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CORPORATIONS, SOCIETY AND THE STATE: A DEFENSE OF THE CORPORATE TAX

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ABSTRACT

This article attempts to provide the first comprehensive rationale for defending the current corporate income tax. It argues that the usual reasons given for the tax (primarily as an indirect way of taxing shareholders, or alternatively as a form of benefit tax) are inadequate. It then explains what the original rationale to adopt this tax was in 1909, namely to regulate managerial power, and that this rationale stems from the "real" view of the corporation, which was the dominant view throughout the many transformations underwent by the corporate form from Roman times to the present. Turning to normative argument, the article then argues that the regulatory rationale given for taxing corporations in 1909 is still valid, since similar social conditions continue to exist, and in fact is strengthened by the rise of multinational enterprises. Finally, the article argues that this rationale is necessary from a normative perspective to support the fight against the two crucial current threats to the corporate tax posed by the corporate tax shelter and tax competition phenomena.

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CORPORATIONS, SOCIETY AND THE STATE: A DEFENSE OF THE CORPORATE TAX

"The power to tax involves the power to destroy"[2]
(John Marshall)

"The power to tax is not the power to destroy while this Court sits"[3]
(Oliver Wendell Holmes)

Corporations are everywhere and nowhere in our society. They are everywhere, first and foremost, on the economic scene: over 80% of economic activity in the US is effectuated through the corporate form. But the reach of corporations is far broader than that. Many of our other institutions, including universities, churches, hospitals, and other non-profit organizations are in corporate form. Other salient features of our society, such as representative democracy, originated from the use of the corporate form in medieval England. Even the idea of the state itself originated in Roman and medieval legal notions about corporate bodies.

And yet, corporations are nowhere. The leading academic theory about corporations, the nexus of contracts (or contractarian) theory, posits that corporations do not really exist: they are merely a convenient connection point for a bundle of relationships between shareholders, bondholders, employees, and customers, to name the most important stakeholder groups. And any useful academic analysis of the corporation must begin by denying its existence and looking through it directly at the various groups of people that interact through it. This is the "aggregate" view of the corporations that sees it primarily as the amalgam of its owners.

It was not always so. Around 1909, when the corporate income tax was first adopted, there were a variety of theories of the corporation, and some of them posited that corporations had a "real" existence separate from both shareholders and the state. Of course, the corporation itself was but a legal fiction, but corporate management was real, and the power that corporate management was able to exercise through use of the corporate form over employees, shareholders, and society at large was real as well.

The goal of this article is to examine the relationship among corporations, society and the state through the lens of the corporate income tax. The corporate income tax offers a unique opportunity to examine this broader issue because, first, it is one way in which the state intervenes directly in the affairs of corporations; and second, because various theories of why the

[2] McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316, 431 (1819).
[3] Panhandle Oil Co. v. Mississippi ex rel. Knox, 277 U.S. 218, 223 (1928).

corporate income tax exists illustrate the dichotomy between the “real” and “aggregate” views of the corporation. When the corporate tax was first adopted in 1909, the “real” view was dominant and the tax was conceived primarily as a device to regulate corporate management in relation to other stakeholders and the state. Today, on the other hand, the aggregate (nexus of contracts) view predominates, and so the tax is seen primarily as an indirect way of taxing shareholders.

The article is divided into five parts. Part 1 examines the current justifications for the existence of the corporate tax. Such an examination is needed first, because some academics and practitioners (including the former Secretary of the Treasury) dispute the need for a corporate tax, and second, because certain practical trends (primarily corporate tax shelters and tax competition) are eroding the existing corporate tax base, and it is hard to mount a convincing normative defense of the corporate tax against these trends without understanding why we need the tax in the first place. Part 1 concludes that the dominant current justifications for the tax are based on the aggregate model and are fundamentally flawed, and that current attempts to find alternative grounds for the tax are unconvincing as well.

Part 2 reconstructs the original reasons for the enactment of the corporate tax in 1909 and shows that it was based on a “real” theory of the corporation, and that the tax was viewed primarily as a regulatory device to limit the power of management. In that way it was different from an earlier corporate tax, the 1894 tax, which was viewed primarily as a way of taxing shareholders.

Part 3 broadens the historical perspective on the transition between the 1894 tax and the 1909 tax by placing it in the context of the larger debate among three views of the corporation- the aggregate view, the real view, and the artificial entity view (which sees the corporation primarily as an extension of the state). Part 3 shows that all three views can be traced back to the origins of corporations in Roman and Medieval law, and that all three views tend to run in cycles. Whenever there arises a significant shift in the relationship of corporations to society and the state, all three views tend to be brought forward, but the view that ultimately prevails tends to be the real view, and that view predominates in periods of stability in the corporation/society/state interchange.

Part 4 begins the normative part of the article by asking whether the original motivation of the corporate tax has any continuing force today. It argues that it does, both because the real view is a better approximation of reality than the aggregate view, and because managerial power is an issue that is still very much with us. In fact, the rise of multinational enterprises is a new shift in the relationship among corporations, society and the state that requires a similar re-examination of the relationship as took place in 1909, and the corporate tax

(extended internationally) can still play an important role in regulating that relationship.

Part 5 concludes by examining some of the policy implications of the above argument. In particular, it argues that the corporate tax should be retained and defended against both corporate tax shelters and tax competition. It also suggests that integration of the corporate and shareholder taxes, as partially adopted by Congress in 2003, is not necessary to prevent “double taxation”, although it may perhaps be defended on different grounds.

1. Current Justifications for the Corporate Tax.

The corporate income tax is under attack. The former Secretary of the Treasury has announced that it should be abolished, and the current drive to eliminate the taxation of dividends can be seen as the first step toward that goal.[4] A significant number of tax academics have argued for repeal of the tax.[5] Other academics have urged radical reform of the tax.[6] And no serious academic has in recent years mounted a convincing normative defense of why this cumbersome tax should be retained.[7]

This lack of a normative justification for retaining the tax is important for three reasons. First, the corporate tax is very complicated and imposes significant transaction costs on society. Many of the best-educated and most talented tax lawyers in this country devote their careers to the intricacies of Subchapter C.[8] Second, there is a widespread consensus among economists that imposing a tax only on certain business entities and not on others leads to significant welfare losses to society as the tax drives business owners away from their preferred form of organization.[9] In the absence of a good reason to have the tax, these two types of costs form a persuasive case for repeal.

Third, and perhaps most importantly, the corporate tax base is being eroded in practice. Revenues from the corporate income tax amounted to about a quarter of all federal tax revenues in 1965; today the tax accounts for less than 10% of revenues and that number is declining. There are two major reasons for this decline in revenues in recent years, and neither of them results from a conscious decision by Congress to reduce the tax.[10] The first is the growth of a corporate tax shelter industry, in which some of America's best minds scour the Code for ways to reduce corporate tax liabilities by various transactions and then sell these transactions for high fees to corporate clients.[11] Estimates

[4] Cite O'Neill, President's proposal.
[5] Dodge, Halperin, Polito.
[6] Bankman, Knoll, Chorvat, CBIT.
[7] See discussion of various partial defenses below. Some academics have defended the double tax on corporations (Kwall, Cummings, Chorvat, Schlunk), but that argument relates more to the question of whether the tax should be integrated, not whether it should exist in the first place. See also Yin, Polito for ways of implementing integration while keeping the corporate tax in place.
[8] See Slemrod & Blumenthal for an estimate of the transaction costs of the tax.
[9] See discussion of efficiency issues below- hard to estimate, but even after check the box some efficiency cost given public trading. See Goolsbee. Integration reduces but does not eliminate these welfare losses, because under most forms of integration there is still differential taxation of C corporations and other entities (compare CBIT).
[10] Corporate tax rates were higher before 1986, but the base was narrower, so that the 1986 tax reform act (which reduced the rate from 46% to the current 35%) actually raised taxes on corporations. However, the effective tax rates today are close to what they were before 1986. See Yin.
[11] See Bankman, Weisbach, Yin.

of the revenue loss vary, but there is a consensus that it is significant and that the IRS has so far not been able to stop it with the weapons at hand.[12] The second reason for the world-wide decline in corporate tax revenues is tax competition among countries to attract corporate investments, which has grown significantly in the last two decades.[13] This competition enables companies like Intel to pay no tax at all on its non-US income. The most recent manifestation of this trend has been inversion transactions, in which US-based corporations nominally move their headquarters to a tax haven like Bermuda. This type of transaction can result in a dramatic decrease in worldwide effective tax rates for the inverting corporation.[14]

The response to both of these trends has been an attempt by Congress and the IRS to combat corporate tax shelters domestically, and an attempt by international actors like the OECD and the EU to restrict harmful tax competition.[15] However, both of these efforts have been hampered by the lack of a convincing normative justification for the corporate tax. In the absence of such a justification, opponents of these efforts can portray them as a pure revenue grab, and supporters find it difficult to explain what is so bad about letting the corporate tax wither away as a result of taxpayer self help.[16]

In what follows, I will survey the existing, and to me unconvincing, attempts to justify the existence of the corporate tax.[17] These defenses can generally be divided into three types, which correspond to the three theories of the corporation adumbrated above.[18] The first and most common type is defenses that view the corporate tax as an administratively convenient device to collect tax on shareholders. This view reflects the currently dominant aggregate (contractarian, nexus of contracts) theory of the corporation as an amalgam of

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[12] The litigation record is mixed- see ACM, Compaq, UPS.
[13] Avi-Yonah, Roin.
[14] Avi-Yonah, Hines and Desai.
[15] See literature on tax shelters, tax competition.
[16] Shakow, Wither, C!; cf. Wolfman, Whither, C?
[17] A simple justification of the corporate tax might be as follows: The state has certain legitimate revenue requirements, part of which it must fulfill by taxation. Corporations have significant financial resources. Thus, the state is justified in taxing corporations to meet its revenue needs. This argument is similar to Willie Sutton's immortal response to the question why he robbed banks ("that's where the money is"). But it is clearly inadequate, because the state can fulfill its revenue needs in other ways (e.g., by taxing individuals more; the revenue raised by the corporate tax in developed countries is a sufficiently low percentage of GDP that it can easily be made up by raising individual taxes). This is particularly true for the U.S.; a very low VAT rate would more than make up for the corporate tax, and if the revenues are used for redistributive purposes might not be more regressive. The corporate tax would be more difficult to replace in Europe (with existing high individual income and VAT rates) and even more so in developing countries where it can amount to 25% of total tax revenues. [cite World Bank data], but not impossible. Therefore, a more elaborate justification of the corporate tax is required.
[18] For a fuller exposition of these three theories see Part 3. These theories are the standard ones described in the literature. See, e.g., Hager, Bratton, Millon, Phillips. Ultimately, they stem from the work of three great German 19th century jurists- Savigny (aggregate), Jhering (artificial entity), and Gierke (real entity). See Schane.

its shareholders. The second type of defenses views the corporate tax as payment for some kind of benefit conferred by the state. These defenses reflect the artificial theory of the corporation as owing its existence to the state. Finally, the third type of defenses relates the corporate tax to the relationship between shareholders and management and views it as a mechanism to regulate this relationship. These defenses are closest to the real view of the corporation as separate from both the shareholders and the state.

a. Aggregate Defenses of the Corporate Tax

The most common current defense of the corporate tax is based on the aggregate theory of the corporation in that it views the corporate tax as an indirect way of taxing the shareholders.[19] The argument goes as follows: If there were no corporate tax imposed, given that corporations are treated as separate legal entities from shareholders, individuals could shelter their income from tax by earning it through corporations.[20] This would result at least in deferral of the tax until a dividend is paid or the shareholder sells the shares, and might result in total income tax exemption if the shareholder holds the shares until her death and a step up in basis is available.[21] In addition, it is argued, collecting the tax from corporations rather than directly from shareholders has administrative advantages because there are fewer corporations than shareholders and because shareholders may be hard to reach (e.g., because they are foreign or tax exempt).

From this perspective, the corporate tax can be viewed as a withholding tax imposed on the shareholders at the corporate source of their income. In fact, that was the view of the tax when it was first imposed in 1894.[22] It naturally follows that shareholders should not be taxed again when dividends are distributed to them, just like employees receive a credit for taxes withheld from their paychecks by employers. There are a variety of ways to accomplish this goal, which has been named "integration." Under the recent proposal by the Bush administration, which is followed by many countries (and has been partially adopted by Congress), dividends should be exempt from tax when received by shareholders.[23] Alternatively, as in other countries, shareholders should get a credit for taxes paid by the corporation against their individual tax liability.[24] A third alternative that is rarely adopted but is also consistent with the aggregate view is to impose a corporate tax but permit corporations to deduct dividends from their corporate tax base, thus in effect eliminating

[19] Warren, Graetz, Musgrave, McLure.
[20] Gordon and MacKie-Mason; Bird.
[21] Section 1014; but estate tax.
[22] Bank.
[23] Graetz. See Part V for fuller discussion of integration.
[24] Warren, Vann. The main difference between the two methods is that under the first the corporate tax is final and thus no taxpayer pays tax at a rate higher than the corporate rate, while the second permits more progressivity. Note trend toward exemption.

the corporate tax to the extent profits are distributed to and taxed in the hands of shareholders.[25]

However, it is far from clear that there are no practical ways of taxing shareholders on corporate income without imposing a corporate level tax.[26] Corporations can for this purpose be divided into two categories- closely-held and publicly-traded. For closely-held corporations, the obvious solution is to tax shareholders directly on corporate income as it is earned, since it can easily be attributed to them (whether or not it is distributed). This is, in fact, the way most closely-held corporations are currently taxed in the US: They are either so-called "S corporations" or Limited Liability Companies (LLCs) that are treated as partnerships or sole proprietorships for tax purposes. In both cases, no corporate level tax is imposed, and shareholders are taxed directly on corporate profits as they are earned. It seems a simple matter to extend this treatment, which is currently elective, to all closely held corporations.[27]

Most of the corporate tax, however, is collected from publicly-traded corporations, and for those it is generally assumed that pass-through taxation is administratively not feasible.[28] However, precisely because they are publicly traded, a ready alternative presents itself to address the deferral problem: Taxing shareholders on a mark to market basis on the appreciation and depreciation of their shares. The usual objections to mark to market taxation are based on liquidity and valuation concerns, and neither of these is an issue for publicly traded shares: They are liquid by definition, and their value can be ascertained on a daily basis by opening the financial pages of any newspaper.

Mark to market or accrual taxation is the normative ideal of a Haig-Simons income tax, and many commentators support moving in that direction to the extent it is administratively feasible to do so.[29] Prof. Dodge has exhaustively explored and demonstrated the feasibility of mark to market taxation for shareholders in publicly traded corporations.[30] Moreover, this type of taxation also exists in practice: US shareholders in certain foreign corporations earning mostly passive income (Passive Foreign Investment Companies, or PFICs) are given the choice between either paying tax on the corporations' income directly (if the corporation agrees to furnish the necessary information, which usually applies only when it is closely held), paying tax on the shares on a mark to market basis, or paying an interest charge when they receive a

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[25] This alternative is rarely adopted because it does not easily permit collection of tax from foreign and tax exempt shareholders.
[26] In addition, it is not clear that the corporate tax in fact falls on shareholders as an economic matter- in some circumstances it may be shifted to consumers or labor. See incidence literature. But most economists assume the tax falls at least in part on shareholders in the long run.
[27] Yin.
[28] But see Polito.
[29] Shakow, Halperin.
[30] Dodge.

dividend or dispose of the shares.[31] A similar system could be applied to all publicly traded corporations.

Mark to market taxation is complex, and imposing tax on unrealized gains is likely to run into significant political opposition. But the costs of these administrative complexities are not likely to be larger than the costs imposed by the existing corporate tax in all its glory, and the political opposition needs to be offset against the political support of corporate management for repealing the corporate tax.[32] The adoption of the PFIC rules in 1986 shows that this solution is not politically unimaginable.

Finally, the other administrative advantages of maintaining a corporate tax should be addressed. It is indeed easier to collect tax from a few corporations than from many shareholders, but even if one assumes that one tax in fact substitutes for the other, this advantage needs to be offset against the many costs of having the tax.[33] The most convincing argument from this perspective is that a corporate tax is necessary when shareholders are hard to reach because they are tax exempt or foreign. A large percentage of corporate equity is in fact held by tax-exempts, but it is not clear as a normative matter why this kind of shareholders should be taxed on income they earn through corporations, but not on other income.[34] As for foreigners, it may be possible to tax at least large foreign shareholders on both dividends and capital gains through withholding.[35] In addition, maintaining the entire corporate tax just in order to reach foreign shareholders in a country like the US in which the large majority of shareholders are domestic seems like letting the tail wag the dog.[36]

Thus, the most common rationale for retaining the corporate tax, i.e., that it is necessary as an indirect way of taxing shareholders which is needed from a deferral and administrability perspective, seems to rest on shaky grounds. Both deferral and administrability issues can be resolved in other ways, such as pass-through taxation of closely-held corporations and mark to market taxation of shareholders in publicly-traded ones.

b. Artificial Entity Defenses of the Corporate Tax

[31] IRC 1291-1297.
[32] A separate issue is political opposition to corporate tax repeal, which is discussed below.
[33] Bird.
[34] The issue of "unfair competition" with taxable businesses can be addressed by imposing UBIT at the shareholder level.
[35] We do in fact tax most dividends, and many countries tax capital gains of large foreign shareholders.
[36] This is a stronger justification for developing countries in which the entire corporate sector is foreign owned and the corporate tax on such enterprises is a significant percentage of all revenues. For a defense of the corporate tax in that context see Avi-Yonah, Bird.

A second type of defenses link the corporate tax to some kind of benefit provided by the state, and thus treat it as a type of benefit tax.[37] The tax is conceived as a payment in return for the benefits of incorporation, such as limited liability. This line of defense is linked to the artificial entity view of the corporation, which views it purely as a creature of the state.[38]

There are several objections to this defense: First, some of the benefits conferred by government also flow to non-incorporated businesses, which are not subject to the tax. Second, the specific benefits of incorporation are provided by state government, not by the federal government. And finally, there is no correlation between corporate income and the benefits provided, since the same benefits apply (and in the case of limited liability, apply more forcefully) to corporations that lose money.[39]

A more sophisticated variant of the benefits theory is advanced by Rebecca Rudnick, who argues that the corporate tax can be justified as a payment for the greater liquidity afforded by access to the public equity market.[40] Under the current regime, there is a correlation between access to public equity markets and the corporate tax, which makes this analysis appealing. However, it is unclear whether there is any correlation between corporate income and liquidity; most publicly traded entities benefit from the same degree of liquidity but vary greatly in profitability. Rudnick argues that liquidity facilitates the creation of economic rents, and she would therefore revamp the tax to focus on these. Similarly, Joseph Bankman and Michael Knoll have proposed basing the corporate tax on changes in the value of outstanding corporate equity.[41] Such changes in the tax base would perhaps create a better link to liquidity, but they are not a defense of the corporate income tax we currently have in place. Similarly, Herwig Schlunk has proposed to substitute for the corporate tax an "entity tax" to be levied on all large entities (incorporated *vel non*) for the benefit of operating as a Coasian "firm."[42] This likewise is not a defense of the current corporate tax; in fact, Schlunk argues that no "colorable" defense of the tax exists.[43]

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[37] See, e.g., Musgrave, Bird. This was also part of the argument in favor of enactment in 1909, in which the tax was described as an excise tax on the privilege of doing business in corporate form, but this was done to avoid treating the tax as a direct tax that would be unconstitutional under the Supreme Court's 1895 Pollock decision. See below.
[38] See below for a fuller description of this view.
[39] Musgrave; Bird. Musgrave also argues that some benefits, such as limited liability, are costless to society and therefore cannot justify a tax (although I'm not sure he is right about limited liability having no costs).
[40] Rudnick.
[41] Bankman, Knoll.
[42] Schlunk, TLR. It is not clear why this is a benefit provided by the federal government. In fact, the inability to decide which government (if any) provides this particular benefit lies at the heart of the difficulty of allocating the income of multinational enterprises among tax jurisdictions. See Avi-Yonah, Arm's Length.
[43] Schlunk, 332.

Finally, the strongest benefits argument for the corporate tax is for a tax on foreign corporations doing business in a source jurisdiction.[44] In that regard, it has long been accepted that source jurisdictions may collect a tax from corporations doing business (above a certain minimal threshold) within their borders, because the host government created the market conditions that enable the income to be earned. There probably is some correlation between, for example, the quality of infrastructure or education in the host country and the degree of profitability of foreign direct investment in it.[45] However, as argued above, it seems strange in the US context to maintain the entire corporate tax just to collect a benefits payment from foreign corporations, since most of the taxpayers subject to the tax are domestic corporations.[46] And if one argues that the same benefits of infrastructure, education, police protection etc. also apply to domestic corporations, that is also true for non-incorporated or closely held businesses that are not subject to the corporate tax.

In sum, the artificial entity or benefits argument for the corporate tax is unconvincing because there is no correlation between the existing corporate tax and the kind of benefits (if any) that the federal government provides only to those entities that are in fact subject to the tax, namely publicly traded corporations.

c. Real Entity Defenses of the Corporate Tax

The view of the corporation as a "real" entity, separate from both its shareholders and from the state, has not had much resonance in the tax area. After all, as Richard Musgrave points out in his classic public finance textbook, a view of the corporation as a distinct entity with economic resources under its control is "hardly tenable" in the tax context because the economic burden of taxes must ultimately fall on natural persons, and there is no reason the income of those natural persons should be subject to a second level of tax simply because it is earned through a corporation.[47]

Nevertheless, there is one way in which the corporation clearly exists as a separate entity from the shareholders and the state, and that is as an organization under the control of corporate management. It is management who make the decisions on deploying the corporation's economic resources, and in that sense they can be regarded as the "real" corporation. This is particularly true for the publicly traded corporation in which ownership is (to use Berle and Means' famous phrase) separated from control.[48]

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[44] Of course, it is also easier politically to tax foreigners than to tax domestic corporations, and precisely for that reason tax treaties make it hard to discriminate against foreign corporations.
[45] Avi-Yonah, Structure and Electronic Commerce; Vogel.
[46] Which may be subsidiaries of foreign corporations.
[47] Musgrave.
[48] Berle & Means.

In recent years, a few academics have focused on the existence of corporate management and the agency cost problem it creates as a separate justification for the corporate tax. This line of argument is appealing because it applies only to publicly traded corporations that bear the brunt of the existing corporate tax.

