note 113, at 17.

[176] 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 Jr., Comment, *supra* note 161, at 613 n. 46.

[177] Louis K. Liggett Co., 288 U.S. at 548 n.4 (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. *See* JOHN W. CADMAN, JR., THE CORPORATION IN NEW JERSEY: BUSINESS AND POLITICS 1791-1875 432-33 (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 106, 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.

require two-thirds approval from each branch of the legislature for any act "creating, continuing, altering, or renewing any body politic or corporate."[178] In the very next session, however, special charters were issued to thirty-nine New York corporations, suggesting that more drastic measures were necessary.[179] The solution was to ban the issuance of such special charters altogether, which New York did by amending its constitution in 1846.[180] 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.[181] In fact, almost every state constitutional convention held after 1840 contained provisions limiting the issuance of special charters as states tried to unburden themselves from the fiscal ruin of excessive subsidization.[182] 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.[183] By 1880, twenty-seven states had adopted constitutional provisions that prohibited the

[178] Louis K. Liggett Co., 288 U.S. at 548 n.3 (Brandeis, J., dissenting). Similar provisions were included in the Delaware Constitution of 1831, the Florida Constitution of 1838 and the Michigan Constitution of 1835. Id.
[179] ANGELL & AMES, *supra* note 98, at 48.
[180] Id.
[181] FRIEDMAN, *supra* note 56, at 196.
[182] SEAVOY, *supra* note 170, at 180; DAVIS, *supra* note 162, at 18. 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. With the financial crisis of 1837-1844, states could no longer stand to bear this burden. Id. at 180.
[183] *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.

issuance of special charters, and by 1913, all but four of the states had adopted such provisions.[184]

As general incorporation statutes became increasingly more liberal, the corporation became the vehicle of choice for non-public enterprises. From the 1830s on, manufacturing company incorporations began to catch up with transportation and other quasi-public incorporations.[185] In New Jersey, for example, manufacturing and mining incorporations accounted for 32% of all incorporations between 1820 and 1844 and in Wisconsin, such charters overtook quasi-public charters between 1848 and 1871.[186] 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.[187] In Massachusetts, only 520 of the approximately 11,000 manufacturing businesses in existence were incorporated in 1878, although it is perhaps more significant that those

[184] The four remaining states were Connecticut, Massachusetts, New Hampshire, and Rhode Island. *See* EVANS, *supra* note 120, at 11 (Table 5); Davis, Jr., Comment, *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 114, at 121-28. Hamill, however, agrees 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*, 24 J. LEG. STUD. 129, 146-161 (1985) (providing a public choice theory-based explanation for the endurance of special charters until the era of inter-jurisdictional competition).

[185] 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 Useful Manufactures). Eventually, however, the private character of these corporations was allowed to dominate. Id.

[186] *See* HURST, *supra* note 106, 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 quasi-public transportation corporations for the first time between 1825 and 1829. CADMAN, *supra* note 176, at 425.

[187] 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 254, 289 n. 85 (1937) (Act of June 16, 1836, relating to corporations formed to manufacture iron by means of coke).

businesses that had incorporated were responsible for over one-third of the state's manufacturing output.[188] By the late 1880s, it is safe to say that state incorporation laws primarily served the general business enterprise.[189]

Eventually, the spread of corporations to non-public enterprises and the adoption of general incorporation statutes suggested a conceptual shift in the nature of the corporation. On the 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.[190] 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.[191] As early 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."[192] 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.[193] In the first edition of his *Treatise on the Law of Private Corporations*, Morawetz

[188] HEILBRONER & SINGER, *supra* note 119, at 189.
[189] Donald E. Schwartz, *Federal Chartering of Corporations: An Introduction*, 61 GEO. L. J. 71, 77 (1972)
[190] HURST, *supra* note 106, at 113 (The action of banning special charters "was coupled with explicit or clearly implied reconfirmation of legislative authority to determine general policy on the availability of incorporation").
[191] *See* Eben Moglen, *The Transformation of Morton Horwitz*, 93 COLUM. L. REV. 1042, 1047 (1993) (reviewing MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW, 1870-1960 (1992)).
[192] HORWITZ, *supra* note 7, at 308 n.6. The legislature overrode the Council's veto. Id.
[193] *See* Horwitz, *supra* note 7, at 90; Mark, *supra* note 99, at 1457.

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."[194] 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."[195] 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."[196]

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.[197]

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[194] VICTOR MORAWETZ, I A TREATISE ON THE LAW OF PRIVATE CORPORATIONS § 1 at 2 (1882). Morton Horwitz explained that "Morawetz's efforts 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 possible to fit corporation law into the new dominant individualistic mode of private contract law." HORWITZ, *supra* note 7, at 90.

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

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

[197] *See supra* notes 34-37.

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 under the 1864 Act. As discussed earlier,[198] corporations in the banking and insurance industries were subject to a five per cent tax on dividends issued to stockholders and on all undistributed sums added to surplus or contingent funds.[199] Corporations in the transportation field were subject to a five per cent tax on dividends and interest paid on bonded indebtedness.[200] Additionally, the gross receipts taxes imposed under both the 1862 and 1864 Acts were direct taxes against corporations in the specified industries.[201] Corporations, partnerships, and persons were each treated as separate taxable actors for purposes of the tax.[202] Although some of these provisions have been called mere withholding mechanisms for the taxes on individuals,[203] they were imposed upon corporations directly and, often, the corporation paid them without

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[198] *See supra* text accompanying notes 38-42.
[199] Act of June 30, 1864, ch. 173, § 120, 13 Stat. 223, 283-84.
[200] Id. at § 122, 13 Stat. at 284.
[201] *See* Act of July 1, 1862, ch. 119, § 80, 12 Stat. 432, 468-69; Act of June 30, 1864, ch. 173, § 103, 13 Stat. 223, 276.
[202] *See, e.g.*, Act of July 1, 1862, ch. 119, § 80, 12 Stat. 432, 468 (imposing the gross receipts tax on "any person or persons, firms, companies, or corporations, owning" railroads or steamboats).
[203] *See* FREDERIC C. HOWE, TAXATION AND TAXES IN THE UNITED STATES UNDER THE INTERNAL REVENUE SYSTEM 1791-1895 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." Act of July 1, 1862, ch. 119, § 80, 12 Stat. 432, 468-69. The same proviso was included in the 1864 Act. *See* Act of June 30, 1864, ch. 173, § 103, 13 Stat. 223, 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 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, 37th Cong., 1st Sess. 1196, 1482, 1484, 2331-33, 2346 (1862); CONG. GLOBE, 38th Cong., 1st Sess. 1917-18 (1864). Even in the 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) ("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") (statement of Sen. Sherman); id. at 2346 (The insurance companies "said it [the gross receipts tax] would

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,[204] 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.[205] While shareholders were entitled to deduct from income dividends and interest derived from corporations that had already paid the tax due on such items,[206] they were not entitled to deduct from income or receive a credit for taxes paid by the corporation itself.[207] 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.[208] Thus, the tax treatment of the corporation only dimly, if at all, reflects the aggregate or partnership theory.

