Tax and the Separation of Ownership and Control

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While generally the impact tax has on patterns of corporate ownership and control has received little attention, this paper argues that tax is potentially an important determinant of ownership patterns in large companies. The paper focuses mainly on historical developments in Britain, where an "outsider/arm's-length" system of corporate governance began to take shape in the years leading up to World War I and became fully entrenched by the end of the 1970s. Taxes imposed on corporate profits, taxation of managerial and investment income and inheritance taxes do much to explain why during this period blockholders sought to exit and why there was sufficient demand for shares among investors to permit ownership to separate from control. The paper also discusses developments in the United States and argues that tax helped to foster the separation of ownership and control that reportedly occurred in larger American companies after World War I.

1. Introduction

As debates about corporate governance have intensified over the past couple of decades, potential explanations why patterns of ownership and control differ around the world have captured much attention from academics and policymakers. Economists Alexander Dyck and Luigi Zingales have shown that among potential variables likely to influence private benefits of control – a key incentive for blockholding in public companies – tax, measured by compliance rates, has considerable explanatory power.[1] Generally, however, little has been said about the impact tax regulation potentially has on the configuration of share ownership in large firms.[2] We argue here the topic is deserving of further attention, and make our case by use of historical examples.

In putting tax in the limelight, we focus primarily on the United Kingdom and show how tax contributed to the emergence of a corporate economy dominated by widely held public companies. The choice is apt because leading theories on why ownership separates (or does not separate) from control in a country's larger companies fail to account adequately for developments in Britain. As we show, taking tax into account helps to explain how ownership separated from control when conditions, theoretically speaking, were not particularly favorable. The point is made by

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* A revised analysis of developments in the U.K. discussed in this chapter appears in CHEFFINS/BANK, Corporate Ownership and Control in the U.K.: The Tax Dimension, 70 Modern Law Review 778 (2007).

1 DYCK/ZINGALES, Private Benefits of Control: An International Comparison, 59 Journal of Finance 537 (2004).

2 DESAI *et al.*, Theft and Taxes, unpublished paper, 1 (2005). Some isolated exceptions are discussed in Parts 6 and 7 of this paper.

relying on tax to help to answer three core questions one must address to understand why ownership separates from control in a particular country: 1) Why did those owning large blocks of shares want to exit? 2) Why were investors willing to buy the shares blockholders wanted to sell? 3) Why didn't the new investors begin to exercise control themselves?

While we focus primarily on Britain in this paper, we also offer a brief historically-oriented assessment of the contribution tax made to the rise of the widely held company in the United States. For both Britain and the U.S. we consider a range of tax laws, including not only corporate tax but also personal income tax, capital gains tax and inheritance tax. Corporate taxation is an important part of the analysis, especially to the extent it had an effect on the profit generating capacity of companies and the availability of profits for distribution to shareholders. Nevertheless, extending the analysis beyond corporate tax is necessary because many of the tax rules that "mattered" were those influencing decisions by individuals to buy or sell shares rather than those applicable directly to corporate entities.

We do not argue that tax is, or has been, the sole or even the prime determinant of ownership structure in the U.K. or the U.S. and do not make claims about the impact tax might have had in other countries. We also do not purport to offer a comprehensive analysis of the relationship between corporate ownership structure and tax. For instance, an issue we only canvass briefly in the conclusion is potential reverse causality, in the sense that, just as tax can help to dictate ownership and control patterns, the configuration of corporate structures in a country can influence the formulation of tax regulation. Despite these caveats, the paper shows that tax is a potential determinant of ownership structure in large companies and argues that further research on the topic is merited.

Parts 2 to 6 of the paper discuss the U.K. Parts 2 and 3 set the scene, with Part 2 providing the relevant chronology and Part 3 indicating that the current literature on comparative corporate governance does not explain satisfactorily why the widely held company became dominant in Britain. Part 4 outlines how tax provided blockholders in the U.K. with incentives to exit, Part 5 discusses how tax influenced the demand for shares from potential investors and Part 6 describes how tax potentially might have deterred activism by Britain's institutional investors. Part 7 addresses similar points, albeit more briefly, for the United States. Part 8 concludes.

2. The Evolution of Ownership and Control in the U.K.

The United Kingdom shares with the United States an "outsider/arm's-length" system of ownership and control, with ownership in large companies typically being dispersed among a large number of individuals and institutional intermediaries rather than being concentrated in the hands of "core investors" (*e.g.* a family) and with shareholders rarely being poised to intervene and take a hand in running a business.[3]

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[3] ARMOUR/CHEFFINS/SKEEL, Corporate Ownership and the Evolution of Bankruptcy Law: Lessons from the United Kingdom, 55 Vanderbilt Law Review 1699, 1704, 1715, 1750-1752 (2002).

Though 19th century railways anticipated the trend,[4] the U.K.'s outsider/arm's-length system of ownership and control took shape primarily during the 20th century. The number of industrial and commercial companies quoted on the London Stock Exchange reflects this, as the figure rose from 70 in 1885 to 571 in 1907 and again to 1,712 in 1939.[5] There were 4,409 companies quoted on the London Stock Exchange in 1963, a figure that had dwindled to just under 2,000 by 2000.[6] Mergers were the primary cause of the decline. Between 1948 and 1970 40% of quoted manufacturing companies left the stock market after being taken over and between 1975 and 1990 the figure was 33%.[7]

There was clearly some ownership dispersion prior to World War I since there were some examples of companies with a few thousand shareholders and since companies using a prospectus to carry out a public offering of ordinary shares on the London Stock Exchange had to offer a minimum of two-thirds of the shares to the public.[8] The available empirical data suggests, however, that original proprietors of publicly quoted companies often retained significant blocks of shares and the companies frequently continued to be managed and owned on a local basis.[9] The investor base was generally composed of friends and regional business contacts of the proprietors, perhaps in combination with wealthy clients of well-connected stockbrokers, such as aristocratic landowners seeking to spread their investments due to falling rental incomes.[10]

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4 GOURVISH, Railways 1830-70: The Formative Years, in: FREEMAN/ALDCROFT (eds.), Transport in Victorian Britain, 57, 83 (1988).

5 FRANKS/MAYER/ROSSI, Spending Less Time with the Family: The Decline of Family Ownership in the United Kingdom, in: MORCK (ed.), A History of Corporate Governance Around the World, 581, 587-588 (2005).

6 *Id.*

7 COSH/HUGHES/SINGH, The Causes and Effects of Takeovers in the United Kingdom: An Empirical Investigation for the Late 1960s at the Microeconomic Level, in: MUELLER (ed.), The Determinants and Effects of Mergers, 227, 234-35 (1980) (using data from 1948-72 to illustrate that "deaths" by merger outnumbered initial public offerings); DICKERSON/GIBSON/TSAKALOTOS, Is Attack the Best Form of Defence? A Competing Risks Analysis of Acquisition Activity in the U.K., 27 Cambridge Journal of Economics 337, 337 (2003) (providing statistics on the percentage of quoted companies being taken over).

8 HANNAH, The Divorce of Ownership from Control from 1900: Re-calibrating Imagined Global Historical Trends, CIRJE Discussion Paper, 20-26 (2007).

9 FRANKS/MAYER/ROSSI, Ownership: Evolution and Regulation, working paper, 30-31, Table 4, Table 10 (2005) (reporting from a sample of 40 companies incorporated around 1900, many of which were publicly traded by 1920, that the directors owned 54 per cent of the shares as of 1910 and 49 per cent as of 1920 and that, based on a sample of 26 of the 40 companies, the proportion of ordinary shareholders living within six miles of the city of incorporation as of 1910 was 56 per cent); for further background *see* DAVIS/GALLMAN, Evolving Financial Markets and International Capital Flows: Britain, the Americas, and Australia, 1865-1914, 160-163 (2001).

10 JEFFREYS, Business Organisation in Great Britain 1856-1914, 329-330, 339-340, 359-362, 373, 401, 409-10 (1977); COTTRELL, Industrial Finance 1830-1914, 153-154 (1980); ARMSTRONG, The Rise and Fall of the Company Promoter and the Financing of British Industry, in: VAN HELTEN/CASSIS (eds.), Capitalism in a Mature Economy: Financial Institutions, Capital Exports and British Industry, 1870-1939, 115, 121-122 (1990); THOMPSON, English Landed Society in the Nineteenth Century, 307-8 (1963).

During the years between World War I and World War II share ownership became commonplace among a considerably wider circle of investors, in particular the middle classes.[11] A 1932 sample of ten leading British industrial and commercial companies illustrates, as eight of the companies had more than 10,000 shareholders and four had 50,000 or more.[12] The Board of Trade, the government department with responsibility for regulation of companies, remarked on the trend in a 1943 discussion paper on company law reform, referring to "(t)he small investor whose numbers are now legion".[13] Still, it does not appear an outsider/arm's-length system of ownership and control was fully in place, with a study of ownership patterns in the U.K.'s largest industrial and commercial companies based on mid-1930s data indicating a majority likely had a "dominant ownership interest".[14]

Family control of some form continued in many U.K. public companies at the beginning of the 1950s.[15] Nevertheless, among Britain's very largest industrial and commercial firms a trend towards a divorce between control and ownership had become clear, with a study using 1951 data finding that only a minority had a dominant ownership interest.[16] The unwinding of voting control in U.K. public companies continued apace through the 1950s, 1960s and 1970s and by the end of the 1970s, family ownership had been largely displaced.[17]

The final demise of family capitalism was accompanied by the exodus of private investors and the rise of institutional investment, with the percentage of shares owned directly by individuals dropping steadily from 66% in 1957 to 20% in 1991 and the percentage of shares owned by institutional investors rising from 21% to 60% over the same period.[18] Institutional shareholders in turn proved to be, for the

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[11] COLE, The Evolution of Joint Stock Enterprise, in: COLE (ed.), Studies in Capital and Investment, 51, 89-90 (1935).

[12] PARKINSON, Scientific Investment: A Manual for Company Share and Debenture Holders, 4 (1932).

[13] Quoted in BIRCHER, The Adoption of Consolidated Accounting, 19 Accounting & Business Research 3, 10 (1988).

[14] FLORENCE, Ownership, Control and Success of Large Companies: An Analysis of English Industrial Structure and Policy 1936-1951, 240-241 (1961).

[15] HANNAH, Visible and Invisible Hands in Great Britain, in: CHANDLER/DAEMS (eds.), Managerial Hierarchies: Comparative Perspectives on the Rise of the Modern Industrial Enterprise, 41, 53 (1980) (119 of the largest 200 British firms had family board members in 1948); CHANNON, The Strategy and Structure of British Enterprise, 75, 161 (1973) (finding in a study of the largest 100 manufacturing companies in the U.K. as of 1970 that 92 were carrying on business as of 1950 and that 50 of the 92 were under family control at that point).

[16] FLORENCE, Ownership, *supra* note 14, at 186-87. Florence based his claim on his study of the share ownership structure in all 92 of the U.K.'s manufacturing and commercial companies having over £3 million of issued share capital as of 1951.

[17] JONES/SLUYTERMAN, British and Dutch Business History, in: AMATORI/JONES (eds.), Business History Around the World, 111, 116-18 (2003).

[18] For 1957, *see* MOYLE, The Pattern of Ordinary Share Ownership, University of Cambridge Department of Applied Economics Occasional Paper #31, 18 (1971). Otherwise, *see* National Statistics Online database: http://www.statistics.gov.uk/statbase/TSDTimezone.asp, "Share Ownership" release/Table A: Beneficial Ownership of Shares, 1963-2006.

most part, passive investors. According to a 1978 report prepared for the Institute of Chartered Accountants of England and Wales,

> "(i)nstitutional participation in managerial decision-making has been favored generally (but)…(f)inancial institutions have generally been unwilling to act collectively in the use of their voting strength, or to accept those responsibilities which others would assign to them".[19]

With institutional investors shying away from direct involvement in the management of U.K. public companies, Britain's version of "outsider/arm's-length" corporate governance was firmly entrenched by the end of the 1970s.

3. Pre-Conditions for a Separation of Ownership and Control

Over the past decade, there has been extensive analysis of why the configuration of ownership and control differs across borders. Following on from well-known research done by economists Rafael La Porta, Florencio López-de-Silanes, Andrei Shleifer and co-authors of theirs, the dominant explanation offered has been that the "law matters" in the sense that the quality of corporate and securities law within a particular country dictates whether large business enterprises will have diffuse or concentrated share ownership.[20] Another theory is that financial services regulation does much to dictate whether a separation of ownership and control will occur, with the logic being large financial institutions will tend to emerge as key blockholders unless the law deters them from doing so.[21] An additional hypothesis is that "left-wing" social democracies will have fewer publicly quoted firms and significantly higher levels of ownership concentration than "right-wing" countries because executives in a social democracy will tend to cater to employee preferences and give dispersed shareholders short shrift, thereby increasing substantially the disadvantages associated with being an outside investor.[22]

None of these theories have much explanatory power in the British context. Corporate law provided scant protection to prospective buyers of shares or minority shareholders during the decades when ownership separated from control.[23] During

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[19] BRISTON/DOBBINS, The Growth and Impact of Institutional Investors, 54 (1978).

[20] On the popularity of this explanation, *see* ROE, Corporate Law's Limits, 31 Journal of Legal Studies 233, 236-37 (2002); ENRIQUES, Do Corporate Law Judges Matter? Some Evidence from Milan, 3 European Business Organization Law Review 756, 766-67 (2002). The leading papers by La Porta *et al.* on point were LA PORTA *et al.*, Law and Finance, 106 Journal of Political Economy 1113 (1998); LA PORTA *et al.*, Corporate Ownership Around the World, 54 Journal of Finance 471 (1999); LA PORTA *et al.*, What Works in Securities Laws?, 61 Journal of Finance 1 (2006); DJANKOV/LA PORTA/LÓPEZ-DE-SILANES/SHLEIFER, The Law and Economics of Self-Dealing, unpublished working paper (2005).

[21] ROE, Strong Managers, Weak Owners: The Political Roots of American Corporate Finance (1994).

[22] ROE, Political Determinants of Corporate Governance (2003).

[23] FRANKS/MAYER/ROSSI, Ownership, *supra* note 9, at 12-16; CHEFFINS, Does Law Matter?: The Separation of Ownership and Control in the United Kingdom, 30 Journal of Legal Studies 459 (2001).

the period when ownership structures were unwinding neither the U.K.'s commercial deposit-taking banks nor the financial institutions which emerged as the key owners of British publicly quoted companies – primarily insurance companies and pension funds – faced significant regulatory constraints likely to deter activism.[24] As for politics, contrary to what theory would predict, a strong leftward trend coincided with the separation of ownership and control. The politicians in office in Britain during the years between World War I and World War II eschewed Victorian *laissez-faire* principles as they presided over a significant growth in government spending financed largely by increases in income tax and their counterparts after World War II swung further to the left, evidenced by continued growth of government, nationalization of key industries and a highly redistributive tax regime.[25]

Given that corporate law in the U.K. was not highly protective of minority shareholders and that the regulatory and political setting apparently was not congenial for the unwinding of control blocks, what explains the separation of ownership and control that occurred? To answer this question, it is instructive to identify three conditions that must be satisfied for ownership to become separated from control in a particular company. First, the dominant shareholders must decide to exit, which can be done by selling in stages into the market or by liquidating their entire stake all at once. Until the dominant shareholder is prepared to exit, though, nothing can change.