Thus, Levmore and Tanaka argue that the corporate tax is necessary because otherwise the agency cost problem will be exacerbated when management (who may or may not be shareholders) face a different tax rate for corporate actions than some shareholders. For example, if management are shareholders and there is no corporate tax, they may face a tax rate of 35% upon selling a corporate asset while other shareholders are taxed at zero. Management may thus be deterred by their individual tax burden from taking actions that are in the best interests of all shareholders. With a corporate tax in place, all corporate actions face the same tax rate.[49]

This argument is unpersuasive, for several reasons. First, if we assume that the corporate tax is borne by shareholders, the same argument would apply even with a corporate tax- management who are taxable shareholders would ultimately face the double tax on dispositions while tax-exempt shareholders face only a single tax.[50] If the corporate tax is not borne by shareholders, then its existence *vel non* should have no impact on management actions. Second, if the Levmore and Kanda analysis is correct, it would apply to any positive corporate tax rate as long as it is imposed on all corporate level activity, so it would at best justify a minimal tax. Finally, it seems far-fetched to hang the entire corporate tax on this type of consideration. Agency cost problems are pervasive in any public corporation and it seems easier to address them by corporate law means rather than through the tax code.[51]

More recently, Mihir Desai has argued that imposing a corporate tax can be a way of preventing management from diverting corporate resources to their own pockets. Specifically, Prof. Desai argues that if corporate income must be declared for tax purposes, it becomes harder to conceal its theft from the shareholders as well.[52] This is an ingenious argument, which (as we shall see) also reflects some of the original intent in enacting the corporate tax in 1909.

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[49] Levmore & Tanaka; for a similar agency-cost based argument see also Snoe, who focuses more on the integration issue.

[50] If dividends are exempt (as under President Bush's proposal), then all shareholders face the same zero rate at the shareholder level whether or not there is a corporate tax.

[51] It also seems implausible if shareholders are taxed on a mark to market basis and the corporate tax is repealed that management would forego corporate actions that increase the value of the shares they hold just because they have to pay tax on that increase, since their job performance and the value of their stock options depend on share value. Levmore and Kanda seem to assume a pass-through model of taxation in the absence of the corporate tax, which is implausible for publicly traded corporations for administrability reasons.

[52] Desai.

However, from today's perspective, it seems like a shaky foundation for the entire corporate tax.[53] Management theft can be combated by other means, and a requirement to report income without tax (or with only a minimal tax) would do just as well to achieve the goal promoted by Prof. Desai.

Thus, there is currently no convincing defense of the corporate tax based on the real entity view either. Nevertheless, as explained below, this view of the corporation provides the best argument in favor of the tax.[54]

d. Summary

It thus seems that there is no convincing defense of the corporate tax in the academic literature. The mainstream view of the corporate tax as an indirect way of taxing shareholders, which is based on the aggregate theory, is flawed, because it is quite possible to tax shareholders directly without a corporate level tax. Alternative defenses of the corporate tax that are based on the artificial and real entity views are likewise unpersuasive. This leads some commentators to the conclusion that the corporate tax, with all its efficiency and complexity costs, should simply be repealed.[55] Other commentators favor letting the tax gradually disappear as a result of taxpayer actions.[56]

And yet it does not seem likely that the corporate tax will be repealed any time soon. Current proposals focus more on repealing the tax on dividends while retaining the corporate level tax, and even more radical reform efforts like the Flat Tax proposal would maintain a corporate level tax on above-normal returns.[57] When former Secretary of the Treasury Paul O'Neill announced that he favored repealing the corporate tax on the basis of his experience as a CEO, the proposal did not have any political traction. In the current political climate, demise of the corporate tax due to taxpayer self-help seems much more likely than actual repeal.

Why is the corporate tax so politically resilient? The reason seems to be the same as the reason the corporate alternative minimum tax was enacted in 1986- ordinary Americans have a viscerally negative reaction to the notion that large, profitable corporations should pay no tax while they bear the

[53] It may, however, have some application in countries like Russia, from which Desai draws most of his examples. In the case of his US example, however, which is Tyco, it should be noted that Tyco managers were ultimately caught by the criminal justice system, and that their behavior (stealing hundreds of millions of dollars from the corporation) seems rather extreme to base a defense of the corporate tax on.
[54] See Part 4, infra.
[55] See, e.g., Dodge.
[56] See, e.g., Goolsbee.
[57] The flat tax and other consumption tax proposals effectively exempt the normal return to corporate equity by permitting corporations to currently deduct all capital expenditures, but they retain the corporate tax for infra-marginal (above normal) returns. Proposals to repeal the income tax (including the corporate tax) and replace it with a sales tax seem less politically prominent, although the practical effect may be the same as he flat tax proposal.

income tax burden.[58] This is universally dismissed as an example of ordinary people's "fiscal illusion", the misguided belief that corporations bear the burden of the tax, while every economically literate person knows that taxes can only be borne by natural persons.[59]

But are people really that ignorant? I would argue that the answer is no, and that in fact what people perceive is closer to reality than the economic models of incidence would suggest. The corporate tax is imposed on corporate income, which adds to the economic resources of the corporation. These resources are managed by individual corporate managers, and their control over such resources gives them significant economic, social and political power. In that sense, imposing a corporate tax reduces the economic resources and therefore also the power of corporate management. Whatever the economic incidence of the corporate tax, from this perspective its most immediate burden falls on corporate management, and not surprisingly they are the strongest supporters of corporate tax repeal.[60]

This argument will be further developed in Part 4. In the meantime, however, it is useful to link it to another question- why was the corporate tax enacted in the first place? What was the "original intent" of its adopters, almost a hundred years ago? Examining this question can help us shed some light on the current debate. As we will see, a major reason for enactment was precisely to regulate and place limits on the power of corporate management.[61]

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[58] The corporate AMT was reacted in response to newspaper reports about GE and other large corporations paying no tax. See Chorvat and Knoll.

[59] Musgrave; Bird; Chorvat & Knoll. See Bank.

[60] Traditionally, they are much more lukewarm about dividend tax relief. In fact, corporate management has largely been responsible for the current classical (double) tax system, which they saw as a way to avoid higher corporate level taxes as well as pressure to distribute dividends. See Bank, Arlen & Weiss.

[61] The regulatory argument for the corporate tax is raised briefly but dismissed by Musgrave, who argued that regulatory aims can be more efficiently achieved by other means. For a discussion, see part 4.

2. A Historical Perspective: Why Was the Corporate Tax Enacted?

a. Antecedents: Aggregate-Based Taxation Before 1909.

The first federal income tax, enacted to raise revenues during the civil war, did not tax corporations, although a withholding tax was imposed on dividends and interest paid by railroad corporations and financial institutions, as well as on amounts added to surplus.[62] Instead, under the 1864 version of the tax, "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."[63] The civil war income tax thus included a form of pass-through taxation that applied to corporations, and the imposition of the tax on the undivided profits of corporations was specifically upheld by the Supreme Court.[64]

Pass-through treatment of corporate profits reflected the aggregate view of the corporation prevalent at the time.[65] It also reflected the fact that most corporations were small, closely held enterprises, and therefore (like today) it was relatively easy to identify the shareholders and to tax them on corporate profits. For those enterprises that were more widely held, like railroads, a withholding tax collected by the corporation effectively replaced the tax on the shareholder.[66]

The civil war version of the income tax was allowed to expire with the end of reconstruction in 1872. In 1894, after the financial panic of 1893 and the economic dislocation that followed, the Democrats in Congress were able to pass an income tax bill. The debate at the time focused on the protective tariff, which was the main source of revenue for the federal government. The tariff functioned as a highly regressive consumption tax, and benefited the manufacturing centers of the Northeast at the expense of the more agricultural South and West. The Democrats argued that relying solely on tariffs allowed

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[62] Act of July 1, 1862, ch. 119, sec. 81-82, 12 Stat. 432, 473. Shareholders and bondholders were permitted to exclude dividends and interest subject to withholding from income. Ibid., sec. 91, 12 Stat. 473-74. On the early history of the corporate tax in the U.S. see generally Steven A. Bank, Entity Theory as Myth in the Origins of the Corporate Income Tax, 43 William & Mary L. Rev. 447 (2001) ("Bank").

[63] Act of June 30, 1864, sec. 117, 13 Stat. 282. Under this act as well a withholding tax was imposed on dividends and interest paid by certain types of corporations and those dividends and interest were excluded from income. Id., sec. 120-122, 13 Stat. At 283-85.

[64] Collector v. Hubbard, 79 US (12 Wall) 1 (1870).

[65] See below; Horwitz.

[66] Note, however, that this was not a perfect replacement since the corporate rate was 5% with no exemption whereas the top shareholder rate was 10% with a $600 exemption. See Bank, 457-58. The decision to treat the withholding tax as the final tax in the case of widely held enterprises presumably reflected the practical difficulty of collecting tax on a pass-through basis in those cases. See Bank, 516-517.

the newly super-rich railroad, steel and sugar magnates to escape any meaningful tax burden. Their argument was further bolstered by the fact that the state level personal property taxes were notoriously ineffective in reaching intangible forms of property, such as stocks and bonds.

The 1894 Act for the first time imposed a tax of 2% on the net income of all "corporations, companies, or associations doing business for profit in the United States, no matter how created or organized, but not including partnerships."[67] At first impression this appears to be a stark departure from the civil war income tax, which taxed corporate income in the hands of the shareholders and only employed withholding at the corporate level as a collection device. However, Steven Bank has convincingly demonstrated that such a reading of the 1894 Act is misleading.[68] First, he points out that dividends from taxable corporations were excluded from shareholder income, so that the corporate tax could be viewed as a collection device for the shareholder level tax (imposed at the same rate).[69] Second, the House version of the 1894 Act followed the civil war income tax in imposing a withholding tax on dividends and interest, except that the tax was also applied to undistributed income and to all corporations.[70] Thus, the progression from the civil war income tax to the House bill to the final version of the 1894 Act can be seen as a gradual process of modifying what was fundamentally a withholding tax imposed on the shareholders.[71] Third, the Congressional debates on the 1894 Act show that the principal motive for the corporate level tax was to reach the shareholders, most of whom were precisely the kind of rich individuals who were able to escape the state-level personal property tax and whose corporations benefited from the high tariffs.[72] And finally, Bank points out that the norm throughout the latter half of the 19th century was for most corporations to distribute their net earnings out as dividends. In that context, imposing a withholding tax on dividends was the most effective way to tax shareholders in widely-held enterprises, and imposing the same tax on additions to surplus was merely another enforcement device to prevent accumulated income from escaping tax. By 1894, the withholding tax was transformed to a tax on all the income of the corporation (distributed or not), but was still seen primarily as a device to tax shareholders.[73]

Thus, throughout the 19th century, there was little evidence at the federal level of direct taxation of corporations as such. Withholding taxes were imposed at the corporate level on both distributed and undistributed income, but those

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[67] Tariff Act of 1894, ch. 349, sec. 32, 28 Stat. 509, 556.
[68] Bank, supra.
[69] Tariff Act of 1894, ch. 349, sec. 28, 28 Stat. 509, 554; Bank, 462. Integration was incomplete because corporations were not eligible for the $4000 exemption, but this can be explained by administrative convenience.
[70] 26 Cong. Rec. 6831 (1894).
[71] Bank, 504.
[72] Bank, 528-530.
[73] Bank, 530-31.

were seen as an indirect way of taxing shareholders, consistently with the aggregate view of the corporation.

b. The 1909 Act: A Real Entity Measure.

In 1895, the Supreme Court struck down the 1894 Act as an unconstitutional direct tax without apportionment.[74] The Democrats immediately made reinstatement of the income tax a major plank of their platform for the 1896 and 1900 elections, but to no avail. With the decisive victory of William McKinley (author of the notorious McKinley tariff of 1890) and his corporate allies in 1900, the income tax issue seemed dead.

The situation changed with the rise of the Progressives and the accession of Theodore Roosevelt to the White House in 1901. Roosevelt spent his seven years in office greatly expanding the powers of the federal government vis-à-vis corporations. He was the first President to attempt to use the Sherman Antitrust Act, adopted in 1890 but left largely unused until his time, to break up the great monopolies, such as John D. Rockefeller's Standard Oil Company. In addition, he established the Bureau of Corporations to assemble information on, and ultimately perhaps to regulate, corporations.[75] He also proposed that all corporations should be incorporated under the authority of the federal government.[76]

On the tax front, Roosevelt expressed support in 1907 (after another financial panic) for a graduated income tax, but supporters of the tariff within the Republican Party were able to delay consideration of the issue until after the 1908 election. The newly elected President Taft was less of a supporter of the income tax than his predecessor, and was worried about enacting another tax that will be found to be unconstitutional. However, he was also faced with increased support for the income tax in Congress and a possible split within his own party between Northeastern opponents of the tax and Midwestern supporters. Eventually, Taft proposed a compromise: Enact a corporate excise tax measured by income, which could withstand judicial scrutiny, and simultaneously submit an amendment to the constitution to permit enactment of an income tax.[77]

The legislative debate on the proposed tax was set in the broader context of the debate on tariff reduction. Opponents of tariff reduction, mostly from Northeastern states, viewed high tariffs as essential to protecting American industry, and argued that the benefits of such tariffs extend to ordinary workers as well as to captains of industry. Proponents of tariff reduction, mostly from the West and the South, argued that high tariffs raised the price

[74] Pollock.
[75] Act of Feb. 14, 1903, ch. 552, sec. 6, 32 Stat. 825.
[76] Kornhauser, Morris. See discussion below.
[77] Taft message.

of goods consumed by ordinary Americans to benefit the rich. They argued that an income tax was more progressive and was also better suited to the fluctuations in economic conditions (since income is more responsive to recessions than consumption).

Initially, it seemed likely that the tariff bill (named after its co-sponsors the Payne-Aldrich Tariff) would get enacted by the Republican majority in both houses. In the House, income tax proponents like Cordell Hull (D-Tenn.) were unable to attach an income tax amendment to the tariff bill. In the Senate, however, progressive Republicans like Robert La Follette (R-Wis.) and Democrats like Joseph Bailey (Tex.) were more effective in arguing for the income tax. La Follette and Bailey argued that since the rich benefited more than the poor from government protection, they should pay more for it, and that enacting the income tax would silence the "envious voice of anarchy" (socialism).

Ultimately, Sen. Nelson Aldrich (R.-R.I.), the main opponent of the income tax, realized that with nineteen Republicans threatening to join the Democrats and vote for the income tax, he might lose. In a crucial meeting at the White House, Aldrich and Taft agreed to support instead a corporate tax plus a constitutional amendment empowering Congress to levy the income tax, while maintaining high tariffs. Aldrich stated that "I shall vote for a corporation tax as a means to defeat the income tax."[78] This compromise ultimately passed the Senate 45-34 and the House 195-183, and was signed into law by the President on August 5, 1909.

The 1909 Act imposed "a special excise tax with respect to the carrying on or doing business" of 1% of net income over $5,000 of "every corporation, joint stock company or association organized for profit" under U.S. law, and every foreign corporation engaged in business in the U.S. Dividends from taxable corporations were excluded from corporate income.[79]

What was the rationale for the 1909 Act, which is the origin of our current corporate income tax? Proponents of the tax gave several reasons, including the benefits theory and viewing the corporate tax as an indirect tax on shareholders. However, as Marjorie Kornhauser has pointed out, a major motive for the act was to regulate corporations.[80] The principal vehicle for regulation was the filing of tax returns, which were to be made public. But more broadly, the tax itself fulfilled a potential regulatory function: It could serve as a vehicle to restrict the accumulation of power in the hands of corporate management.

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[78] 44 Cong. Rec. 3929 (June 29, 1909).
[79] Tariff Act of 1909, sec. 38, 36 Stat. 112.
[80] Kornhauser.

The various motives for enacting the corporate tax, which reflect the three theories of the corporation, can be seen in President Taft's message to Congress and in the debate that preceded enactment in the Senate. President Taft's message of June 16, 1909 gives three reasons for enacting a corporate tax (rather than a general income tax, which may be unconstitutional, or an inheritance tax, which did not have sufficient political support among Republicans in the Senate). The first reason is that "[t]his is an excise tax upon the privilege of doing business as an artificial entity and of freedom from a general partnership liability enjoyed by those who own the stock."[81] This argument is clearly based on an artificial entity view of the corporation as a creature of the state. However, Taft was aware that it is difficult to make this argument for a federal tax when the privileges enjoyed by the corporation derived from state law. The reason he made the argument nevertheless was that this formulation was necessary to ensure the tax's constitutionality, since the Supreme Court had upheld such an excise tax on sugar and oil companies in the Spreckles case.[82] Taft added that nevertheless the tax "accomplishes the same purpose as a corporation income tax."[83]

The second argument made by Taft was that the corporate tax "imposes a burden at the source of the income at a time when the corporation is well able to pay and when collection is easy."[84] The reference to collection "at the source" relates to the aggregate view of the corporation, since the tax is viewed as a withholding tax imposed on the shareholders (referred to at the time as "stoppage at source"). This is similar to the mainstream modern view of the tax, although the reference to the corporations' ability to pay (as opposed to the shareholders') has a real entity overtone. Taft probably did not emphasize the nature of the tax as an indirect tax on shareholders because that would have made it more suspect to the opponents of the income tax as well as more vulnerable to a constitutional challenge.

Instead, the principal reason Taft gave for enacting a corporate tax was the third one- that it will enable the federal government to exercise some degree of supervision, primarily by obtaining information about the business affairs of corporations. Taft devotes a whole paragraph of his message to this argument, much more than he gave to the first two. He stated that-

> Another merit of this tax is the federal supervision which must be exercised in order to make the law effective over the annual accounts and business transactions of all corporations. While the faculty of assuming a corporate form has been of the utmost utility

[81] 44 Cong. Rec. 3344 (June 16, 1909).
[82] Spreckles Sugar Refining Co. v. McClain, 192 US 397 (189-), cited by Taft in 44 Cong. Rec. 3344 (1909). This argument eventually succeeded in persuading the Court to uphold the corporate tax. [cite].
[83] Ibid.
[84] 44 Cong. Rec. 3344 (1909).

> in the business world, it is also true that substantially all of the abuses and all of the evils which have aroused the public to the necessity of reform were made possible by the use of this very faculty. If now, by a perfectly legitimate and effective system of taxation, we are incidentally able to possess the Government and the stockholders and the public of the knowledge of the real business transactions and the gains and profits of every corporation in the country, we have made a long step toward that supervisory control of corporations which may prevent a further abuse of power.[85]

This remarkable paragraph rests on the real entity of the corporation as separate from both the state and the shareholders. It identifies corporate management as the source of "abuses of power" and suggests that the imposition of the corporate tax will enable the government, the shareholders and the public to obtain information that will serve as the basis for restricting such managerial abuses of power. While the tax itself is incidental to the regulatory mechanism, this statement is important because it delineates a reason to tax corporations that is unrelated to the tax on shareholders or to the benefits conferred by the state. The tax is imposed on corporations because of the power exercised by corporate management, and management is clearly regarded as distinct from the shareholders (who will in fact be beneficiaries of the supervision over management actions).[86]

The same mixture of motives can also be seen in the Congressional debate over enactment. Proponents and opponents of the tax reflected all three theories of the corporation: Some viewed it primarily as a benefits tax, others primarily as a tax on the shareholders. However, the predominant strain in the debate was to view the tax as a regulatory device to restrict abuses of managerial power.

The artificial entity view of the tax was expressed primarily by those proponents who sought to defend it from a constitutional attack.[87] Sen. Root, for example, who was one of the main drafters of the bill, defended the tax in part as based on the privilege of limited liability.[88] Opponents, however, were quick to point out that since corporations were created under state law, the federal government had no right to tax them under an artificial entity view.[89]

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[85] Ibid.

[86] Similarly, in a letter dated June 27, 1909, Taft identified the publicity feature as a particularly important element of the tax, stating that "publicity gives a kind of federal supervision over corporations, which is quite a step in the direction of similar reforms I am going to recommend at the next session of Congress." Letter to Horace Taft, cited in Kornhauser, 99.

[87] See, e.g., 44 Cong. Rec. 4237 (July 7, 1909) (Sen. Daniel).

[88] 44 Cong. Rec. 4006 (July 1, 1909).

[89] "The United States did not create these corporations" (Sen. Cummins, 44 Cong. Rec. 3977 (June 30, 1909)).

In addition, opponents pointed out that unincorporated businesses obtained from the federal government the same benefits as corporations.[90]

The aggregate view was advanced by proponents who argued that the corporate tax was an indirect way to tax wealthy shareholders. Opponents argued that the tax did not discriminate between wealthy and less wealthy shareholders.[91] Sen. Cummins stated that "[s]o far as taxes are concerned, corporations are mere trustees for their shareholders; and their shareholders must pay the tax."[92] Others argued that the tax would be shifted to consumers or wage earners, at least by the strongest corporations in the best position to avoid competition- the trusts.[93]

But by far the most significant debate centered on the real entity view of the corporation and the argument that the tax was a regulatory device. Some of this debate centered on the publicity feature of the tax, but some of it viewed the tax as a preliminary measure to control and limit managerial power directly. For example, Sen. Flint (a supporter of the tax) stated that "it would give a certain amount of control of corporations by the national government, publicity as to the conditions and affairs of corporations, and supervision to a certain extent over those corporations."[94] Publicity was part of the regulatory scheme, but not the only part.

The publicity feature was stressed by many. Sen. Dixon, for example, stated that he favored the tax primarily because of the publicity feature, because it would not reach wealthy shareholders.[95] Sen. Newlands likewise supported the tax as "securing, through publicity and otherwise, such supervisory control by the National Government as can be constitutionally exercised over

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[90] "I deny the right of Congress to levy a tax upon the business of corporations as such." (Sen. Cummins, 44 Cong. Rec. 3976 (June 30, 1909).

[91] "Shall we levy an income tax upon the stockholders of all corporations for pecuniary profit, without respect or regard to the extent of the income earned or enjoyed by those stockholders" (Sen. Cummins, 44 Cong. Rec. 3955 (June 29, 1909)). See also 44 Cong. Rec. 4008 (July 1, 1909) (statement of Sen. Clapp to same effect).

[92] 44 Cong. Rec. 3975 (June 30, 1909). See also the Bureau of Corporations Report on State Taxation (May 17, 1909): "Obviously a tax on the corporation is really a tax upon its stockholders, for otherwise than as a matter of legal reasoning a corporation and its stockholders are one." Kornhauser, at 94.

[93] See statement of Sen. Borah, 44 Cong. Rec. 3985-87 (June 30, 1909); Sen. Cummins likewise considered that the tax may be shifted from shareholders, 44 Cong. Rec. 3975 (June 30, 1909), as did Sen. Clapp, 44 Cong. Rec. 4008 (July 1, 1909).

[94] 44 Cong. Rec. 3937 (June 29, 1909).

[95] 44 Cong. Rec. 3941 (June 29, 1909). See also 44 Cong. Rec. 4000-01 (July 1, 1909) (statement of Sen. Bourne in favor of the publicity feature: "I personally concur with the President that the corporation net-earnings tax, in view of the publicity feature incident to it, is of infinitely greater importance and will be far more beneficial to this country than either the inheritance or income tax.")

corporations."[96] Even Sen. Aldrich, the ultra-conservative chair of the Finance Committee, supported the publicity feature.[97] And Sen. Cummins, who opposed the tax, nevertheless supported the publicity feature because the "revolution in industry" resulting from the rise of large corporations "is simply a prelude to industrial commercial slavery unless the Government intervenes with its strong arm, and it can not intervene unless it has the information necessary to enable it to act intelligently and wisely."[98]

Other Senators, however, emphasized the potential of the tax to directly limit managerial power. Sen. Newlands stated that "I favor also present legislative action imposing an excise tax in such form as to reach the great accumulated wealth of the country, or its earnings, engaged in corporate enterprise."[99] Nor did he mean by this indirect taxation of wealthy shareholders, because he went on to state that "there was no reason why the great combinations monopolizing these industries [protected by the tariff] should not pay some part of national expenses as well as the masses of the people who use and consume [their products]."[100] Newlands thus viewed the tax as falling on the accumulated wealth in the hands of the corporation itself, i.e., upon corporate management.[101] Sen. Owen likewise spoke of the "enormous volume of corporate wealth": "The most important need of the people of the United States of this generation requires the abatement of the gigantic fortunes being piled up by successful monopoly…which have brought about a grossly inequitable distributions of the proceeds of human labor."[102] Like other Democrats, he would have preferred an income or inheritance tax, but supported the corporate tax for its direct potential impact on corporate (i.e., managerial) wealth.