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.[209] Alabama and

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come hard on those who were insured, because they must pay it, and not the companies.") (statement of Sen. Fessenden).

[204] Act of June 30, 1864, ch. 173, §§ 120, 122, 13 Stat. 223, 283-84.

[205] *See* Edwin R. A. Seligman, *The Income Tax*, 9 POL. SCI. Q. 610, 628-29 (1894) ("In the case of the corporate-income tax, however, the 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.

[206] Id. at § 117, 13 Stat. at 281.

[207] *See* BOUTWELL, *supra* note 26, at 305 (Ruling No. 29).

[208] Act of June 30, 1864, ch. 173, §§ 121, 13 Stat. 223, 284.

[209] *See* Seligman, *supra* note 138, at 303-305 (citing the examples of Massachusetts, New Jersey, Maryland, Illinois, Alabama, and Virginia).

Virginia, for instance, both imposed taxes on the capital stock and dividends of all domestic corporations and Alabama enacted an income tax in 1867 that was later held to apply to corporations.[210] The most prominent example, however, is in Massachusetts. In 1863, Massachusetts enacted a tax on corporate dividends paid to non-resident stockholders.[211] After this was declared unconstitutional,[212] 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.[213] The proportion of the tax corresponding to stock owned by Massachusetts residents was credited and paid to the municipalities in which those shareholders resided.[214] The state effectively retained only the value of the capital stock attributable to non-residents. In one sense the new law merely centralized the administration of the local shareholder tax that had been previously held to be unconstitutional.[215] As one commentator described it, though, "[t]he change involved . . . an important departure in principle, for it really meant the

[210] *See* id., at 304-05; Ala. Laws of Feb. 22, 1866, § 2, par. 4 (imposing a 0.5% 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 par. 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"); Ala. Laws of Feb. 19, 1867, § 3 (imposing an income tax on persons, which was later held to include corporations); ALA. CODE § 1(1) (1867) (stating that "the word 'person' includes a corporation as well as a natural person."). *See* Board of Revenue v. Montgomery County Gas-Light Co., 64 Ala. 269, 277 (1879)). None of these measures ever raised substantial sums because of certain exceptions and a lack of enforcement. *See* Seligman, *supra* note 138, at 304.

[211] 1863 Mass. Acts ch. 236.

[212] *See* Oliver v. Washington Mills, 93 Mass. 268, 275 (1865) (holding that the tax violated the state constitution's apportionment clause).

[213] 1864 Mass. Acts ch. 208, § 5; HARRY G. FRIEDMAN, THE TAXATION OF CORPORATIONS IN MASSACHUSETTS 47 (1907).

[214] Id. at § 8.

[215] 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 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

taxation of corporations in place of individuals."[216] In 1865, the state underscored the entity-level nature of the tax by calling it "a tax upon its corporate franchise."[217]

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.[218] Since the government lacked the administrative apparatus to administer such a tax, however, collection was left to the individual states with predictably unsatisfactory results.[219] After a disastrous experiment with loan financing and, eventually, to printing paper currency to pay its bills,[220] the Confederate government resorted to an income tax in 1863.[221] As part of the income tax, all corporations were required to reserve one-tenth of annual earnings set apart for dividends and reserves.[222] When this amount exceeded 10% of the paid capital stock, the government imposed a 12.5% tax and when it exceeded 20% of paid capital stock, the tax rate increased to 16.66%.[223] This provision did not result in double taxation because stockholders were permitted to exempt from income all

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Union." GEORGE CLAPPERTON, TAXATION OF CORPORATIONS: REPORT ON SYSTEMS EMPLOYED IN VARIOUS STATES 14 (1901).

[216] FRIEDMAN, *supra* note 212, at 46.

[217] 1865 Mass. Acts ch. 283, § 5.

[218] SELIGMAN, *supra* note 46, at 482; RATNER, *supra* note 26, at 102.

[219] 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. RATNER, *supra* note 26, at 102-03; KENNAN, *supra* note 62, at 269; EMORY M. THOMAS, THE CONFEDERATE NATION: 1861-1865 137 (1979) ("state governments undertook to pay the levies for their citizens – largely in unsupported state currency.").

[220] *See* J.C. Schwab, *The Finances of the Confederate States*, 7 POL. SCI. Q. 38, 39 (1892) (noting that loan financing amounted to more than 90% of its total revenues during the first few years of the war); SELIGMAN, *supra* note 46, at 483-84; THOMAS, supra note 218, at 137-38; RANDOLPH E. PAUL, TAXATION IN THE UNITED STATES 18-19 (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."). By January 1, 1864, the inflation rate was over 600 percent. *See* THOMAS, *supra* note 218, at 197.

[221] 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.

[222] SELIGMAN, *supra* note 46, at 487; RATNER, *supra* note 26, at 104.

[223] SELIGMAN, *supra* note 46, at 487; RATNER, *supra* note 26, at 104.

dividends received from such corporations.[224] 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 50% on the profits of all corporations beyond that necessary to support a dividend of 25% to their stockholders.[225] 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."[226] This plea got the government's attention and on February 17, 1864, the Confederacy enacted a more draconian income tax act.[227] In this measure, however, the Confederacy broadened the provision from a tax on corporations to a tax on all businesses. A tax of 25% was imposed on any business' profits in excess of that necessary to support a 25% dividend.[228] 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.[229] 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

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[224] SELIGMAN, *supra* note 46, at 487; RATNER, *supra* note 26, at 104.
[225] SELIGMAN, *supra* note 46, at 489 (quoting REPORT OF THE COMMISSIONER OF TAXES ACCOMPANYING THE REPORT OF THE SECRETARY OF THE TREASURY 2 (1863).
[226] RATNER, *supra* note 26, at 105 (quoting REPORT OF THE COMMISSIONER OF TAXES ACCOMPANYING THE REPORT OF THE SECRETARY OF THE TREASURY 2 (1863).
[227] THOMAS, *supra* note 218, at 264; SELIGMAN, *supra* note 46, at 490-91.
[228] RATNER, *supra* note 26, at 106.
[229] RATNER, *supra* note 26, at 107; PAUL, *supra* note 211, at 22.