Second, there must be buyers. A blockholder seeking to exit will find this impossible to do unless there is demand for the shares. This condition can be satisfied either by parties looking to buy the company (or at least the blockholder's stake) outright or by stock market investors being prepared to buy the company's shares as and when equity is made available to the public.

Third, the buyers of the shares must not be inclined to exercise control themselves. Otherwise, "insider/control-oriented" corporate governance will continue unabated.[26] If the company's incumbent blockholders exit by selling shares into the market, a single investor potentially could accumulate a substantial ownership stake and then seek to dictate how the company will operate, perhaps in tandem with a formal takeover offer to remaining shareholders. In the case of an exit by merger, the firm carrying out the acquisition typically will be inclined to exercise close control over the relevant assets. This implies insider/control-oriented corporate governance, but if the purchaser is itself a widely held company outsider/arm's-length corporate governance in effect results.

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24 CHEFFINS, History and the Global Corporate Governance Revolution: The U.K. Perspective, 43 Business History 87, 103-4 (2001).

25 On the interwar years GLYNN/BOOTH, Modern Britain: An Economic and Social History, 47-52 (1996); DEWEY, War and Progress: Britain 1914-1945, 66, 71 (1997). On the situation after World War II, *see* CHEFFINS, Putting Britain on the Roe Map: The Emergence of the Berle-Means Corporation in the United Kingdom, in: MCCAHERY *et al.* (eds.), Corporate Governance Regimes: Convergence and Diversity, 147, 160-63 (2002).

26 On differences between "insider/control-oriented" and "outsider/arm's-length" corporate governance, *see* BERGLÖF, A Note on the Typology of Financial Systems, in: HOPT/WYMEERSCH (eds.), Comparative Corporate Governance: Essays and Materials, 151, 157-64 (1997).

Extrapolating from an individual company's situation, the three questions one needs to address to explain why the widely held company might move to the forefront in a particular country are: 1) Why would those owning large blocks of shares want to exit? 2) Why were investors willing to buy the shares blockholders wanted to sell? 3) Why did the new investors fail to exercise control themselves? Considering events in the U.K. through this analytical prism illustrates tax made a significant contribution to the separation of ownership and control in the U.K. With each of the three questions, and particularly the first two, tax reinforced trends precipitated by other factors. Tax did not in isolation cause the widely held company to move to the forefront in the U.K. However, tax did play a significant supplementary role.

4. Tax as a Catalyst for Exit by Blockholders

Being a blockholder is attractive in various ways. There potentially will be pecuniary private benefits of control that can be secured through one-sided "sweetheart" deals between a public company and its "core" investors. Also, blockholders can treat their public companies as a personal fief and bestow upon themselves various desirable corporate perks, such as generous managerial pay, lavish offices and luxurious business travel. Private benefits of control can also be of the non-pecuniary sort,[27] including the "buzz" associated with running a major company and a potential entrée to "elite" circles occupied by leading politicians and the wealthy. Circumstances at Marks and Spencer, a successful and widely admired retailer that went public in 1926 but remained firmly under family control until the mid-1960s through the use of shares with multiple voting shares, illustrate:

> "Simon Marks, who, as 'proprietor' of the business, enjoyed the trappings of wealth, the influence it gave him with politicians and the allure of film stars and celebrities … The Sieffs, the Sachers and the Laskis, as big shareholders in the company, came to believe that a luxurious lifestyle both inside and outside the office was their proprietorial right …"[28]

Despite the benefits of blockholding, there will be instances where exit will become a desirable option. For instance, under buoyant markets conditions blockholders might opt to sell out because the terms on offer are simply too generous to ignore.[29] Also, founders who lack a suitable heir to take the helm will generally look for a way out. Jaguar, a successful U.K. automobile manufacturer, merged with a competitor in the mid-1960s because the founder's heir had been killed in an automobile crash a decade earlier.[30]

Disappointing financial results can also prompt a desire to exit. Individuals owning a large block of shares in a public company will typically have much of their capital tied up in the company, which means they run the risk of a precipitous decline in

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[27] GILSON, Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy, 119 Harvard Law Review 1641, 1663-64 (2006).
[28] BEVAN, The Rise and Fall of Marks & Spencer, 68 (2001).
[29] HANNAH, The Rise of the Corporate Economy, 59 (2nd ed. 1983).
[30] "Jaguar to Join Up With B.M.C.", Times, July 12, 1966, 1; "Jaguar's Driving Force", Daily Post (Liverpool), October 24, 2001, 9.

their personal wealth if the company encounters hard times.[31] Hence, sustained erosion of profit margins brought on by competitive forces can force a dominant shareholder's hand.[32] As a 1969 book on business in Britain said

> "family businesses face increasing pressures; tougher competition … (and) the need for expensive new investment. Many have disappeared under these pressures … The family empire … is being steadily swept away by the forces of nature."[33]

Tax is a related factor that can affect decisions blockholders make about unwinding their stake partially or to exit completely. Taxes can, on one hand, be a deterrent to exit, with an obvious circumstance being where capital gains arising from the sale of shares are heavily taxed. On the other hand, taxes can in various ways induce shareholders to contemplate exit. For instance, they can erode the returns companies deliver to the point where dominant shareholders conclude it is no longer worthwhile having most or all eggs in the same basket. The experience in the U.K. shows this can happen not only because of taxes imposed at the corporate level in the form of taxation of corporate income or "excess" corporate profits, but also because of taxes imposed at the individual level in the form of taxation of dividends, capital gains and managerial compensation.

Tax policy can also make alternative investments more attractive to blockholders. If, for instance, taxes are reduced or exempted for investments in asset classes other than shares for investments designed to deliver benefits upon retirement rather than immediately and for assets transferred to others prior to death, blockholders subject to tax may choose to exit partially or fully to take advantage of these tax-preferred options. Also important is that individuals owning big blocks of shares in a large company will generally be badly diversified, and to make this sacrifice there needs to be the potential for a significant "upside". If tax largely precludes blockholders from benefiting substantially from the large stake they own, they might well be motivated to exit the business so they can benefit from risk-spreading – even if only by investing in a portfolio of assets taxed on a similar basis. Finally, at certain levels of taxation, individuals may choose to increase their current consumption – including their consumption of leisure – rather than to reinvest or save the proceeds from a sale of their assets.[34]

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[31] BECHT/DELONG, Why Has There Been So Little Block Holding in America?, in: MORCK, History, *supra* note 5, at 613, 618-19 (discussing why lack of diversification gives blockholders an incentive to exit).

[32] DYCK/ZINGALES, *supra* note 1, at 577.

[33] TURNER, Business in Britain, 239 (1969).

[34] For a discussion of the tradeoff between high taxes on capital and the incentive to save or invest rather than consume currently, *see* FELDSTEIN/TSIANG, The Interest Rate, Taxation, and the Personal Savings Incentive, 82 Quarterly Journal of Economics 419, 434 (1968). Contemporaries recognized that the U.K.'s high taxes affected choices about how hard to work; *see*, for example, TREASURE, "The Toll Our Taxes Take", Times, January 12, 1968, 21.

4.1 Corporate Income Tax

If companies hand over most of their profits in the form of tax payments there is likely to be little left over for shareholders. As a result, income tax payable by companies, particularly to the extent that it is higher than the burden on alternative forms of investment, is one type of taxation that can influence a blockholder's decision to exit. In Britain, however, it is unlikely that corporate income taxation in isolation did a great deal to motivate blockholders to exit, in large part because of the system of corporate taxation that was in place.

The corporate income tax system in the U.S. operates as economic double taxation since corporate income is subject to tax at the corporate level where it is earned and at the shareholder level when distributed as a dividend. In Britain, by contrast, corporate income tax has traditionally operated on an "imputation" basis, reducing or eliminating the second layer of tax.[35] Under the British version of this system of corporate tax, at least with profits distributed in the form of dividends, companies operated as *de facto* collecting agencies, nominally paying dividends "gross" but withholding on behalf of shareholders tax pegged at a prescribed standard rate. Shareholders could then claim a partial or full credit against their dividend income, depending on their income level. Hence, corporate taxation generally only impinged directly on the profitability of companies when earnings were retained.[36]

During the period when ownership separated from control, U.K. public companies tended to distribute a large percentage of their reported profits, with decade by decade averages reaching as high as 80% in the 1920s and 1930s before falling to approximately 40% in the 1960s and around 30% in the 1970s.[37] Also, the standard rate of taxation was generally not particularly high, with the rate fluctuating between 20% and 30% throughout much of the 1920s and 1930s, and generally being set between 39% and 45% from the late 1940s to the early 1970s.[38] Under such condi-

[35] For basic comparisons of the "classical" and imputation systems, *see* BANK, The Dividend Divide in Anglo-American Corporate Taxation, 30 Journal of Corporation Law 1, 2-3 (2004); KAY/KING, The British Tax System, 184-85 (1978).

[36] PARKINSON, Scientific, *supra* note 12, at 199. The tax burden was alleviated still further by permissible tax deductions. For instance, amounts companies paid as managerial remuneration were deductible in calculating taxed profits but dividends were not. This distinction potentially mattered greatly for smaller companies – various rules were introduced with the express intention of precluding smaller companies from distributing profits in the form of managerial salaries – STANLEY, "Basic Rules Prescribing a Director's Pay", Times, March 3, 1969, 22. The distinction, however, was of limited significance for larger companies since revenues typically dwarfed managerial salaries.

[37] On the 1920s and 1930s, *see* BANK, Dividend, *supra* note 35, at 11-12; THOMAS, The Finance of British Industry 1918-1976, 89 (Table 4.2) (1978). On the 1950s, the average for the decade was calculated on the basis of annual figures set out in ROYAL COMMISSION ON THE DISTRIBUTION OF INCOME AND WEALTH, Report No. 2: Income from Companies and its Distribution, 161, Table P7 (1975). On the 1960s and 1970s, *see* TOMS/WRIGHT, Corporate Governance, Strategy and Structure in British Business History, 1950-2000, 44 Business History 91, 105 (2002).

[38] For data on the standard rate, *see* PARKINSON, Scientific, *supra* note 12, at 208 (1920s and early 1930s); "Proposed Changes in Taxation", Times, April 27, 1938, 10 (reporting an increase in the standard rate of taxation from 30% to 35%); THOMAS, Finance, *supra* note 37, at 230 (Table 8.4) (1947-48 to 1975-76).

tions, the burden imposed by "mainstream" corporate tax was not particularly onerous and likely did not, in isolation, precipitate blockholder exit.

4.2 Corporate Profits Taxation

While corporate tax on its own typically should not have provided the impetus for exit by blockholders, additional "profits" taxes imposed on companies, most notably to finance the war effort in World War I and World War II, might well have had this effect. In 1915, to increase revenues to pay for World War I and to preclude politically controversial "profiteering" in trades and industries benefiting form the war-time conditions, the U.K. government imposed on all trading concerns an Excess Profits Duty (E.P.D.) of 50% on profits above a prescribed pre-war standard.[39] The E.P.D. rate was raised to 60% in 1916, increased again to 80% in 1917, cut to 40% for 1918 and 1919 and then raised again to 60% for 1920/21, when the tax was abolished.[40]

The E.P.D. was a lucrative tax for the government, yielding 25% of tax revenue raised between 1915 and 1921.[41] Concomitantly, it had a strong impact on the bottom line for companies. According to a 1999 study of corporate accounts of 30 leading industrial companies for 1910 to 1924, the pre-tax return on equity was significantly higher from 1915 to 1920 (23.8%, on average, annually) than it was from 1910 to 1914 (10.5%).[42] Tax, primarily in the form of the E.P.D., did much to reduce the differential, with post-tax return on equity averaging 13.9% annually between 1915 to 1920 and 10.0% for 1910 to 1914. Once inflation was taken into account, return on equity was lower during the war years (8.7% on average annually) than it was prior to World War I (9.9%). Moreover, averages are somewhat deceptive since the burden the E.P.D. imposed hinged on profits earned in the benchmark pre-war years. As one critic of the tax said in 1920, "(o)ld established and prosperous firms…got off lightly, while new and struggling firms had the breath knocked out of them."[43] Exit might well have been an appealing option for blockholders in companies having their breath knocked out by the E.P.D.

The E.P.D. also made the future more precarious for blockholders than it otherwise might have been. As an American economist observed in 1920, "huge sums, a substantial portion of which would have otherwise gone toward strengthening and

[39] DAUNTON, Just Taxes: The Politics of Taxation in Britain, 1914-1979, 41, 55-57 (2002). "Excess profit" was defined as an increase over the profit of the three years before the war or above 6% on prewar capital.

[40] *See* DAUNTON, How to Pay for the War: State, Society and Taxation in Britain, 1917-24, 111 English Historical Review 882, 896 (1996).

[41] HICKS/HICKS/ROSTAS, The Taxation of War Wealth, 71 (1941).

[42] ARNOLD, Profitability and Capital Accumulation in British Industry During the Transwar Period, 1913-1924, 52 Economic History Review 45, 58-62 (1999).

[43] Quoted in "Excess Profits A 'Lottery'", Times, May 8, 1920, 11. *See* also STRACHAN, Financing the First World War, 74 (2004) ("new businesses with low profits before the war but which became established during it were hit harder than pre-existing large and over-capitalized firms."). Some allowances were made in calculating the pre-War benchmark for "abnormal depression": STAMP, Taxation During the War, 156 (1932).

expanding business undertakings, have been rendered unavailable for this purpose and consequently business in the aggregate must be less well established and safeguarded than would have been the case if the tax had not been imposed at all."[44] For those businesses – and blockholders – that were suffering, there was a tax-driven exit option. Under the E.P.D. when one company bought out another the pre-war records of the two were amalgamated to form the standard by which the "excess" war profits of the combined businesses was measured. As a result, there was a "lively trade" for companies that had been prosperous before the war but had struggled from then on.[45]

In 1920, the U.K. imposed a new levy on profits – the Corporation Profits Tax (C.P.T.) – designed to supplement and ultimately replace the E.P.D.[46] While the E.P.D. was imposed on all businesses, as the name of the tax implies, the C.P.T. applied only to limited liability entities such as corporations. Moreover, rather than being linked to pre-war profits, the C.P.T. was a flat 5% levy on all corporate profits, with the amount payable being capped at 10% of net profits, calculated after deducting fixed interest on bonds and dividend payments on preferred shares.[47]

The 1921 abolition of the E.P.D. was much welcomed, particularly since the government retained the tax after World War I ended and had even increased the rate of tax. As the Times newspaper said, repeal would be "hailed with satisfaction in business circles, and it should go a long way towards reviving that spirit of enterprise which its retention, and increase last year did much to destroy."[48] The C.P.T. was hardly a popular alternative, though, being labeled by some as "more vicious and more destructive of the spirit of enterprise than the much-condemned E.P.D."[49] The Federation of British Industries denounced the tax as "fundamentally unsound",[50] predicting that "industry should be absolutely crushed under a load they cannot carry."[51]

A point the Federation and other critics of the C.P.T. made was that it had a disproportionate effect on holders of ordinary shares.[52] As the vice-chairman of a railroad corporation explained in denouncing the tax, since dividends paid to ordinary shareholders were not deductible when computing the maximum 10% tax on net profits, "in nearly every case [the profits tax] is paid entirely by the Ordinary share-

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44 HAIG, British Experience With Excess Profits Taxation, 10 American Economic Review, Papers and Proceedings of the Annual Meeting of the American Economic Association, 1, 6-7 (1920).
45 HAIG, *id.*, at 9.
46 DAUNTON, How to Pay for the War, *supra* note 40, at 901.
47 TUCKER, The British Finance Act, 1920, 35 Quarterly Journal of Economics 167, 170 (1920).
48 "The End of E.P.D.", Times, February 4, 1921, 11.
49 "City Notes; Important New Issues; The Corporation Tax", Times, March 1, 1921, 18.
50 DAUNTON, How to Pay for the War, *supra* note 40, at 902.
51 *Id.*; "Lighter Burden of Taxes; Appeal by F.B.I. to Government", Times, Jan. 31, 1923, 7.
52 *See*, *e.g.*, "Company Meetings: The Costa Rica Railway Company, Limited", Times, July 20, 1921, 19; "City Notes; Important New Issues; The Corporation Tax", Times, March 1, 1921, 18. Labour's Hugh Dalton called the tax "especially objectionable, discriminating against ordinary shareholders in joint-stock companies as compared with other property owners, and discouraging, in a specially high degree, the taking of business risks." DAUNTON, How to Pay for the War, *supra* note 40, at 914.

holder."[53] The point was potentially telling for blockholders, since the voting control they would have exercised would have been derived from owning a substantial percentage of ordinary shares rather than other securities, such as preference shares and debentures (*i.e.* corporate bonds).