Sen. Root, a principal draftsman of the tax (and personal friend of the President), likewise emphasized the potential of the tax to reach the wealth accumulated in the hands of corporate management, because he favored taxing such wealth over earned income:

> Mr. President, it has so happened that in the development of the business of the United States the natural laws of trade have been

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[96] 44 Cong. Rec. 3756 (June 24, 1909). See also 44 Cong. Rec. 3759 (June 24, 1909) ("securing information which would enable Congress to act intelligently in future with reference to taxation, the regulation of industrial combinations, and the imposition of tariff duties.").
[97] 44 Cong. Rec. 3930 (June 29, 1909); see also 44 Cong. Rec. 4006-07 (July 1, 1909) (statement by Sen. Root in support of the publicity feature).
[98] 44 Cong. Rec. 3965 (June 30, 1909).
[99] 44 Cong. Rec. 3756 (June 24, 1909).
[100] 44 Cong. Rec. 3761 (June 24, 1909). See also 44 Cong. Rec. 3762 ("Justice demands that the various forms of manufactured wealth, in whose favor the taxing power of the Nation is so freely exercised, should make some substantial contribution to the national expenses.").
[101] 44 Cong. Rec. 4048-49 (July 2, 1909) and 44 Cong. Rec. 4233 (July 7, 1909) (advocating a tax concentrated on the management of the great trusts, and exempting small corporations); 44 Cong. Rec. 4229-30 (statement ogf Sen. Dolliver to same effect).
[102] 44 Cong. Rec. 3950 (June 29, 1909).

> making the distinction [between earned and unearned income] for us, and they have put the greater part of the accumulated wealth of the country into the hands of corporations, so that when we tax them we are imposing the tax upon the accumulated income and relieving the earnings of the men who are gaining a subsistence for their old age and for their families after them.[103]

Opponents of the tax, on the other hand, also stressed the regulatory aspect, but suggested that it had the potential of giving the federal government too much power over corporations. Sen. Cummins, for example, stated that:

> If this tax is intended not to create a revenue, but if it is intended for the purpose of supervising and regulating corporations, that is quite a different proposition. I should like to know before we get through with this whether it is proposed through this tax to impose supervisory regulation upon all the corporations of the United States… You know there is just a little intimation in the message of the President that that is the end which is finally to be reached… I think that before the Government of the United States enters upon the work of supervising and regulating all those corporations…we had better stop and think a while.[104]

Cummins, however, was not opposed to any federal regulation through the corporate tax, just to a tax that indiscriminately applied to all corporations, big or small, as opposed to those corporations that should be the proper target- the great trusts:

> If we can regulate our corporations simply through the medium of taxation, we can destroy every trust in a fortnight. It would be a great deal better for the Finance Committee to turn its attention to the imposition of such a tax upon corporations and the persons who actually need regulation, who are exercising powers that are injurious to the American people, destroying competition and invading our prosperity, than to attempt to levy a revenue tax upon all the little shareholders of all the little corporations throughout the length a breadth of the United States.[105]

Other opponents of the tax likewise supported regulating the large trusts through taxation, referring to the excise tax imposed on the gross income of

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[103] 44 Cong. Rec. 4003 (July 1, 1909); see also 44 Cong. Rec. 4006 (distinguishing between earned income and "accumulated capital" which should be taxed). Sen. Cummins argued that the corporate tax would not achieve this purpose since it would fall on all shareholders, rather than just on management. 44 Cong. Rec. 4038 (July 2, 1909).

[104] 44 Cong. Rec. 3978 (June 30, 1909). See also 44 Cong. Rec. 4047 (July 2, 1909) (statement of Sen. Hughes arguing that regulation should be done directly).

[105] Ibid. He suggested that much higher rates would drive the trusts out of business, 44 Cong. Rec. 4232 (July 7, 1909).

the sugar and oil trusts in 1898. However, they opposed the proposed corporate tax because it exempted dividends received from other taxable corporations from the tax base, thereby encouraging the formation of holding companies- precisely those companies that formed the legal basis for the trusts (after New Jersey permitted the formation of holding companies in 1890).[106] Proponents of the tax replied, however, that it was better to attack the trusts via a tax on all corporations, than to refrain from attacking them at all.[107]

c. Summary.

We thus see than between 1894 and 1909 a significant change occurred in regard to the justification for the corporate tax. The 1894 tax was conceived as a continuation of the civil war tax, i.e., as a withholding tax on shareholders. The 1909 tax, on the other hand, while still seen by some opponents as an indirect tax on shareholders, was primarily conceived as a regulatory device to restrict managerial power. This goal was achieved most directly through the publicity feature of the tax, but both proponents and opponents also saw the tax as having the potential to regulate management directly by reducing corporate wealth and therefore restricting managerial power that depended on such wealth.

The shift that occurred can clearly be seen if one compares two Supreme Court opinions dealing with the corporate tax. In 1870 the Court decided that the civil war income tax may be applied to tax shareholders upon the undivided profits of a corporation.[108] Fifty years later the Court held that a shareholder may not be taxed on a stock dividend distributed by a corporation since that would be tantamount to taxing her on the undistributed income of the corporation, which is not her "income" under the Sixteenth Amendment.[109] The Court stated that:

> We have no doubt of the power or duty of a court to look through the form of the corporation and determine the question of the stockholder's right, in order to ascertain whether he has received income taxable by Congress without apportionment. But, looking through the form, we cannot disregard the essential truth disclosed; ignore the substantial difference between corporation and shareholder; treat the entire organization as unreal; look upon stockholders as partners, when they are not such; treat them as having in equity a right to a partition of the corporate assets, when they have none; and indulge the fiction that they have received and

[106] 44 Cong. Rec. 4010 (July 1, 1909) (statement of Sen. Clapp); 44 Cong. Rec. 4230 (July 7, 1909) (Sen. Dolliver). Sen. Aldrich replied that this was necessary to avoid double corporate taxation and that no for profit corporation was exempt from tax. Ibid., at 4231.
[107] 44 Cong. Rec. 4036 (July 2, 1909) (statement of Sen. Davis).
[108] Collector v. Hubbard, 79 US (12 Wall) 1 (1870).
[109] Eisner v. Macomber, 252 US 189 (1920).

> realized a share of the profits of the company which in truth they have neither received nor realized. We must treat the corporation as a substantial entity separate from the stockholder, not only because such is the practical fact but because it is only by recognizing such separateness that any dividend- even one paid in money or property- can be regarded as income of the stockholder. Did we regard the corporation and stockholder as altogether identical, there would be no income except as the corporation acquired it; and while this would be taxable against the corporation as income under the appropriate provisions of law, the individual stockholders could not be separately and additionally taxed with respect to their several shares even if divided, since if there were entire identity between them and the company they could not be regarded as receiving anything from it, any more than if one's money were to be removed from one pocket to another.[110]

Thus, by 1920, the Court viewed the corporation as a real entity separate and distinct from the shareholders "because such is the practical fact."[111] The same real entity view underlay most (although not all) of the arguments made when the corporate tax was adopted in 1909.

What accounts for the change between 1894 (when as we have seen the corporate tax was seen as a withholding device, and the aggregate view was dominant) and 1909 (when the real entity view was the main reason for adopting a corporate tax)? The principal reason is a significant change in the nature of the corporation that occurred in these 15 years. The period from 1890 to 1916 marked the transformation of American capitalism from a system of owner/manager enterprises operating in largely unregulated competitive markets to a system dominated by relatively few large, mostly non-owner managed corporations in a regulated competitive market.[112] In particular, although there were large scale corporations (especially the railroads) before the Progressive Era, consolidation began only in the early 1890s and accelerated to a wave of consolidation by merger between 1898 and 1904.[113] The key legal change was the adoption by New Jersey in 1890 of a new corporate law that for the first time permitted holding corporations.[114] This enabled the consolidators to avoid the cumbersome

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[110] Ibid., at -. The Court then went on to state that Collector v. Hubbard was overruled by Pollock and was not reinstated by the Sixteenth Amendment. Ibid., at --.

[111] The other argument advanced by the Court (that cash dividends could not be taxed) interestingly ignores the fact that between 1913 (when the Sixteenth Amendment was adopted and the first individual income tax adopted) and 1936 cash dividends were to some extent exempt from tax to shareholders. But dividends were taxed to the extent the individual rate exceeded the basic or normal rate, and the corporate rate was set higher than the normal rate from 1918, resulting in partial double taxation. See Bank.

[112] M. Sklar, The Corporate Reconstruction of American Capitalism, 1890-1916 (1988); see also A. Chandler, The Visible Hand: The Managerial Revolution in American Business (1977).

[113] Sklar, 45-46, noting that little further concentration took place between 1904 and 1954.

[114] See Lincoln Steffens, New Jersey- The Traitor State.

"trust" structures (in which shareholders contributed their shares to a trust in exchange for certificates of beneficial ownership) for the simpler holding company structure of parent and operating subsidiaries. The result was a wave of corporate migration to New Jersey, followed in the 1910s by another migration to Delaware when New Jersey balked at further pro-management rule changes.[115]

The reaction to the emergence of the "trust issue" from around 1896 onward was a chorus of calls for more regulation.[116] For example, in 1906 Rep. Martin of South Dakota defined a trust as "a combination of corporations", identified the resulting "evils" as "overcapitalization…the tendency to monopoly, and…the destruction of individual enterprise and success," and called for remedial legislation that will combine "publicity," "free competition" and "close Federal supervision or regulation."[117] One immediate result was the attempt by President Roosevelt to control the trusts by using the Sherman Antitrust Act of 1890, which led to the Supreme Court ultimately breaking up the Standard Oil Company (while declaring at the same time that only "unreasonable" restraints of trade were illegal).[118]

Roosevelt was not opposed to the growth of big business; unlike the populists, he did not believe in turning the clock back to a "golden age" of small producers. But he did favor federal regulation. In his 1907 message to Congress Roosevelt declared that –

> I am in no sense hostile to corporations. This is an age of combination, and any effort to prevent all combination will be not only useless, but in the end vicious… We should, moreover, recognize in cordial and ample fashion the immense good effected by corporate agencies…The corporation has come to stay.[119]
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> But he also stated that:
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> I strongly advocate that instead of an unwise effort to prohibit all combinations, there shall be substituted [for the Sherman Act] a law which shall expressly permit combinations which are in the interest of the public, but shall at the same time give some agency of the National Government full power of control and supervision over them.[120]

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[115] Cite race to bottom/top literature [Cary, etc.]
[116] See, e.g., the Nationalist Newsletter, edited by Edward Bellamy, arguing that democracy was threatened by the rise of big business. [cite]
[117] 40 Cong. Rec. 1849-1851 (Jan. 31, 1906).
[118] Standard Oli v. United States, 221 US 1 (1911); see also United States v. American Tobacco Co., 221 US 106 (1911). This "rule of reason" is still the standard today.
[119] 42 Cong. Rec. 67-68 (Dec. 3, 1907).
[120] 43 Cong. Rec. 16, 17 (Dec. 8, 1908).

Roosevelt's first concrete proposal was for federal incorporation.[121] The Hepburn Bill, introduced in 1908, would have allowed corporations to voluntarily register with a federal office.[122] The Bill failed, however, because of Republican opposition to such an expansion of executive branch power: If the Federal government registered corporations, it could also de-register them.[123] Ultimately, these concerns led to the Clayton Antitrust Act of 1914 and the establishment of the Federal Trade Commission.

The same concerns regarding trusts are reflected in the debates over the corporate tax, which as Marjorie Kornhauser first pointed out was seen by both supporters and opponents as a regulatory measure.[124] Kornhauser focused primarily on the publicity feature of the tax, but as we have seen this was not its only regulatory aspect- both supporters and opponents saw the tax also as having the potential to directly restrict managerial power.[125] Thus Sen. Root, the principal Senate drafter of the tax, spoke about the accumulation of wealth in the hands of corporations as a principal reason for the tax.[126] Sen. Newlands likewise supported the tax because "there was no reason why the great combinations monopolizing these industries should not pay some part of the national expenses."[127] Similarly Sen. Owen stated that "[t]he most important need of the people of the United States of this generation requires the abatement if the gigantic fortunes being piled up by successful monopoly."[128] And Sen. Cummins, an opponent of the tax, likewise spoke about "the new force entering American life and American business" which is "a prelude to industrial commercial slavery unless the Government intervenes with its strong arm."[129] Sen. Cummins opposed the tax because it applied to all corporations, rather than just to the great combinations, which should be taxed more heavily.[130] Sen. Clapp was similarly concerned about the trusts but argued that the proposed tax did not address the

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[121] 42 Cong. Rec. 70 (1907).
[122] 42 Cong. Rec. 3769-70 (1908).
[123] M. Sklar, at 282-85.
[124] Kornhauser.
[125] For a discussion of publicity, see Kornhauser, 69-
[126] 44 Cong. Rec. 4003 (July 1, 1909).
[127] 44 Cong. Rec. 3761 (June 24, 1909). Newlands supported in particular taxing all industries benefiting from the tariff, 44 Cong. Rec. 3762 (June 24, 1909). He noted in particular the unwillingness of the Supreme Court to break up the Sugar trust as an argument in favor of the tax, 44 Cong. Rec. 3997 (July 1, 1909); 44 Cong. Rec. 4048-49 (July 2, 1909) (proposing an exemption for small corporations so as to "confine our taxation to these great combinations of capital whose profits have been enormous, whose ability to bear is greater than that of any other class of the community, and whose abuses have awakened the attention of the country and demand legislative cure.")
[128] 44 Cong. Rec. 3950 (June 29, 1909). He stated that corporate wealth of publicly traded corporations amounted to one third of national wealth, ibid. See also statement by Sen. Bourne, supporting the tax because the tendency of business to consolidate requires strengthening the government's ability to regulate, 44 Cong. Rec. 4000-01 (July 1, 1909).
[129] 44 Cong. Rec. 3965 (June 30, 1909).
[130] 44 Cong. Rec. 3978 (June 30, 1909) (quoted above).

problem because of the exemption of dividends paid to holding corporations.[131] Sen. Cummins' solution was to tax the trusts more heavily:

> If a company is organized for the purpose of consolidating a dozen other companies with a view to controlling the business in which those companies are engaged for the purpose of being able to direct through a single board the management of the entire field of industry… aside from the contravention of public policy involved in such an organization the privilege enjoyed is of priceless value, and instead of being taxed at 2 per cent on the net earnings it ought to be taxed at 10 or 15 per cent on the net earnings, that it ought to be taxed so heavily that such companies would become not only unfashionable but unprofitable as well.[132]

The principal reason for the difference between the 1894 tax (viewed primarily as a tax on shareholders) and the 1909 tax (viewed primarily as a tax on management) was thus the rise of the great trusts in the period between 1896 and 1904.[133] By 1909, the trust problem was perceived as the most serious issue facing the country.[134] Some Democrats would have liked to turn back the clock and outlaw the trusts, but the majority preferred to follow President Roosevelt and regulate them. A primary vehicle for such regulation was the corporate tax, in part because of its publicity feature, but in part because potentially (to use a phrase cited by many during the Congressional debate) "the power to tax is the power to destroy."[135] To tax the powerful trusts was seen as the beginning of a federal power to regulate and, if need be, destroy them.

More broadly, the transition from 1894 to 1909 can be seen as the move from an aggregate view of the corporation to a real entity view.[136] This is a

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[131] 44 Cong. Rec. 4009 –10 (July 1, 1909): "the plain invitation, the plain effect of this provision is to encourage the organization of the very kind of corporations, great, powerful, overshadowing, absorbing industries, absorbing industrial life and industrial affairs, by holding out to them immunity from taxation." See also the similar sentiments of Sen. Dolliver, who likewise focused on the trust problem, 44 Cong. Rec. 4230 (July 7, 1909). Sen. Davis, on the other hand, thought that the solution to "the corporations of the country invading every avenue of business and trade" was "that if we cannot tax all the corporations, we should tax just as many of them as we can". 44 Cong. Rec. 4036 (July 2, 1909). And Sen. Aldrich pointed out that no corporation was exempt from the tax. 44 Cong. Rec. 4231 (July 7, 1909).

[132] 44 Cong. Rec. 4232 (July 7, 1909); see similarly Sen. Newlands, 44 Cong. Rec. 4233 (July 7, 1909).

[133] By 1900, John D. Rockefeller had created the Standard Oil Comoany and capitalized it at $122 million. The following year J. P. Morgan created U.S. Steel in a $1.4 billion transaction. Between 1898 and 1901, the capitalization of mergers totaled $5.4 billion and 2,274 firms were merged out of existence. Davis, 620.

[134] See, E.g., Wilgus, Need of a National Incorporation Law, 2 Mich. L. Rev. 358 (1904).

[135] Cite to Marshall & Cong. Rec.

[136] It is true that when the personal income tax was enacted after passage of the Sixteenth Amendment in 1913, it provided an exemption for dividends up to the corporate tax rate. This is consistent with viewing the corporate tax as a tax on shareholders, as Steven Bank has argued. See Bank, Entity Myth. However, as noted in Part V, whether or not one adopts integration for

transition that took place several times during the long and convoluted history of the corporate form, from its Roman origins onward. To appreciate how and why this move happens, and in particular understand its application to the present, it is necessary to take such a broader historical view, and to examine the various cycles through which the theory of corporations was transformed from its origins to the present.

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economic efficiency reasons is not necessarily related to whether one takes the real or aggregate view of the corporate tax. It is notable that in the US context double taxation began already in 1918, since at that point the corporate rate diverged from the individual "normal" rate but the exemption was only provided at the normal rate. The reason for this divergence, which continued to grow until the full double tax was introduced in 1936, was Congressional concern about management's tendency to retain rather than distribute earnings, thus preventing them from being taxed at the higher shareholder rates. The rate on the corporation was thus raised to equal the top shareholder rate, but without increasing the dividend exemption. This is consistent with treating the corporate tax as a tax on managerial wealth accumulation, since for a publicly traded entity accumulation did not result from shareholder tax planning. In England, on the other hand, there was less separation of ownership from control until the 1960s, and most corporate earnings were distributed; England thus retained an integrated system until 1965. See Steven Bank, The Influence of Firm Dividend Policy on the Method of Taxing Corporate Income: Insights from the Divergence of the U.S. and British Systems (2003). It is notable that the US has now adopted partial integration at a point when managerial ownership of stock has increased so as to blur the separation of ownership from control.

3. A Broader Historical Perspective: Three Views of the Corporation.

The corporation as a legal person separate from its owners is a uniquely Western institution. Other legal systems, such as Muslim law, did not (before they were influenced by the West) have a concept of legal personality separate from individual human beings. The corporate form originated in Roman law in its classical period (the first two centuries AD), was further developed in the Middle Ages in both canon (Church) and civil law, and was adopted from civil law by the Anglo-American common law tradition.

In the West, the existence of the corporate form was crucial to the development of several other important institutions, such as the university (whose very name derives from the Latin term for corporation, universitas) and Parliament. It has in fact been argued that other important Western developments such as the rise of representative democracy and the scientific revolution can be tied to the corporate form.[137]

To get from the Roman origins of the corporate form to today's multinational enterprises, the corporation had to undergo several crucial changes. First, the concept of the corporation as a separate legal person from its owners or members had to be developed, and this development was only completed with the work of the civil law Commentators in the fourteenth century. By the end of the Middle Ages, the membership corporation, i.e., a corporation with several members who chose others to succeed them, had legal personality (the capacity to own property, sue and be sued, and even bear criminal responsibility) and unlimited life, was well established in both civil and common law jurisdictions. The next important step was the shift from non-profit membership corporations to for-profit business corporations, which took place in England and the U.S. in the end of the eighteenth and beginning of the nineteenth century. The third transformation was the shift from closely-held corporations to corporations whose shares are widely held and publicly traded, and with it the rise of limited liability and freedom to incorporate, which took place by the end of the nineteenth century and the beginning of the twentieth. Finally, the last major transformation was from corporations doing business in one country to multinational enterprises whose operations span the globe, which began after World War II and is still going on today.

Each of these four transformations (as well as a smaller, more temporary one which occurred in the U.S. in the 1980s with the advent of hostile takeovers) was accompanied by changes in the legal conception of the corporation. What is remarkable, however, is that throughout all these changes spanning two millennia,

[137] On representative democracy and its connection to the borough as a corporation see, e.g., G. Post, Studies in Medieval Legal Thought (1964); B. Tierney, Religion, Law, and the Growth of Constitutional Thought, 1150-1650 (1982). On the link between the rise of universities in the West and the scientific revolution see Reuven S. Avi-Yonah, The Aristotelian Revolution (1986).

the three theories of the corporation that we have outlined above can be discerned. Those theories are the aggregate theory, which views the corporation as an aggregate of its members or shareholders; the artificial entity theory, which views the corporation as a creature of the State; and the real entity theory, which views the corporation as neither the sum of its owners nor an extension of the state, but as a separate entity controlled by its managers. In this Part, we will try to show that every time there was a shift in the role of the corporation, all three theories were brought forward in cyclical fashion. However, every time the real entity theory prevailed, for reasons we will discuss below, and it is the dominant theory during periods of stability in the relationship between the corporation, the shareholders, and the state.

a. First Transformation: The Establishment of the Corporation as a Legal Person.

Scholars have been debating for a long time whether classical Roman Law had in fact developed a concept of the corporation as a legal person with legal attributes (owning property, the capacity to sue and be sued) separate not just from its members as individuals but also from its members as a group.[138] The classical texts are in fact ambiguous and reflect different views.[139] But one can already discern in them the three views of the corporation outlined above.

The artificial entity view, for example, is reflected in the following excerpt from the classical jurist Gaius:

> Partnerships, *collegia*, and bodies of this sort may not be formed by everybody at will; for this right is restricted by statutes, *senatus consulta*, and imperial *constitutiones*. In a few cases only are bodies of this sort permitted. For example, partners in tax farming, gold mines, silver mines, and salt works are allowed to form corporations. Likewise, there are certain *collegia* at Rome whose corporate status has been established by *senatus consulta* and imperial *constitutiones*, for example, those of the bakers and certain others and of the shipowners, who are found in the provinces too. Those permitted to form a corporate body consisting of a *collegium* or partnership or specifically one or the other of these have the right on the pattern of the state to have common property, a common treasury, and an attorney or syndic through whom, as in a

[138] P.W. Duff, Personality in Roman Private Law (1938) argues in the affirmative; F. Schultz, Classical Roman Law (1951), 88-102 and Otto Gierke, Associations and Law: The Classical and Early Christian Stages (1977), 95-142, in the negative.