Van Allen v. Commissioner.[230] In this case, 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.[231] The stockholders argued that that the tax was effectively against the bank's capital itself, thus violating the prohibition against state taxation of United States securities.[232] The Court rejected this argument, concluding that the shares did not represent an ownership interest in the underlying property.[233] Quoting from a British authority, the Court noted that "[t]he individual owners 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."[234] 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."[235] This decision, which was both widely anticipated and attracted much attention,[236] was cited throughout the latter part of the nineteenth century in support of the notion that the

[230] 70 U.S. (3 Wall.) 573 (1865).
[231] Id. at 581-582.
[232] Id. at 583.
[233] Id. at 584.
[234] Id. (*quoting* Queen v. Arnoud, 9 Adolphus & Ellis, New Series, 806).
[235] 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 in reliance upon its reasoning in *Van Allen*. People v. Commissioner, 71 U.S. (4 Wall.) 244 (1866).
[236] *See, e.g*., *The Taxation of Shareholders in National Banks, By States*, BANKERS' MAG. & STAT. REG 29 (Dec. 1865); *Bank Items – New Jersey*, BANKERS' MAG. & STAT. REG. 589 (Jan. 1866); *Law Reports – United States Supreme Court*, N.Y. TIMES, April 19, 1866, at 2; *Bank Items – Supreme Court Decision*, BANKERS' MAG. & STAT. REG, 900 (May 1866).

taxation of both the stock and the property of a corporation was neither illegal nor double taxation.[237]

C. The advent of the large corporation

If the middle period of the nineteenth century is important for the spread of the corporate form, the latter part of the nineteenth century is important for the advent of the truly mega corporation. 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 quasi-public 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.[238] Corporations offered limited liability and thereby reduced the personal financial risks of the owners.[239] As business enterprises expanded their markets

[237] *See, e.g.*, Bradley v. People, 71 U.S. 459 (1866); New Orleans v. Houston, 119 U.S. 265, 277 (1886); Tennessee v. Whitworth, 117 U.S. 129, 136-37 (1886); Gibbons v. Mahon, 136 U.S. 549, 557 (1890); Bank of Commerce v. Tennessee, 161 U.S. 134, 146 (1896); Shelby County v. Union and Planters' Bank, 161 U.S. 149, 159 (1896); Mercantile Nat. Bank v. Mayor, 28 F. 776, 784 (S.D. N.Y. 1886); Covington City Nat. Bank v. City of Covington, 21 F. 484, 491 (1884); Exchange Nat. Bank v. Miller, 19 F. 372, 379 (S.D. Ohio 1884); Albany City Nat. Bank v. Maher, 6 F. 417, 420 (N.D. N.Y. 1881); Frazer v. Seibern, 16 Ohio St. 615, 620 (1866); Wright v. Stilz, 27 Ind. 338, 341 (1866); Batterson v. Hartford, 50 Conn. 558, 560 (1883); Exchange Bank of Macon v. Macon Constr. Co., 97 Ga. 1, 6 (1895).

[238] *See* BERLE & MEANS, *supra* note 105, at 17 ("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."); *Reform of Corporations*, 32 BANKER'S MAG. 184, 188-89 (1877) ("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.").

[239] *See* 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

and became increasingly more speculative, investors demanded what was once thought to be the unnecessary feature of limited liability.[240] Furthermore, stock ownership was preferable for investors seeking the enhanced liquidity available in corporate ownership.[241] This was not so much because there was a ready market for corporate stock, since a truly public stock market did not develop until early in the 20th century,[242] but rather because a certificate of stock could be transferred more conveniently than a partnership interest.[243]

The increasing attractiveness and accessibility of the corporate form led to an explosion in the number of corporations in the post-war period.[244] In Massachusetts, for example, the Secretary of the Commonwealth reported to the legislature that the rise in

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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 not be brought 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 Corporations Acts: Their Origin*, 20 AM. L. REV. 757 (1886).

[240] *See* 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 99, at 236. Shareholders were not always provided limited liability under their corporation's charter or the general incorporation statute. For instance, up until 1830, Massachusetts imposed unlimited liability on manufacturing enterprises seeking to incorporate. *See* Dodd, *supra* note 186, at 267-68. *See also* Goebel, *supra* note 109, at xxii-xxiii (noting that limited liability was not an automatic feature of corporate charters).

[241] Id.

[242] *See* JONATHAN BARRON BASKIN & PAUL J. MIRANTI, 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. *See* CHARLES R. GEISST, WALL STREET: A HISTORY 101 (1997).

[243] *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 99, at 64-65 n. 65. Although the Supreme Court confirmed as early as 1827 that partnership interests were freely transferable if permitted by the partnership agreement, *see* Alvord v. Smith, (5 Pick.) 232 (1827), it was not until 1843 that England reversed its stance on this issue. See LIVERMORE, *supra* note 99, at 64-65 n. 65.

[244] *See* EVANS, *supra* note 120, at 31; COLEMAN, *supra* note 106, at 30. 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).

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."[245] In Michigan, the number of corporations rose from less than 100 in 1850 to approximately 8,000 in 1894.[246] Moreover, the rush to incorporate was not limited to individual jurisdictions and industries. In its 1869 decision in *Paul v. Virginia*,[247] the 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."[248] While the number of new incorporations steadied as the economy readjusted, a new spurt of incorporations took place in the 1880s and finally stabilized in the early 1890s.[249]

Even more significant than the increase in new incorporations was the introduction of the large corporation. The early American business corporation shared more in common with the partnership than a true corporate organization.[250] The number of stockholders was usually fairly small and each stockholder was intimately involved in

[245] 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. *See* id., at 119 (Table).
[246] *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," Publications of Michigan Political Science Association, No. 2, p. 97).
[247] Paul v. Virginia, 75 U.S. (8 Wall.) 168 (1869).
[248] Id. at 181-82.
[249] *See* EVANS, *supra* note 120, at 31.
[250] *See* LIVERMORE, *supra* note 99, at 2 n. 2 (distinguishing between partnership-like corporations involving owner-managers and "true corporate bodies" involving owner-outsiders).

the daily operations of the business.[251] Before the 1880s, even the largest factories employed no more than a few hundred workers and even these larger enterprises were still predominately family-owned.[252] By contrast, the business corporation of the latter half of the 19th century grew in size and complexity.[253] Each of the large railroads employed more than 100,000 workers by 1890 and the common stock of many of the largest corporations was publicly traded.[254] The single-plant one function enterprise was replaced by a multi-faceted 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]

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[251] 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. *See* GLENN PORTER, THE RISE OF BIG BUSINESS 1860-1910 17-18 (1973).