The C.P.T. not only was unpopular with business but also failed to generate the tax revenue that had been predicted and was repealed in 1924.[54] The fact the C.P.T. was in place during "one of the worst recessions in history"[55] likely depressed the revenue generated since the adverse business conditions cut sharply into profits companies were generating.[56] For instance, according to the 1999 study of the accounts of 30 leading industrial companies cited earlier, the average annual after-tax inflation adjusted return on equity between 1921 and 1924 was a meager 3.1%, well below the figures for 1910-14 and 1915-20. The recession, rather than the C.P.T. apparently was to blame, since there was only a small difference between the pre-tax and post-tax return on equity (6.9% on average annually, unadjusted for inflation, vs. 6.2%). Regardless, the fact remains that due to tax and adverse business conditions, the decade following the start of World War I was a difficult period for U.K. companies. Operating under such conditions likely would have prompted numerous blockholders to contemplate exit, particularly in favor of investments not subject to the profits taxes, such as war bonds.

A similar combination of war-time taxation and adverse economic conditions likely prompted blockholders to do likewise during the World War II era. An economic recovery occurring throughout the mid-1930s came to an abrupt halt in 1938, and corporate profits dropped sharply.[57] The difficulties for business were compounded by increased taxation. To help pay for rearmament in preparation for the looming war against Germany, Parliament introduced in 1937 a National Defence Contribution (N.D.C.) that was similar to the C.P.T. except that it imposed a levy of 5% on profits of all businesses rather than just companies.[58]

The N.D.C., as with the C.P.T., was criticized on the grounds the tax fell entirely on ordinary shareholders.[59] However, of much greater practical significance for companies and those owning blocks of shares in them was the Excess Profits Tax (E.P.T.), introduced in 1939 to raise revenue for fighting World War II and mute hostility towards anticipated war-time profiteering. The E.P.T. constituted a tax on prof-

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53 "Company Meetings", *supra* note 52.

54 DAUNTON, How to Pay for the War, *supra* note 40, at 914 (calling the tax's yield "disappointing"); "Lighter Burden of Taxes; Appeal by F.B.I. to Government", Times, Jan. 31, 1923, 7 (noting that while it was originally estimated that the tax would yield £50 million annually, the actual yield was only £17.5 million at its height).

55 ALDCROFT, The British Economy, Volume 1: The Years of Turmoil 1920-1951, 6 (1986).

56 An alternative explanation for the reduced revenues from the C.P.T. is that the tax was "easily evaded" because of the ability to reclassify profit as something else. HICKS *et al.*, The Taxation of War Wealth, *supra* note 41, at 90.

57 THOMAS, Finance, *supra* note 37, at 104-5; THORPE, Britain in the 1930s: The Deceptive Decade, 62-66 (1992).

58 DAUNTON, Just, *supra* note 39, at 173; FARNSWORTH, Some Reflections upon the Finance Act 1937, 1 Modern Law Review 288, 290-91 (1938).

59 "Industry and War Taxation", Times, September 28, 1945, 2.

its exceeding a benchmark fixed by reference to a company's profit levels in prescribed pre-war years, with the rate being set initially at 60% and increased in 1941 to 100%, subject to a 20% credit on the tax paid when the war ended.[60] Companies potentially liable for both the N.D.C. and the E.P.T. paid only the higher of the two.[61] Due to the high E.P.T. rates, if there was any sort of meaningful difference between the pre-war benchmark and war-time profits levels, the E.P.T. was the tax companies would have to pay.

The E.P.T.'s 100% rate of taxation on profits above a prescribed pre-war level constrained substantially the return companies could generate for shareholders, particularly for firms that could not take advantage of high pre-war profits to establish a favorable benchmark.[62] Operating under the uncertainties created by World War II combined with this tax burden likely prompted numerous blockholders to think of exit, but orchestrating this was not straightforward. For instance, selling out by way of a merger was problematic because the E.P.T. rules were enacted to close the E.P.D. loophole that allowed businesses to establish a favorable excess profits benchmark by acquiring companies which prospered during the relevant pre-war years.[63] As for exiting by selling shares to outside investors, this was difficult but not impossible. Full-scale public offerings of shares were officially discouraged to ensure adequate investor backing for the sale of government debt being issued to finance the war effort.[64] However, it was possible to launch stock market trading in a large block of shares that had been tightly held (*e.g.* by a family) by the "placing" of shares privately with a small syndicate of investors, usually followed by seeking permission for dealings to begin on the Stock Exchange.[65]

The E.P.T. was abolished by the Finance Act 1946, thus theoretically easing conditions for business.[66] However, a backlog of placings had built up due to a 1944 "grey market agreement" orchestrated by the Treasury, which had become con-

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[60] SAYERS, Financial Policy 1939-45, 40, 86, 88-89, 118-19 (1956).

[61] SPICER, Excess Profits Tax and National Defence Contribution, 109 (1940).

[62] A concession was made available for businesses with fluctuating profits, but this provision was "bitterly criticized" since relief was only offered up to the point where a company could satisfy its obligations to pay interest on its debts, satisfy its preferred dividend obligations and distribute a 6% dividend for ordinary shareholders (8% in the case of director-controlled companies): Hicks *et al.*, *supra* note 41, at 96.

[63] SAYERS, Financial, *supra* note 60, at 122; FARNSWORTH, The Finance Act, 1941, 5 Modern Law Review 128, 132 (1941).

[64] SAYERS, Financial, *supra* note 60, at 164, 172-74 (discussing the work done by the capital issues committee struck by the Treasury); MICHIE, The London Stock Exchange: A History, 314 (1999) (of securities quoted on the London Stock Exchange between 1941 and 1945, 86% by value were issued by the British government).

[65] GRANT, A Study of the Capital Market in Britain From 1919-1936, 161-62 (2nd ed. 1967); KYNASTON, The City of London: Volume III, Illusions of Gold 1914-1945, 421 (1999). Blockholders wanting to carry out a placing during World War II without confronting Stock Exchange constraints could tap a "grey market" where shares were sold "off market": SAYERS, Financial, *supra* note 60, at 178-79; "Black Markets and Grey", Times, November 19, 1943, 9.

[66] Finance Act 1946, s. 36.

cerned about the impact such transactions were having on capital markets.[67] The backlog, combined with a partial relaxation of war-time restrictions on the raising of capital, contributed to a new issue boom in the late 1940s characterized by a large number of share offerings by family-owned companies.[68]

The difficult business conditions that would have prompted blockholders to contemplate exit from the late 1930s until the end of World War II eased substantially in the 1950s. A flourishing domestic market where customers "just got into the queue" and a rapid acceleration of export demand helped U.K. companies to prosper throughout the decade.[69] From a tax perspective, however, the repeal of the E.P.T. proved to be only a short-lived reprieve for companies, particularly with respect to dividends. In 1947, the N.D.C. became a permanent tax on profits, but with a twist, namely differentiation between retained earnings and profits distributed as dividends. Initially, the tax rate on distributed profits was increased to 12.5% while the rate for undistributed profits remained 5%, but the rates were soon doubled to 10% on retained earnings and 25% on profits distributed as dividends.[70] For the following decade, distributed profits were consistently taxed at a significantly higher rate than undistributed profits.[71] The policy was explicitly designed to discourage dividends, which were criticized on the basis that they incited employees to make high wage demands, fostered inflation by increasing consumer spending and constituted "unearned" (and implicitly undeserved) income in the hands of shareholders.[72]

In 1958, the profits tax was restructured to abolish the differential between retained and distributed earnings but an explicit corporate tax bias against dividends soon reappeared.[73] In 1965 the Labour government replaced the profits tax and the imputation version of corporate income tax with what is typically known as a "classical" system of corporate tax under which corporate profits were subject to tax at the corporate level and were then taxed again fully at the shareholder level as income when dividends were paid. James Callaghan, Labour's Chancellor of the Exchequer at the time, freely acknowledged the reforms reintroduced an explicit corporate tax bias against dividends and justified this on the basis that the pre-existing regime did "not provide sufficient incentive to companies to plough back profits for growth

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67 On the "grey market" agreement, *see* SAYERS, Financial, *supra* note 60, at 179-80. On the backlog, *see* "Fresh Ruling on New Issues", Times, April 5, 1945.

68 On conditions after the war ended, *see* THOMAS, Finance, *supra* note 37, at 146-48; "New Issue Boom Goes On", Times, July 23, 1947, 8; "'The Times' Book of New Issues", Times, June 24, 1949, 9; ROGOW, The Labour Government and British Industry 1945-1951, 27-29 (1955).

69 TURNER, Business, *supra* note 33, at 59-60; LITTLEWOOD, The Stock Market: 50 Years of Capitalism at Work, 122 (1998).

70 DAUNTON, Just, *supra* note 39, at 200-1.

71 For a year-by-year breakdown of the differential, *see* THOMAS, Finance, *supra* note 37, at 230; KING, Public Policy and the Corporation, 258 (1977).

72 DAUNTON, Just, *supra* note 39, at 249; BANK, Dividend, *supra* note 35, at 37; RUBNER, The Ensnared Shareholder: Directors and the Modern Corporation, 191-93 (1965); *see* also ROYAL COMMISSION ON THE TAXATION OF PROFITS AND INCOME, Final Report, Cmnd. 9474, 158-59 (1955) (explaining rather than agreeing with the policy justifications).

73 On the 1958 change, *see* DAUNTON, Just, *supra* note 39, at 252-53; BANK, Dividend, *supra* note 35, at 41.

rather to distribute them as dividends".[74] The change was not permanent, as the U.K. abandoned the classical system of corporate taxation in 1973 and restored the imputation system of corporate tax without reintroducing any sort of profits tax. From this point onwards U.K. corporate taxation did not impose any sort of special burden on profits distributed as dividends.[75]

The explicit tax bias against dividends in place between 1947 and 1958 and 1965 and 1973 provided blockholders with a potentially potent incentive to exit. Dividends can be a significant source of income for any blockholder but they can gain special importance when a successful business reaches its second and third generation. Under such circumstances, many of the shareholders within the company's founding family will lack an operational role with the company, and the only ongoing source of return they will derive from the shares they own will be cash distributions the company makes to shareholders.

U.K. company law prohibited companies from repurchasing shares until the early 1980s, so as a practical matter dividends constituted the only cash flow shares generated for shareholders.[76] Thus, to the extent the tax system was biased against the payment of dividends, this could have provided second and third generation family owners with an incentive to sell out. Empirical studies done on the impact the 1947-58 differential profits tax and the 1965-73 classical system of corporate tax had on dividend payouts do not conclusively establish that the tax rules actually affected dividend levels.[77] Nevertheless, investors, including blockholders, might reasonably have surmised that government policy would depress dividend pay-outs and thus may well have taken the presence of tax rules biased against dividends as their cue to exit in search of better investment options.

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[74] 701 Parl. Deb., H.C. (5th Ser.) (1964) 1041 (statement of Mr. Callaghan). For further background on the rationale underlying the change, *see* DAUNTON, Just, *supra* note 39, at 291-92; THOMAS, Finance, *supra* note 37, at 233-34.

[75] KAY/KING, *supra* note 35, at 188.

[76] *Trevor v. Whitworth*, 12 App. Cas. 409 (1887) (establishing the common law rule prohibiting the repurchase of shares); Companies Act 1981, c. 62, ss. 45-62 (authorizing share buy-backs under prescribed circumstances).

[77] *See* RUBNER, The Irrelevance of the British Differential Profits Tax, 74 Economic Journal 347 (1964) (abolition of the differential profits tax had no impact on dividend-profits ratios); FELDSTEIN, Corporate Taxation and Dividend Behaviour, 37 Review of Economic Studies 57 (1970) (the U.K.'s differential profits tax had an effect on corporate saving and dividends); BRISTON/TOMKINS, The Impact of the Introduction of Corporation Tax upon the Dividend Policies of United Kingdom Companies, 80 Economic Journal 617 (1970) (the introduction of the classical corporate tax system in the U.K. in 1965 was not a significant factor in determining dividend policy). For studies covering from 1950 through the 1970s, compare POTERBA/SUMMERS, The Economics Effect of Dividend Taxation, in: ALTMAN/SUBRAHMANYAM (eds.), Recent Advances in Corporate Finance (1985) (dividend taxes affected the dividend policy of U.K. public companies); BANK/CHEFFINS/GOERGEN, Dividends and Politics, unpublished working paper (2004) (not finding a statistically significant correlation between tax and dividend policy).

4.3 Shareholder-Level Taxation of Dividends

During the period when ownership separated from control in the U.K., the tax bias against dividends extended beyond corporate-level tax to the taxation of personal income at the shareholder level. For instance, the rules governing personal income tax imposed an explicit penalty against dividends, but it was not until 1973 that a distinction between earned and unearned income would have motivated blockholders to consider exit. As part of tax reform carried out that year, a 15% income tax surcharge was imposed against unearned income that applied regardless of income levels. Hence, between 1974 and 1979 for taxpayers who earned more than £21,000 annually (about £87,400 in current terms)[78] dividends were taxed at 98%: the top tax rate of 83% plus the investment income surcharge of 15%.[79] Dividends obviously were of little practical value for blockholders in this predicament, and for those whom receipt of dividends was a high priority tax would have given them a motive to exit.

Prior to 1973, in contrast, the manner in which the tax system distinguished between earned income and dividends would have been of little concern to blockholders, largely because owners of a substantial block of shares in a larger public company generally would have had an income sufficient to place them in a high income tax bracket.[80] From 1909 to 1973 U.K. income tax had two elements, income tax set at the "standard rate" and "supertax", generally known as "surtax".[81] Surtax was imposed on taxpayers with incomes exceeding a prescribed level and was levied on a rising scale on successive slices of income above that level. Prior to World War II, the tax break for earned as opposed to unearned income was achieved by setting income tax rates for earned income at a rate below the "standard rate" that applied to investment income up to a specified income level (*e.g.* £2,500 in 1919).[82] Since surtax was set at the same rate for earned and unearned income for those with high incomes the total tax due varied little depending on whether their income was earned or derived from investments.[83]

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78 Historical currency calculations have been done with http://www.measuringworth.com/calculators/ukcompare/, using the retail price index to calculate the relative value of £s and 2005 as the "current" year, which was the latest available at the time of writing. 1977 was used as the "original" year for the purpose of the currency conversion in this instance.