[139] These texts are taken from the Corpus Juris Civilis, the major compilation of Roman Law performed under the Emperor Justinian in 528-534 AD. The Corpus Juris Civilis consists of three parts: The Institutes (Inst.), an introduction to the law in general; the Digest (D.), a collection of pronouncements of individual jurists, mostly from the classical period (the first two centuries AD); and the Code (C.), a collection of imperial statutes. The views of the classical jurists thus come to us in fragmentary fashion, and with the possibility of later editing or interpolation, so it is hard to be sure what any classical jurist actually said. For the Digest, I used the text edited by Mommsen and Krueger and translated by Alan Watson (1985).

> state, what should be transacted and done in common is transacted and done.[140]

The emphasis here is on the authority granted to the various types of corporation by the state: without imperial permission, they could not have legal personality, own property, or have an agent who can act in their name. In fact, we know from other sources that the Roman emperors were suspicious of private corporations, especially in the provinces, as potentially seditious, and refused permission to set up such corporations even for seemingly innocuous purposes.[141]

The aggregate view of the corporation as equivalent to its members acting collectively is reflected in the following excerpt from the classical jurist Paul:

> Citizens of a municipality can possess nothing of themselves, because the consent of all is not possible. Hence, they do not possess the marketplace, public buildings, and the like, but they use them in common. The younger Nerva, however, says that they can both possess and usucapt through a slave what he has acquired through his *peculium*; there are, however, those who think differently, since the citizens do not own the slaves themselves.[142]

This refers to the Roman concept of possession (possessio), which requires animus and corpus, the intention to possess and the capacity to hold[143]; Paul is saying that since the members of a corporation cannot have a single animus, they cannot actually own anything.[144] A similar aggregate view can also be discerned in the excerpt from Gaius cited above, where he discusses the members acting collectively through an agent. The same view is also reflected in the classical prohibition against instituting corporate bodies as heirs because they are "uncertain", i.e., their membership is changing.[145]

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[140] Gaius, D. 3.4.1 pr.-1 (tr. Alan Watson).

[141] See, e.g., Emperor Trajan's refusal to allow Pliny to set up a voluntary fire brigade at Nicomadea for fear it may be breeding ground for anti-Roman sedition. Pliny, Letters, 1.33-34; cf. Schultz, at 99-100; F.M. de Robertis, Il fenomeno associativo nel mondo romano (1981).

[142] Paul, D. 41.2.1.22 (Tr. Alan Watson). This could be interpreted as saying that the municipal corporation itself possesses the property (supporting the real view), but this is not how the text was read in the Middle Ages (see below).

[143] D. 41.2.3.1; cf. W.W. Buckland, A Textbook of Roman Law, rev. P. Stein (3rd ed., 1963), 199-202.

[144] However, in another text he seems to imply that the agent can act for the collective: A legacy was left to townships, if they took an oath. The condition is not impossible of fulfillment. But how can the towns comply with it? The oath will be sworn by those who conduct the town's affairs. Paul, D. 35.1.97. Ulpian, on the other hand, believed that corporate bodies can be guilty of crimes that require intent. See D. 4. 2. 9. 1 (intimidation) but cf. D. 4.3.15.1 (fraud).

[145] Neither municipalities nor the members of a municipality can be instituted as heirs, because they are uncertain bodies, and cannot all decide to enter the inheritance nor act as an heir, so as to become heirs. Epitome of Ulpian's Regulae, 22.5. If this Fourth Century Epitome actually reflects Ulpian's views (which is unclear), it seems inconsistent with other excerpts from his writings, which reflect a real entity view of the corporation. This prohibition was gradually relaxed by

The real view, finally, is mostly reflected in the excerpts of the classical jurist Ulpian. For example:

> If members of a municipality or any corporate body appoint an attorney for legal business, it should not be said that he is in the position of a man appointed by several people; for he comes in on behalf of a public authority or corporate body, not on behalf of individuals.[146]

Ulpian here uses "universitas" (corporate body) as equal to the "municipes" (members), and speaks of the representative as acting for the corporate body rather than on behalf of the "individuals", which can be consistent with the aggregate view; but he also states that the representative does not act for the "several people" , which favors the real entity view that he acts for the corporation itself. Similarly, he states elsewhere that –

> It has very frequently been written in rescripts that a slave belonging to a municipality [may] be tortured in capital cases affecting the citizens because he is not their slave but the state's, and the same should be said of other slaves belonging to corporate bodies; for the slave appears to belong, not to a number of individuals, but to the body [itself].[147]

This text likewise reflects Ulpian's real entity view of the corporation as separate not just from the individual members but also from the "number of individuals" in aggregate. A slave could not be tortured to give evidence against its master, but he could if the master was a corporation.[148]

Finally, consider the following:

> As regards decurions or other corporate bodies, it does not matter whether all the members remain the same or only some or whether all have changed. But if a corporate body is reduced to one member, it is usually conceded that he can sue and be sued, since the rights of all have fallen to one and the corporate body continues to exist in name only.[149]

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various emperors and was finally abolished in 469 AD. See C. 6.24.8 (290 AD); C. 1.12.1 (321 AD); C. 6.24.12 (469 AD).

[146] Ulpian, D. 3.4.2.

[147] Ulpian, D. 48.18.1.7.

[148] Similarly the concept of limited liability: A debt to a corporate body is not a debt to individuals and a debt of a corporate body is not the debt of individuals. D. 3. 4.7.1. But this text is more ambiguous because it can be interpreted as distinguishing the debts owed by the individual members from debts owed by them as a group. See also Gaius, Inst. 2.11: What is public is considered to be nobody's property, because it is believed to belong to the corporate body itself. Private goods belong to individual people. Again, the distinction is between property owned by individuals and the collective.

[149] Ulpian, D. 3.4.7.2.

In this text Ulpian envisages the corporate body as remaining unchanged as the membership changes, and he even considers the possibility of a "corporation sole." This is the clearest evidence of the real entity view in the Roman texts; but note that not even Ulpian could imagine a corporation continuing to exist without any members.[150]

The same debate continued through the Middle Ages. Consider the following examples, which come from the Ordinary Gloss by Franciscus Accursius (1182-1258), which was written around 1250 and summarized the previous century's work by the jurists in Bologna of commenting on the Corpus Juris Civilis.

First, the artificial entity view:

> Of others: Which are many: The congregation of any city, village or castle ... similarly any congregation to uphold justice, such as the Tuscan scholars or the entire university ... similarly religious congregations ... And because certain societies are permitted, as the text says, it is clear that normally they are prohibited ... But can a society, such as that of scholars living in one inn, appoint an agent [to sue]? It seems they can, if the case is the society's, as it is a permitted society.[151]

Here Accursius emphasizes the need for a society to get permission from the state to have legal personality, just as Gaius did in the text he was commenting upon. The identity of the state has changed (the Bolognese jurists professed allegiance to the German emperors), as did the identity of the corporations, but the concept is similar.

The aggregate view can be seen in Accursius' definition of the agent as "Syndicus: Who acts for any corporate body, but only for the many ... for he is called syndicus because he argues (dicens) cases for the single ones (singulorum)."[152] Here the agent is seen as speaking for the members as a collective, as opposed to the members as individuals.[153] Similarly, Accursius rejected the concept of limited liability, requiring the members to be liable for debts of the corporation, which again reflects the aggregate view.[154] And he allows departing members to take their share, although not of inheritances or other property that belonged to the corporation itself.[155]

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[150] For later references to the view that a corporation ceases to exist if all its members die see [Deveaux, etc.]

[151] GO on D. 3.4.1.1(cited above), v. aliorum. The translation of this and other medieval texts is mine.

[152] GO on D.3.4.1.1 (cited above), v. syndicum.

[153] See also GO on C. 10.31.30, v. reipublicae: "And say that they all act through the agent or syndicus whom they elect;" GO on D. 3.4.2, v. haberi (cited above): "An agent stipulates for the corporate body, not for its individual members."

[154] "But what if they have nothing common to satisfy creditors? They must be compelled to make collections so that they will have something in common." GO on D.3.4.1.2 v. proconsul.

[155] "Or say that whatever colleges and corporate bodies have also belongs to the single [members], and whoever withdraws receives his portion, because they have something in common through

In yet other locations, the real entity view predominates, even when it requires challenging the Roman authorities. For example-

> The people are called by trumpet or by bell or by voice, and even though they do not all come, the majority of two thirds can consent ... Thus this law conceives they cannot all will together easily ... But they can with difficulty.[156]

> It is as if [Paul] said not easily, because they cannot will together easily ... but they can with difficulty, so as when a bell is tolled, because all are considered to have done what the council or a majority did ... and they can commit intimidation ... and obtain possession ... and elect a tribune or leader ... for this question notes the rarity, not the impossibility [of doing so].[157]

Here Accursius rejects Paul's view that corporate bodies cannot own anything because they cannot will together, referring to the notion that the majority if the members can act for the corporate body.[158] Likewise,

> What if a member of a corporate body injures you, can the corporate body be said to have done it and be sued by you? It seems that not, because he did it out of his own will, not as a corporate body, i.e., after deliberation and sounding a bell or having been otherwise gathered together. On the contrary, yes, because a corporate body is nothing more than the people who are there.[159]

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combining goods of the individual members ... but when a legacy is left to a college or a town, it is left only to those who are members of the college, and they divide it, so that if anyone withdraws, he receives nothing, because it does not belong to the single individuals [as such], but to the town's citizens or to the members of the college." GO on D.47.22.1.1 v. competit. "But what if the corporate body is dissolved, can any member demand his portion as a proper and private debt? [Yes], because that is the rule [when the body still exists], here therefore even more so. ... But if some corporate body has a common grove that is otherwise undivided, should the creditors be given possession of that part that seems to belong to them? I do not think so, because neither the grove nor any part thereof belong to anybody." GO on D.3.4.7.1 v. non debetur.

[156] GO on D. 50.160.1 v. refertur, citing D. 41.2.1.22 (cited above).

[157] GO on D. 4.3.15.1 v. facere possunt (cited above).

[158] Similarly: "They are like one body, whether all are present or whether two thirds are, and whatever the majority of this present body does, is valid." GO on D.3.4.3, v. due partes; "[Rogerius said that] members of municipalities cannot possess, but those to whom the administration of the members is entrusted ... [Accursius]: They can properly possess through those to whom the municipality's affairs are entrusted." GO on D.41.2.1.22 v. adquiratur (cited above). Accursius also makes a distinction between what can happen naturally and "by law": "Here it is doubted whether they can all swear by nature, but similarly children and others who are like a corporate body, who cannot swear by nature, but can by law." GO on D. 35.1.97, v. geruntur (cited above). And he rejects the notion that corporate bodies are "uncertain": "It is no objection that a corporate body is said not to be able to consent, because it should be understood as "easily" ... or add by the order of those who manage the corporate body." GO on D. 29.2.25.2 v. adibit; see also GO on D. 4.2.9.1 v. collegium (corporate bodies can be guilty of fraud and intimidation).

[159] GO on D.3.4.7.1 v. non debetur (above).

This text clearly reflects the aggregate view. However, when Accursius considers the question what happens when the membership changes, he seems to reject the aggregate view in favor of the real entity view:

> Some say that goods that belong to a college belong to the people, or to many single individuals ... but they do not concede that if those [individuals] die the people is dead, because others are considered (finguntur) to take their place. Thus the emitted cry perishes, but not your voice. But what is argued to the contrary, that the goods do not belong to single individuals, is true, as can be proven by the law against torturing slaves.[160]

This text conceives of the membership corporation as unchanging even though the individual members change. This could still be consistent with the aggregate view (the membership remains as a collective), but the rejection of the view that the goods belong to "many single individuals" and the citation to Ulpian suggest the real entity view.

Finally, consider the following:

Even though a single person cannot be a corporate body, he still retains the rights of the corporate body, even though a single person cannot constitute a corporate body initially, but only three persons ... But can he appoint a syndicus, who argues cases for the many, or [at least] for two? It seems so ... But what if nobody at all remains, [asks] Johannes [Bassianus]? The college is then dissolved, and the goods belong to nobody, like inherited goods. But if thereafter by authority of the Pope or whoever is in charge of that college, someone is appointed to that college, by the artifice of the law the goods are considered (fingitur) to belong to him ... Even though some Bishop Moses said that the walls themselves possess even during the existence of the college, which seems very difficult to say and contrary to the law. To the contrary, in no way do the goods belong to anyone, but once the college has been dissolved, by the law they belong to the fisc or the Pope. ... But it can be said for Moses, that the church is frequently called the place itself which is surrounded by walls and consecrated; and it is also said that the church can have rights and possess and sue ... thus the location itself, or the walls, possess even while the college exists, through the priest, like a private person through an agent.[161]

In this gloss on Ulpian, Accursius goes beyond his Roman source to ask (following his predecessor Johannes Bassianus) what happens if all members of a corporation die. He then resorts to the artificial entity theory to argue that the state should appoint a replacement; alternatively, he states that the college ceases to exist, consistent with the aggregate view.[162] But he also mentions the possibility that the

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[160] GO on D.47.22.1.1 v. competit.

[161] GO on D. 3.4.7.2 v. nomen universitatis (cited above).

[162] The reference to the Pope may be a reflection of the work of Accursius' contemporary Innocent IV, who developed the concept of the corporation as artificial entity and applied it to the Church. See, e.g., Innocent IV, Commentary on X.2.12.4: "From this we order, and because of it we say, that

"location" of the corporation continues to exist, which is closer to the real entity view. There is no resolution: all three views co-exist in this text.

A hundred years later, however, the real entity view comes to predominate. This can be seen in the following examples from the work of Bartolus of Sassoferato (1314-1357), the most important of the Commentators, the generation that followed the Glossators in further developing the interpretation of the Roman text. The work of Bartolus was influential well into the nineteenth century, i.e., until the codification movement, which replaced the Corpus Juris Civilis as the main source of civil law.[163]

Bartolus clearly adhered to the real entity view of the corporation. First, he rejected the artificial entity view that permission by the state is needed to set up a corporation: "If some people want to settle in some place, and create a city, castle, or village, they can do so, as it is permitted by the law of nations."[164] This is understandable because by Bartolus' time the Holy Roman Empire had ceased to exist as a force in Italian political life and the Italian city-states were independent municipal corporations.[165]

Second, Bartolus clearly envisaged the corporation remaining even if all of its members perish: "What if this university [Perugia] were to perish by pestilence, and nobody remained? ... The privileges would remain in the place where it was."[166] This commentary was probably written after the Black Death of 1347-1348 swept through Europe, so it reflects the reality of Bartolus' time. But it also goes beyond Accursius and Ulpian to reject the aggregate view.

Instead, Bartolus developed the concept of the corporation as persona representata, i.e., a legal personality that is separate from both the state and its members, but that had to act through agents. For example:

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whenever the priest and all the clergy of a church die, nevertheless the property remains in Christ who lives forever, or in the universal Church, which never dies." Similarly: "A corporate body, like a chapter, the people, and similar [entities], are legal names, not persons, and therefore they cannot be excommunicated." Innocent IV, Commentary on X.5.39.52; "It is proper that they swear through one, because a college in a case of the corporate body is fictively considered a person." Innocent IV, Commentary on X.2.20.57, n.5.

[163] For development of the corporate personality between Bartolus and the nineteenth century see, e.g., T. Kilcullen, The Collegiate Moral Person as Party Litigant (1947) (canon law); F.M. Hussen-De Groot, Rechtspersonen in de 19e eeuw: een studie van privaatrechtlijke rechtpersonen in de 19e eeuwse wetgeving van Frankrijk, Nederland en Duitsland (1976) (France, the Netherlands, Germany); F. Hallis, Corporate Personality (1930) (England).

[164] Bartolus, Commentary on D.3.4.1.1 (cited above).

[165] Following the death of Emperor Frederick II (1250) there was a long interregnum, which weakened the empire and strengthened the Italian city states. The premature death of Henry VII (1314) effectively eliminated the last chance that the Empire would be restored to the position it held in the middle of the twelfth century. See Dante.

[166] Bartolus, Comm. on D. 47.22.4. See also Comm. On D.3.4.7.2: "Even though the individuals change, the corporate body remains the same."

> A corporate body is a legal name, and it does not have a soul or an intellect. Therefore it cannot commit crimes ... Others say, that corporate bodies can commit crimes ... We must consider first, whether a corporate body differs from its members? Some say no, like the philosophers and canonists, who hold that the whole does not really differ from its parts. The truth is, that if we speak about reality proper, those say the truth. For a university of scholars is nothing other than the scholars. But according to legal fiction they err. For a university represents a person, which is different than the scholars, or its members ... Thus, if some scholars leave and others return, nevertheless the university stays the same. Similarly if all members of a people die and others take their place, the people is the same ... and thus a corporate body is different from its members, by legal fiction, because it is a represented person ... [Thus] a corporate body can commit crimes of omission, because the corporate body itself omits, even though it is done by the negligence of its rulers ... [Some crimes of commission] can be committed by corporate bodies, nor can it be said that somebody private did it, but the corporate body itself ... [murder and other acts of violence] cannot be committed by the corporate body itself, for that requires a real person ... but they can be committed by its rulers ... but it cannot be beheaded, as it has no real head, but only a fictive one.[167]

This text shows that Bartolus had a clear vision of the corporation as separate both from the state and from its members. It was a "legal fiction" that could have the basic attributes of legal personality, i.e., the capacity to own property, sue and be sued, and even commit crimes, although in all these respects it had to act through its agents, and it was not subject to certain kinds of punishment.[168]

What enabled Bartolus to go beyond his Roman and medieval sources to reach this conclusion? In part, it was a natural evolution of moving away from and beyond the ancient text through the process of commentary and debate, which can also be seen for example in medieval commentary on Aristotle.[169] Interestingly, it was the rise of universities that enabled this unique process of comment and debate to take place in the West, and the rise of universities in turn was premised on the availability of the corporate form.[170]

But Bartolus was also influenced by external factors, the most important of which were the decline of the Holy Roman Empire, which led to the abandonment of artificial entity theory that corporations needed imperial permission to exist, and the rise of independent corporations in Italy such as the city state and the Italian universities. For these corporations to maintain their independence, they needed to

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[167] Comm. on D. 48.19.16.10.
[168] See also Bartolus, Comm. On D.41.2.2 (corporate body as represented body can possess property); Comm. On D. 34.5.21 (an inheritance left to the corporate body is not the same as an inheritance left to its members).
[169] See Avi-Yonah, The Aristotelian Revolution, supra.
[170] Ibid.

be seen as separate both from the state and from their members, since even the collective membership could perish. Bartolus and his colleagues did not want the privileges and property of the university to revert to the Popes or the Emperors should the membership all change at once. Hence, the natural theory for Bartolus to embrace as representative of the university was real entity theory, which enabled the university to maintain its independence both from the state and from its members.[171]

We thus see that in the period between the classical Roman jurists in the second century AD and the Commentators in the fourteenth century the concept of the corporation as a legal person gradually evolved, and that as this evolution proceeded all three theories of the corporation (aggregate, artificial entity, and real entity) were brought forward by various legal commentators. We also see that in the end, aided by external factors such as the decline of the state, real entity theory, which most closely reflects the views and interests of corporate management, emerges as the dominant theory. As we shall see, this pattern of debate among the three theories followed by the triumph of real entity theory is typical of subsequent transformations in the role of the corporation as well.

b. Second Transformation: From Non-Profit to For-Profit Corporations.

The period between Bartolus (mid 14th century) and the late 18th century was one of relative stability in the development of the corporate form. The corporation was established as a membership corporation, i.e., a corporation made up of members who selected their own successors, like the President and Fellows of Harvard College still do today. As such, a corporation had legal personality, i.e., the rights to own property, sue and be sued, act under a common seal, and other such "chestnuts."[172] Private corporations were used primarily for non-profit purposes (e.g., hospitals and universities), but by the 18th century there were also some commercial ones (e.g., the East India Company).[173]

From our perspective, there were two significant developments in this period. The first was the reassertion of royal control over corporations; in England and other European countries corporations could only be established by royal charter. Blackstone notes that although in Roman law corporations could be established without "the prince's consent", "with us in England, the king's consent is absolutely necessary."[174] Second, some degree of outside control over management was established through the institution of the committee of visitors, which represented the interests of the founder and of the wider community.[175]

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[171] See Avi-Yonah, Universitas: The Development of Corporate Personality from Labeo to Bartolus (1989).
[172] Clark, Corporate Law. As we have seen these "chestnuts" were not at all self-evident.
[173] See the classification and description of various corporations in William Blackstone, 1 Commentaries, chap. XVIII (1765).
[174] Blackstone, 460; Tipling v. Pexall, 3 Bulstrode 233 (1614) ("the King creates them"). For an example of a charter enumerating corporate legal rights, see, e.g., Sutton's Hospital Case, 10 Co. Rep. 1 (1612).
[175] Blackstone, 467-469.

But other than in extraordinary cases, the real entity view of the corporation prevailed throughout this period and management (the members) were firmly in control. "A corporation aggregate of many is invisible, immortal, and rests only in intendment and consideration of the law."[176] As such, it was a self-perpetuating body subject to relatively little outside regulation. Corporations, Blackstone notes, are "artificial persons, who may maintain a perpetual succession, and enjoy a kind of legal immortality."[177] When the members "are consolidated and united into a corporation, they and their successors are then considered as one person in law: as one person, they have one will, which is collected from the sense of the majority of the individuals… for all the individual members that have existed from the foundation to the present time, or that shall ever hereafter exist, are but one person in law, a person that never dies."[178] This one person then acquires all the rights of corporations, including perpetual succession, the right to sue and be sued, the right to own property, to have a common seal, to make by-laws, and to be subject to certain criminal liabilities.[179] The king constituted corporations, and the king or other visitors exercised some degree of supervision over them, but once established, the corporation (i.e., its members) remained subject to relatively little outside regulation.

This situation meant that corporate status was very desirable, especially since the members also enjoyed limited liability for corporate debts.[180] But the English Kings were very cautious with granting corporate charters, especially in the case of for-profit enterprises; only corporations that were clearly vested with a public purpose and benefited the public fisc, like the East India and Hudson Bay Companies, received royal approval, and accumulated vast power. As more capital was required for commercial enterprises this resulted in promoters organizing corporations with transferable shares and claimed that under authority of a lost or obsolete charter the shareholders enjoyed limited liability. After the South Sea Bubble burst in 1720, this problem led to the Bubble Act, under which it became a crime to organize such corporations without explicit royal consent.[181] Although prosecutions under the Bubble Act were rare, it meant that the entire Industrial Revolution in England (1760-1820) took place outside the corporate form and without limited liability.[182] The Bubble Act was ultimately repealed in

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[176] Sutton's Hospital Case, 10 Co. Rep. 1, 973 (1612).
[177] Blackstone, 455.
[178] Blackstone, 456.
[179] Blackstone, 463.
[180] Although this was not clear in the Roman sources, it was well established by Blackstone's time for royally chartered corporations. "The debts of a corporation, either to or from it, are totally extinguished by its dissolution, so that the members cannot recover, or be charged with them, in their natural capacities." Blackstone, 472 (citing Ulpian).
[181] The Bubble Act, 6 Geo. I c. 18 (1720).
[182] For attempts to avoid the Bubble Act which led to prosecutions see King v. Dodd, 9 East 516 (1808) and King v. Webb, 14 East 406 (1811).