[252] *See* THOMAS K. MCCRAW, PROPHETS OF REGULATION 64 (1984); BASKIN & MIRANTI, *supra* note 241, at 193. The exception was in the railroad industry. For example, whereas 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 4,000 employees. By the 1880s, the Pennsylvania Railroad employed almost 80,000 workers. *See* Alfred Chandler, *The Organization of Manufacturing and Transportation, in* THE ESSENTIAL ALFRED CHANDLER: ESSAYS TOWARD A HISTORICAL THEORY OF BIG BUSINESS 208-209 (Thomas K. McCraw, ed., 1988).

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

[254] *See* MCCRAW, *supra* note 251, at 64; BASKIN & MIRANTI, *supra* note 241, at 193. According to one contemporary observer, publicly traded corporations held nearly twenty-five percent of the country's wealth. *See* ARTHUR T. HADLEY, RAILROAD TRANSPORTATION 42-43 (1885).

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

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

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

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

Paralleling this increase in the size and complexity of the corporation was a decline of the partnership or aggregate theory among legal scholars of the late 19th century.[259] As Morton Horwitz noted, "the picture of the corporation as a contract among individual shareholders was itself becoming a nostalgic fantasy at the very moment the partnership view was most forcefully 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 both

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

[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 the essential change that 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 CARLTON HUNT, THE DEVELOPMENT OF THE BUSINESS CORPORATION IN ENGLAND, 1800-1867 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. It was that year that the philosopher Otto von Gierke first published his study of the history of associations in Germany, a study which focused on medieval communalis m 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 95, at 670.

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

draw upon and corroborate the claims of contemporary sociologists such as Emile Durkheim of France and others that group behavior must be evaluated as a real and separate phenomenon -- a phenomenon that could not be reduced to the wills of the individual actors.[264] As Arthur Machen 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

Supporters of the entity theory explanation for the origins of the corporate income tax base rely principally upon two features of the legislative history of the 1894 Act.

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[264] *See* Hager, *supra* note 99, at 581; 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, the Court declared that "[a] corporation is a distinct entity . . . it is as distinct a being as an individual is . . . ." 102 U.S. 148, 161 (1880).

[265] Machen, *supra* note 97, 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. Thus, 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. Id. at n.6, (*citing* De Vareilles-Sommieres, Les Personnes Morales, pp. 77-78). 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."

Maitland, Collected Papers at 311 in Dewey, *supra* note 95, at 656.

[266] *See* Jones, *supra* note 262, at 80; Henry Winslow Williams, *An Inquiry Into the Nature and Law of Corporations – Part I*, 38 AM. L. REG. 1, 8 (1899) (a corporation' "rights are in no sense predicated of these agents or any of the various persons or aggregations of person 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

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 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. Enacting 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 dividends received from corporations already taxed under the Act.[271] The ostensible justification for this exclusion was to avoid double taxation of

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such rights, duties and penalties, and in truth and fact just as much a person in contemplation of law as they.").

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

[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." See 26 CONG. REC. 6831 (1894). This was added after some discussion took place 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. *See* 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.").

[271] Act of Aug. 27, 1894, ch. 349, § 28, 28 Stat. 509, 554 ("*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.").

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, 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 $4,000.[277] Corporations, however, were permitted no such exemption under either the House or Senate versions of the bill. This meant that the integration of the corporate-shareholder income taxes was only partial. Corporations were subject to the income tax even if they had income of less than $4,000 per year and 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]

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[272] WALKER, *supra* note 73, at 65-66.
[273] Id. at 64.
[274] Id. ("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.").
[275] Such a connection would likely be made on an alternative ground, such as the efficiency-related concern of subjecting corporate and non-corporate income to the same tax burden.
[276] *See* Kornhauser, *supra* note 4, at 88; AMERICAN LAW INSTITUTE, *supra* note 9, at 38.
[277] Act of Aug. 27, 1894, ch. 349, § 27, 28 Stat. 509, 553.
[278] *See* 26 CONG. REC. 6865 (1894) (One Senator explained that if an individual makes a $3,000 profit from a $5,000 investment in a partnership, "that profit of $3,000 is not taxed, as the individual is entitled to an

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, "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 cooperative 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 that "[w]e 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

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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.") (statement of Sen. Hill).

[279] *See, e.g.*, Kornhauser, *supra* note 4, at 88. This view may be buttressed, in part, because of 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 $1,000 to receive a refund for amounts withheld from dividends).

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

[281] Id. at 6876 (statement of Sen. Aldrich).

[282] Id at 6874. *See also* id. at 6868 (1894) ("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.") (statement of Sen. Allison).

[283] *See* MANUEL IRWIN KUHR, THE SPEAKING CAREER OF GEORGE GRAHAM VEST 313-14 (unpub. Ph.D. dissertation, University of Missouri, 1963).

import tax as does the individual, then the exemption should apply."[284] 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]

This 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

[284] 26 CONG. REC. 6866 (1894). *See also* id. at 6879 ("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."). Earlier, Senator Vest explained the consumption argument by stating that "it 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. Does that rule apply to corporations? Does the corporation eat anything? Does it drink anything?" *See* id. at 6866.

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

[286] KUHR, *supra* note 282, at 309. *See* 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 282, 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 (statement of Sen. Vest) ("We are told now that liberty lies bleeding on 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

arguments, however, such as the fact that the corporations received privileges unavailable to individuals,[289] were based on a grant or concession theory that had supposedly lost its force amidst the spread of general incorporation statutes.[290] Still other arguments, such as the difficulty administering a more broadly applicable individual exemption,[291] were unrelated to the entity theory rationale. Not surprisingly, the spokesmen for 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 is 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 would have provided a $4,000 exemption to corporations and another would have exempted from the corporate tax the share of

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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] *See, e.g.*, 26 CONG. REC. 420 (1894) (statement of Rep. McMillin) ("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 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 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.").

[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, which 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 $4,000 exemption amount when combined with all of the shareholder's other sources of income).

[292] *See* 26 CONG. REC. 420 (1894) (statement of Rep. McMillin) ("if 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."); id. at 6883 (statement of Sen. Vest) ("I am here as the organ of the committee. I have no personal discretion in the matter. . . .[a]ll 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.").

[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 (variant on the $4,000 exemption);

dividends owed to individuals with total incomes below the $4,000 exemption.[294] The former appeared to support an entity and the latter an aggregate view of the corporation. Despite such stark contrast in their apparent theoretical underpinnings, both amendments were defeated by similar 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 that the exemption issue was both less significant and closer to resolution than others have implied. It was thought to be of less significance because few honestly believed that many taxpayers would suffer from the failure to track the exemption to cover corporate profits. Few taxpayers with income less than $4,000 held 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,

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id. at 6868 (exempting all corporations with a capital of less than $100,000 from the tax altogether); id. at 6875 ($3,000 exemption); id. at 6878 ($1,000 exemption).