79 KAY/KING, *supra* note 35, at 51.

80 *See* MERRETT, Executive Remuneration in the United Kingdom, 33, 38 (1968) (of 51 executive directors interviewed for a survey on executive pay in the U.K., 19 were probably blockholders, as 13 were categorized as "self made" and 6 were categorized as "inherited". On average, the marginal tax rate was 76% for "self-made" executives and 69% for "inherited" executives.).

81 For a nutshell history of "super tax", *see* LEWIS, British Tax Law – Income Tax: Corporation Tax: Capital Gains Tax, 14 (1977).

82 COMSTOCK, British Income Tax Reform, 10 American Economic Review 488, 496 (1920). For numerical illustrations, *see* DAUNTON, Just, *supra* note 39, at 47 (setting out income tax rates and allowances for 1913/14 and 1918/19); CAUDWELL, A Practical Guide to Investment, 10-11 (1930) (providing a table of income tax payable on earned and investment income with total incomes of between £135 and £150,000).

83 For instance, while as of 1930, £32 2s 6d was taxed on £500 of earned income and £50 17s 6d was taxed on £500 of unearned income, the corresponding figures for £5,000 were £1,313 7s 6p (earned) and £1,369 12s 6p (unearned): CAUDWELL, Practical, *supra* note 82, at 10-11.

After World War II, the nature of the tax bias against "unearned" income changed, as deductions that were made available for "earned" income were not available for investment income.[84] Again, though, the distinction mattered little for those with high incomes, since the "earned income allowance" was capped in a way that meant for individuals at or near the top income tax bracket dividends were taxed at effectively the same rate as earned income.[85] Blockholders typically would have had high incomes, so for them dividends would have been taxed no more harshly than salaries.

While the explicit income tax bias against dividends likely would not have induced blockholders to exit, the rates at which income – whether earned or unearned – was taxed reduced considerably the after-tax value of dividends in the hands of investors in high income brackets, and thus likely induced blockholders to contemplate selling out. There is generally little data available comparing pre-tax and post-income from dividends but statistics compiled on behalf of a royal commission studying the distribution of wealth and income revealed that in 1972/73 for those earning more than £12,000 (£106,000 currently), post-tax net income from dividends and interest was a mere 28.5% of the pre-tax figure.[86] The 1972/73 figures are not entirely typical, since rates of income taxation varied through the 20th century. However, throughout the period when ownership separated from control a general trend in favor of a "progressive" graduated system of tax rates meant income taxation cut substantially the net income dividends yielded in the hands of any blockholder with high personal income.

Aside from abatement of income tax for low incomes, there was no graduation of income tax in the U.K. until the introduction of surtax in 1909.[87] The financial demands of World War I prompted the government to introduce a markedly more progressive income tax regime, with the top rate of tax rising from 8.3% on an income of £5,000 or more in 1913 (£328,000 in current terms) to 52.5% on an income of over £10,000 in 1918 (£324,000 currently).[88] The end of the war did not yield significant tax relief for the wealthy. Instead, the Conservative government of the time, to paraphrase Chancellor of the Exchequer Winston Churchill, opted to leave the very rich "stranded on the peaks of taxation to which they have been carried by the flood".[89] The Labour party, during a short spell in office, took the opportunity in 1930 to increase the tax burden on the well-off by boosting the tax rate on income between £15,000 (£631,000 currently) and £20,000 from 42.5% to 50% and by setting the top rate of tax at 60% on income greater than £50,000.[90] Income tax rates were hiked yet again in the late 1930s to finance rearmament, so that in 1938 tax pay-

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[84] PLUNKETT/NEWPORT, Income Tax: Law and Practice, 394-95 (29th ed. 1961).

[85] PLUNKETT/NEWPORT, *id.*, at 30.

[86] Derived from ROYAL COMMISSION ON THE DISTRIBUTION OF INCOME & WEALTH (Lord Diamond, chairman), Report No. 2: Income from Companies and its Distribution, Cmnd. 6172, 23, 27 (1975).

[87] COMSTOCK, British, *supra* note 82, at 497.

[88] DAUNTON, Just, *supra* note 39, at 47 (Table 2.5).

[89] DAUNTON, *id*, at 133.

[90] Extrapolated from "The Budget", Times, April 15, 1930, 11.

able on income above £6,000 (£255,000 currently) was 50% or more and the top marginal tax rate, applicable to income greater than £50,000, was set at 72.5%.[91]

Taxes were increased still further during World War II, with high rates of income tax being applied at much lower levels of income than had been the case previously and the top rate of income tax being increased substantially. From 1941 throughout the war income above £2,000 (£65,800 currently, using 1941 as the base year) was taxed at a rate of 60%.[92] The top rate of income tax throughout this period was 95% for all taxable income above £20,000, which meant that whereas in 1938 a gross income of £12,000 would have yielded a net income of £7,000 during the war years roughly £150,000 was required.[93]

The Labour government elected in 1945 had no intention of providing any sort of tax breaks for the rich.[94] The Labour government did reduce the standard rate of income tax from 50% to 40%. At the same time, though, it increased surtax rates on higher levels of income, meaning that there was no tax break for those with incomes of £12,000 (£313,000) or more annually.[95] During Labour's tenure (1945-51), the tax rate for income above £12,000 was set at 85% and the top marginal rate of 90% applied to income above £15,000.

Labour's decision to tax heavily those with high incomes set the tone until the 1980s, with the top rate of income tax being 83% or more until Margaret Thatcher's Conservative government began cutting it dramatically in the 1980s.[96] Hence, aside from any explicit tax bias in favor of earned income, for a period of more than four decades taxation of income reduced dramatically after-tax return from dividends in the hands of blockholders. This, in turn, would have given blockholders who assigned a high priority to the income derived from dividends a tax-oriented incentive to unwind their holdings.

Taxation of capital gains (or lack thereof) likely reinforced the bias in favor of exit created by taxation of dividends since those owning a large block of shares in a company could reap a one-off tax windfall by selling out. Capital gains were untaxed until the early 1960s and even after capital gains were taxed generally from 1965 onwards, the rate was set at 30%, which at least for those in higher income tax

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91 Extrapolated from "War Budget/Proposed Changes in Taxation", Times, September 28, 1939, 4.

92 For income tax and surtax rates throughout World War II, *see* ROGOW, Taxation and 'Fair Shares' Under the Labour Government, 21 Canadian Journal of Economics and Political Science 204, 204-5 (1955).

93 SAYERS, Financial, *supra* note 60, at 49; SHIRRAS/ROSTAS, The Burden of British Taxation, 26-27, 72 (1942).

94 As Hugh Dalton, Chancellor of the Exchequer, explained in Parliament in 1946, an "awakened and war scarred generation" was demanding the government "close from both ends the gap which separates the standard of living of the great mass of our fellow citizen from that of a small privileged minority": quoted in FIJALKOWSI-BEREDAY, The Equalizing Effect of the Death Duties, 2 Oxford Economic Papers (N.S.) 176, 177 (1950).

95 "Tax Changes", Times, October 24, 1945, 7; "Surtax Increased", Times, October 24, 1945, 7.

96 *See* http://www.ifs.org.uk/ff/income.xls (individual tax rates, 1973-74 to 2005-2006). The one exception was the 1973 tax year, when the top marginal rate was set at 75%.

brackets was considerably lower than the tax burden on income.[97] Moreover, if a blockholder had the opportunity to exit by way of a merger and the purchase price took the form of shares of the acquiring company, the transaction did not constitute a taxable capital gain for the target shareholders and the exiting blockholders would not have to pay any tax until they sold their shares in acquiring company.[98] Mergers of this sort were common, as between 1955 and 1985 one in four successful U.K. takeovers of public companies were "all-equity" offers and in two out of three deals there was some form of equity component.[99]

The tax advantages of exit would have been neutralized if former blockholders had to invest the proceeds in assets fully exposed to income tax on investment income. This, however, was unlikely to occur since those in high income brackets were prepared to go to great lengths to side-step the penal tax liability on income. One option was to take advantage of tax relief on interest and use borrowed funds to finance the purchase of durable goods that yielded no regular taxable income, would retain their real value over time and would give pleasure to the owner and his family.[100] Land, antiques, and works of art were prime examples. Also, as section 5.2 discusses, life insurance based savings schemes and contributions to pension plans offered potentially significant tax advantages.[101] Moreover, former blockholders could reduce income tax payable by transferring income-generating assets to a trust established on behalf of individuals (*e.g.* children) with little or no other taxable income.[102] Hence, for blockholders discouraged by heavy taxes on dividends, the tax treatment of capital gains gave them a good reason to unwind their stake in the company and invest their capital in ways that ensured not all of their eggs were in one basket.

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97 On the position prior to the early 1960s, *see* ROSE, The Economic Background to Investment, 335 (1960). On the change to the law, *see* Finance Act 1965, c. 25, ss. 19, 20, 22.

98 SPOLIANSKY/BUCKLEY, Practice and Procedures for Takeovers in England, 28 Business Lawyer 63, 74-75 (1972-73).

99 FRANKS/HARRIS/MAYER, Means of Payment in Takeovers: Results for the United Kingdom and the United States, in: AUERBACH (ed.), Corporate Takeovers: Causes and Consequences, 221, 236 (1988). "All equity" takeovers were highly conducive to separating ownership from control since not only would blockholders in the target exit but if the acquiring company had blockholders, their stake would typically be diluted as part of the deal since the company would be issuing new shares to finance the acquisition. *See*, for example, FRANKS/MAYER/ROSSI, Spending Less Time with the Family: The Decline of Family Ownership in the United Kingdom, in: MORCK, History, *supra* note 5, at 581, 600-1; "Cadbury Shares over 83s in Heavy Trading", Times, January 30, 1969, 17 (discussing how the 1969 merger of Cadbury Ltd., a chocolate manufacturer, with Schweppes, a drinks company, diluted the percentage of shares owned by the families controlling Cadbury).

100 NELSON-JONES, "Unremitting Search for Surtax Relief", Times, July 1, 1972, 22; KAY/KING, *supra* note 35, at 51, 55.

101 TITMUSS, Income Distribution and Social Change, 167 (1962) (saying that in 1959-60 life assurance relief cost the government £49 million, about one-seventh of which was received by the top 1% of taxpayers).

102 WHEATCROFT, The Attitude of the Legislature and the Courts to Tax Avoidance, 18 Modern Law Review 209, 210-11 (1955).

In circumstances where taxes on dividend income were high and there was no taxation of capital gains (or the rate was low compared to the rate imposed on income) a top marginal rate taxpayer had an incentive to create "homemade" dividends by carrying out "dividend stripping", which in this context meant avoiding the payment of income tax on dividends paid by converting income into capital gains. The fact that U.K. public companies made a practice of announcing the value of a dividend a few weeks before the payment is due created an obvious way for individuals to "launder" dividends. Assuming a reasonably generous dividend had been announced and market conditions did not change, the price of a company's shares "pregnant with dividend" or "full of dividend" would rise in anticipation of the payment and fall sharply when payment day arrived.[103] To avoid the income tax on the dividend payment, an investor could sell his shares "cum dividend" – with the right to receive the forthcoming dividend attached – immediately before the dividend payment date.[104] The inflated price of the shares at that date would often mean the investor would have a capital gain on the holding, which until the early 1960s was not taxable.

For this sort of scheme to work, there needed to be investors willing to purchase the shares "pregnant with dividend". Obvious candidates were investors exempt from paying income tax on dividends, which included pension funds and charities, and marketmakers (stockbrokers specializing in making a market for shares) who could offset the dividend received for tax purposes with a capital loss incurred from selling the shares subsequently.[105] To complete the circle, the top marginal rate taxpayer would return to the buyer of the shares or to the stock market and purchase the company's shares "ex dividend" (after the dividend had been paid) at a price that had declined due to the payment of the dividend.[106] The result would be ownership of the equity with the dividends "stripped".

While in theory "dividend stripping" could be used to sidestep high taxes on dividends, it is doubtful blockholders engaged in the practice with sufficient frequency to blunt tax incentives to exit. The Finance Act 1961 added a draconian anti-tax avoidance provision addressed specifically to the dividend stripping scenario.[107]

[103] ROSE, Economic, *supra* note 97, at 306; ARMSTRONG, The Book of the Stock Exchange, 248 (5th ed. 1957). On the "pregnant with dividend" metaphor, *see* MONROE, Intolerable Inquisition? Reflections on the Law of Tax, 74 (1981).

[104] This could occur because public companies customarily closed their transfer registers on a specified date shortly before a dividend payment and would not reopen their books until the dividend had in fact paid out: ROSE, Economic, *supra* note 97, at 306; ARMSTRONG, Book, *supra* note 103, at 244; NAISH, The Complete Guide to Personal Investment, 20 (1962).

[105] ROYAL COMMISSION ON THE TAXATION OF PROFITS AND INCOME, Final Report, Cmd. 9474, 369 (minority report) (1955); BEATTIE, Elements of the Law of Income and Capital Gains Taxation, 236 (9th ed. 1970); HOSKING, Pension Schemes and Retirement Benefits, 170 (1956).

[106] If there was an agreement at the time of sale that the taxpayer would repurchase the shares, the payment of dividends was treated as income of the seller. *See* Income Tax 1952, s. 203, which was enacted in 1937. *See* PLUNKETT, The Income Tax Act 1952, § 203 (1952); PLUNKETT/NEWPORT, Income Tax: Law and Practice, 223 (29th ed. 1961).

[107] Finance Act 1961, s. 28; for analysis *see* TAPPER, Finance Acts, 1961 and 1960, 25 Modern L. Rev. 64 (1962); POTTER, A Counterblast to Tax-Free Profits, 1960 British Tax Review 248, 259-67.

Even prior to this, dividend stripping in public companies was not particularly prevalent. Between 1955, when the government introduced an easily evaded provision designed to preclude dividend stripping, and 1958, the total loss to the Inland Revenue as a result of dividend stripping was estimated to have been between only £4 million and £10 million, and a significant proportion of the lost revenue likely involved shares in private companies rather than public companies.[108] This likely was due to costs arising from stamp duty (a tax on share transactions), stockbroker commissions and the "turn", this being the difference between the buying and selling prices quoted by those making a market in the company's shares (known as "jobbers").[109] Investors reportedly had to make a profit of at least 10% on the sale of shares to cover relevant transaction costs.[110]

4.4 Taxation of Managerial Income

The manner in which employment income was taxed potentially provided blockholders with a strong incentive to exit, particularly from World War II onwards. For major shareholders who worked in a managerial capacity – typically the founder of a company and, in subsequent generations, members of a blockholding family deemed qualified – employment income was potentially a significant perk associated with blockholding. As with dividends, however, the punishing income tax rates the U.K. government imposed ensured that if executives were highly paid they handed over much of what they earned.