1825, after the Industrial Revolution was over, but with the provision of unlimited liability for shareholders, which continued to be the rule in England until 1855.[183]

This situation, which can be seen as a way of maintaining state control over corporations through restrictions on charters, meant that the next great shift in the use of corporate form took place in the fledgling United States. There, once the revolution was over, every state could issue corporate charters. The result was an explosion of charters for commercial enterprises. One of the first treatises written on corporate law was Joseph Angell and Samuel Ames' Treatise on the Law of Private Corporations Aggregate, published in Boston in 1832.[184] Angell and Ames begin their book by stating that-

> The reader does not require to be told, that we have in our country an infinite number of corporations aggregate, which have no concern whatever with affairs of a municipal nature. These associations we not only find scattered throughout every cultivated part of the United States, but so engaged are they in all the varieties of useful pursuit, that we see them directing the concentration of mind and capital to…the encouragement and extension of the great interests of commerce, agriculture, and manufacturing. There is a great difference in this respect between our own country, and the country from which we have derived a great portion of our laws. What is done in England by combination, unless it be the management of municipal concerns, is most generally done by a combination of individuals, established by mere articles of agreement. On the other hand, what is done here by the co-operation of several persons is, in the greater number of instances, the result of a consolidation effected by an express act or charter of incorporation.[185]

The main reason for this proliferation of corporations in the United States was the second great transformation in the role of the corporation in society: from primarily a non-for-profit to primarily a for-profit enterprise. As Judge Kent stated, "the multiplication of corporations in the United States, and the avidity with which they are sought, have arisen in consequence of the power which a large and consolidated capital gives them over business of every kind; and the facility which the incorporation gives to the management of capital, and the

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[183] Bubble Act Repeal, 6 Geo. IV c. 91 (1825); Limited Liability Act, 18 & 19 Vict. C. 133 (1855).
[184] Angell and Ames were preceded by the English work of John Kyd, published in London in 1793, but that treatise was devoted primarily to municipal corporations. See Angell & Ames, vi. The Angell & Ames treatise was very successful, with 11 editions published until 1875.
[185] Angell & Ames, v; see also ibid, 35: "In no country have corporations been multiplied to so great an extent, as in our own…There is scarcely an individual of respectable character in our community, who is not a member of, at least, one private company or society which is incorporated…Acts of incorporation are moreover continually solicited at every session of the legislature."

security which it affords to the persons of its members, and to their property not vested in the corporate stock."[186]

This was a profound shift, and not surprisingly it led to a revival of the centuries-old debate about the nature of the corporate form and its relationship to the shareholders and to the state. This debate can be seen if we examine the opinions on the subject issued by the first great American jurist, John Marshall. Three of Marshall's opinions, written decades apart, are particularly relevant here: *Bank of the United States v. Deveaux* (1809), *Dartmouth College v. Woodward* (1819), and *Bank of the United States v. Dandridge* (1827).[187] These opinions represent the evolution of his thinking on corporations, which moved from the aggregate view (Deveaux) to the artificial entity view (Dartmouth College) to the real entity view (Dandridge).

Deveaux involved an attempt by the state of Georgia to tax the Savannah branch of the Bank of the United States, a corporation established by Congress in 1791, as part of the early struggles around federalism. The Bank was a membership corporation ("The President, Directors and Company of the Bank of the United States") and all the members were citizens of Pennsylvania. The Bank refused to pay the tax and the State sent its collectors to enforce payment, whereupon the Bank sued the collectors in federal court, claiming diversity jurisdiction. The issue facing the court was whether a corporation made up of members from one state could sue citizens of another state in federal court on diversity grounds. This in turn required deciding between the view that "the individual character of the members is so wholly lost in that of the corporation, that the court cannot take notice of it", and the contrary view that "a corporation is composed of natural persons", i.e., between the entity (artificial or real) and aggregate views.[188]

Marshall decided in favor of the aggregate view. He stated that the corporation itself, "that mere legal entity", cannot be a citizen or sue in federal court, unless it can be regarded as "a company of individuals".[189] However, since the reasons that led Congress to enact diversity jurisdiction applied to corporations as well, Marshall was inclined to see the controversy as being between the members "suing in their corporate character" and their opponents.[190] "The controversy is substantially between aliens, suing by a corporate name, and a citizen…in this case the corporate name represents persons who are members of the corporation."[191] The Court therefore held that federal jurisdiction existed.

Ten years later Marshall was faced with another difficult issue involving corporations. In the famous *Dartmouth College* case, the state of New Hampshire

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[186] Angell & Ames, 36, citing 2 Kent's Com. 219. The last sentence refers to limited liability, which will be discussed below.
[187] 9 U.S. (5 Cranch) 61 (1809); 17 U.S. (4 Wheat.) 518 (1819); 25 U.S. (12 Wheat.) 64 (1827).
[188] Deveaux, 9 U.S. 63-64.
[189] 9 U.S. 86-87.
[190] Ibid., 87-88.
[191] Ibid., 91.

attempted to alter the charter of Dartmouth College (incorporated as a membership corporation by George III in 1769, under the name of Trustees of Dartmouth College), by transferring the appointment of trustees to the state, thereby effectively taking it over. The trustees objected, arguing that the charter constituted a contract and altering it violated the contracts clause of the Constitution.[192]

Marshall held that as the College was a private corporation, its charter was a contract and was protected by the contracts clause. He began by noting that the funds for the College came from private sources and its educational character did not make it public either. He then got to the heart of the question- whether the act of incorporation by the state makes it possible for the state to take it over. In frequently quoted language, Marshall held that-

> A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly, or as incidental to its very existence.[193]

This language reflects the artificial entity view of the corporation. But Marshall then went on to note that, having created the corporation, the state may not treat it as a mere extension of itself: "this being does not share in the civil government of the country, unless that be the purpose for which it was created."[194] Even though its object is to promote governmentally approved aims, this does not make corporations into mere instruments of government. Instead, the corporation exists to represent the interest of the founder and his descendants in the aims for which it was founded. This interest is in the United States protected by the contracts clause, although in England, Marshall recognized, Parliament had the power to annul the charter.[195] In this country "the body corporate, as possessing the whole legal and equitable interest, and completely representing the donors, for the purpose of executing the trust, has rights which are protected by the constitution."[196]

It should be noted that while Marshall held that the state may not take over a private corporation, even one founded for public ends, the emphasis on the artificial nature of the corporation left ample room for state regulation via the original charter. Since states were busy granting charters by the hundreds, the Dartmouth opinion left ample room for the states to regulate corporations, should they wish to do so.

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[192] The Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518 (1819).
[193] 17 U.S. 636.
[194] Ibid.
[195] 17 U.S. 642-643.
[196] 17 U.S. 654.

Finally, six years later, Marshall was once more called to opine on the nature of corporations in another case involving the Bank of the United States.[197] The case involved a suit by the Bank on a bond executed by Dandridge, one of its cashiers, in which the defendant argued that the bond had never been approved by the Board of Directors, as required by the charter of incorporation. The key issue was whether the level of evidence required of corporations was higher than that required of individuals, since corporations are incapable of acting not in writing. Justice Story for the Court held that no distinction should be made: "The same presumptions are…applicable to corporations."[198] Marshall, however, dissented. He argued that—

> The corporation being one entire impersonal entity, distinct from the individuals who compose it, must be endowed with a mode of action peculiar to itself, which will always distinguish its transactions from those of its members. This faculty must be exercised according to its own nature…This can be done only in writing.[199]

The Court's view was the more pragmatic one, but Marshall's view was more consistent with the real entity view of the corporation as distinct from its members, individually or collectively. It certainly forms an interesting contrast with the views he expressed in the *Deveaux* case sixteen years earlier.

How can one explain the shift in Marshall's view of the corporation from aggregate (*Deveaux*) to artificial (*Dartmouth College*) to real (*Dandridge*)? In part, this stems from the circumstances of these particular cases. In *Deveaux*, Marshall wanted to confer diversity jurisdiction to protect a federal institution (he was after all a Federalist), and the only way to do so was to look through the corporation to its members. In *Dartmouth College*, the issue involved the relationship of private corporations (albeit "imbued with a public purpose"; the full fledged private/public distinction had not yet evolved) to the state, and thus Marshall emphasized the role of the state in creating the corporation, while placing clear limits on its ability to regulate corporations thereafter. These limits were required as the result of the proliferation of corporations, especially for-profit business corporations, since otherwise the state would be able to take over purely private businesses. The result in *Dartmouth College* favored in practice the real entity view, since once a private corporation was created, it could no longer be taken over or perhaps even be overly regulated by the state. Thus, it may not be surprising that by the time he came to write his *Dandridge* dissent Marshall took the real entity view, even though it contradicted his opinion in *Deveaux* (which is not mentioned).

Two important legal developments during the same period strengthened the real entity view and weakened the aggregate and artificial entity views of the

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[197] Bank of the United States v. Dandridge, 25 U.S. (12 Wheat.) 64 (1825).
[198] 25 U.S. 70.
[199] 25 U.S. 91-92.

corporation: the rise of limited liability and the spread of general incorporation laws. Limited liability weakened the aggregate view, and general incorporation weakened the artificial entity view.

First, limited liability: As we have seen, in England limited liability did not exist for corporations until 1855. In the United States, however, most states adopted limited liability in the 1830s.[200] In their second edition, Angell & Ames explain that this was the primary distinction between a partnership and a corporation:

> In every private unincorporated company, the members are liable for the debts without limitation, whereas in incorporated societies, they are only liable to the extent of their shares…It is frequently the principal object, in this and in other countries, in procuring an act of incorporation, to limit the risk of the partners to their shares in the stock of the association; and prudent men are always backward in taking stock when they become mere copartners as regards their personal liability for the company debts.[201]

When Angell & Ames wrote this limited liability was by no means a universally established rule for corporations[202]; they were thus trying to establish the law as much as describing the law that existed. Their main argument, familiar from current debates on limited liability[203], was that "[t]he public, therefore, gain by acts incorporating trading associations, as by such means persons are induced to hazard a certain amount of property for the purposes of trade and public improvement, who would abstain from doing so, were not their liability limited."[204]

Eventually this argument won the day, and by 1840 most of the states established limited liability.[205] Limited liability, in turn, led to a decline in the emphasis on the aggregate theory, because the aggregate view of corporations tend to reduce the distinction between the corporation and its members or shareholders that is at the heart of limited liability.

The decline of the aggregate view can clearly be seen in two cases from the period 1839-1844, in which the Supreme Court repudiated Marshall's opinion in *Deveaux*. In *Bank of Augusta v. Earle* the Court held that a corporation

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[200] Bloomberg.
[201] Angell & Ames, 23; see also id., at 349: "No rule of law we believe is better settled, than that, in general, the individual members of a private corporate body are not liable for the debts." See also the cite from Judge Kent, supra, emphasizing limited liability as a reason to incorporate.
[202] Bloomberg.
[203] See, e.g., Grundfest; Hansmann & Kraakman.
[204] Angell & Ames, 24. They go on to argue that states who pursue the contrary policy, like Massachusetts, "drive millions of capital into the neighboring states for investment"- an early instance of a "race" (to the top or bottom). Ibid., 362.
[205] This was subject to one limitation, the "trust fund" doctrine, which held that the capital stock of corporation was to be held in trust for paying corporate debts and thus could not be distributed to shareholders while debts were outstanding. See Wood v. Dummer, 30 Fed. Cas. 435 (Cir. Ct. D. Maine, 1824).

incorporated by Georgia may execute a valid contract in Alabama on comity grounds, but it rejected the argument that Alabama was required to accept the contract on the basis of the privileges and immunities clause applied directly to the corporation's members (as required by the aggregate view), stating that *Deveaux* has never been extended that far. Chief Justice Taney emphasized that he rejected the aggregate view because of its implications for limited liability, as well as its implications for state regulation of the corporations operating in it:

> The result of this [aggregate view] would be to make the corporation a mere partnership in business, in which each stockholder would be liable to the whole extent of his property for the debts of the corporation…Besides, it would deprive every state of all control over the extent of corporate franchises proper to be granted in the state.[206]

In *Louisville, Cincinnati, and Charleston Railroad Co. v. Letson*, decided in 1844, the Court explicitly limited *Deveaux* to its facts, holding that diversity jurisdiction may arise even when some of the members of a defendant corporation are citizens of the same state as the plaintiff.[207] The Court stated that the *Deveaux* results "have never been satisfactory to the bar" and that a corporation "seems to us to be a person, although an artificial one, inhabiting and belonging to that state [of incorporation], and therefore entitled, for purposes of suing and being sued, to be deemed a citizen of that state."[208]

This result was required by the proliferation of business corporations having many shareholders in many states, as opposed to the membership corporations of Marshall's early days. As Angell & Ames stated, by 1832 "Joint stock companies are composed of persons who seldom know any thing of the business of the company, but who leave the management of it entirely to the board of directors, and are contented with receiving such periodical dividends as the directors think proper to make."[209] The separation of management from ownership, and the rise of limited liability, rendered the aggregate view implausible.[210]

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[206] Bank of Augusta v. Earle, 38 U.S. 519, 586-587 (1839).
[207] 43 U.S. 497 (1844).
[208] 43 U.S. 376. See also Marshall v. Baltimore & Ohio Railroad Co., 57 US 314 (1853), in which the Court held that for diversity purposes a corporation should be deemed a resident of its place of incorporation. This led to the current rule, adopted in 1958, under which a corporation is for diversity purposes a citizen of both the state it is incorporated in and the state in which it has its principal place of business. 28 USC 1332 ©.
[209] Angell & Ames, 32.
[210] See also Chief Justice Shaw's statement in Burrill v. Nahant Bank, 43 Mass. 163 (1840), that "A board of directors of the banks of Massachusetts is a body recognized by law. By the by-laws of these corporations, and by a usage, so general and uniform as to be regarded as part of the law of the land, they have the general superintendence and active management of all the concerns of the bank, *and constitute, for purposes of dealing with others, the corporation*" (emphasis added). It is hard to imagine a clearer rejection of the aggregate view. Similarly, in Hoyt v. Thompson's Executor, decided by the New York Court of Appeals in 1859, the court held that "[i]n corporate bodies the powers of the board of directors are, in a very important sense, original and undelegated. The stockholders do not confer, nor can they revoke those powers. They are

Second, general incorporation: The granting of corporate charters by state legislatures became in the 1820s and 1830s a process fraught with corruption.[211] Some Jacksonians reacted by advocating elimination of the rights of states to grant corporate charters. But the corporate form was so widely used that this was impracticable; instead, laws were passed in all the states permitting anyone to form a corporation on payment of a fee, without permission by the state legislature.[212] This democratizing move meant that the artificial entity theory, under which the corporation derives its powers from the state, lost most of its appeal, since the state was only vestigially involved in creating corporations. Instead, corporations were viewed as separate from both their shareholders and the state, and the real entity view reigned supreme.[213]

c. Third Transformation: From Closely-Held to Widely-Held Corporations.

The situation between the 1820s and the end of the Civil War was thus the proliferation of for profit corporations, incorporated under general incorporation laws with minimal interference by the state, and whose shareholders enjoyed limited liability. Those shareholders were, however, relatively limited in number; despite the Angell & Ames quotation above, few corporations before 1865 required massive amounts of capital, and most were small, closely held enterprises. As we have seen, this enabled the Civil War income tax to be imposed directly on the shareholders of corporations.

This state of affairs began to change with the advent of the railroads, followed by the steel and oil companies. With the rise of large corporate enterprises, massive amounts of capital were required, and between 1865 and the 1890s the widely held, publicly traded, non-owner managed enterprise gradually became the norm for U.S. business activities. This was followed from 1890 to 1916 by a wave of

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derivative only in the sense of being received from the State in the act of incorporation. The directors convened as a board are the primary possessors of all the powers which the charter confers, and like private principals they may delegate to agents of their own appointment the performance of any acts which they themselves can perform. The recognition of this principle is absolutely necessary in the affairs of every corporation whose powers are vested in a board of directors. Without it the most ordinary business could not be carried on, and the corporate powers could not be executed." 19 N.Y. 207, 216 (1859). This constitutes a recognition that the aggregate view deriving from the membership corporation could not be maintained as a practical matter in corporations with hundreds or thousands of shareholders, as already existed in the 1850s.

[211] See Angell & Ames, 35-36.

[212] See, e.g., the act adopted in 1837 by Connecticut permitting incorporation of "any lawful business", ch. 63, 1837 Conn. Pub. Acts 49, and various cases upholding such laws, e.g., Nesmith v. Sheldon, 48 US 812 (1849). See also President Jackson's veto message of the second bank of the United States, cited in Davis, 611: "If [the government] would confine itself to equal protection, and, as Heaven does its rains, shower its favors alike on the high and the low, the rich and the poor, it would be an unqualified blessing."

[213] The same result was obtained in England by the adoption of the Regulation and Incorporation Act, 19 & 20 Vict. C. 47 (1856).

consolidation that left several important business areas dominated by monopolies run by the "robber barons."

The shift from small, closely held enterprises to massive, publicly held ones once again necessitated a re-examination of the corporate form, and again all three theories of the corporation appear. A classic example of the aggregate view is the *Santa Clara* case, ultimately decided by the Supreme Court in 1886. This case is famous for Chief Justice Waite's statement that "The court does not wish to hear argument on the question whether the [equal protection clause] applies to these corporations. We are all of the opinion that it does."[214] Some scholars identified this as an application of the real entity view to corporations, but Prof. Horwitz has shown by examining Justice Field's opinion in the court below that it actually represented an application of the aggregate view. Specifically, Field held that the equal protection clause must apply to corporations for the following reasons:

> Private corporations consist of an association of individuals united for some lawful purpose, and permitted to use a common name in their business and have succession of membership without dissolution…But these members do not, because of such association, lose their right to protection, and equality of protection…Whatever affects the property of the corporation- that is, of all the members united by the common name- necessarily affects their interests…So, therefore, whenever a provision of the constitution or of a law guarantees to persons protection in their property… the benefits of the provision are extended to corporations; not to the name under which different persons are united, but to the individuals composing the union. The courts will always look through the name to see and protect those whom the name represents [citing *Deveaux.]*[215]

A clearer statement of the aggregate view can hardly be imagined; most remarkable is Field's reliance on *Deveaux* despite the fact that the Supreme Court overturned its results forty years earlier. Similarly, in *Pembina Consolidated Co. v. Pennsylvania*, decided two years later, Justice Field for the Court stated that "Under the designation of person there is no doubt that a private corporation is included. Such corporations are merely associations of individuals united for a special purpose."[216]

However, the artificial entity view was also raised in these cases. In *Santa Clara*, the railroad corporations made the argument that because they were operating under special congressional legislation they should be regarded as an extension of

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[214] Santa Clara County v. Southern Pacific R.R. Co., 118 U.S. 394 (1886).
[215] 18 F. 385 (C.D.D. Cal. 1883), 409-410.
[216] 125 U.S. 181, 189 (1888). See also Mason v. Pewabic Mining Co., 133 U.S. 50 (1890), in which the Court stated that "we do not see that the right of the parties in regard to the assets of this corporation differ from those of a partnership on its dissolution."

the federal government and therefore California could not tax them.[217] Field rejected this view (citing *Dartmouth College*), but noted that "when the instrumentality is the creation of the state- a corporation formed under its laws- and is employed or adopted by the general government for its convenience…it remains subject to the taxing power of the state."[218] And notably, in *Pembina* Field followed Taney in rejecting the argument that the privileges and immunities clause applied to corporations because they were not "citizens", even though the aggregate view he adopted in *Santa Clara* might have led to the contrary position. Instead, Field emphasized the relationship between the corporation and the incorporating state under the artificial entity view:

> The term citizens, as used in this clause, applies only to natural persons, members of the body politic owing allegiance to the State, not to artificial persons created by the legislature, and possessing only such attributes as the legislature has prescribed…a grant of corporate existence was a grant of special privileges to the corporators, enabling them to act for certain specified purposes as a single individual, and exempting them, unless otherwise provided, from individual liability.[219]

Moreover, all three views of the corporation appear in *Hale v. Henkel*, decided by the Supreme Court in 1906. The issues were whether an agent of a corporation could invoke the Fifth Amendment privilege against self-incrimination or the Fourth Amendment protection against unreasonable search and seizure in the name of the corporation. On the Fifth Amendment issue, the Court held that the right against self-incrimination does not apply to corporations:

> The right of a person under the Fifth Amendment to refuse to incriminate himself is purely a personal privilege of the witness…The question whether a corporation is a "person" within the meaning of this Amendment really does not arise…since it can only be heard by oral evidence in the person of some one of its agents or employees.[220]

This is closest to the real entity view, since it rejects (like Marshall in *Dandridge*) the aggregate position of looking through a corporation to its shareholders, and takes into account the special characteristics of the corporation itself.

On the other hand, on the Fourth Amendment issue, the Court at first emphasized the artificial entity view, using it to justify regulation by the state:

> Conceding that the witness was an officer of the corporation under investigation, and that he was entitled to assert the rights of the corporation with respect to the production of its books and papers, we are

[217] 18 F. Rep. 387.
[218] 18 F. Rep. 389.
[219] 125 US 187-88.
[220] Hale v. Henkel, 201 U.S. 43, 69-70 (1906).

> of the opinion that there is a clear distinction in this particular between an individual and a corporation, and that the latter has no right to refuse to submit its books and papers for an examination at the suit of the State. The individual may stand upon his constitutional rights as a citizen…Upon the other hand, the corporation is a creature of the State. It is presumed to be incorporated for the benefit of the public. It receives certain special privileges and franchises, and holds them subject to the laws of the State and the limitations of its charter. Its powers are limited by law. It can make no contract not authorized by its charter. Its rights to act as a corporation are only preserved to it so long as it obeys the laws of its creation. There is a reserved right in the legislature to investigate its contracts and find out whether it has exceeded its powers. It would be a strange anomaly to hold that a State, having chartered a corporation to make use of certain franchises, could not in the exercise of its sovereignty inquire how these franchises had been employed, and whether they had been abused, and demand the production of the corporate books and papers for that purpose…While an individual may lawfully refuse to answer incriminating questions unless protected by an immunity statute, it does not follow that a corporation, vested with special privileges and franchises, may refuse to show its hand when charged with an abuse of such privileges.[221]

However, having clearly stated its reasons for limiting the application of the constitutional right, the Court suddenly reverts to the aggregate view when facing the question whether corporations have any Fourth Amendment rights at all:

> [W]e do not wish to be understood as holding that a corporation is not entitled to immunity, under the Fourth Amendment, against unreasonable searches and seizures. A corporation is, after all, but an association of individuals under an assumed name and with a distinct legal entity. In organizing itself as a collective body it waives no constitutional immunities appropriate to such body. Its property cannot be taken without compensation. It can only be proceeded against by due process of law, and is protected, under the Fourteenth Amendment, against unlawful discrimination. Corporations are a necessary feature of modern business

[221] 201 US 74-75. Remarkably, the court applies this analysis to give powers to the federal government over state corporations (as we have seen, this issue came up in the corporate tax area as well): "It is true that the corporation in this case was chartered under the laws of New Jersey, and that it receives its franchise from the legislature of that State; but such franchises, so far as they involve questions of interstate commerce, must also be exercised in subordination to the power of Congress to regulate such commerce, and in respect to this the General Government may also assert a sovereign authority to ascertain whether such franchises have been exercised in a lawful manner, with a due regard to its own laws. Being subject to this dual sovereignty, the General Government possesses the same right to see that its own laws are respected as the State would have with respect to the special franchises vested in it by the laws of the State. The powers of the General Government in this particular in the vindication of its own laws, are the same as if the corporation had been created by an act of Congress. It is not intended to intimate, however, that it has a general visitatorial power over state corporations." Ibid, 75.