[294] *See* 26 CONG. REC. 6867 (1894) ("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."); id. at 6883 ("there 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] *See, e.g.*, 26 CONG. REC. 6867 (1894) (statement of Sen. Vest) ("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?").

[296] 26 CONG. REC. 6882 (1894) (reporting the defeat of the individual exemption amendment); id. at 6883 (reporting the defeat of the corporate exemption amendment)..

[297] 26 CONG. REC. 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." 26 CONG. REC. 1739 (1894) (statement of Rep. John Sharp Williams).

Some senators may have also believed that the Service the would in practice alleviate the "injustice" in their collections from individuals. During the Civil War and Reconstruction, the Service directed its

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

Ultimately, the problem with 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. It is this history, as much as the legislative history of the 1894 Act

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collectors to obtain the extra amount due from shareholders whose income tax rates exceeded the tax imposed on corporations. *See supra* text accompanying note 23. 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 both 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 (1971) (party affiliations).

[299] Sen. David Hill of New York was the lone Democrat dissenter on the income tax. *See* KUHR, *supra* note 282, at 308.

[300] Id. at 311.

[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. Under the latter purpose, the corporation would be on 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 19th century, *see* text accompanying notes [118-143], 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 pass-through, taxation of the corporation. Kornhauser, *supra* note 4, at 87.

itself, which 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 that 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. 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 then discarded the dividend tax used in the 1864 Act and again in the House bill in favor of a corporate income tax. The following examination of each of these changes and its underlying history, however, suggests that the 1894 Act's taxation of corporate income is a great deal closer to the 1864 Act's approach than most observers have assumed. 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 the 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 5% tax on all dividends and undistributed sums of companies in the transportation, banking, and insurance industries.[303] By contrast, in 1894, the 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," have implied 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 has commonly been assumed and the similarities between the two acts become more striking.

1. Property taxation and the "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' wealth was in tangible

[302] Act of June 30, 1864 at § 117, 13 Stat. at 282.
[303] Id at § 120-22, 13 Stat. at 283-85.
[304] 26 CONG. REC. 6831 (1894).

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]

This increase in the value of intangible property was primarily attributed to the growth in the corporation.[308] While some of the intangible wealth was surely 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. Clifton Yearley explained that "[b]y 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]

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[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* 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 perhaps as much as double the value of all real property).
[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.

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 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

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[311] *See* ELY, supra note 306, 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."); 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) ("the 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."); 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).

[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] YEARLEY, *supra* note 252, at 39-41; ELY, *supra* note 306, at 144. Yearley, quoting from an 1881 article in *The Nation*, noted that, "[a] few farmers 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.*, Report of John A. Wright, *supra* note 300, 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 the State of Pennsylvania."); 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.").

[315] *See* ELY, *supra* note 306, 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

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 instance, only 8,900 individuals out of 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 more than $1.2 million.[320] Few believed the decline was attributable to an actual drop in value.[321]

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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*, PUBLICATIONS OF THE MICH. POL. SCI. ASS'N 49 (1894). *See* 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" studied.).

[317] Jarvis, *supra* note 311, 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 citizenry and produce the lowest possible tax burden relative to other areas of the state. *See* Adams, *supra* note 315, at 55 (describing the system of local assessment); QUINCY, *supra* note 72, at 6.

[318] YEARLEY, *supra* note 252, at 43.

[319] Charles F. Dunbar, *The New Income Tax*, 9 Q. J. ECON. 26, 35-36 (1894) (*quoting* REPORT OF THE TAX COMMISSION OF OHIO OF 1893, p. 42).

[320] Adams, *supra* note 315, at 56 (*quoting* Edwin Seligman, *The General Property Tax*).

[321] *See* 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"); Benson, *supra* note 310, at 53 ("the absolute decline in personal property assessment and the relative

2. Tax evasion and anti-corporate sentiment

While tax evasion involving intangible assets was widespread across different classes of taxpayers and categories of property, corporate shareholders were on every legislator's "Most Wanted" list for such abuse. Investors often either failed to list corporate securities among their assets, or, if they did list them, they seriously understated the value of such securities. 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 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 $5,000 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 it 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]

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decline in the role of personal property were clear signs that assessment practice did not reflect changes in the national economy. . . . Clearly, many citizens, when faced with a tax list on which they were to report all of their personal property, simply did not display the same spirit of idealism that had prompted the adoption of general property tax requirements.").

[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 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 300, at 132.

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

In states where the tax was primarily targeted at the source of the 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 with 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 has been bought like cattle 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 to charges that corporate wealth failed to bear its fair share of the tax burden.

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[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, April 12, 1882, at 2.
[328] *See* JAMES H. COLEMAN, LETTERS &C. ON CORPORATIONS AND TAXATION 2 (date unk. (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.
[330] YEARLEY, *supra* note 252, at 61 (paraphrasing the words of Rev. Henry Ward Beecher).
[331] *See* 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."); Edward C. Moore, Jr., *Corporate Taxation*, 18 AM. L. REV. 750, 752

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 of such evasion, Cornelius Vanderbilt's New York Central Railroad, which claimed to have capital of $143 million in its financial documents, paid taxes on only $22 million of it by double deducting its indebtedness.[334] In another example, the Western Union Telegraph Company, by 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 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 widespread feeling that corporate bodies are the natural enemies of the people."[337] It became popular to call on state legislatures to collect all of their revenues from corporations.[338]

(1884) ("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."). 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." Id. at 80-81.

[333] YEARLEY, *supra* note 252, at 60.

[334] Id. at 62; COLEMAN, *supra* note 327, 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 327, at 9.

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

[337] Moore, *supra* note 331, at 751. *See Current Events – The Growth of Corporate Organization*, 20 CENTRAL 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.*, Adams, *supra* note 315, at 58 ("the chief source of revenue to the states should be from the corporation tax. . . . [Since] the states do not expend more than $140,000,000 annually, their demands could be easily met by a corporation tax."); Bolton Hall, *in* EQUITABLE TAXATION 58 (1892) (describing the governor of New York's recent expression of hope that all expenses could be met through the taxation of

3. State targeting of corporations for special taxation

The combination of this anti-corporate 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 to target certain industries dominated by corporations by 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 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

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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.'").

[339] *See* 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 315, 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."); ADAMS, *supra* note 324, 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.").

[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 to cover all forms of tangible and intangible property. *See* Benson, *supra* note 310, at 63.