Changes in government, as we have seen, provided little respite for those in top income brackets in the decades following World War II. Also, since the U.K. had an effective apparatus for tax-gathering, including not only the Inland Revenue but a "fiscal establishment" consisting of lawyers, accountants, taxation departments of banks and wage and salary departments of companies, the well-off, including blockholders, could not ignore the rules.[111] Hence, during the late 1960s, when the top marginal rate of income tax was 91% and became effective as gross income reached £19,000 (£221,000 in present-day terms), an executive earning £20,000 paid 62.8% of this amount in income tax and received £7,445 net while an executive earning £50,000 paid out 80% to the government and only received £10,070 net.[112] Indeed, it was virtually impossible for an executive of a public company to earn much more than £10,000 (£116,000 currently) after tax.[113]

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[108] FLETCHER, Retrospective Fiscal Legislation, 1959 British Tax Review 412, 424 (discussing revenue lost); ROYAL COMMISSION ON THE TAXATION OF PROFITS AND INCOME, *supra* note 105, at 369 (indicating the most extreme forms of dividend stripping involved private companies mainly).

[109] On the terminology, *see* ROSE, Economic, *supra* note 97, at 301.

[110] On the 10% figure, *see* NAISH, *supra* note 104, at 25; GLEESON, People and Their Money: 50 Years of Private Investment, 136 (1981). Another estimate was 19%: WINCOTT, The Stock Exchange, 141 (1946).

[111] "A Charter for Tax Reform", Times, April 10, 1967, 17.

[112] TREASURE, Toll, *supra* note 34.

[113] TREASURE, *id*. *See* also TURNER, Business, *supra* note 33, at 435 (discussing how the chairman of British Petroleum received in 1939 £10,000 out of a salary of £25,000 and was paid £50,000 in 1968 and had a take-home pay of £9,700).

There were means by which companies could remunerate executives so as to diminish the tax burden partially, such as the awarding of stock options in lieu of payment of salary and the provision of benefits in kind, such as expense accounts for meals and entertainment, a company car and guaranteeing housing loans.[114] The government, however, was prepared to crack down on such techniques, as it did with changes to tax law in the mid-1960s that eliminated the tax advantages of stock options.[115] As a result, accumulating substantial wealth purely through executive remuneration was difficult to achieve.[116] A 1968 study of executive directors in U.K. companies found that nearly two-thirds would never obtain disposable wealth in excess of £20,000.[117]

It was well-known the high rates of income tax standard during World War II and the decades following discouraged those otherwise inclined to manage companies from doing so.[118] As the Federation of British Industries put it in 1951, "If this situation continues that, to young men of character and ability, endeavour in this country does not offer the same rewards in others, then the spirit of enterprise which has been characteristic of British industry for so long must inevitably suffer".[119] The tax regime would have been discouraging for executives who happened to be major shareholders as well as for other managers, which implies income tax provided blockholders in the U.K. who otherwise might have been inclined to stay and work for their company with a potent incentive to exit.

4.5 Death Duties

In the U.K. the number of publicly quoted companies more than doubled between the late 1930s and early 1960s.[120] This can be attributed to a significant extent to estate tax – charges imposed on assets transferred on or shortly prior to death. As the Economist observed in 1968, "(n)ew flotations (initial public offerings) tend to have been built up by one man or a group since before or just after (World War II), going public to avoid death duties, actual or prospective".[121]

While estate taxes were first introduced in the U.K. in 1894, their impact in this context was greatest from the end of World War II onwards. Even though estate taxes had already been increased during World War II, the Labour government of 1945-51 stiffened them again, boosting the death duty rate for estates with a value of between £100,000 (£2.611 million)[122] to £150,000 from 27% to 50%, dropping the class of estate where the top rate applied from £2 million to £1 million and increasing the top

[114] TITMUSS, *supra* note 101, at 123-24, 176-82.
[115] MARLEY, "Entrepreneurial Aid for the Ailing Economy", Times, March 21, 1969, 27.
[116] GRIERSON, "The Case for Incentives Now", Times, August 11, 1967, 19; "Why High Pay Pays Off at the Top", Times, January 4, 1968, 21.
[117] MERRETT, *supra* note 80, at 40.
[118] ROGOW, Taxation, *supra* note 92, at 206.
[119] Quoted in ROGOW, *id. See* also BEDDINGTON-BEHRENS, "Need for Incentives at the Top", Times, February 2, 1967, 13.
[120] *Supra* notes 5-6 and related discussion.
[121] "New Issues – Less Important and Much Less Fun", The Economist, March 16, 1968, 107.
[122] Using 1947 for the purposes of conversion.

rate from 65% to 80%.[123] The rates remained unchanged until estate duty was replaced by capital transfer tax in 1975, which taxed transfers made on or within three years before death at 60% for estate values between £250,000 and £1 million and 65% beyond that.[124]

With careful planning, rich individuals could leave estates that for tax purposes bore little relation to their real wealth.[125] For blockholders in family companies, unwinding their ownership stake often was a key step in minimizing death duties. As the chairman of a leading issuing house said in 1951,

> "Not only is the splendid habit of building up out of retained profits rendered impossible by income and profits tax but the very fabric of these concerns is being torn to pieces by death duties. Hardly a working day passes but we are asked if we can help the proprietors of a private company to dispose part of their holdings so as to prepare for or to pay death duties."[126]

When the well-off structured their affairs to minimize death duties, they often used trusts under which family members would be the beneficiaries since, prior to the change from estate tax to the capital transfer tax in 1975, assets held in trust were exempt from estate taxes.[127] For blockholders, selling out was an obvious way to generate proceeds to transfer to trusts held on behalf of family members that could in turn be invested in marketable securities.

Death duties provided an additional incentive for those owning a business to exit, at least partially.[128] As the Times observed in a 1951 article on family firms and death duties, when families were planning their affairs to minimize death duties, "the large business is floated as a public company so that shares can be sold in good time to the public and a Stock Exchange price obtained for estate duty valuation."[129] From 1930 onwards, U.K. tax legislation stipulated that in the case of a publicly quoted company where at least 25% (later 35%) of the shares were widely held and traded the valuation of the shares for estate tax could be determined by reference to the

[123] FIJALKOWSI-BEREDAY, Equalizing, *supra* note 94, at 182; JEREMY, A Business History of Britain, 1900-1990s, 117 (1998).

[124] JEREMY, Business, *supra* note 123, at 118 (providing a table on estate duty rates, 1894-1975); KAY/KING, *supra* note 35, at 161 (setting out rates of capital transfer tax, 1977-78).

[125] KAY/KING, *supra* note 35, at 161.

[126] "The Charterhouse Investment Trust", Times, January 9, 1951, 8. On the status of the Charterhouse Investment Trust as an issuing house, *see* CHARTERHOUSE FINANCE CORPORATION LIMITED, Corporate Financing in Great Britain, 17 Law and Contemporary Problems 239, 239 (1952). *See* also "Family Firms and Death Duties", Times, July 16, 1951, 8.

[127] TITMUSS, *supra* note 101, at 92, 96-97; WHITING, The Labour Party and Taxation: Party Identity and Political Purpose in Twentieth-Century Britain, 241 (2000). Even after 1975, trusts could operate as partial shields against estate tax: KAY/KING, *supra* note 35, at 55.

[128] The analysis here does not take into account changes introduced in 1975 when estate duty was replaced by the Capital Transfer Tax, which imposed tax on gifts by the deceased not only under the will but up to seven years prior to death.

[129] "Family Firms", *supra* note 126.

stock market price during the year prior to death.[130] Otherwise, the shares were valued by estimating a company's net assets and allocating a fraction of this amount to the estate in accordance with the percentage of shares the deceased owned at the time of death.

Valuation by the stock market was typically advantageous to the deceased's estate. For instance, whereas the share price of a company with shares traded on the stock market was determined in an unbiased fashion by the sources of supply and demand, net asset valuations were made by tax officials typically lacking experience in assessing the market value of shares and facing the temptation to do well for the government by ascribing a high price to equity for death duty purposes.[131] Also, using the share price was advantageous to the estate because in companies with a blockholder the stock market price would typically have incorporated a minority discount due to the controlling block not being "in play". As a result, all else being equal, the share price would have been lower than an asset-based valuation conducted on the basis that all shares were equivalent.[132] Owners of large, successful private firms thus had an incentive to carry out a public offering and then ensure the "free float" met or exceeded the prescribed limits.

5. Taxation and Demand for Shares

Given that the taxation of corporate profits, dividends, employment income and the transfer of assets on death provided blockholders with incentives to exit, tax clearly contributed to the emergence of the U.K.'s outsider/arm's-length system of ownership and control. Willingness by blockholders to unwind their holdings is not a sufficient condition, however, for the diffusion of share ownership. Also crucial is that there must be demand on the part of investors who are prepared to own small percentages of equity in public companies and who are either indifferent or less affected by the tax considerations that helped motivate the blockholders to sell. If there is no such appetite for shares then blockholders eager to exit will either have to transfer the business to a new "core" investor or simply liquidate the firm's assets on a piecemeal basis. Either way, the predominant corporate governance arrangement will remain insider/control-oriented.

It cannot be taken for granted there will be demand for small holdings in publicly quoted companies. Ownership of a tiny percentage of shares in a public company is an investment potentially fraught with risk. Due to information asymmetries, investors can struggle to distinguish "high-quality" companies from their less meritorious counterparts. With a company that has a blockholder, minority shareholders can fall

[130] Finance Act 1930, 20 & 21 Geo. 5, c. 28, s. 37; STANFORD, Tax Planning and the Family Company, 124 (2nd ed. 1964). The original statutory provision, enacted in 1922, extended the option to companies that had issued shares to public and otherwise were not under control of fewer than five persons: Finance Act 1922, 12 & 13 Geo. 5, c. 17, s. 21(6).

[131] HADRILL, "Family Businesses" (Letter), Times, January 3, 1953, 7.

[132] "Shell Kernels", The Economist, March 15, 1958, 957. On the fact that an assets value measure did not take into account explicitly the size of the shareholding involved, *see* BAYNES, Share Valuations, 64-65, 115 (1966).

victim to extraction of private benefits of control. Matters are not necessarily any better in a widely held company. Since none of the shareholders is likely to have a stake large enough to justify close monitoring of management, senior executives potentially have a licence to pursue their own interests at the shareholders' expense. Moreover, the tax considerations that induce blockholders to exit can also discourage individuals investors from purchasing shares since their after-tax return will be diminished.

The thesis that the quality of corporate and securities law is the key determinant of ownership structures in a particular country plausibly accounts for how ownership can separate from control despite the difficulties associated with being an outside investor. The logic is that corporate and securities law, by addressing informational asymmetries and imposing constraints on potential insider misconduct, can make investors feel sufficiently "comfortable" about owning tiny percentages of shares in companies to create robust demand for shares in publicly quoted companies.[133] U.K. company law in fact did not provide extensive protection to outside shareholders and disclosure regulation was primitive by contemporary standards as ownership separated from control (*see* section 3). Various other factors, however, encouraged investors to buy shares in sufficient volume to permit blockholder exit. Tax played a significant role in the process due to clientele effects arising from the structure of personal income taxation rates in the interwar period and rules governing institutional investment in the decades following World War II.

5.1 The Interwar Period

While it is unlikely that the U.K. had a fully-fledged outsider/arm's-length system of ownership and control by the end of the 1930s, during the decades following World War I the middle class began investing in shares in a serious way.[134] One reason for the broadening of stock market investment was that shares were generating better returns than obvious alternatives.[135] Swings in investor sentiment further reinforced the momentum in favor of investing in shares, with enthusiasm peaking in stock market booms during 1919-20, 1927-29 and the mid-1930s.[136] A 1930 text on investing in public companies remarked upon how investor sentiment influenced demand for shares, saying "(i)n times when much Stock Exchange activity prevails and prices of stocks generally are rising opportunities for public flotations are exceptionally favorable…(with) the public being, at such times, infected with the

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[133] The terminology is borrowed from ROE, Political Preconditions to Separating Ownership from Corporate Control, 53 Stanford Law Review 539, 586 (2000).

[134] *Supra* notes 11 to 13 and accompanying text.

[135] Between 1919 and 1939 shares were a good bet since average year-to-year returns for equities were 12.4% compared with 6.5% for consols, a type of U.K. government bond. *See* MERRETT/SYKES, Return on Equities and Fixed Interest Securities: 1919-1966, District Bank Review, June 1966, 29, 36, 41; *see* also SCOTT, Towards the "Cult of the Equity"? Insurance Companies and the Interwar Capital Market, 55 Economic History Review 78, 93 (2002) (reporting that from 1921 to 1938 the average annual return on equities was 10.4% and the average annual return on gilts was 6.5%).

[136] On the timing, *see* THOMAS, Finance, *supra* note 37, at 26-29, 32.

general optimism prevailing on the Stock Exchanges, and therefore specially gullible".[137]

While flourishes of investor sentiment could periodically provide a highly congenial environment in which blockholders could sell out, adjustments to the proportional burden of income tax helped to provide a more enduring source of demand for shares in the interwar period. The experience in the U.S. is instructive on this count. Adolf Berle and Gardiner Means proclaimed in their famous 1932 book *The Modern Corporation & Private Property* that "in the largest American corporations, a new condition has developed … (T)here are no dominant owners, and control is maintained in large measure from ownership".[138] Relying on data Means compiled for a 1930 paper on dividends received by taxpayers in different income brackets, they deduced that the percentage of shares owned by wealthy Americans dropped substantially between 1916 and 1921 and characterized the process as "a shift in corporate ownership…of almost revolutionary proportions".[139]

Berle and Means, again drawing on Means' work, relied on income tax to explain what had occurred.[140] Financial pressures arising from World War I precipitated a dramatic increase on taxation of income of the wealthy, with the federal government boosting the top marginal rate of individual income tax (actually a combination of income tax and surtax) from 7% in 1915 to 54% in 1917 and to 77% in 1918 with an effective rate of 61%, meaning that someone with a taxable income of $100,000 had to pay $61,000 in taxes.[141] The top rate of income tax remained as high as 75% until 1922; by 1925 it had been cut to 33%.

To quote Means' 1930 paper, the increases in income tax made "the rich man a poor market for corporate securities" since they had less after-tax income to invest and new incentives to allocate what they had to invest in tax-favored assets, such as tax-exempt government bonds, real estate and insurance.[142] Banks and life insurance companies apparently were not buying shares in any volume at this time, and foreign demand was negligible.[143] As a result, if companies wanted to raise capital or blockholders wanted to exit, the middle class became the obvious market.