> activity, and their aggregated capital has become the source of nearly all great enterprises.[222]

What can explain this remarkable oscillation between the three views? The key is the last sentence quoted. As noted above, the period between 1890 and 1916 marked the height of the debate on the rise of the great corporations. The Court is trying to strike a balance between the rights of the corporations, which can best be protected under either the aggregate or the real entity views, and the regulatory power of the state, which is best reflected in the artificial entity view. On the one hand, as the Court states, "[c]orporations are a necessary feature of modern business activity" and must be protected. On the other hand, the right of the state to regulate must also be preserved, especially since the context of *Hale v. Henkel* was an antitrust investigation into two major corporations, the American Tobacco Company and McAndrews & Forbes Inc.

Ultimately, however, the real entity view prevailed.[223] This involved first the rejection of the aggregate view. For example, in *Western Turf Association v. Greenberg*, decided just one year after *Hale v. Henkel*, Justice Harlan emphasized that a corporation is a separate entity from its shareholders, and therefore is not a "citizen" for purposes of the privileges and immunities clause or entitled to the protection of the due process clause: "the liberty guaranteed by the Fourteenth Amendment against deprivation without due process of law is the liberty of natural, not artificial, persons."[224] But by itself this position would have led to too much state regulation for the Lochner court. Thus, in *Southern Railway Co. v. Greene*, decided in the same year the corporate tax was adopted, the Court came out clearly for the position that the corporation *as such* was entitled to constitutional protection under the equal protection clause, without any reference to its shareholders: "the corporation…is within the meaning of the Fourteenth Amendment, a person within the jurisdiction of the state of Alabama, and entitled to be protected against any statute of the State which deprives it of the equal protection of the laws."[225]

Once again, the triumph of the real entity view can be explained by several factors. The aggregate view was raised by Field and others to protect the rights of

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[222] Ibid., 76 (cites omitted).

[223] This view was also reflected in contemporary books and law review articles. See, e.g., Freund, The Legal Nature of Corporations (1897); Deiser, The Juristic Person, 57 U. Pa. L. Rev. 131 (1908); Machen, Corporate Personality, 24 Harv. L. Rev. 253 (1911); Laski, The Personality of Associations, 29 Harv. L. Rev. 404 (1916) ; I. Maurice Wormser, Piercing the Veil of Corporate Entity, 12 Columbia L. Rev. 496 (1912) (all rejecting the aggregate view). Compare for a statement of the aggregate view Morawetz, A Treatise on the Law of Private Corporations (1882), at iii ("the existence of the corporation as an entity independent of its members is a fiction.")

[224] 204 U.S. 359, 363.

[225] 216 U.S. 400, 417. Remarkably this case involves a discriminatory state tax similar to the one struck down by Field on aggregate grounds in Santa Clara. See also similar statements in Ludwig v. Western Union Tel. Co., 216 US 146, 157 (1910); Pullman Co. v. Kansas, 216 US 56, 64 (1910); Western Union Tel. Co. v. Kansas, 216 US 1, 36 (1910), which finally eliminated the restrictions imposed by Bank of Augusta v. Earl. See Horwitz.

corporations, but it was even more incongruous in the context of the mega-corporations of the 1890s, with thousands of shareholders, than in the pre-civil days. It also gave the corporation too many rights vis-a-vis the state, as seen in *Hale v. Henkel* and in *Greenberg*. The artificial entity view gave the state too much power to regulate corporations, as the *Hale v. Henkel* court came to realize when it laid out its implications. The real entity view was the most congruent with business realities as well as the one most suited to some balance between corporations and the state. By 1909, it was well established as the dominant view of the corporation, as we have seen above when discussing the corporate tax enacted that year.

The rise of the real entity view is also reflected in two other contemporary developments: the rise of the business judgment rule, and the decline of the *ultra vires* doctrine.[226] The business judgment rule rejected the aggregate view in holding that the board of directors held powers that were not delegated from the shareholders and that shareholders could not normally call into question the exercise of those powers. The *ultra vires* doctrine represented the ability of the state to require corporations to adhere to their charter, and was thus based on the artificial entity view; its decline thus reinforced the rejection of that view.

The first full statement of the business judgment rule was made in *Leslie v. Lorillard*, decided by the New York Court of appeals in 1888. The court held that-

> In actions by stockholders, which assail the acts of their directors or trustees, courts will not interfere unless the powers have been illegally or unconscientiously executed…Mere errors of judgment are not sufficient as grounds for equity interference; for the powers entrusted with corporate management are largely discretionary.[227]

A year later the same court expanded this statement, holding that-

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[226] Another related development was the strengthening of limited liability resulting from the demise of the "trust fund" doctrine, which held that the capital stock of a corporation must be held in trust for the benefit of its creditors. This doctrine, which originated from Justice Story's opinion in Wood v. Dummer, 30 Fed. Cas. 435 (1824), was upheld by the Supreme Court in Sawyer v. Hoag, 84 U.S. 610 (1873) on the basis on the aggregate view ("after all this artificial body is but the representative of its stockholders, and exists mainly for their benefit, and is governed and controlled by them through the officers whom they elect", 84 U.S. 623). See also W. W. Cook, Stock & Stockholders (1887), 322. However, in 1892 the Supreme Court of Minnesota held in Hospes v. Northwestern Mfg. & Car Co., 48 Minn. 174, that "this trust fund doctrine…is not sufficiently precise or accurate to constitute a safe foundation upon which to build a system of legal rules…corporate property is not held in trust…Absolute control and power of disposition are inconsistent with the idea of trust. The capital of a corporation is its property…a corporation is in law as distinct a person as an individual is, and is entitled to hold property (if not contrary to its charter) as absolutely as an individual can hold it." The doctrine then fell into desuetude, reinforced by the invention of no par stock in the early 20th century. See Horwitz.

[227] 110 N.Y. 519, 532 (1888).

> All powers directly conferred by statute, or impliedly granted, of necessity, must be exercised by the directors who are constituted by the law as the agency for the doing of corporate acts. The expression of the corporate will and the performance of corporate functions in the management of a corporation, may originate with its directors…Within the chartered authority they have the fullest power to regulate the concerns of a corporation, according to their best judgment…In the management of the affairs of the corporation, they are dependent solely upon their own knowledge of its business and their own judgment as to what its interests require.[228]

This rule became well established, so that by 1905 a court could write that "it is [the board's] judgment, and not that of its stockholders outside of the board of directors, that is to shape [a corporation's] policies or decide upon its corporate acts. This principle is not disputed, and the citation of authorities in its support is unnecessary."[229] The rule reflected the real entity view, which equates the corporation with its management, and rejected the aggregate view of the corporation as an aggregate of its shareholders.[230]

The one potential limitation on the power of the board was the *ultra vires* doctrine, which held that a board could not act contrary to the powers conferred on it by the state. The *ultra vires* doctrine thus represented the artificial entity view. The doctrine originated in the pre- civil war era,[231] but became prominent in the arguments on the relationship of the state and the corporation in the 1880s and 1890s.[232] The artificial entity argument for upholding the limitation was stated clearly by the New York Court of Appeals in 1888-

> In the granting of charters the legislature is presumed to have had in view the public interest; and public policy is (as the interests of stockholders ought to be) concerned in the restriction of corporations within chartered limits, and a departure therefrom is only deemed excusable when it cannot result in prejudice to the public or to the shareholders. As artificial creations, they have no powers or faculties, except those with which they were endowed when created…Corporations are great engines for the promotion of the public convenience, and for the development of public wealth, and, so long as they are conducted for the purposes for which organized, they are a public benefit; but if allowed to engage, without

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[228] Beveridge v. New York Elevated Railroad Co., 111 N.Y. 1 (1889).

[229] Siegman v. Electric Vehicle Co., 140 F. 117, 118 (D.D.C.N.J. 1905). See also Manson v. Curtis, 223 N.Y. 313, 323 (1918), in which the court held that "[d]irectors are the exclusive, executive representatives of the corporation and are charged with the administration of its internal affairs and the management and use of its assets. Clearly the law does not permit the stockholders to create a sterilized board of directors."

[230] It also represented a transition from an agency to a trustee model of the relationship between shareholders and management. See Millon.

[231] See, e.g., Abbott v. American Hard Rubber Co., 33 Barb. 578 (NY Sup. Ct. 1861).

[232] See, e.g., the extensive discussion in W.W. Cook's treatise, ch. 19 and 38 (1887).

> supervision, in subjects of enterprise foreign to their charters, or if permitted unrestrainedly to control and monopolize the avenues to that industry in which they are engaged, they become a public menace, against which public policy and statutes design protection.[233]

The doctrine was upheld by the Supreme Court in the following year. Referring to the artificial entity doctrine, the Court stated that --

> It may be considered as the established doctrine of this court in regard to the powers of corporations, that they are such and such only as are conferred upon them by the acts of the legislatures of the several States under which they are organized. A corporation in this country, whatever it may have been in England at a time when the crown exercised the right of creating such bodies, can only have an existence under the express law of the State or sovereignty by which it is created. And these powers, where they do not relate to municipal corporations exercising authority conferred solely for the benefit of the public, and in some sense parts of the body politic of the State, have in this country until within recent years always been conferred by special acts of the legislative body under which they claim to exist. But the rapid growth of corporations, which have come to take a part in all or nearly all of the business operations of the country, and especially in enterprises requiring large aggregations of capital and individual energy, as well as their success in meeting the needs of a vast number of most important commercial relations, have demanded the serious attention and consideration of law makers. And while valuable services have been rendered to the public by this class of organizations, which have stimulated their formation by numerous special acts, it came at last to be perceived that they were attended by many evils in their operation as well as much good, and that the hasty manner in which they were created by the legislatures, sometimes with exclusive privileges, often without due consideration and under the influence of improper motives, frequently led to bad results.[234]

The reference to corporate abuses relates to the rise of trusts, and indeed the *ultra vires* doctrine was used to dissolve sugar and oil trusts under New York and Ohio law.[235] However, in 1895 the Supreme Court rejected an antitrust challenge to the sugar trust on the grounds that the Sherman Act applied only to corporations engaged directly in interstate commerce.[236] And in 1896 the Court rejected an *ultra vires* challenge to the ability of the Union Pacific Railway to lease its tracks

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[233] Leslie v. Lorillard, 110 N.Y. 519, 531-533 (1888).
[234] Oregon Railway & Navigation Co. v. The Oregonian Railway Co. Ltd., 130 U.S. 1 (1889).
[235] See People v. North River Sugar Refining Co., 121 N.Y. 282 (1890); State v. Standard Oil Co., 49 Ohio St. 137 (1892). See also Theodore Dwight, The Legality of Trusts, 3 Poli. Sci. Q. 592 (1888); William Cook, The Corporation Problem (1891).
[236] United States v. E.C. Knight Co., 156 U.S. 1 (1895).

for 999 years to another railroad, when the charter would not permit an outright sale.[237] This literal decision significantly reduced the power of the *ultra vires* doctrine.[238]

The ultimate demise of the doctrine resulted not from a court decision but from the competition among states to attract corporate charters, which was begun by New Jersey in 1890 and continued by Delaware in the 1900s.[239] This competition meant that New Jersey and Delaware had every incentive to relax any limiting elements in their charters that restricted the power of corporate management.[240] Thus, for example, the long-lasting prohibition against corporations owning stock in other corporations, which led to the necessity of "trusts", was eliminated by New Jersey in its 1890 law.[241] As a result, although the Supreme Court still held in 1899 that such a combination was *ultra vires* under New York law, this holding became rather meaningless since most corporations were incorporated in New Jersey.[242] As the New Jersey statute explains:

> It was formerly the rule in this State that acts of a corporation in excess of its express powers, or those necessarily implied, were void, and contracts which were *ultra vires* the corporation were incapable of enforcement or ratification…This rule no longer obtains.[243]

The decline of the *ultra vires* doctrine was sealed by the spread of corporate laws permitting incorporation "for any lawful purpose". With the doctrine gone, the artificial entity view of the corporation became less plausible, and the real entity view reigned supreme again.[244]

d. A Failed Transformation: The Hostile Takeover Crisis.

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[237] Union Pacific Railway Co. v. Chicago, Rock Island and Pacific R.R. Co., 163 U.S. 564 (1896).
[238] See W. Cook, Treatise on Stock and Stockholders, 971-73 (3rd ed. 1894): "The courts are becoming more liberal, and many acts which fifty years ago would have been held to be ultra vires would now be held to be intra vires." By 1898 Cook wrote that "the doctrine of ultra vires is disappearing." Cook, Treatise on the Law of Corporations vii (4th ed. 1898). On this entire development see Horwitz.
[239] See Edward Q. Keasbey, New Jersey and the Great Corporations, 13 Harv. L. Rev. 198 (1899); Lincoln Steffens, New Jersey: A Traitor State, 25 McLure's Magazine 41 (1905); Russel Larcom, The Delaware Corporation (1937), ch. 1.
[240] See James Dill, Trusts-Their Uses and Abuses (1901); "New Jersey Legislating for the United States", Indianapolis Journal (Nov. 11, 1901);
[241] General Corporation Act of New Jersey (1890 rev.), sec. 51. See also sec. 104 (authorizing mergers); W.W. Cook, A Treatise on the Law of Corporations (4th ed., 1898), vi.
[242] De La Vergne Refrigerating Machine Co. v. German Savings Institution, 175 U.S. 40 (1899).
[243] General Corporation Law of New Jersey, 10 (1896).
[244] See Machen, supra. Another significant development in this period was states passing statutes that allowed a majority of shareholders to sell corporate assets (before the 1890s, shareholder unanimity was required). This greatly facilitated mergers and also represented the decline of the aggregate view. See Horwitz.

In 1926 John Dewey published an article in the Yale Law Journal in which he dismissed as irrelevant the debate among the aggregate, artificial entity, and real entity views of the corporation. These views, he explained, could be deployed to suit any purpose; and he used examples relying on the cyclical nature if these theories. His conclusion was that theory should be abandoned for an examination of reality.[245]

Dewey was influential in that the theoretical debate on corporate personality largely disappeared until the 1970s. As a practical matter, however, the real entity view predominated for large, publicly traded corporations. The board ran the corporation as it saw fit, protected from the shareholders by the separation of ownership from management noted by Berle & Means in the 1930s, and by the business judgment rule, and protected from the state by the relaxation of corporate law limits begun by New Jersey and continued by Delaware.

The next significant practical change in this state of affairs only arose in the 1980s. As a result of the invention of the junk bond market, it suddenly became possible for hostile raiders to threaten takeovers of even the largest corporations. After RJR Nabisco was taken private for $25 billion in 1988, it was clear that no board was safe. As a result, debates on the nature of the corporation and its relationship to the shareholders and the state, which began in the academic literature in the 1970s, once again became a matter of practical concern. And once again all three theories of the corporation reappeared, as can be seen if one examines three seminal cases decided between 1982 and 1989 by the Supreme Courts of the United States and of Delaware.

Edgar v. MITE Corp., decided by the Supreme Court in 1982, involved the constitutionality of an anti-takeover act enacted by the state of Illinois.[246] Under the Illinois Business Take-Over Act, a hostile tender offer for the shares of a company covered by the act had to be registered by the Secretary of State and the offeror had to give both the target and the state a 20 day notice during which only the target could communicate with its shareholders regarding the offer. The act applied both to corporations 10% of whose shareholders were resident of Illinois and to corporations that were either incorporated in the state or had their principal office in it. The MITE corporation made a hostile offer for an Illinois corporation and refused to comply with the act, arguing that it violated the commerce clause.

The Supreme Court agreed with MITE. Writing for a 5-4 majority, Justice White held that the Illinois act was unconstitutional because it could apply to tender offers that did not affect a single Illinois *shareholder;* "the state has no legitimate interest in protecting nonresident shareholders."[247] Moreover, the fact that the target corporation was an Illinois corporation was irrelevant since state regulation

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[245] John Dewey, The Historical Background of Corporate Legal Personality, 35 Yale L.J. 655 (1926).
[246] 457 U.S. 624 (1982).
[247] 457 U.S. 644.

only applied to the corporation's "internal affairs": "Tender offers contemplate transfers of stock by stockholders to a third party and do not themselves implicate the internal affairs of the target company."[248] Instead, the focus should be entirely on the impact of blocking the tender offer on the company's shareholders and their relationship with management:

> The effects of allowing the Illinois Secretary of State to block a nationwide tender offer are substantial. Shareholders are deprived of the opportunity to sell their shares at a premium. The reallocation of economic resources to their highest valued use, a process which can improve efficiency and competition, is hindered. The incentive the tender offer mechanism provides incumbent management to perform well so that stock prices remain high is reduced. See Easterbrook & Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 Harv. L. Rev. 1161, 1173-1174 (1981); Fischel, Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers, 57 Texas L. Rev. 1, 5, 27-28, 45 (1978); H. R. Rep. No. 94-1373, p. 12 (1976).

This part of the opinion clearly reflects the aggregate view: The focus is entirely on the impact on the corporation's shareholders, and the corporation itself (including its management) barely exist, as indicated by the statement that a change in corporate control has no relevance to the internal affairs of the corporation. The market for corporate control is praised because of its ability to overcome the agency cost problem and the incentive it provides for management to maximize stock prices. Moreover, White quotes the work of Easterbrook and Fischel, who are among the principal proponents of the "nexus of contracts" theory of the corporation, according to which the corporation is merely a convenient legal term for a series of contracts, the most important of which is the contract between shareholders and management.[249]

This part of the opinion, which rejects both the artificial entity and the real entity theories, evoked some misgivings on the part of Justice Powell, even though he joined it to provide the crucial fifth vote. Powell noted that in some cases the state may have a legitimate interest because the corporation has a real presence that goes beyond a contract between management and the shareholders, reflecting both the artificial and real entity views:

> I join Part V-B because its Commerce Clause reasoning leaves some room for state regulation of tender offers. This period in our history is marked

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[248] 457 U.S. 645.

[249] Cite Easterbrook & Fischel. Fischel stated that "[a] corporation…is nothing more than a legal fiction that serves as a nexus for a mass of contracts which various individuals have voluntarily entered into for their mutual benefit." The point that the nexus of contracts theory is a reinvention of the aggregate view has been made repeatedly. See, e.g., Bratton, Millon, Phillips. For a critique of the theory see, e.g., Brudney, Eisenberg, Bebchuk, Hazen, Dallas, and from an economic perspective, Hart.

> by conglomerate corporate formations essentially unrestricted by the antitrust laws. Often the offeror possesses resources, in terms of professional personnel experienced in takeovers as well as of capital, that vastly exceed those of the takeover target. This disparity in resources may seriously disadvantage a relatively small or regional target corporation. Inevitably there are certain adverse consequences in terms of general public interest when corporate headquarters are moved away from a city and State.*
>
> * The corporate headquarters of the great national and multinational corporations tend to be located in the large cities of a few States. When corporate headquarters are transferred out of a city and State into one of these metropolitan centers, the State and locality from which the transfer is made inevitably suffer significantly. Management personnel -- many of whom have provided community leadership -- may move to the new corporate headquarters. Contributions to cultural, charitable, and educational life -- both in terms of leadership and financial support -- also tend to diminish when there is a move of corporate headquarters.

Five years later Powell had the opportunity to translate these misgivings into an opinion for the Court that emphasized instead the artificial entity view of the corporation. *CTS Corp. v. Dynamics Co.* involved a so-called "second generation" anti-takeover statute, i.e., one that was drafted to get around the problems with the Illinois statute struck down in MITE.[250] The Indiana statute applied only to corporations incorporated in Indiana, which have specified level of shareholders within the state, and which opt for its protection. Under the statute, an acquirer who acquired "control shares" in such an Indiana target could vote them only with the approval of a majority of the pre-existing disinterested shareholders, to be obtained in a meeting within 50 days after the acquisition.

The Court of Appeals followed MITE and declared the statute unconstitutional under the commerce clause, because it interfered with the market for corporate control: "Even if a corporation's tangible assets are immovable, the efficiency with which they are employed and the proportions in which the earnings they generate are divided between management and shareholders depends on the market for corporate control- an interstate, indeed international, market that the State of Indiana is not authorized to opt out of."[251]

The Supreme Court reversed. Justice Powell, writing for a 5-4 majority, stated that-

> No principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations, including the authority to define the voting rights of shareholders…We think the Court

[250] 481 U.S. 69 (1987).
[251] 481 U.S. 77 (quoting from 794 F.2d 264).

> of Appeals failed to appreciate the significance for Commerce Clause analysis of the fact that state regulation of corporate governance is regulation of entities whose very existence and attributes are a product of state law. As Chief Justice Marshall explained: "A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly, or as incidental to its very existence. These are such as are supposed best calculated to effect the object for which it was created." Trustees of Dartmouth College v. Woodward, 4 Wheat. 518, 636 (1819).[252]

Powell thus rejected the view that states do not have the right to regulate transactions affecting shareholders, including shareholders in other states. He argued that the "free market system depends at its core upon the fact that a corporation…is organized under, and governed by, the law of a single jurisdiction…A State has an interest in promoting stable relationships among parties involved in the corporations it charters."[253] And he explicitly rejected the market for corporate control and its underlying aggregate theory: "The Constitution does not require the States to subscribe to any particular economic theory…there is no reason to assume that the type of conglomerate corporation that may result from repetitive takeovers will result in more effective management or otherwise be beneficial to shareholders…the very commodity that is traded in the "market for corporate control"- the corporation- is one that owes its existence and attributes to state law."[254]

This entire opinion, with its quotation from Dartmouth College, is clearly based on the artificial entity view that the corporation owes its existence to the incorporating state and that state may therefore regulate it, including in ways that affect shareholders' ability to sell their shares. Not surprisingly, Justice White dissented, arguing that while the statute may help Indiana corporations "particularly in helping those corporations maintain the status quo", it is inimical to the interests of the shareholders and constitutes "economic protectionism."[255]

After CTS, the battle for corporate control moved to state law, and the most important state in this regard was Delaware, in which most major US corporations are incorporated. Delaware law was favorable to hostile takeovers until 1989, when the Supreme Court of Delaware issued an opinion in *Paramount v. Time* that in practice ended the hostile takeover boom.[256] Paramount had made a $175 (later raised to $200) per share offer for Time at the time when Time was about to enter into a $70 per share merger with Warner. Paramount argued that under the previous decisions of the Delaware Supreme Court in *Unocal* (1985) and *Revlon*

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[252] 481 U.S. 89.
[253] 481 U.S. 90-91.
[254] 481 U.S. 92-94.
[255] 481 U.S. 100.
[256] 571 A.2d 1140 (1989); cf. Unocal, Revlon.