[341] *See* Id. at 143-166 (discussing the various attempts to target each industry with something other than the general property tax); CADMAN, *supra* note 176, at 389 (In New Jersey, there were "certain 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."). Not surprisingly, the majority of businesses incorporated during this period operated in one of these industries. HURST, *supra* note 106, at 17.

[342] Id. *See* FRIEDMAN, *supra* note 212, at 28-32 (describing Massachusetts' tax on savings banks as a an excise on the privilege of operating in corporate form).

[343] Moore, *supra* note 331, at 754.

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 industries.[346] The taxation of corporations in some industries, while 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 taxing industries to taxing corporations.[348] Industry-specific

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[344] Walter E. Weyl, *in* EQUITABLE TAXATION 21 (1892) (Weyl, a 19-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 324, at 449-50.

[346] *See* Adams, *supra* 315, at 65 (statement of Mr. Cutcheon as part of the discussion after delivery of 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] *See* Id. at 207 ("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.").

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 those in industries governed by other provisions.[353] Similarly, a special revenue commission in Iowa recommended to the Legislature in 1892 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 corporation taxation such as the tax on a corporation's capital stock. The problem was that a corporation's capital stock was not

[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.
[353] Seligman, *supra* note 138, at 301-02.
[354] HERRIOTT, *supra* note 339, 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.

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 the equity, rather than the 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 corporation taxes based upon earnings, business transacted, dividends, and profits or income.[358] The trend was away from the taxation of corporate property and toward the taxation of corporate income.

Thus, the corporate income tax 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

[355] *See* JACOB 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 452.

and earnings."[359] While states might have also 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 the 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 alternative was the consumption-based tariff and excises taxes then in use. 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

[359] ADAMS, *supra* note 324, at 441-42.
[360] YEARLEY, *supra* note 252, at 226.
[361] CONG. GLOBE, 37th Cong., 1st Sess. 306 (1861) (statement of Schuyler 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 or personal, and consequently the owners of personal estate that amounts to such a large proportion of aggregate wealth of the United States ought not be wholly exempt from the direct tax." CONG. GLOBE, 38th Cong., 1st Sess. 2631 (1864) (statement of Sen. Davis). *See* id ("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.").
[362] RATNER, *supra* note 26, at 64-65.
[363] CONG. GLOBE, 37th Cong., 2d Sess. 2350 (1862) (statement of Senator Simmons).

the income tax' 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. . . . in 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 intention was to focus on the industries in which the largest corporations operated and leave shareholders in corporations where the traditional methods of taxation were adequate to be covered by the general income tax provisions.[369]

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[364] 26 CONG. REC. 6804 (1894) (statement of Sen. Hill).
[365] RATNER, *supra* note 26, at 67.
[366] 26 CONG. REC. 6832 (1894) (statement of Sen. Allison).
[367] Id.
[368] HOWE, *supra* note 202, at 103.
[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.").

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] Thus, the application of the tax to corporations rather than specific industries was a product of the spread of the corporations 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-prong approach for 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

[370] 26 CONG. REC. 6866 (1894) (statement of Sen. Vest).
[371] *See* SELIGMAN, *supra* note 125, at 166 (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.").

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 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 the reliance on stoppage-at-the-source methods of collection. Rather than reflecting a change in the understanding of the corporation vis-à-

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[372] 26 CONG. REC. 6831 (1894).
[373] Act of June 30, 1864 at § 117, 13 Stat. at 282.
[374] Act of June 30, 1864, ch. 173, §§ 120-22, 13 Stat. at 283-85.
[375] Id. at § 120, 13 Stat. at 283.
[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 discounted this concern, usually by neglecting to take into account the value of tax deferral. *See* Moore, *supra* note 331, at 764 (suggesting that this is less of a problem than might otherwise be thought because of the taxation upon eventual distribution).
[378] In fact, the shareholder undivided profits provision was effectively designed to address the same concern. *See* SELIGMAN, *supra* note 125, at 197 ("it 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.").

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 "tax resistance," rather than tax evasion, because it represented the combination of an anti-government political ideology and a successful economy in which government spending appeared to only minimally 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

[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 (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 10-15%, but still fell far short of ensuring fair and complete reporting. Id. at 42.

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 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]

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[386] Id. at 41-42.
[387] Seligman, *supra* note 204, at 646. One contemporary commentator reported that "[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 301 (describing system of local assessment).
[389] Adams, *supra* note 315, at 55.
[390] YEARLEY, *supra* note 252, at 46-47.
[391] Id. at 48-49.
[392] Id. at 49.
[393] *See, e.g.*, CONG. GLOBE, 37th Cong., 2d Sess. 2486 (1862) (statement of Sen. Chandler) ("But the 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."); id, 38th Cong., 1st Sess. 1940 (1864) (statement of Rep. Morrill) ("I believe the result of this differential system of duties upon men of large

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, "[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 law?"[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,

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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.").

[394] Dunbar, *supra* note 318, 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 211, 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. *See* Hill, *supra* note 18, at 444-45 ("In 1866 there was a marked falling off in 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."); YEARLEY, *supra* note 252, at 228 (the number of returns filed fell from 460,000 in 1866 to 72,000 in 1872).

[398] *See e.g.*, CONG. GLOBE, 41st Cong., 3rd Sess. 720 (1871) (statement of Sen. Scott) (the income tax "is unjust, unequal, inquisitorial, and unconstitutional."); CONG. GLOBE, 42d Cong., 2d Sess. 1737 (1872)

gossiping 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 lightening 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

(statement of Rep. Rice) (decrying "[t]he cries of 'espionage' and 'inquisitorial' that have been rung, with all their changes, from 1863 to the present" because they apply equally to many existing forms of taxation).

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

[400] Id.

[401] *See* Hill, *supra* note 18, at 436 ("in 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."); Wells, *supra* note 398, at 8 ("one 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 398, at 8.

[404] PAUL, *supra* note 211, at 24 (*quoting* Butler).

Enforcing 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 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 reason for the trend away from a shareholder undivided profits tax was the difficulty 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 yet 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

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[405] *See* SELIGMAN, *supra* note 125, at 197 ("some commonwealths have even sought to obviate the supposed difficulty by providing that the tax should apply to dividends, whether declared or merely earned and not divided.").
[406] KINSMAN, *supra* note 146, at 50-51 (*quoting* Acts of the General Assembly of the Commonwealth of Virginia, 1869-70, ch. 189, sec. 16).
[407] Id. at 56.
[408] SELIGMAN, *supra* note 125, at 198-99.
[409] WILLIAM WALLACE HEWETT, THE DEFINITION OF INCOME AND ITS APPLICATION IN FEDERAL TAXATION 81 (1925).
[410] 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

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, "[h]ow is the corporation to settle with each individual stockholder in making up 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 to 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

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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* SELIGMAN, *supra* note 46, at 444; LANGENDERFER, *supra* note 24, at 509.