By happy coincidence, according to Means, "the man of moderate means became a potential market for securities of all sorts".[144] Readjustments brought about by World War I – including income tax imposed primarily on the rich – meant the less well-to-do profited economically from the war and had considerable addi-

[137] CUTFORTH, Public Companies and the Investor, 149 (1930); *see* also at 50.
[138] BERLE/MEANS, The Modern Corporation & Private Property, 110-11 (1997, originally published in 1932).
[139] BERLE/MEANS, *supra* note 138, at 60; MEANS, The Diffusion of Stock Ownership in the United States, 44 Quarterly Journal of Economics 561 (1930).
[140] BERLE/MEANS, *supra* note 138, at 58-59.
[141] MEANS, Diffusion, *supra* note 139, at 586 (discussing the effective rate for a top marginal rate taxpayer); BANK, Dividend, *supra* note 35, at 17 (setting out individual and corporate tax rates for 1913-35).
[142] MEANS, Diffusion, *supra* note 139, at 586.
[143] MEANS, *id.*, at 587.
[144] MEANS, *id.*, at 586.

tional income at their disposal, part of which could be invested.[145] At the same time, a successful Liberty Bond campaign launched by the U.S. government to finance American participation in World War I was familiarizing millions to securities markets who had previously saved purely through real estate and bank accounts and creating a new class of financial intermediaries that could quickly mobilize Liberty bondholders into other investments.[146] The number of stockholders and the proportion of corporate equity owned by individuals who were prosperous but not rich accordingly increased substantially, providing the platform for what Berle and Means characterized as a separation of ownership and control in large U.S. companies.[147]

A similar tax-supported broadening of the investor base likely occurred in the U.K. during the interwar years. As in the U.S., tax made, in Means' words, "the rich man a poor market for corporate securities". Due in large part to income tax that was very high by pre-World War I standards, the share of wealth held by the top 1% of the population fell from 69% to 56% between 1911/13 and 1936-38.[148] Most dramatically, caught by inflation, falling rents and rising taxes, many wealthy landowners broke up their estates to finance the lifestyle to which they were accustomed and did so at such a rate between 1918 and 1921 there reportedly was a transfer of land "probably not equalled since the Norman Conquest".[149]

In contrast to the situation at the beginning of the 20th century, when the wealthy, through local business connections or as clients of stockbrokers, constituted an integral source of demand for shares, after World War I the rich often became net sellers of securities to pay income tax and anticipated death duties.[150] Moreover, when the rich did buy shares, they were more conservative in their approach than they had been previously.[151] Sir Josiah Stamp, a wealthy industrialist and Bank of England director, made the point in 1930 when giving evidence to a government-appointed committee investigating finance and industry, saying, "you cannot expect these private businesses to be financed as they were by people who knew them once the money has left them by high taxation and…if (rich investors' money) is bid for by home enterprise it goes into the very large concerns."[152]

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[145] MEANS, *id.*, at 586; WARSHOW, The Distribution of Corporate Ownership in the United States, 39 Quarterly Journal of Economics 15, 37 (1924).

[146] WARSHOW, Distribution, *supra* note 145, at 35; SOBEL, Inside Wall Street: Continuity and Change in the Financial District, 203 (1977); GEISST, Wall Street, A History, 157 (1997).

[147] BERLE/MEANS, *supra* note 138, at 5. For further details on the rise of the private investor, *see* section 6.2 of the paper.

[148] LOWE, Riches, Poverty, and Progress, in: ROBBINS (ed.), The British Isles 1901-1951, 197, 200 (2002) (noting, however, that the data for 1911-13 is probably not as reliable as it was for later years).

[149] THOMPSON, English, *supra* note 10, at 333.

[150] GORDON, The Capital Market of Today, 102 Journal of the Royal Statistical Society 501, 509 (1939).

[151] MICHIE, The City of London: Continuity and Change, 1850-1990, 121 (1992); *see* also THOMAS, Finance, *supra* note 37, at 117.

[152] Quoted in MICHIE, City, *supra* note 151, at 120-21.

At the same time the wealthy receded as a source of demand for shares, "the man of moderate means became a potential market". While the very rich in Britain did poorly relative to others during World War I and the decades following, the merely well-off fared well as the share of wealth held by the top 2% to 10% of the population rose from 23% to 32% between 1911/13 and 1936-38.[153] Things that had generally been the exclusive preserve of the wealthy in turn became dispersed more widely,[154] including ownership of shares among an (upper) middle class with increased capital at their disposal available for investment. The trend was correctly anticipated by a witness giving evidence in 1918 to a committee investigating company law reform, citing the large number of people who invested in bonds the U.K. government issued to finance World War I:

> "We have seen during the War a remarkably widespread diffusion of money, and a wonderful growth in the habit of investment, among classes of the population to whom both are a novelty. It is computed that no less than 13,000,000 people are directly interested in various forms of Government war securities. After the war it may be expected that a large number of people who were never investors before will be willing to entrust their savings to commercial companies …"[155]

A 30% inflation-adjusted increase in average earnings between 1914 and the end of the 1930s, supported by significant increases in GDP per capita, contributed significantly to the new prosperity the middle class enjoyed.[156] Tax also played a role, since the Conservative government of the 1920s that opted to leave the very rich "stranded" sought to give relief to "professional men, small merchants and businessmen – superior brain workers of every kind".[157] For instance, the government cut the standard rate of income tax from 30% to 25% in 1923 and cut it further to 22.5% in 1924 and 20% in 1926.[158] As the 1920s drew to a close, the top marginal tax rate applicable to incomes up to £5,000 (£203,000) was a fairly modest 31% and a single person earning £5,000 paid under £1,200 in income tax.[159]

Income taxes payable by the (upper) middle class did rise somewhat in the 1930s.[160] However, at least until taxes were boosted to finance rearmament just prior to World War II, tax was not really hurting the middle class.[161] For instance, for a single person earning £5,000 in 1937, his "take home" pay still would have been more

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[153] LOWE, Riches, *supra* note 148, at 200; THORPE, Britain, *supra* note 57, at 95.
[154] LLOYD, Empire, Welfare State, Europe: History of the United Kingdom 1906-2001, 176 (5th ed. 2002).
[155] Quoted in MICHIE, City, *supra* note 151, at 117.
[156] ALDCROFT, British, *supra* note 55, at 150; LOWE, Riches, *supra* note 148, at 202.
[157] DAUNTON, *supra* note 39, at 133.
[158] On the standard rate of income tax between 1901 and 1930, *see* CAUDWELL, Practical, *supra* note 82, at 11.
[159] "Income Tax and Surtax", Times, April 15, 1930, 11. The precise amount payable would have varied a small amount depending on the proportion of the income was "earned" and "unearned".
[160] GLYNN/OXBORROW, Interwar Britain: A Social and Economic History, 48 (1976) (noting, though, that the government moderately reduced the standard rate of income tax for 1934 and 1935).
[161] GLYNN/OXBORROW, Interwar, *id.*, at 48.

than 70% of his income.[162] Given rising earnings, taxation at this sort of level should have left prosperous members of the middle class with sufficient spare funds to buy shares and other securities in considerable volume. Thus, even during the 1930s a congenial tax environment would have helped to provide a platform for middle class investment in shares.

5.2 Post-World War II

The most important trend underlying the form of outsider/arm's-length ownership and control that ultimately emerged in Britain was the rise of institutional investors, who dominated the U.K. stock market following World War II. As section 2 discussed, between 1957 and 1991 the proportion of U.K. quoted equities owned by institutional shareholders rose from one-fifth to three-fifths and the proportion of U.K. public company shares owned by individuals on their own behalf dropped from two-thirds to one-fifth.[163] Among institutional investors, pension funds and insurance companies were the dominant players, with the percentage of shares owned by pension funds growing from 1% in 1957 to 17% in 1975 and 31% in 1991 and the equivalent figures for insurance companies being 8% (1957), 16% (1975) and 20% (1991). Two trends underpinned the strong demand for shares by pension funds and insurance companies, these being a reallocation of investment priorities by institutional intermediaries and a massive increase in funds available for investment. Tax played a role with both, and was a pivotal cause of the latter.

The activities of U.K. insurance companies have traditionally been divided into "general" and "life" business. "General" insurance comprises contracts that pay a sum if a misfortune occurs within a specific period of time (*e.g.* insurance against accidents and property damage) whereas "life" insurance (technically "assurance") provides coverage for a certain event occurring at an uncertain time, namely death.[164] In the U.K. life insurance has been by far the more important from an investment perspective, with life offices being much better positioned to accumulate substantial funds earmarked for long-term investment because hasty liquidation of investments to meet outstanding commitments is a much more remote prospect.[165]

Life insurance companies first began to treat shares in U.K. companies as a serious investment option during the interwar years, as a number of advocates of an "enlightened" investment policy emphasized the merits of shares and a number of

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[162] The taxpayer would have been liable to pay £1,465 in income tax: "Higher Rate of Income Tax", Times, April 27, 1938, 10.

[163] For more precise figures, *see supra* note 18 and related discussion.

[164] SAMPSON, Anatomy of Britain, 398-401 (1962); RUTTERFORD, Introduction to Stock Exchange Investment, 339 (1983).

[165] *See* COMMITTEE ON THE WORKING OF THE MONETARY SYSTEM (Lord Radcliffe, Chairman), Report, Cmnd. 827, 82 (1959); COMMITTEE TO REVIEW THE FUNCTIONING OF FINANCIAL INSTITUTIONS (Sir Harold Wilson, Chairman), Evidence on the Financing of Trade and Industry, vol. 3, 46-47 (1977), making the point by indicating that, as of 1957, life fund investments amounted to £4.042 billion whereas general fund investments were only £399 million and that, as of 1978, life fund investments were £37.8 billion and general fund investments were £7.1 billion.

insurance company pioneers followed up by investing significant sums in equity.[166] As a result, by 1937, nearly 10 per cent of British life assurance assets were invested in ordinary shares.[167] This figure remained unchanged in 1946 but rose to 12% in 1951, 16% in 1956 and 21% by the beginning of the 1960s when insurance companies in effect called a halt to the expansion in the proportion of shares in the portfolios.[168] In the years immediately following World War II, however, insurance companies stood out as the major source of fresh funds for the capital market.[169]

With pension funds, during the opening decades of the 20th century the trust deeds governing investment usually precluded buying shares and those trustees vested with wide discretion generally shunned "risky" equity investments.[170] By the 1950s, the custom was for private pension funds to have the full power of an ordinary investor and investing in equity became fashionable as trustees became aware that shares were steadily delivering better returns than fixed income securities.[171] By 1953 pension funds of commercial and industrial companies had 19% of their assets invested in ordinary shares of companies, and this figure rose to 30% by 1955 and 48% by 1963.[172] Over the next decade, further reallocations in favor of equity were primarily carried out by local authority pension funds, which had been prohibited from owning shares until the mid-1950s but had almost as high a proportion of shares in their portfolios as did private pension funds by the mid-1970s.[173]

The manner in which dividends were taxed in the hands of pension funds contributed to the popularity of shares as an investment. While for individuals earning high incomes punishing income tax rates detracted considerably from the value derived from dividends (*see* section 4.3), for pension funds dividends were tax-friendly. Beginning in 1921, pension funds meeting criteria stipulated by tax legislation qualified as zero-bracket taxpayers, meaning they were not liable to pay

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[166] PAISH/SCHWARTZ, Insurance Funds and Their Investment, 92-93, 97 (1934).

[167] SCOTT, *supra* note 135, at 98; COMMITTEE ON THE WORKING OF THE MONETARY SYSTEM, *supra* note 165, at 86.

[168] On the data, *see* COMMITTEE ON THE WORKING OF THE MONETARY SYSTEM, *supra* note 165, at 86; MENNELL, Takeover: The Growth of Monopoly in Britain, 1951-61, 87-88 (1962); BRISTON, The Stock Exchange and Investment Analysis, 411 (3rd ed. 1975). On the change in investment policy *see* CLAYTON/OSBORN, Insurance Company Investment: Principles and Policy, 135-36 (1965).

[169] CHARTERHOUSE FINANCE CORPORATION LIMITED, *supra* note 126, at 245.

[170] COMMITTEE ON THE WORKING OF THE MONETARY SYSTEM, *supra* note 165, at 89; HANNAH, Inventing Retirement: The Development of Occupational Pensions in Britain, 74 (1986).

[171] On permitted investments, *see* COMMITTEE ON THE WORKING OF THE MONETARY SYSTEM, *supra* note 165, at 89. On the switch to equities, *see* LITTLEWOOD, Stock, *supra* note 69, at 107-8; PLENDER, That's the Way the Money Goes: The Financial Institutions and the Nation's Savings, 40-41 (1982).

[172] COMMITTEE ON THE WORKING OF THE MONETARY SYSTEM (Lord Radcliffe, Chairman), Minutes of Evidence, 501; BLEASE, Institutional Investors and the Stock Exchange, District Bank Review, September 1964, 38, 45.

[173] On the position up to the mid-1950s, *see* COMMITTEE ON THE WORKING OF THE MONETARY SYSTEM, *supra* note 165, at 88. On the situation in the mid-1970s, *see* MIDGLEY/BURNS, Business Finance and the Capital Market, 363 (3rd ed. 1979).

income tax on dividends they received.[174] As a result, when companies under the imputation system of corporate tax deducted at source part of the income tax shareholders were obliged to pay on dividends, pension funds could in effect demand from U.K. tax officials a refund for amounts notionally deducted on their behalf.[175]

Events occurring during the 1990s confirm that pension funds took into account the tax-advantaged status of dividends when buying shares. In 1993, the government placed limits on the refund pension funds could claim, and the availability of a tax refund was abolished entirely in 1997 although pensions remained exempt from further tax on dividends received.[176] This coincided with pension funds winding down considerably their investment in U.K. public companies, with the proportion of U.K.-quoted shares pension funds owned dropping from 28% in 1994 to 16% in 2001.[177] The abolition of the tax break for dividends was one factor that helped to prompt the switch out of equities,[178] though a desire on the part of pension fund trustees to achieve greater diversification and to meet funding commitments looming due to the ageing process and tightened regulation of pension fund investments also played an important role.[179]

While readjustments in asset allocation contributed significantly to the rise of institutional investors as shareholders in the U.K., just as important was a large increase in the volume of cash to invest. Annual growth in assets held by life insurance companies and pension funds rose each year from 1948 (a combined £218 million) to 1952 (£351 million)[180] and the pattern held thereafter. The total financial holdings of insurance companies grew more than tenfold between 1952 and 1979, and more than doubled in real terms (£4.0 billion in 1952, or £77 billion in today's currency; £52.8 billion in 1979 or £178.9 billion now).[181] The trend was even more dramatic with pension funds, with total financial assets of pension funds growing 32 times over the same period, or more than five times in inflation-adjusted terms

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[174] BLAKE, Pension Schemes and Pension Funds in the United Kingdom, 38-39 (2nd ed. 2003); COMMITTEE ON THE TAXATION TREATMENT OF PROVISIONS FOR RETIREMENT (James M. Tucker, Chairman), Report, Cmd. 9063, 22 (1954).

[175] This option was not available during the U.K.'s 1965-73 experiment with corporate tax.

[176] On the effect of the 1993 reforms, *see* RILEY, "Second Thoughts on the Dividend Tax Dangers", Fin. Times, June 18, 1997, 29. On the repeal of the refundable tax credits in 1997, *see* BANK, The Dividend Divide in Anglo-American Corporate Taxation, 30 Journal of Corporation Law 1, 47-48 (2004).

[177] On ownership data, *see* sources cited *supra* note 18.

[178] SEARJEANT, "Seven Years On, Brown's Swoop on Pensions Looks Less Clever", Times, October 15, 2004, 58; *see* also COHEN, "End Nostalgia for a Tax Break", Financial Times, August 11, 2003, FT fm, 6 (acknowledging the popularity of the argument, but casting doubts on its validity).

[179] FIFIELD, "Pension Funds Shun Equities for Bonds", Financial Times, December 23, 2003, 4; COGGAN, "Pension Funds Steadily Forsaking U.K. Equities", Financial Times, June 19/20, 2004, M28; KALETSKY, "Regulation Killed the Pensions Industry", Times, October 16, 2006, 35.

[180] WRIGHT, The Capital Market and the Finance of Industry, in: WORSWICK/ADY (eds.), The British Economy in the Nineteen-Fifties, 461, 482 (1962).

[181] On the data, *see* PRAIS, The Evolution of Giant Firms in Britain: A Study of the Growth of Concentration in Manufacturing Industry in Britain 1909-70, 116 (1976); POLLARD, The Development of the British Economy, 332 (4th ed. 1992).