(1986), Time was “up for sale” and therefore the business judgment rule was suspended and Time’s board was required to maximize shareholder value by accepting the much higher Paramount bid.

The Delaware Supreme Court held in favor of Time. It stated that-

> Two key predicates underpin our analysis. First, Delaware law imposes on a board of directors the duty to manage the business and affairs of the corporation. This broad mandate includes a conferred authority to set a corporate course of action, including time frame, designed to enhance corporate profitability. Thus, the question of "long-term" versus "short-term" values is largely irrelevant because directors, generally, are obliged to charter a course for a corporation which is in its best interest without regard to a fixed investment horizon. Second, absent a limited set of circumstances as defined under *Revlon*, a board of directors, while always required to act in an informed manner, is not under any per se duty to maximize shareholder value in the short term, even in the context of a takeover.[257]

The court thus rejected the view that maximizing short-term shareholder value was always required; instead, the board was permitted to pursue its view of the best long-term corporate strategy:

> Delaware law confers the management of the corporate enterprise to the stockholders' duly elected board representatives. The fiduciary duty to manage a corporate enterprise includes the selection of a time frame for achievement of corporate goals. That duty may not be delegated to the stockholders. Directors are not obliged to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy.

Thus, the board was permitted to prefer preservation of the “Time culture” (its stated goal over maximizing the cash return to shareholders). This effectively killed the takeover threat, because any board could find good long-term share value maximization reasons to reject a superior cash bid. The Delaware court, in thus enhancing managerial power, in effect endorsed the real entity view: A corporation was an entity with its own corporate culture, which should not be subordinated to the shareholders or to the state. This view was ratified when the ALI corporate governance project adopted a rule that corporate boards may take into account the interests of other “stakeholders,” not just the shareholders.[258]

Why did the real entity view prevail? The obvious answer was that corporate management determines the state of incorporation, and therefore the Delaware Supreme Court felt that it had to side with management once the U.S. Supreme

[257] 571 A.2d 31.
[258] ALI project.

Court had approved the anti-takeover laws of other states, lest corporations choose to relocate there. However, it seems unlikely that this was the only reason; Delaware is very well established as the preferred state of incorporation, and stock values would likely decrease if shareholders perceive that management were leaving Delaware just to protect themselves. Instead, it seems likely that the Delaware Supreme Court genuinely believed that a corporation like Time had a corporate existence and culture with implications for other stakeholders, and therefore rejected the aggregate view equating the corporation with its shareholders. In that way, its concerns were similar to those raised by Justice Powell in his concurrence in MITE: A corporation is more than a "nexus of contracts", and courts and legislatures are allowed to take the interests of other stakeholders into account.

e. Fourth Transformation: From National Corporations to Multinational Enterprises.

The last transformation in the nature of the corporation began in the 1950s and is still going on, so that its ultimate outcome is hard to judge. This is the transformation from corporations based mostly in one country to multinational enterprises based in many countries.

Multinationals, in the sense of corporations owning assets overseas, have existed since the 17th century. However, as recently as the 1950s, the shareholders and other sources of capital, the management, most of the production facilities, and most of the markets of even large multinationals tended to be in one country, so that "what was good for G.M. was good for America." By the 1990s, however, this has changed profoundly. As more countries opened up to foreign direct investment, communications improved, and many products became lighter and easier to ship, more and more corporations became "globalized." In a globalized multinational, the sources of capital are in many countries: The shares of large multinationals trade on as many as twenty exchanges, and borrowing facilities are similarly diversified. Research and development and production facilities are likewise spread throughout the globe, as are markets. The only thing that usually ties a modern multinational to its home country is the location of management.

In this context, the debate over the nature of the corporation has re-opened. There is abundant academic writing on the relationship between multinationals and the state, and most writers from both left and right concede that this relationship has changed profoundly so that the home state (the state of incorporation) has become powerless to control "its" multinationals; it is hard even to identify to which country multinationals "belong".[259] On a practical level this situation has led to attempts by home states to control the behavior of multinationals abroad in areas as diverse as trading with the enemy, antitrust, corruption and others, with varying success.[260] The most recent development in this regard has been "inversion"

[259] Reich, Krugman and Graham; but see Tyson.
[260] Vernon, Blumberg, Muchlinski, Avi-Yonah.

transactions, in which the management changes the country of incorporation of a multinational's parent corporation. These transactions are undertaken primarily for tax reasons, but they have corporate governance implications as well.[261] Specifically, the artificial entity theory becomes hard to maintain when management can pick weak countries like Bermuda as the country of incorporation for the parent of a multinational.

The relationship with shareholders has also undergone changes as shareholders now tend to come from many countries. One implication of this has been that the securities laws of the weakest country tend to dominate because of cross-country price arbitrage.[262] Another is academic proposals to let management choose the country of securities law as well as the country of incorporation.[263] On a practical level globalization has led the SEC to relax requirements for some foreign issuers.[264] This trend has tended to weaken the applicability of the aggregate view as well. It is hard to predict where these trends will lead, but at the moment they appear once more to favor the real entity view.

To summarize: Throughout all the transformations we have studied, the same pattern recurs. As the relationship of the corporation to the state, to society and to its members or shareholders changes, all three views of the corporation emerge, submerge and then re-emerge in a slightly different but fundamentally similar form. In the end, however, the real entity view prevails.

Why does the real entity view prevail? In part, this is no doubt due to the fact that it represents the most congenial view to corporate management, because it shields them from undue interference from both shareholders and the state. Corporate management wields political power and it influences the outcome of the debate; judges again and again refer to the importance of corporations, by which they mean corporate management. But the very fact that corporate management wields this power shows that there is another reason why the real entity view prevails: It fits reality much more than the other two. In some periods (e.g., the Roman Empire or 18th century Europe) the power of the state is overwhelming and the artificial entity view seems plausible, and in other periods (the medieval membership corporation, the 19th century close corporation) the aggregate view seems plausible, but in most periods equating the corporation either with the state or with shareholders must have seemed to most non-academics highly implausible. The real entity view prevailed because it was more *real* than the others. And this observation enables us to move from the historical to the normative part of the discussion and ask what implications does the reality of managerial power have for corporate regulation in general and for the corporate tax in particular.

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[261] Avi-Yonah, Hines and Desai.
[262] Licht.
[263] Romano, Fox, Guzman.
[264] Fox.

4. A Normative Perspective: What Is the Justification For The Corporate Tax Today?

A page of history may be worth a volume of logic as far as explanatory power is concerned, but Holmes also conceded that history *per se* has no normative power.[265] Are there any normative lessons that can be drawn from the above history to justify the existence of the corporate tax today?

I would argue that the answer is yes, for the following reasons. In looking back over the debates over the nature of the corporation from Roman law to the present, what stands out is the persistence of the "real" view of the corporation- the view that sees it as an organization separate from both its members or shareholders and from the state. As I have argued above, the explanation for this persistence is two-fold. First, the real view persisted because it represents a better approximation of reality that the artificial entity and aggregate views. Moreover, it *became* a better approximation over time because of the transformations that the corporate form underwent. Roman or medieval corporations could plausibly be seen as creatures of the state or as identical with their members because the state had a crucial role in creating them and in permitting them to continue in existence, and the membership was identical with corporate management. These views are much less plausible today, however, since the state plays only a minimal role in creating corporations (and that role is sharply constrained by management's ability to shift the location of incorporation). The shareholders, meanwhile, are (in the case of large, publicly traded multinationals) widespread over the globe and clearly separate from the corporate entity.[266]

Second, another way of looking at the persistence of the real view is that it reflects the power of corporate management.[267] One way of looking at the transformations described above is that both the artificial entity and aggregate views were advanced in order to limit the power of management. The artificial entity view was usually brought forward in order to enable the state to regulate corporations, and the aggregate view was usually advanced to enhance the power of shareholders (although sometime it was used to give corporations rights that normally only belong to individuals). The ultimate success of the real entity view resulted from the fact that it gave more power to management than the other views, and that both legal commentators and courts were ultimately solicitous of the welfare of corporations (i.e., corporate

[265] N.Y. Trust Co. v. Eisner, 256 US 345, 349 (1921); Oliver Wendell Holmes, The Path of the Law, 10 Harv. L. Rev. 457, 459 (1897).
[266] The situation is different in countries with interlocking corporate structures, but arguably that means that individual shareholders have even less power and management is more firmly entrenched. See Roe, convergence debate.
[267] See, e.g., Vik Khanna on why corporations continue to be made criminally liable (because management prefer criminal to civil liability, and both to being held liable themselves).

management).[268] But the very success of management to persuade courts to adopt the real entity view also shows that the real entity view is more accurate than the other ones, since it depends on recognizing the power of management. If management has the power to persuade courts to adopt the real entity view, that view must also be accurate (or at least more accurate than the others).

In fact, one good way of describing the aggregate and the artificial entity views is that they represent *normative aspirations* of their proponents. People who believe that corporations are insufficiently regulated by the state advance the artificial entity view to justify more regulation. People (including much current scholarship on corporate law) who believe that the biggest problem with corporations is the agency cost issue, i.e., that management are insufficiently attentive to the welfare of shareholders, advance the aggregate (nexus of contracts, contractarian) view.[269] Neither of these views actually describes corporations as they actually operate in the real world- they represent idealized, normatively based descriptions of what corporations would look like in a better world.[270]

To see what corporations look like in the real world, a more accurate perspective is available in the sociological literature.[271] As one sociologist has stated, "[t]he recurrent problem in sociology is to conceive of corporate organization, and to study it, in ways that do not anthropomorphize it and do not reduce it to the behavior of individuals or of human aggregates."[272] A whole branch of economic sociology centers on the study of organizations,

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[268] But see Mark M. Hager, Bodies Politic [cite], who argues that the real view could sometime be used to limit managerial power, e.g., to justify corporate criminal and tort liability. See also Dodd, who uses real entity theory as the foundation for corporate social responsibility. This article continues that tradition.

[269] For the classic expositions, see Alchian & Demsetz, Production, Information Costs, and Economic Organization, 62 American Econ. Rev. 777 (1972); Jensen & Meckling, Theory of the Firm, 3 J. Fin. Econ. 305 (1976); Eugene Fama and Michael C. Jensen, Separation of ownership and control, 26 J. Law and Econ 301 (1983); Daniel R. Fischel and Frank Easterbrook, The Economic Structure of Corporate Law (1991). As stated by two of its original proponents, under this view, the various participants in the corporation do not differ "in the slightest degree from ordinary market contracting between any two people." Alchian & Demsetz, 777. "Ownership of the firm disappears as a meaningful concept under this model because no one can own a "nexus"…Control is reflected in the terms of various contracts entered into by individuals." Dallas, Two Models of Corporate Governance, 22 U. Mich. J. L. Ref. 19, 23 (1989).

[270] The contractarian view almost became the law in the 1980s, but then it didn't- probably for the better, given that it is unclear that an unfettered market for corporate control would have been socially beneficial (for example, recent attempts to align the interests of management with shareholders via stock options have had detrimental consequences). Recent law and economics scholarship is in fact beginning to recognize the crucial importance of managerial power in contexts like setting executive compensation. See Bebchuck and Fried.

[271] This view stems from the work of Durkheim, who was the first to focus on groups as being more than the sum of their members. See Hager, 582.

[272] Guy E. Swanson, The Tasks of Sociology, 192 Science 665 (1976).

and there are numerous books devoted to the topic.[273] Most of these books revolve around the study of large corporations, since these are the dominant forms of organization in this society. Moreover, they are informed by the economic perspective inaugurated by Ronald Coase in his classic "Nature of the Firm" article from 1937, and developed by Oliver Williamson and others into transaction cost economics.[274] This branch of economics, which now forms part of the "new institutional economics", begins by recognizing that the firm is fundamentally different from the market because of its hierarchical structure, and proceeds to investigate when operating as a firm as opposed to buying in the market makes sense (the "make or buy" issue). Recently, transaction cost economics has become the leading explanation for the most recent transformation of the corporation- the rise of multinational enterprises.[275]

From a normative perspective, the key observation that emerges from this literature is that corporate management have power (defined as the ability to influence the behavior of others, or more generally "the ability to get what one wants"[276]) by virtue of their position at the top of the corporate hierarchy and the financial resources they therefore control.[277] The economist Kenneth Boulding, for example, distinguishes between threat, economic, and integrative power (the stick, the carrot, and the hug) and ascribes all three to corporations.[278] The political scientist Joseph Nye distinguishes between

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[273] See, e.g., James D. Thompson, Organizations in Action: Social Science Bases of Administrative Theory (1967, reissued 2003); W. Richard Scott, Organizations: Rational, Natural, and Open Systems (5th ed. 2003); Jeffrey Pfeffer and Gerald R. Salancik, The external control of organizations: A resource dependence perspective (1978, reissued 2003); Walter W. Powell and Paul j. DiMaggio (eds.), The New Institutionalism in Organizational Analysis (1991); Neil J. Smelser and Richard Swedberg (eds.), The Handbook of Economic Sociology (1994), especially Part II, Section C, The Sociology of Firms, Organizations, and Industry.

[274] Ronald Coase, The Nature of the Firm, 4 Economica 386 (1937); Oliver E. Williamson, Transaction cost economics and organization theory, in Smelser and Swedberg, supra; for a critique see Mark Granovetter, Economic action and social structure: The problem of embeddedness, 91 Am J Sociology 481 (1985)

[275] Pitelis and Sugden, The Nature of the Transnational Firm (esp. Ch. 2).

[276] Boulding.

[277] This was clearly recognized by Berle & Means in 1932 and was still the prevalent view in 1959, see Chayes, The Modern Corporation and the Rule of Law, in E. Mason (ed.) The Corporation in Modern Society (1959), but this view has now (since around 1980) been largely replaced by the nexus of contracts theory. See Bratton, who calls the power-centered view "managerialism". An interesting analogy is to compare corporations and the state (which, as we have seen, was a corporation in Roman law, see Gaius). Even extreme rational choice oriented political scientists (i.e., the ones most likely to regard the state merely as a collection of rent-seeking politicians) would not deny that the state (i.e., the politicians) wields significant power. [cites]. This point was made by Machen, who noted in 1911 that "Uncle Sam is a fictitious person; but the government of the United States is a reality." See also Berle and Means in 1932: "the enterprise becomes transformed into an institution which resembles the state in character." See Bratton, 1497.

[278] Kenneth E. Boulding, Three Faces of Power (1989); see also Valeri G. Ledyaev, Power: A Conceptual Analysis (1997); Steven Lukes (ed.), Power (1986); John Scott (ed.), Power: Critical Concepts (1994); Marvin E. Olsen (ed.), Power in Modern Societies (1993).

"hard" power (military and economic) and "soft" power (cultural power, or the ability to persuade others to want to be more like you) and describes how the major U.S. multinationals wield both hard and soft power.[279] Likewise, distinguished tax scholars like Richard Musgrave and William Andrews have recognized that control over financial resources is a source of power beyond the pure ability to consume.[280] In fact, corporate management is the best example of this point, because they typically cannot consume corporate resources directly, yet they derive significant power from controlling those resources.[281]

The sociological literature indicates that corporate (managerial) power can generally be divided into three categories.[282] The first is political power- the power of management to affect political outcomes by lobbying and political contributions. That power is somewhat constrained by campaign finance reform laws, but those laws (including most recently McCain-Feingold) are generally recognized as not very effective, and decisions like *Bellotti* (recognizing a first amendment right of corporations to engage in political speech) enhance corporate power.[283] Moreover, even if campaign finance reform completely banned political contributions by corporations (i.e., indirect as well as direct contributions), corporate lobbying would still be effective to the extent corporations have power over the lives of voters in the politician's constituency.

The second category of corporate power is economic power, which applies directly to corporate employees and indirectly to communities in which corporations have significant facilities. While the relationship between shareholders and management can perhaps plausibly be analyzed in purely

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[279] Nye, The Paradox of American Power (2003).

[280] Dan Shaviro argues that "many believe that wealthy people escape the burden of a consumption tax by deferring their consumption, and that advocates of such a tax ignore the effects of unconsumed wealth on one's security, political power, and social standing. The argument overlooks the fact that what makes wealth valuable is the real purchasing power that it commands. Otherwise, real money would be no different than Monopoly money. A consumption tax affects the purchasing power even of unspent wealth, and the burden it imposes generally is not reduced by deferring one's consumption." Shaviro, Replacing the Income Tax With a Progressive Consumption Tax (2003). This is wrong because the power of the wealthy (and of corporate management) stems primarily from their ability to invest, not consume, their wealth, and investments are by definition not curtailed by a consumption tax.

[281] Musgrave, Andrews; see also Meade report, Alstott, Simons.

[282] The point that corporate management have power was clearly seen in 1932 by Berle and Means, who wrote that "[t]he economic power in the hands of the few persons who control a giant corporation is a tremendous force which can harm or benefit a multitude of individuals, affect whole districts, shift the currents of trade, bring ruin to one community and prosperity to another. The organizations which they control have passed far beyond the realm of private enterprise- they have become social institutions." Berle & Means, at 46. When this was written, "something over one-third of the national wealth of the country [was] administered by some two hundred corporations who in turn are dominated by less than eighteen hundred men." Today, the top 350 multinationals control about one sixth of the world's productive resources. [cite].

[283] 435 US 765 (1978); for a trenchant critique see Hager, Mayer.

contractual terms (shareholders are free to sell), the same cannot be said of many situations involving corporate employees.[284] Employees have invested human capital in corporations and may find it difficult to find another employer except at significant costs (e.g., the costs of moving to a distant city), especially in industries characterized by monopoly or oligopoly (e.g., Microsoft, Intel, Boeing, Wal-Mart). Nor is contract the best way to describe the relationship between corporations and their communities. When a major corporation closes a plant or moves its headquarters, the effects are felt by both employees and the community. In general, the presence of corporate headquarters in particular is associated with positive externalities that are not reflected in any contractual arrangement. That consideration is what led Justice Powell to reject the contractarian approach in CTS. It is very hard to regulate this kind of corporate power without unduly restricting corporate economic flexibility; hence, even unionized plants are not immune to closing. In addition, this is the kind of power that makes developing countries feel so dependent on Multinationals and their decisions where to open new plants.

The third category of corporate power, which exists only sporadically but is crucial in several cases, is market power over consumers. Market power exists in several industries through monopoly or oligopoly. The antitrust laws regulate this power to a certain extent, but as was shown recently in the case of Microsoft, their ultimate reach is limited. Under the "rule of reason" adopted by the Supreme Court upon breaking up Standard Oil, market domination by itself is not sufficient to invoke antitrust laws. A similar rule applies in Europe, since it is only abuse of a dominant position (and not that position itself) that is actionable.

What are the normative consequences of the recognition of corporate managerial power? There are two principal arguments why a liberal democratic state should curb excessive accumulations of private power. The first is the argument from *democracy*: In a democracy, all power should ultimately be accountable to the people.[285] Private accumulations of power are by definition unaccountable, since the holders of power are neither elected by the people nor have their power delegated from the people's representatives. In fact, the American Revolution was founded on the conception that while people have natural, Lockean liberal rights to their property, undue concentrations of private power and wealth should be discouraged.[286] This view found its expression in the republican creed of civic humanism, which emphasized public virtue as a balance to private rights. A virtuous republic, the Founders believed, was to be free from concentrations of economic power such as characterized England in the 18th century.[287] Therefore,

[284] But see, e.g., Hazen, who critiques the contractarian paradigm even in the shareholder context. See also Brudney, Eisenberg, Bebchuk.
[285] This view is further explored in Avi-Yonah, Yale, where it is argued that limiting private power is the best argument for taxing the rich.
[286] Ventry, 4-5.
[287] Ventry, 4.

from the beginning of the republic, federal and state legislators used taxation to restrict privilege and to "affirm communal responsibilities, deepen citizenship, and demonstrate the fiscal virtues of a republican citizenry."[288] As Dennis Ventry has written, "[t]he ideal of civic virtue created a unique form of ability-to-pay taxation that was hostile to excess accumulation and to citizens who asserted entitlement through birth…Inherited wealth, as well as gross concentrations of wealth (inherited or not), characterized an aristocratic society, not a free and virtuous republic."[289] In the 20th century, the same view was best expressed in the corporate context by Berle, who wrote that in a democracy like the United States "it becomes necessary to present a system (none has been presented) of law or government, or both, by which responsibility for control of national wealth and income is so apportioned and enforced that the community as a whole, or at least the great bulk of it, is properly taken care of. Otherwise the economic power now mobilized and massed under the corporate form… is simply handed over, weakly, to the present administrators with a pious wish that something nice will come of it all."[290]

The other principal argument against excessive corporate power is based on a liberal conception of *equality*. Michael Walzer has explained that when liberals talk about equality, they are not concerned with "simple equality", i.e., equalizing everyone's initial means. Instead, they are advocating "complex equality," by which Walzer means that every social "sphere" should have its own appropriate distributive principles and that possession of goods relevant to one sphere should not automatically translate into dominance in other spheres as well. "In formal terms, complex equality means that no citizen's standing in one sphere or with regard to one social good can be undercut by his standing in some other sphere, with regard to some other good."[291] In our capitalist society, money is the "dominant good", and the people who possess it are the most likely to accumulate illegitimate power in other spheres, such as politics.[292] "This dominant good is more or less systematically converted into all sorts of other things- opportunities, power, and reputation."[293] Walzer goes on to explain the insidious effects of money and why it needs to be curbed by redistribution, including redistributive taxation:

> Market imperialism requires another sort of redistribution, which is not so much a matter of drawing a line as of redrawing it, What is at issue now is

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[288] Brownlee, 31; W. Elliott Brownlee, Economic History and the Analysis of "Soaking-the-Rich" in 20th Century America, in Ventry and Thorndike, 1.
[289] Ventry, 5.
[290] Berle [cite]. It is ironic that Berle is sometimes regarded as a progenitor of the current nexus of contracts approach. See also Hager, at 639: "Such [corporate] power, insulated from participation, criticism, or revision by a public that cannot escape its effects, poses an enormous obstacle toward achieving maximum democratic control over condition of social life."
[291] Walzer, Spheres of Justice (1983), 19. See also Don Herzog, Happy Slaves (1989), ch. 5 (on liberal "differentiation" between different spheres).
[292] Walzer, 11.
[293] Walzer, 12.