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

[413] HEWETT, *supra* note 408, at 41.

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

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 partnership earnings in advance of such divisions of profit.[417] By contrast, under state corporate 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

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[415] Dunbar, *supra* note 318, at 38. *See* Moore, *supra* note 331, at 762 ("To assess all corporate taxes to the corporation instead of 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 FORMS AND DIRECTIONS FOR ALL TRANSACTIONS 232-33 (1871) (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* H.W.R., *Dividends*, 9 CENT. L. J. 162, 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."); 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."). 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.*, 22 COMM. & FIN. CHRON. & HUNT'S MERCHANT MAG. 11 (Jan. 1, 1876) (compilation of recent dividends announced by corporations in the railroad, banking, and insurance industries); Id. at 41 (Jan. 8, 1876) (Annual Report for New York Central & Hudson Railroad, including a description of dividends paid); 40 COMM. & FIN. CHRON. & HUNT'S MERCHANT MAG. 59 (Jan. 10, 1885) (Annual Report for the Buffalo, New York & Philadelphia Railroad, including a description of dividends paid); Id. at 19 (Jan. 3, 1885) (compilation of recent dividends announced by corporations in the railroad, banking, insurance, and other miscellaneous industries).

income tax were thus avoided. Thomas Cooley, in his *Treatise on the Law of Taxation*, explained that "[t]axes on dividends 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 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 non-corporate entity, was a uniquely appropriate target for the imposition of the 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

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[420] THOMAS M. COOLEY, A TREATISE ON THE LAW OF TAXATION 22 (1876).
[421] Wilson, *supra* note 425, at 7.
[422] Wells, *supra* note 398, at 4-5.
[423] Id.; SELIGMAN, *supra* note 125, at 203.

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 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 only eliminated the return requirement for those

[424] *First Annual Message, in* A COMPILATION OF THE MESSAGES AND PAPERS OF THE PRESIDENTS, 1789-1897 434, 460 (1899).
[425] RATNER, *supra* note 26, at 174 (*quoting* TREASURY REPORT 83 (1893)).
[426] William L. Wilson, *The Income Tax on Corporations*, 158 N. AM. L. REV. 1 (1894).
[427] Id. at 7.
[428] Id.
[429] McCrea, *supra* note 308, at 493-94.
[430] RATNER, *supra* note 26, at 174-75.

individuals with non-dividend income of less than $3,500,[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 it is this language that 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, 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

[431] *See* Dunbar, *supra* note 318, at 41 (noting that the corporate tax did not exempt a considerable number of individuals from filing a return).
[432] *See* Dunbar, *supra* note 318, at 41 (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 that barred 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. at 556. *See* Yin, *supra* note 86, at 146.
[435] *See supra* text accompany notes 325-30.

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, 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 non-existent markets, dividends served the important functions of setting a market valuation and 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]

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[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, CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED PARTNERSHIPS: CASES AND MATERIALS 382 (4th ed. 1990).
[439] BASKIN & MIRANTI, *supra* note 241, at 18-19.
[440] *See* 26 CONG. REC. 6869 (1894) (statement of Sen. Allison).

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 following 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 that simplified, rather than replaced, 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]

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[441] 26 CONG. REC. 6873 (1894) (statement of Sen. Hill).
[442] Id. at 6866 (statement of Sen. Vest).
[443] Id. at 6880 (statement of Sen. Chandler) ("the Senator from Missouri seems to have thought that he could roll all those sections into one" by imposing an income tax).
[444] This was something that corporations and shareholders had already undertaken to do 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.

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] Thus, 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 on "The Taxation of Corporations," first published in 1890, that "[i]t

[445] 26 CONG. REC. 6869 (1894) (statement of Sen. Allison) ("We did not undertake to tax corporations as respects their income in 1864 and 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 turned on their stockholders, and were authorized to deduct from bonds and from stock as well.").
[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 of these potential problems was the awkward definition of "net income" as "income above ordinary working or operating expenses." *See* 26 CONG. REC. 6881 (1894) (statement of Sen. Chandler).

is generally assumed that the tax on the corporation is a tax on the shareholder or bondholder."[449] Assuming that a 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 as a tax upon the shareholders.[452]

Thus, far from evidencing 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 of the 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 in 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] *See* WALKER, *supra* note 73, at 67 ("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.").
[452] Id. at 64-65.
[453] 26 CONG. REC. 6880 (1894) (statement of Sen. Chandler) ("never, 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.

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 269-70 ("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 308, at 493 n. 1 (*quoting* REPORT OF THE WISCONSIN STATE TAX COMMISSION (1903)).

[457] 44 CONG. REC. 3344 (1909) (message from President Taft). He also spoke of "another 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. *See also infra* text accompanying notes 448-49 (discussing Prof. Kornhauser's argument that the 1909 Act was prompted in part by the desire to regulate corporations).

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 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, 158 U.S. at 635-37 (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. *See 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*, TAXATION OF CORPORATIONS: PART III – EASTERN CENTRAL STATES 3 (July 31, 1911) ("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,

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] Regardless of its original premises, Congress set a precedent for straying from the 1894 Act's original vision by viewing the corporate and individual income taxes as discrete rather than complementary taxes.

IV. Conclusion

The shareholder focus of the original corporate income tax challenges the traditional justification for double taxation. Under the entity theory explanation, the simultaneous and "double" taxation of shareholder and corporation is quite logical since the two are separate taxpayers. Congress could choose to alleviate the burden of this taxation as a matter of economic policy, but it would not be inequitable as a matter of tax policy to choose not to do so.[461] By contrast, under the shareholder income tax explanation, imposing a tax directly on the corporation is simply a more convenient and efficient way of taxing the shareholder on his or her corporate income. Corporate income tax makes sense only in the absence of a shareholder tax.

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except in so far as that property and that business differ from those of natural persons, should be taxed with no exceptional machinery.").

[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* 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.").

Perhaps more importantly, the historical evidence that the corporate tax was designed to enforce the individual income tax provides an important basis for distinguishing among the various recent proposals to integrate the corporate and shareholder-level taxes. While it is beyond the scope of this paper to comprehensively survey the benefits or detriments of such proposals, a brief review is warranted to determine which proposal is most faithful to the original understanding. By focusing on the corporate tax's role in the operation of the individual income tax, we may weed out those proposals that address only the symptoms of double taxation and focus on those that get at the root of the problem.