(£1.3 billion in 1952, or £25.0 billion today; £41.0 billion in 1979, or £138.9 billion now).[182]

The massive increase in assets in institutional hands was pivotal because it meant robust institutional demand for shares existed, in a sense, by default. The period between the mid-1960s and mid-1970s illustrates. During these years the percentage of total assets under management by key institutional investors – insurance companies, pension funds and the U.K. equivalents to mutual funds, known as investment trusts and unit trusts – invested in shares remained virtually unchanged.[183] Regardless, due to a steady increase in funds to invest, collectively institutional investors were net purchasers of shares in each and every year throughout this period.[184] The authors of a 1978 study on the rise of institutional investment put this data into context, saying:

> "The continuous net acquisitions of company…securities by institutional investors is the result of the increased total assets held by financial institutions, the increase in total assets being financed by the contractual savings of the personal sector."[185]

Tax does much to explain why institutional investors grew so rapidly in the U.K., as there was a strong bias in favor of investment via institutional intermediaries as compared with direct ownership of shares. As the Economist magazine said in a 1977 survey of investment in Britain, "the enormous advantages of institutional saving for the rich who might once have invested in equities but who are now prevented from doing so by tax, explains the overwhelming dominance the institutions have acquired in the stock market."[186] The punishing taxation of dividends was one key factor that "prevented" direct investment in shares, but there were other tax-related constraints. There were transaction costs, of which stamp duty formed a part.[187] From 1965 onwards, investors had to pay capital gains tax of 30% on profits derived from selling shares, which though lower than income tax was higher than rates imposed in other countries, leading the Economist to observe when the tax was introduced that "Britain has gone from virtually nowhere to the top of the major international league".[188] Also, from 1962 to 1971 capital gains derived from "short term" dealings (six months initially, extended to twelve in 1965) were deemed to constitute income and thus were subjected to taxation at the same punitive levels as dividends.[189]

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[182] On 1952, 1962, 1967, 1972, *see* PRAIS, Evolution, *supra* note 181, at 116. On 1979, *see* COAKLEY/HARRIS, The City of Capital: London's Role as a Financial Centre, 96 (1983).

[183] BLUME, The Financial Markets, in: CAVES/KRAUSE (eds.), Britain's Economic Performance, 261 (1980).

[184] BRISTON/DOBBINS, *supra* note 19, at 189.

[185] BRISTON/DOBBINS, *id.*, at 18.

[186] "Investment in Britain: A Survey", The Economist, November 12, 1977, 49.

[187] *Supra* notes 109-110 and related discussion.

[188] "Missed Opportunity", The Economist, April 10, 1965, 210, 210.

[189] Finance Act 1962, 10 & 11 Eliz. 2, c. 44, ss. 12-16, sch. 9; Finance Act 1965, s. 17; for background, *see* BEATTIE, Elements of the Law of Income and Capital Gains Taxation, 6, 106-9 (9th ed. 1970).

Given the unfavorable climate for direct investment in shares, private investors not surprisingly turned to forms of savings that received more favorable tax treatment.[190] From the end of World War II onwards, direct ownership of shares by individuals plummeted. As the Economist noted in 1953:

> "In the last five years there has been no net personal investment on the Stock Exchange. Sales of securities from private portfolios seem to have clearly exceeded the purchases that individuals have made."[191]

A 1980 survey of U.K. financial markets, relying on data from a study of the flow of funds prepared by the Bank of England, confirmed individuals were net sellers of corporate equity. Each year between 1963 and 1977 individuals sold more shares than they bought, with the amounts involved varying from a low of £1.22 billion in 1969 to a high of £3.79 billion in 1973.[192] The persistent trend of net selling can be fairly attributed to tax rather than other investment considerations. A 1952 survey of corporate finance in the U.K. noted "(t)he private investor, owing to the incidence of high taxation, has to a large extent ceased to have surplus funds available year by year out of income"[193] and through the 1950s, 1960s and 1970s shares steadily outperformed obvious alternate investments, such as government bonds and corporate debentures.[194]

When investors gave up on shares in search of other more tax-friendly investments, pensions were one of the principal beneficiaries.[195] In the years following World War II the dramatic growth of pension fund assets was partly due to a significant expansion in the percentage of employees covered by company pension funds and an "immature" demographic pattern in which cash inflows greatly exceeded outflows.[196] Tax, however, also channeled funds towards pension funds, as the tax treatment of pensions was, given the robust taxation of investment income, strikingly benign.

An expert on pension funds observed in 1974 that some advertisements for retirement savings plans were "so absurdly generous that the reader must feel there must somehow be a snag" but assured readers that this was not the case due to tax advantages afford to pensions.[197] To be more precise, assuming a pension fund met a series of Inland Revenue criteria, all employer contributions were excluded from the recipient's income until withdrawal and employee contributions were deductible from

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[190] GLEESON, *supra* note 110, at 136.

[191] "Corpse in the Capital Market", The Economist, February 7, 1953, 375, 375.

[192] BLUME, Financial, *supra* note 183, at 276-77, 294 (only citing precise amounts for 1966 to 1977).

[193] CHARTERHOUSE FINANCE CORPORATION LIMITED, *supra* note 126, at 245.

[194] DIMSON/MARSH/STAUNTON, Triumph of the Optimists: 101 Years of Global Investment Returns, 153, 303 (2002); PRATTEN, The Stock Market, University of Cambridge Department of Applied Economics Occasional Paper No. 59, 75 (1993) (offering data on investment returns for shares, government bonds and debentures for the 1950s, 1960s and 1970s).

[195] For an overview, *see* BLAKE, Pension, *supra* note 174, at 38-41.

[196] LITTLEWOOD, Stock, *supra* note 69, at 255; HANNAH, Inventing, *supra* note 170, at 66-67.

[197] GILLING-SMITH, Pensions, in: STANLEY (ed.), The Creation and Protection of Capital, 109, 110 (1974).

employment income.[198] Also, pension funds were "gross funds", meaning that no tax was levied on their investment income or on capital gains.[199]

Given the fiscal benefits associated with pension funds, "top hat" pension schemes, which involved employees in higher income brackets agreeing to accept a reduced salary in return for their employer increasing its pension contribution, proved very popular.[200] Similarly, employees who were part of approved schemes and had cash available for investment could reap tax advantages by forgoing direct investment in shares or other financial assets in favor of making additional pension contributions. Individuals who were not members of a pension fund lacked similar incentives until the mid-1950s. Reforms carried out then and subsequently meant that by 1971 money they set aside in an approved form for retirement purposes received much the same tax benefits as private contributions to an employee-established approved scheme.[201]

Life insurance was another example of a tax advantaged investment vehicle that helped hasten the decline of direct ownership of equity by personal investors and the rise of institutional investment.[202] Up to 1984, an individual received on premiums paid a partial allowance against the basic rate of income tax, generally in the neighborhood of 15%. Also, so long as certain statutory criteria were met, with life insurance policies structured so as to deliver an investment-driven return rather than simply pay out upon death, the amounts distributed to policyholders were "tax free" in the sense that they were not subject to income tax or capital gains tax. Insurance companies were liable to tax on the returns earned from invested funds but since insurers were not taxed heavily, for investors purchasing life insurance significant tax advantages remained.

Life insurance companies exploited the tax rules to market as life assurance *de facto* contractual savings plans with only a nominal link to paying a guaranteed sum in the event of the premature death of the policyholder.[203] For instance, with unit-linked life insurance, a "potent innovation" of the late 1950s,[204] only a tiny percent-

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[198] On employer contributions, *see* BEATTIE, Elements, *supra* note 189, at 129-30; COMMITTEE ON THE TAXATION TREATMENT OF PROVISIONS FOR RETIREMENT (James M. Tucker, Chairman), Report, Cmd. 9063, 21 (1954). On employee contributions, *see* BLAKE, Pension, *supra* note 174, at 38-40; HOSKING, Pension Schemes and Retirement Benefits, 63-65 (1956).

[199] PILCH/WOOD, Pension Schemes: A Guide to Principles and Practice, 113 (1979).

[200] TITMUSS, *supra* note 101, at 148-50; "Advantages of a 'Top Hat' Pension Scheme", Times, December 4, 1967, 26.

[201] On the changes made in the mid-1950s, *see* HANNAH, Inventing, *supra* note 170, at 49-50. On the 1971 reforms, *see* GILLING-SMITH, Pensions, in: STANLEY (ed.), *supra* note 197, at 109, 109-10.

[202] On the tax advantages life insurance traditionally offered, *see* KAY/KING, *supra* note 35, at 62-63, 210; SIMPSON, Life Policies and Annuities, in: STANLEY (ed.), *supra* note 197, at 133. On the partial erosion of the tax-favored status of insurance from the 1970s onwards, *see* SOLE, The Puzzle of Life Office Tax, 1 British Actuaries Journal 79, 97 (1995); ARMITAGE, Returns After Personal Tax on U.K. Equity and Gilts, 1919-1998, 10 European Journal of Finance 23, 29, 32 (2004).

[203] KAY/KING, *supra* note 35, at 64; SIMPSON, *supra* note 202, at 133.

[204] GLEESON, People, *supra* note 110, at 74.

age of regularly paid premiums were used to purchase insurance and the remainder was invested in a unit trust, with the benefits payable to the policyholder at the end of the term of the contract being determined by reference to the value of the units underlying the policy.[205] The tax advantages of life insurance were not lost on the British public, as they invested massively in this sector during the decades following World War II. By the mid-1970s, life assurance premiums constituted a higher percentage of gross national product in the U.K. than they did in the U.S., Canada, Japan or any western European country.[206]

Since life insurance was much more important from an investment perspective than "general" insurance the tax rules that induced investment in life insurance contributed to the accumulation of funds that underpinned institutional demand for shares following World War II. With the pattern being the same for pension funds, tax helped to fortify the institutional wall of money that by default ensured there were buyers for shares in U.K. public companies during the period when Britain's outsider/arm's-length system of ownership and control became entrenched. Hence, tax was fostering demand for shares while simultaneously providing blockholders with incentives to exit.

6. Why Did New Investors Fail to Exercise Control?

In order for an outsider/arm's-length system of ownership and control to take shape in a particular country, incumbent blockholders must be looking to exit and there must be buyers willing to purchase the available equity. Fulfillment of these conditions is merely necessary, however, not sufficient. The new investors may be intent on exercising control themselves, in which case they would either buy all of a company's shares available for sale or accumulate holdings large enough to exercise a dominant influence. If this in fact is the standard operating procedure, insider/control-oriented corporate governance will continue to prevail despite the exit by incumbent blockholders. As matters transpired, those buying shares in U.K. public companies were not inclined to exercise control, thus ensuring the final of the three conditions precedent for ownership to separate from control was satisfied. There were various reasons for this, but in this particular instance tax did not have a major role to play.

6.1 General Factors Deterring Intervention by Investors

Up to World War II blockholders continued to hold sway in many U.K. public companies, thus necessarily limiting the scope for outside investors to wield meaningful influence. Regardless, those buying shares during the interwar years were generally ill-suited to step forward and exercise control. During this period, middle and upper-

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[205] MIDGLEY/BURNS, Business, *supra* note 173, at 436-37; BLUME, Financial, *supra* note 183, at 287-88; BROWN/TRIMM, Life Assurance: Its Tax Implications and Practical Uses, 5 (1977).

[206] COMMITTEE TO REVIEW THE FUNCTIONING OF FINANCIAL INSTITUTIONS, *supra* note 165, at 66; CLARKE, Inside the City: A Guide to London as a Financial Centre, 102 (1983).

middle class investors constituted the primary source of demand for shares (*see* sections 2 and 5.1). As economist P. Sargant Florence observed in a 1953 book on the organization of British and American industry, private investors were too "ignorant, business-shy or *too* busy – or any two of them or even all three" to take any sort of active role in the governance of the companies in which they owned shares.[207] Even among those with business expertise, it was standard practice to diversify by buying shares in a variety of different companies, meaning the fate of any one would not have a significant impact on their personal financial circumstances.[208] Moreover, as Hargreaves Parkinson said in a 1932 book on investment, if a shareholder lost faith in a company's directors he would "usually cut his loss and sell out".[209] The "natural and inevitable" result, as economist G.D.H. Cole said in a 1935 paper on a share ownership in Britain, was that those buying shares "ceased…to regard themselves in any way responsible for the conduct of the enterprises which were legally their property."[210]

Given the rapid rise of institutional shareholders after World War II, if they had chosen to act collectively they could have used their voting power to dictate how U.K. public companies would be run, thus creating a system of corporate governance that would have been "control-oriented" rather than "arm's-length". This, however, did not occur. Instead, institutional shareholders were "the sleeping giants of British corporate life".[211]

Fear of government intervention was one deterrent to activism. There was concern among institutional investors that if they sought to influence business policy regularly and openly, resentment of institutional power would build and prompt government interference in the affairs of the institutions.[212] Insurance companies were affected particularly since they had to engage in a fierce anti-nationalization campaign to counteract a plan announced by Labour in 1949 to take the industry into public ownership.[213]

A strongly entrenched belief among institutional shareholders that they were investors, not proprietors, was a further obstacle to activism. The institutions considered themselves well-placed to understand markets and implement trading strategies but felt they lacked the manpower, training and experience to involve themselves in the management of public companies.[214] The idea that expertise limitations accounted for institutional passivity was accepted in official circles. While a committee struck by the U.K. government to review the functioning of financial institutions and chaired by former Prime Minister Harold Wilson urged institutional shareholders in its 1980 report to be more activist, it excused past passivity on the grounds

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[207] FLORENCE, *supra* note 14, at 179.
[208] COLE, Evolution, *supra* note 11, at 58; FLORENCE, *supra* note 14, at 181-82.
[209] PARKINSON, Scientific, *supra* note 12, at 13.
[210] COLE, Evolution, *supra* note 11, at 59.
[211] KYNASTON, The City of London, Volume IV: A Club No More 1945-2000, 434 (2001).
[212] SAMPSON, Anatomy, *supra* note 164, at 412; PLENDER, *supra* note 171, at 20.
[213] DENNETT, A Sense of Security: 150 Years of Prudential, 298-301 (1998); HOBSON, The National Wealth: Who Gets What in Britain, 1005 (1999).
[214] SPIEGELBERG, The City: Power Without Accountability, 57 (1973); COMMITTEE TO REVIEW THE FUNCTIONING OF FINANCIAL INSTITUTIONS, *supra* note 165, at 90, 122.

"(t)he institutions are still to some extent feeling their way, which may inhibit them intervening at an early enough stage".[215]

6.2 Tax as a Potential Deterrent to Blockholding by Investment Trusts and Unit Trusts

Did tax have any role to play in deterring U.K. institutional shareholders from exercising control over the companies in which they owned shares? In the U.S., as section 7 discusses, regulatory constraints helped to deter financial institutions from becoming "hands on" investors in large companies, and tax law was part of this regulatory matrix. At first glance, there were British parallels, since from the mid-1960s onwards tax law contained a potential deterrent against blockholding by investment trusts and unit trusts, the British collective investment vehicles equivalent to mutual funds in the U.S. In practice, though, tax likely did little to deter activism by U.K. institutional shareholders.