> the dominance of money outside its sphere, the ability of wealthy men and women to trade in indulgences, purchase state offices, corrupt the courts, exercise political power…the exercise of power belongs to the sphere of politics, while what goes on in the market should at least approximate an exchange between equals (a free exchange)…When money carries with it the control, not of things only but of people, too, it ceases to be a private resource.[294]

Nor, as we have noted above, is the power of money limited to direct political power:

> It would be a mistake to imagine, however, that money has political effects only when it "talks" to candidates and officials…It also has political effects closer to home, in the market itself and in its firms and enterprises…Even within the adversary relation of owners and workers, with unions and grievance procedures in place, owners may still exercise an illegitimate kind of power. They make all sorts of decisions that severely constrain and shape the lives of their employees (and their fellow citizens, too). Might not the enormous capital investment represented by plants, furnaces, machines, and assembly lines be better regarded as a political than an economic good? To say this doesn't mean that it can't be shared among individuals in a variety of ways, but only that it shouldn't carry the conventional entailments of ownership. Beyond a certain scale, the means of production are not properly called commodities… for they generate a kind of power that lifts them out of the economic sphere.[295]

Walzer thus advocates taxation as one means of restricting the market to its proper sphere (along with trade unions and limiting property rights). But he also recognizes the inherent limitations of all redistribution, since his aim is not to abolish the market: "All these redistributions redraw the line between politics and economics, and they do so in ways that strengthen the sphere of politics- the hand of citizens, that is, not necessarily the power of the state…But however strong their hand, citizens can't just make any decisions they please. The sphere of politics has its own boundaries…Hence redistribution can never produce simple equality, not so long as money and commodities still exist, and there is some legitimate social space within which they can be exchanged."[296]

How can corporate power be limited? It depends on the type of power. Political power can most obviously be restricted by placing direct limits on campaign contributions, which are an incredibly cheap sort of power for large corporations (a whole campaign can be financed for a few million dollars, whereas an elected politician can make decisions worth billions). Admittedly, the experience with this kind of limits since corporations were first banned from directly contributing

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[294] Walzer, 119-121.
[295] Walzer, 122. See also his discussion of "company towns", pp. 302-303.
[296] Walzer, 122-23.

to political campaigns in 1907 has not been good: The very political power of corporations seem to ensure that campaign finance reform is hard to pass and riddled with loopholes, and Supreme Court decisions like *Bellotti* do not help. Nevertheless, it is conceivable that the direct political power of corporations could be limited by campaign finance reform. The problem, however, is that this will by no means eliminate the political power of corporations, because that power stems from their economic power. As long as GM and Ford employ tens of thousands of Michigan voters, their views will resonate with the Michigan delegation to Congress, even if they are strictly prohibited from donating a penny to any politician (directly or indirectly).

The market power that some corporations possess can be limited through the antitrust laws. Having said that, though, it is important to note that for the past forty years antitrust law has been moving away from curbing corporate market power and toward ensuring that consumers do not pay higher prices. The shift in focus from curbing corporate size and power to consumer protection is particularly striking in US antitrust law, and is evidenced by the failure of the government to break up even monopolies like IBM in the 1970s or Microsoft in the 1990s. In Europe, there is more of a focus on preventing "abuse of a dominant position" even if it only hurts competitors rather than consumers, but even there, it is the abuse rather than the dominant position itself that is at stake. But even if American antitrust law were changed to re-focus more on directly on corporate market power (and that would be a radical re-direction), it is still a very unwieldy and imprecise tool. Proving antitrust violations is hard and in the case of large corporations can take years of litigation, and courts typically shy away from the breakup remedy because they fear damaging the corporation in the economic sphere where the benefits of its existence are most clearly felt.

Finally, it should be emphasized that curbing corporate power cannot be achieved through corporate governance reform. It may be possible to place limits on the power of corporate management vis-a-vis shareholders in this way, although once more the power of management makes this very difficult to do (as shown by the rise and fall of the market for corporate control). But even if management were to operate perfectly in the interests of the shareholders, they would still from my perspective exercise excessive power over the rest of society, and it is that power that the corporate tax seeks to curb. By definition, corporate governance reforms cannot hinder management when they exercise power in ways that are beneficial to shareholders.[297]

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[297] Oliver Hart, for example, has argued that corporate debt can be used to discipline managers: corporations use a lot of debt so that managers will not squander too much of shareholders' money, and the corporate tax assists in this function. [cites]. See also Joseph Stiglitz, The corporate income tax, J. Pub. Econ (1973) (corporations can avoid tax by using debt). But while debt might help restrict managerial power vis-a-vis shareholders, and to some extent vis-a-vis society as well (and that is a good reason to allow corporations to deduct interest), debt cannot limit managerial use of equity or retained earnings. (As noted below, it may from this perspective also be acceptable to let corporations deduct dividends).

In the final analysis, **the problem of corporate power can only be addressed by direct regulation of the kind of activities we want corporations to perform, namely production and distribution of goods and services**. Some of these activities may have negative externalities that are best regulated by, for example, labor safety or environmental laws. But these laws will still do nothing to limit corporate power that is exercised by producing and distributing goods and services in an environmentally sound and safe way. Given that we do *not* want government to tell corporate management directly how to run their business (that idea was tried and failed in the socialist economies), only the tax law can directly reach these types of activities, which are the ultimate source of corporate power accumulation.

My basic argument is therefore that *the corporate tax is justified as a means to control the excessive accumulation of power in the hands of corporate management*,[298] which is inconsistent with a properly functioning liberal democratic polity.[299] As I have argued above, this was also the principal reason why the corporate tax was enacted in 1909, and I believe is also the principal reason for its political resiliency today. People understand that corporations are powerful and that the corporate tax is one way in which the state, as representative of the people, can limit their power.[300]

This argument has particular resonance today as a result of the rise of multinational enterprises. As many academics have pointed out, the rise of MNEs has significantly weakened the regulatory power of the state, since MNEs by definition operate across jurisdictions and can set one jurisdiction off against

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[298] The idea that the tax was a regulatory tool is hinted at in Mayer, at 583, and raised but rejected by Musgrave. Except for Walzer's brief mention (cited above) I have not found it elsewhere.

[299] See Walzer, Herzog. From this perspective the "incidence" of the corporate tax is on management, since they are the ones whose power is diminished by it. This is a separate question from the knotty problem of who bears the burden of the corporate tax in the sense that their own resources (and not "other people's money") are diminished by it. It is important to note, however, **that if one could show that the incidence of the corporate tax is actually shifted to consumers or labor, then presumably management would not care that the tax was imposed since it would not actually diminish the resources they control**. This would eliminate the regulatory rationale for the tax. But forty years of research on incidence by economists have failed to demonstrate that the tax can in fact be shifted in most cases, at least in the long run. See [Mulligan, 2002; Fullerton & Metcalf, 2002; US Treasury, 1991; Judd, 1985; Homma, 1981; Grieson, 1975; Feldstein, 1974; Harberger, 1962]. See, in particular, the Treasury's extensive 1991 study (up to 50% of tax may be shifted in short run but not in long run). And corporate management certainly seem to care enough about the corporate tax to engage in significant tax planning to try to avoid it as much as possible. See tax shelters literature.

[300] One interesting corollary of this view is that the corporate tax should apply to non-profit corporations (which have no shareholders) since their management have as much power as the management of for-profit entities. But I accept the mainstream view that since non-for-profits perform functions that would otherwise fall to the state, they should not be taxed. [Hansmann, Clark; see Horwitz for a showing that non for profits do in fact function differently]. It is interesting to consider the mirror image of this argument, i.e., that for profit corporations should be taxed because their management choose not to address problems they could help solve, and therefore create more work for the state. This requires considering the debate on corporate social responsibility, which is a topic for another day. [CSR cites].

another.[301] Taxation is one vehicle of regulation, and an area in which extraterritorial jurisdiction is well established in international law.[302] Therefore, it offers a promising venue to regulate MNEs.[303]

It should also be noted that this rationale for the tax applies more or less precisely to the current scope of the tax we have today- i.e., a tax imposed primarily on publicly traded enterprises, since it is only those that exhibit the separation of ownership from control (i.e., managerial power).[304] And this rationale can also explain why we tax corporate equity but not debt, since issuing debt constrains managerial power in ways that issuing equity does not (as many of the leveraged buyout targets of the 1980s discovered).[305]

How does taxation restrict and regulate managerial power? It does so in two ways: by directly limiting the rate of corporate wealth accumulation (the "*limiting function*"), and by providing incentives and disincentives to particular corporate activities (the "*regulatory function*"). For reasons explained below, both functions are necessary and related to each other, in the same way that both a break and a steering wheel are necessary for driving a car.

First, the limiting function: Imagine first a 100% tax imposed on corporate profits. Such a tax would effectively eliminate the corporation's reason to exist. Over time, it would also eliminate all sources of corporate power, since it would force the corporation to use its existing resources to pay politicians and employees, and it would remove any incentive to sell goods to consumers. Once these resources are exhausted the corporation would be liquidated. A 100% federal tax (assuming it cannot be avoided) is therefore as effective a corporate death sentence as the mandatory liquidation imposed by state courts on the trusts.[306] The power to tax is indeed potentially the power to destroy.

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[301] Vernon, Blumberg, Avi-Yonah.
[302] Cite- comparative CFCs.
[303] Avi-Yonah, MNEs: Taxation falls in the right column and middle row of the matrix developed in that article to distinguish various areas of state regulation of MNEs, i.e., it is an area in which extraterritoriality is required and countries (but not MNEs) agree on its basic principles. See also Braithwaite.
[304] This is contrary to the view expressed by Schlunk, who argues that "there is no colorable justification for the double taxation scheme currently imposed in the United States" (p. 332), i.e., a tax imposed almost entirely on equity capital of publicly traded enterprises, with full taxation of dividends when distributed. Admittedly, from a power perspective the tax could be limited to large corporations, such as the S&P 500, which account for over [85%] of the corporate tax base. An exemption of the first $100 million would be acceptable, just as I support exempting the first $100,000 of individual income from the income tax (an idea advocated by Graetz, cite). It could also be argued that corporations can be powerful without being profitable; this may be true for any given year, but over a longer run there is a correlation between size, power and profitability.
[305] This requires developing ways to distinguish equity from debt. That distinction is hard to defend theoretically but in practice can be defended; transaction costs make it impossible to easily convert all equity into debt, as financial theory would predict. See Warren, Weisbach, Schizer. Otherwise, the $200 billion collected annually by the corporate tax would have vanished long ago. See Stiglitz.
[306] Cite cases.

But a 100% tax is inconceivable. Taxation faces an inherent limit that was well expressed by Holmes when he stated that "the power to tax is not the power to destroy while this court sits."[307] The constitution places limits on the power to tax, limits that are implicit already in *Dartmouth College*: The public sector may not use taxation to completely eliminate the private one. This is both a matter of constitutional law (a tax may be a taking if the rate exceeds any reasonable estimate of the state's contribution to private wealth creation)[308] and a matter of practicality: Just as in the case of the rich, we do not want to kill the goose that lays the golden eggs by imposing taxation at rates that create huge deadweight losses to the economy at large (the deadweight loss is approximately a square function of the tax rate).[309] The precise limit of desirable taxation thus becomes the quintessential political question of our time, to be refought every four years at the ballot box.

Given that we cannot tax at 100%, what is the effect on corporate power of a lower tax rate, such as the current 35%? Even at that historically low rate,[310] the corporate tax does significantly slow down the accumulation of corporate resources, which are the foundation of managerial power.[311] For example, imposing a tax at 35% on corporate assets invested at a 10% yield (compounded annually) over ten years results in approximately 27% less assets being available to management at the end of the period than would be available in the absence of the tax.[312] Thus, taxation at lower rates can meaningfully restrict the build-up of assets that forms the base of managerial power, even when it does not destroy it. Bust since corporate power will continue to exist and grow at any reasonable rate of taxation, we also need the tax to perform a regulatory function.

Second, the regulatory function: Managerial use of corporate assets (i.e., its use of its power) may be impacted by the threat that the tax rate will be raised if it is perceived that the assets are not used for the betterment of society. This can be seen by the imposition of higher effective rates on certain forms of behavior Congress disapproved of, like bribes paid to foreign officials and participation in international boycotts. In both cases, empirical research has suggested the tax penalties had a significant impact.[313] More recently, the threat of increased tax

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[307] Cite.
[308] Murphy and Nagel; Epstein.
[309] Rosen, Public Finance. It should be noted, however, that to the extent the corporate tax falls on economic rents, it is not inefficient even at very high rates. And there is a significant literature that suggests that MNEs in particular earn economic rents. [cite].
[310] The corporate tax rate was 46% as recently as 1986, and higher before then.
[311] This assumes that management cannot avoid the tax either by corporate tax shelters or tax competition. These two problems are discussed in Part V below. It also assumes that the corporate tax cannot generally be shifted. See note – above.
[312] 100 invested at 10% over ten years, compounded annually, yields 257 at the end of Year 10 in the absence of tax and only 188 (or 27% less) if the earnings are subject to a 35% tax. The key is of course the effective tax rate; George Yin has calculated that the effective rate for the S&P 500 is on average about 30%.
[313] Hines.

rates applied to US corporations that moved their nominal place of incorporation to Bermuda seems to have sufficed to block one such "inversion" transaction and stop other corporations from adopting the same strategy.[314] This is particularly striking since the imposition of an actual tax on the *shareholders* of inverting corporations in 1994 had no effect whatsoever on the rate of inversions; management do not care enough about the tax on shareholders. Thus, it seems that just as Senator Cummins predicted in 1909, taxation even at rates much less than 100% can suffice to regulate corporate managerial power.[315] But the rates cannot be set too low (1%, as in 1909, is not enough), because then management would not care sufficiently to avoid the tax. This is why we need the limiting function (i.e., set rates at sufficiently high levels for management to notice) for the regulatory function to work properly.

Finally, in addition to providing disincentives, the tax can be used to provide incentives as well.[316] For example, investment incentives are provided to corporations as a way of bolstering the economy.[317] Another example is research and development, which has been shown by economists to produce significant positive externalities for society, which justify government in providing a subsidy via the tax code.[318] Now it is of course true that the government could subsidize these functions directly, rather than use tax expenditures, so that this cannot strictly be an argument for taxing corporations. However, that would require setting up an IRS-like agency to monitor the use of the subsidies, so that any simplification advantage from abolishing the corporate tax is diminished. And once the corporate tax is in place, it seems like an obvious and convenient vehicle to deliver the desired subsidies at little additional cost.

To summarize: The corporate tax is justified as a way for a liberal democratic state to limit excessive accumulations of power in the hands of corporate management, which is inconsistent with both democratic and egalitarian ideals. It achieves this goal in two ways: By directly limiting the rate of corporate wealth accumulation, and by regulating managerial uses of corporate assets and channeling it in directions deemed beneficial to society as a whole. Neither of these functions can be effectively achieved in a capitalist economy by other means than a corporate tax imposed at a significant rate. The corporate tax can thus be seen as an essential part of a liberal democratic alternative to a socialist command and control economy. In the last part, I will discuss some practical implications that follow from this argument.

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[314] Cite Stanley, others. See Grassley, Thomas proposals.
[315] Cite Cummins.
[316] This function is controversial [cite tax expenditure debate: Surrey, Bittker, Kahn & Lehman].
[317] Cite book on history of investment incentives.
[318] Hines; cite sections (both expensing and source rule).

5. Conclusion: Some Policy Implications.

The first and most obvious practical conclusion from the above is the negative one: **The corporate tax should not be repealed**.[319] This outcome seems at present unlikely, but it is important to stress it because of the widespread opposition to (or very lukewarm support for) the corporate tax in academic and policy circles.

Having said that, there are three areas in which one can draw more specific policy conclusions from the above arguments. Those are the two most significant threats to the corporate tax- corporate tax shelters and tax competition, and the current drive to reform the tax by integrating it with shareholder (i.e., dividend) taxation.

a. Corporate tax shelters.

Since the mid 1990s, the corporate tax in the U.S. has been under significant practical attack by the growing corporate tax shelter movement. This movement has been described elaborately elsewhere.[320] Its essence involves promoters (mostly accounting firms and investment banks) who scour the Code for sheltering ideas and then sell them for a hefty fee to a growing list of corporate clients. Ten years ago it was unusual to find mainstream corporate tax departments who would buy these ideas. Today, with the tax department viewed as a profit center, it is rare to find a major corporation that does not use them. As John Braithwaite noted, the phenomenon is both supply and demand driven.[321]

Various proposals have been advanced to curb this practice, and the IRS has issued elaborate regulations.[322] However, courts (especially appellate courts with little tax expertise) have tended to uphold the shelters.[323] It therefore seems that more drastic action is needed to address this problem. Prof. George Yin has proposed a solution based on making tax reporting conform better to financial (book) reporting.[324] I support this idea because it would exact a price (in the form of higher tax payments) from corporate management who manipulate financial reporting, and if management chooses to employ tax shelters this would result in reduced earnings per share (EPS). Since management tend to care more about short term EPS than about taxes[325] such a rule (which is similar to the rule adopted in other countries, like Germany

[319] The same applies to the corporate AMT, which I view as an important backstop to the corporate tax. See Avi-Yonah, SMU.
[320] Bankman, Yin, Shaviro, Weisbach, Braithwaite, etc.
[321] Cite Braithwaite book.
[322] Cite regs
[323] Compaq, UPS, etc.
[324] Yin; but see Engler.
[325] Cite pooling/purchase debate.

and Japan) is likely to be more effective in curbing tax shelters than financial manipulation, although it also has some drawbacks in terms of reduced flexibility for both tax and accounting rulemakers.

In any case, whatever the solution adopted for the tax shelter problem, the important point derived from this article is that it is indeed a problem- that from a normative perspective it is not a good thing to let management eliminate the corporate tax through self-help measures. This point is missing from the corporate tax shelter literature, but it is essential to it.

b. Tax Competition.

The other main challenge to the corporate tax is tax competition involving multinational enterprises (MNEs). Currently, some major U.S. MNEs (e.g., Intel) pay no tax to non-U.S. jurisdictions because all of their foreign operations benefit from special tax holidays designed to attract the investment. The MNEs can be sure to obtain such tax reductions because they can conduct an auction among the several countries that offer equivalently suitable locations to their investment in non-tax terms. More recently, we have seen tax competition flare up in the location of corporate headquarters, with several US MNEs moving their nominal location of incorporation to tax havens like Bermuda.[326]

The OECD and the EU have both launched projects aimed at curbing such tax competition, but so far they have achieved only limited success. In the academic literature, meanwhile, there is a raging debate between those who believe that tax competition is harmful and those who believe it is beneficial from either a global perspective or from the perspective of the countries involved.[327] Opponents have suggested various ways of combating tax competition, most of which involve some form of cooperation among developed countries (for example, taxing MNEs based on where their headquarters are or where their goods are sold).[328]

There is, however, a major missing element in this literature: Even the opponents of tax competition (including myself) have not been successful in explaining why the threat posed by it to the corporate tax should be viewed negatively. The best we could do is to point out the threat posed by it to the welfare state, and indeed developed welfare states like France and Japan have been at the forefront of the fight. But this just leads to the counter-charge that bloated welfare leviathans are trying to create a cartel to save themselves from efficient competition at the expense of small Carribean jurisdictions.[329]

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[326] Avi-Yonah, inversions.
[327] Cites (Avi-Yonah, Roin, Schlunk, Easson).
[328] Avi-Yonah, Globalization. The rise of inversions raises some doubt about taxation based purely on where the parent corporation is incorporated. See Avi-Yonah, inversions.
[329] See, e.g., Dan Mitchell; Aruba PM letter; Sanders letter.

This article, I believe, supplies the missing piece in the armament of tax competition opponents by pointing out the negative consequences of abolishing the corporate tax through self-help, beyond the damage caused to the coffers of the developed countries. If management can defeat regulation by taxation through the simple mechanism of going overseas, the efficacy of the tax as a regulatory mechanism is eliminated.

c. Integration.

In early 2003, President Bush proposed to integrate the corporate tax and the individual shareholder tax by exempting shareholders from paying tax on dividends, as long as the dividends were paid from after-tax corporate earnings. Eventually, Congress balked at adopting full integration, and opted instead to reduce the tax rate on dividends from 35% to 15% (and have the same rate apply to capital gains). Significantly, the lower rate on dividends applies whether or not corporate tax has been paid.

Thus, for the first time since 1936, the U.S. now has a partially integrated corporate tax system. Indeed, if the corporate tax can be eliminated by self-help (by tax shelters or tax competition), it is now possible for a corporate investment to be taxed at a total rate of 15% - significantly lower than non-corporate investment.

This result is of course inconsistent with the stated rationales for adopting integration, which have to do with "taxing corporate income once". But even the economic case for the original Bush proposal, which did not envisage this kind of "super-integration", was debatable, as I have argued elsewhere.[330] In particular, integration introduces economic biases in regard to cross-border investment that may be no less significant than the biases it attempts to cure domestically.

From the perspective of this article, the important point to note is that the rationale given for the corporate tax is independent from the tax on shareholders. Thus, it is entirely consistent to tax corporations on their income to regulate management, while at the same time taxing shareholders on dividends.[331] The tax on dividends has to do with the rationale for having an individual income tax (rather than, for example, a VAT). I have argued elsewhere that this rationale was to restrict the power of the rich.[332]

But it should also be noted that the rationale given above for retaining the corporate tax does not require us to forego integration. As long as the corporate tax is maintained, it is quite possible to exempt shareholders from

[330] Avi-Yonah, ITPF.
[331] Cf. Schlunk.
[332] Avi-Yonah, Yale.

tax on dividends or give them a credit for economic reasons, without causing harm to the rationale for the corporate tax. In fact, shareholders were partially exempted from tax on dividends from 1913 to 1936, when the regulatory rationale for the tax was well understood.[333] Thus, although this article gives an answer to the question why we should tax corporations that is different from the mainstream view that is cited to support integration, it does not necessarily follow from it that we should refrain from adopting integration if we are persuaded by the economic case for doing so.

d. Summary.

This article has attempted to provide the first comprehensive rationale for defending the current corporate income tax. It argues that the usual reasons given for the tax (primarily as an indirect way of taxing shareholders, or alternatively as a form of benefit tax) are inadequate. It then explains what the original rationale to adopt this tax was in 1909, namely to regulate managerial power, and that this rationale stems from the "real" view of the corporation, which was the dominant view throughout the many transformations underwent by the corporate form from Roman times to the present. Turning to normative argument, the article then argues that the regulatory rationale given for taxing corporations in 1909 is still valid, since similar social conditions continue to exist. Finally, the article argues that this rationale is necessary from a normative perspective to support the fight against the two crucial current threats to the corporate tax posed by the corporate tax shelter and tax competition phenomena.

In the end, however, it must be emphasized that the function of taxation is inherently limited. As the two quotes cited in the beginning illustrate, the state wields enormous power through taxation, but it is limited in its ability to use it by the fear of destroying or unduly damaging institutions that are essential to the welfare of its citizens. Corporate taxation is an important regulatory tool and an important element in managing the delicate balance between corporations, society and the state. But because all taxation is to some extent harmful (in the sense of creating welfare loss), taxation cannot be the only mechanism to solve social problems. Ultimately, it is up to all of us- as voters, as politicians, and as managers of corporations- to find the right balance among these competing considerations.

[333] Even the third possible method of integration, dividend deduction, which is rarely adopted in practice, is consistent with the above rationale insofar as the corporate tax is reduced only if management relinquish power by distributing corporate assets.