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.[462]

Standing alone, all of these methods are either over or under-inclusive with respect to the continuing role of the corporation in enforcing the individual income tax. Each of the first three methods has an historical precedent (or at least an ancestor) at the

[462] *See generally*, AMERICAN LAW INSTITUTE, *supra* note 14, at 3-4; Graetz & Warren, *supra* note 2, at 1769.

federal level, but this lineage does not necessarily establish that the proposals are faithful to the original understanding.

The first method is essentially the conduit method now in use for partnerships and originally applied to corporations as well in the 1864 Act.[463] It was replaced with a stoppage-at-the-source principle in the 1894 Act in part because of the tax evasion and complexity associated with the shareholder allocation method.[464] While it is not clear that those difficulties are insurmountable today, it is clear that the difficulties are still fairly significant for large and complex corporations such as those that have publicly-traded shares. Thus, this method would reintroduce the complexity and potentially the tax evasion Congress sought to prevent with the adoption of the corporate income tax in 1894.

The second method could be structured as a form of withholding tax similar to the one applied for taxable businesses under the 1862 and 1864 Acts and in the 1894 House bill.[465] This was effective when the corporation commonly distributed all or nearly all of its earnings in the form of dividends each year. In an era of retained earnings, however, a pure withholding tax is no longer sufficient because of the delay in taxation between the corporation's earning of its income and the distribution of such income to the shareholders as a dividend. Furthermore, proposals for a shareholder credit or dividend deduction assume the corporate income tax remains in place for all corporations. This

[463] *See supra* text accompanying notes 36-39.
[464] *See supra* text accompanying notes 372-431.
[465] *See supra* text accompanying notes 27-30, 40-42, 65-67. The shareholder credit is roughly equivalent to the corporate deduction for dividends paid depending upon how they treated dividends paid to tax-exempt or foreign shareholders. *See* Graetz & Warren, *supra* note 2, at 1769 n. 6.

method, therefore, is the farthest from the original shareholder proxy understanding of the corporation because it presumes the corporation is a legitimate taxable entity.[466]

The third method was adopted in the 1894 Act and in the first post-16th Amendment income tax acts.[467] Excluding corporate dividends from income would require the least change to our existing corporate income tax structure. As with the withholding methods, however, the corporate income tax is the primary tax under this method and the focus is on the corporation rather than the shareholder. Thus, it overtaxes the shareholder who would otherwise pay taxes at a lower rate if corporate income were attributed directly and it undertaxes the shareholder who would otherwise pay taxes at a higher rate if corporate income were attributed directly.

Finally, the fourth method, the mark-to-market or annual valuation approach, has not been attempted as a method of reaching income from corporate investment. Because it would involve providing an exception to the realization requirement for corporate shareholders, this proposal has never gained political momentum despite its popularity among academics.[468]

Although the primary proposals are individually problematic, the shareholder proxy rationale may provide a basis for combining these approaches. For example, the mark-to-market method might be impractical if applied to all corporations, but in the public corporation where shares are easily valued, the mark-to-market method could replace the corporate income tax as a proxy for shareholder income. In the private corporation, where shares are illiquid and difficult to value, the corporate income tax

[466] See Joseph M. Dodge, *A Combined Mark-to-Market and Pass-Through Corporate-Shareholder Integration Proposal*, 50 TAX L. REV. 265, 291 (1995) (suggesting that the dividend deduction method "presupposes . . . that the corporation is a meaningful taxable entity.").
[467] *See supra* text accompanying notes 76-77, 84-85.

could either be abandoned in favor of a shareholder allocation method or, if that was not feasible, it could be reconceived as a withholding tax through the adoption of a shareholder credit or corporate deduction for dividends paid. The result would be that the corporate income tax would still be utilized in the private corporation, but it would be discarded for the public corporation.

This compromise solution could be further refined by replacing the corporate income tax for private corporations with a revival of the corporate undistributed profits tax briefly enacted during the New Deal. As originally proposed by President Roosevelt in 1936, the undistributed profits tax would have replaced the corporate income tax and imposed a tax at the corporate level on only those earnings retained by the corporation and not distributed and taxed to the shareholders as dividends.[469] Although such an undistributed profits tax would be an imperfect proxy for the modern individual income tax because of the difficulty of matching the undistributed profits tax to the rates of the individual shareholders, it would still be markedly closer to the original ideal of the corporate income tax.[470]

The shareholder-focused explanation for the corporate income tax does not preclude other, non-tax related, goals that may justify continuing the tax. Professor Marjorie Kornhauser, in her study of the adoption of the Corporate Excise Tax in 1909, concluded that the tax "reflect[ed] the Progressive Era's attempts to regulate

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[468] Graetz & Warren, *supra* note 2, at 1769. *See generally* Dodge, *supra* note 466, at 265 and Michael S. Knoll, *An Accretion Income Tax*, 49 STAN. L. REV. 1 (1996) for variants on this proposal.

[469] *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 (suggesting same). For a variety of reasons, primarily relating to uncertainty about revenue, the 1936 Act compromised by imposing the undistributed profits and shareholder dividend taxes while retaining the corporate income tax. GEORGE E. LENT, THE IMPACT OF THE UNDISTRIBUTED PROFITS TAX 1936-1937 20-21 (1948).

[470] *See* Rebecca S. Rudnick, *Corporate Tax Integration: Liquidity of Investment*, 42 TAX NOTES 1107, 1113 (1989).

corporations."[471] By establishing a means of federal oversight, proponents of a corporate income tax at the turn of the century expected that the corporate tax would have the additional benefit of exerting a "salutary" influence on corporations.[472] While it is unclear to what extent it has had this effect, or to what extent we should continue to use the Internal Revenue Code to regulate state law corporate governance issues,[473] the maintenance of the corporate income tax potentially could be justified on such alternative grounds.

The bottom line is that we should retain the corporate income tax where it is still necessary to enforce the individual income tax and abandon it where it no longer serves that or some other purpose. The traditional explanation for the origins of the corporate income tax has long clouded discussions of the merits of a corporate-level tax. Rather than conceiving of integration as a process by which we minimize the effects of double taxation with the least amount of disruption to our dual system of taxing business entities, integration should be a process of streamlining the individual income tax system. The corporation is only a servant to that system – a servant of diminishing usefulness.

[471] Kornhauser, *supra* note 4, at 53.
[472] Wilson, *supra* note 425, at 7.
[473] *See* Steven A. Bank, *Devaluing Reform: The Derivatives Market and Executive Compensation*, 7 DEPAUL BUS. L. J. 301, 332 (1995) (critiquing Congress' attempt to limit executive compensation by restricting deductibility under § 162(m)).