An investment trust is a company whose business is to invest money in equity and fixed-income securities on behalf of its shareholders. Unit trusts perform much the same function, with the basis being a trust deed rather than a company. Coinciding with the introduction of capital gains tax in 1965, U.K. tax law began to distinguish between "approved" investment trusts and unit trusts on the one hand and other investment companies on the other. When an investment trust or unit trust was "approved," profits derived from the sale of shares could be taxed at the more favorable capital gains rate rather than being taxed as corporate income.[216] Investors in approved investment trusts and unit trusts could also claim credit against their own capital gains liability for any tax already paid by the investment trust or unit trust. In 1972, the nature of the tax break was changed as approved investment trusts and unit trusts paid tax on capital gains at a reduced rate of 15% and holders of shares or units were entitled to a potential 15% credit for capital gains tax already paid by their investment trust or unit trust.[217]

The price for receiving the tax advantages of being an "approved" investment trust or unit trust was that these investment vehicles had to meet a series of prescribed criteria. One such requirement was that no more than 15 per cent of a unit trust or an investment trust's assets could be invested in the shares of a single company.[218] This meant if an investment trust or unit trust that otherwise qualified for approved status was a major shareholder in a company it would lose its tax advantages if the ownership stake formed too large a proportion of its investment portfolio.

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[215] COMMITTEE TO REVIEW THE FUNCTIONING OF FINANCIAL INSTITUTIONS (Sir Harold Wilson, Chairman), Report, Cmnd. 7937, 311 (1980).

[216] Finance Act 1965, c. 25, ss. 37-38, 67-68; for background, *see* WHEATCROFT, Capital Gains Tax, 127 (1965). The position was complicated further by a tax on "short-term" profits in place between 1962 and 1971, discussed *supra* note 189 and related text.

[217] REVELL, The British Financial System, 447 (1973).

[218] Finance Act 1965, s. 37. Other requirements were that the investment trust or unit trust had to derive its income mainly from shares and securities, had to be quoted on a recognized stock exchange, could not distribute dividends from profits arising from the realization of investments, and could not retain more than 15% of its income from shares in any accounting period.

Thus, tax theoretically constituted a potential obstacle to investment trusts or unit trusts achieving blockholder status.

In practice, the tax rules appeared to have little effect on institutional blockholding as a whole. One reason is that as ownership separated from control in the U.K., investment trusts and unit trusts were something of a side-show compared to insurance companies and pension funds. During the interwar period, the influence of investment trusts on capital markets allegedly matched that of insurance companies and during the late 1950s and early 1960s an average of 15 new investment trust companies were formed each year.[219] Generally, however, in the decades following World War II, investment trusts were eclipsed by other institutional shareholders.[220] Government regulations precluded investment trusts from issuing shares to raise capital during the late 1940s and early 1950s and subsequently investment trusts failed to market themselves effectively among private investors, were handicapped in managing foreign investments by exchange controls and struggled to cope with the tax and administrative burdens imposed by the 1965 introduction of capital gains tax.[221]

In contrast, unit trusts, due to a combination of clever marketing, reliable price quotations and the pricing of units in small denominations that facilitated regular purchases by individuals, grew considerably beginning in the late 1950s.[222] Unit trusts were, however, starting largely from scratch, as doubts about their legality arising in the latter part of the 19th century derailed their use as a vehicle for collective investment until the 1930s.[223] The fact that neither investment trusts nor unit trusts constituted tax-favored investments in the manner of life insurance or pension funds also diminished their popularity.[224]

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[219] On the interwar period, *see* COMPTON/BOTT, British Industry: Its Changing Structure in Peace and War, 195 (1940); WILLIAMS, Insurance Companies and Investment Trusts, in: COLE, Studies, *supra* note 11, at 139, 154. On the formation of investment trusts in the late 1950s and early 1960s, *see* NEWLANDS, Put Not Your Trust in Money, 256 (1997).

[220] BRISTON/DOBBINS, *supra* note 19, at 17; LITTLEWOOD, Stock, *supra* note 69, at 262.

[221] On the impact of capital controls, *see* MACRAE, The London Capital Market: Its Structure, Strains and Management, 85-86 (1955). On the difficulties investment trusts had on the marketing front, *see* BRISTON/DOBBINS, *supra* note 19, at 17; LITTLEWOOD, Stock, *supra* note 69, at 262. On the effect of exchange controls and capital gains tax, *see* NEWLANDS, Put, *supra* note 219, at 268-70, 279-80, 297-302.

[222] LITTLEWOOD, Stock, *supra* note 69, at 260; SAMPSON, The New Anatomy of Britain, 479-80 (1971).

[223] HADDEN, Company Law and Capitalism, 385 (1972); GOWER, The Principles of Modern Company Law, 266 (4th ed. 1979).

[224] Investment companies were liable to pay income tax and any applicable profits taxes, but could deduct taxes on profits and dividends already paid by companies in which they invested: GIFFORD/STEVENS, Making Money on the Stock Exchange: A Beginners' Guide to Investment Policy, 162 (1955). Cash distributions made by unit trusts and investment trusts generally were taxable in the hands of investors in the same way as a dividend received from a normal U.K. company: MERRIMAN, Mutual Funds and Unit Trusts: A Global View, 54 (1965); ADAMS, Investment, 24, 187, 199 (1989). Once capital gains tax was introduced in 1965, it applied to dispositions of holdings in investment trusts and unit trusts in the same manner it applied to a sale of equity in a public company, though during the 1970s credits potentially available could make the effective rate lower. *See* BEATTIE, Elements of the Law of Income and Capital Gains Taxation, 271-72 (8th ed. 1968); CARMICHAEL, Capital Gains Tax, 356-57 (2nd ed. 1974); CRETTON, Practical C.G.T., 107-8 (1982).

The percentage of shares of U.K. public companies unit trusts owned rose from 0.5% in 1957 to a still-modest 4.1% in 1975 before falling back somewhat by 1981.[225] Precise data is harder to come by for investment trusts, but they likely owned somewhere between 5% and 10% of U.K. public companies between the late 1950s and the early 1980s.[226] While certainly not trivial, with share ownership on this scale neither unit trusts nor investment trusts were primary candidates to take a dominant role in U.K. corporate governance.

Even if investment trusts and unit trusts had been major players, it is unlikely that the tax rules introduced in 1965 would have had a major impact on the manner in which they operated. A 1965 text on capital gains speculated that many investment companies would have to alter their shareholding patterns to comply with the new rules.[227] This, however, generally proved unnecessary. With unit trusts, even prior to 1965 it was nearly universal practice for trust deeds to impose limits on the proportion of assets a unit trust could invest in any one security, so the reforms would not have affected investment policy significantly.[228]

With investment trusts, only a minority had internally generated pre-1965 limitations on the amount that could be invested in one type of security.[229] Nevertheless, it evidently was rare for investment trusts to have more than 15% of their assets tied up in a single company. If blockholding of this kind had been common, it should have taken investment trusts some time to respond to the 1965 tax changes since such large stakes would have been difficult to liquidate promptly without forcing down drastically the share prices of the companies involved. No such difficulties seem to have arisen, since within a year of the tax changes, fewer than 5% of publicly quoted investment trusts, representing less than 2% of total assets held, had failed to qualify for approval.[230] Thus, for investment trusts, as with unit trusts, the tax advantages bestowed on "approved" schemes apparently did little to deter institutional activism in the decades following World War II.

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While tax played at best a minor role in deterring U.K. institutional investors from exercising substantial control over the companies in which they owned shares, more generally tax contributed significantly to the emergence of Britain's outsider/arm's-length system of ownership and control. High income tax rates, corporate tax rules biased against dividends and estate taxes worked in tandem with other factors to

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[225] For sources, *see supra* note 18.

[226] Investment trusts, in the available data, are encompassed within "other financial institutions". MOYLE, *supra* note 18, provided a separate breakdown within this category for investment trusts and other owners, with the figures being 5.2% (investment trusts) and 1.6% (other) for 1957 and 7.4% (investment trusts) and 2.6% (other) in 1963.

[227] WHEATCROFT, Capital, *supra* note 216, at 202.

[228] BURTON/CORNER, Investment and Unit Trusts in Britain and America, 291 (1968).

[229] BURTON/CORNER, *id.*, at 4; GLASGOW, The English Investment Trust Companies, 110-88 (1930) (of 76 investment trusts listed, 10 restricted investments in any one security to 10% of total issued funds, 15 imposed a limit of 5% and 12 had a lower percentage limit. The remaining 39 had no restrictions).

[230] BURTON/CORNER, *id.*, at 150.

induce blockholders to exit. At the same time, tax fuelled the rapid growth of institutional investors, which provided the only meaningful source of demand for shares as Britain's outsider/arm's-length system of ownership and control became entrenched. Tax, then, helps to answer why ownership separated from control in Britain in a way currently fashionable explanations of ownership structure do not.

7. Tax and the Rise of the Widely Held Company in the U.S.

Events in the United States confirm that tax can help to cause a separation of ownership from control to become the norm in a country's bigger companies. The United States, it is said, experienced a "corporate revolution" between 1880 and 1930.[231] While family-oriented companies were the norm at the beginning of this period,[232] share ownership became increasingly diffuse and by the end, according to Alfred Chandler, the distinguished business historian, "the great majority of industrial enterprises…came to be controlled by managers".[233] Or as Berle and Means put it in their well-known 1932 book *The Modern Corporation and Private Property*, America's "corporate system" was characterized by a "separation of ownership and control".[234]

The causes of the separation of ownership and control in an American context have not been identified fully.[235] Even the chronology is not entirely clear. While Berle and Means were proclaiming in 1932 that ownership had separated from control in the U.S., a study carried out by the Securities and Exchange Commission implied differently, finding that as of 1937 there was "ownership control" in seven out of ten of the country's 200 largest non-financial companies.[236] It is beyond the scope of this paper to offer any sort of definitive account of what occurred in the United States, with respect to tax or otherwise. The existing literature on the rise of the widely held company in the U.S. nevertheless confirms that tax played a role, and in particular helps to explain why blockholders wanted to exit and why new owners of shares failed to step forward and exercise control themselves.

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[231] ROY, Socializing Capital: The Rise of the Large Industrial Corporation in America, 3, 16-18 (1997); O'SULLIVAN, Contests for Corporate Control: Corporate Governance and Economic Performance in the United States and Germany, 75-77 (2000).

[232] BASKIN/MIRANTI, A History of Corporate Finance, 193 (1997).

[233] CHANDLER, The United States: Seedbed of Managerial Capitalism, in: CHANDLER/DAEMS (eds.), Managerial Hierarchies: Comparative Perspectives on the Rise of the Modern Industrial Enterprise, 9, 30-31 (1980).

[234] BERLE/MEANS, *supra* note 138, at 5.

[235] BECHT/DELONG, *supra* note 31, at 651.

[236] BURCH, The Managerial Revolution Reassessed: Family Control in America's Large Corporations, 3-4 (1972), discussing TEMPORARY NATIONAL ECONOMIC COMMITTEE, The Distribution of Ownership in the 200 Largest Nonfinancial Corporations, Monograph, No. 29 (1940); LEECH, Ownership Concentration and Control in Large U.S. Corporations in the 1930s: An Analysis of the TNEC Sample, 35 Journal of Industrial Economics 333 (1987).

7.1 Tax and Blockholder Exit

As sub-sections 4.3 and 4.4 outlined, in the U.K. high taxes on income likely provided an incentive for blockholders to exit during the period when the country's outsider/arm's-length system of ownership and control became entrenched since much of what they would have received in the form of dividends or managerial remuneration would have been handed over to the government. A similar process may well have been at work in the United States about the time of World War I.

Berle and Means, as discussed in section 5.1, relied on data on dividends received by taxpayers in different income brackets to argue that a "revolutionary" shift in corporate ownership occurred in the U.S. between 1916 and 1921 and attributed the change largely to a dramatic increase in income tax at higher income levels. Berle and Means' data does not indicate whether the wealthy individuals transferring their shares were blockholders unwinding their holdings or merely rich individuals selling out. Means nevertheless did speculate in the 1930 paper that provided the basis for Berle and Means' analysis that blockholders were exiting. He argued a significant increase in income tax in 1916 "concentrated the attention of the former owners of industry on the possibility of retaining control without important ownership…thereby accelerat(ing) that separation of ownership and control which has become such a marked feature of our modern economy."[237]

The effect of the rise in top marginal rates for blockholders may have been exacerbated by the onset of the double taxation of corporate dividends. When the corporate income tax was first introduced in 1913, corporate income was taxed at 1%, which also served as the normal base rate for the individual income tax.[238] Since corporate income had already been taxed at the normal rate, dividends were exempt from the normal tax in the hands of individuals and only subject to the surtax imposed on taxpayers with high incomes, with the top rate at that point being 6%. In 1917, however, the corporate rate was set at 10%, two percentage points over the then prevailing individual normal tax of 8%.[239] Though the differential was small, establishment of the principle of double taxation of corporate dividends led to denunciation of the reforms as unprincipled "discrimination" against corporations and their stockholders.[240]

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[237] MEANS, Diffusion, *supra* note 139, at 591-92. For shareholders in companies with large accumulated profits, there was some expectation that the effect of the higher rates would be mitigated by a provision in the 1917 Revenue Act that tied the rate of dividend tax to the rate of tax in effect in the year when the profits were earned. *See* ADAMS, Principles of Excess Profits Taxation, 75 Annals of the American Academy of Political and Social Science 147, 149 (1918); SELIGMAN, The War Revenue Act, 33 Political Science Quarterly 1, 23 (1918).

[238] Tariff Act of 1913, ch. 16, § II(B), (G), 38 Stat. 114, 166, 172.

[239] War Revenue Act of 1917, ch. 63, 40 Stat. 300.

[240] ZOLLER, A Criticism of the War Revenue Act of 1917, 75 Annals of the American Academy of Political and Social Science 182, 186-87 (1918) (Zoller was a tax attorney for General Electric corporation); TAUSSIG, The War Tax Act of 1917, 32 Quarterly Journal of Economics 1, 20 (1917) (calling the differentiation "indefensible as a matter of principle."). The prejudice to taxpayers was contained to some degree because corporations were retaining an increasing amount of earnings, all of which avoided the surtax until distribution. BANK, A Capital Lock-In Theory of the Corporate Income Tax, 94 Georgetown Law Journal 889, 918 (2006).

Wartime taxes on profits compounded the tax "hit" blockholders took. For 1918 there was a war profits tax (W.P.T.) in place that was based on the British E.P.D., with profits exceeding a benchmark based on pre-war profits by more than $3,000 being taxed at 80%.[241] For this one year, the W.P.T. constituted a supplement to an excess profits tax already in place, with corporations only paying the W.P.T. if the tax due was higher than it would have been under the excess profits tax.[242] The U.S. version of the excess profits tax, which was imposed on all businesses from 1917 to 1918 and on corporations only from 1918 to 1921, used as its basis "invested capital", a complex concept redefined over time but which generally had as its foundation cash paid for shares issued by a corporation, undistributed profits, and the value of property owned by a corporation.[243] Excess profits tax was generally imposed at a rate of 65% on profits exceeding 20% of invested capital, with the rate being less on profits below the 20% threshold.[244] Critics claimed the 65% rate was high enough to create a *de facto* upper limit on profits companies could generate for shareholders.[245]

The war-induced combination of high income tax rates, the introduction of double taxation of dividends and the introduction of excess profits tax meant the tax burden on corporate investment was unprecedented, especially for shareholders in higher income brackets, as blockholders typically would have been. As the New York Times account of a 1919 memorandum issued by a partner of investment bank Kuhn Loeb said, "the owner of industrially invested capital has suffered (diminished purchasing power of the dollar) while in addition thereto he is subject to a heavy excess profits tax and, if his income is large, to an income tax of unparalleled severity".[246] Blockholders thus had a series of novel incentives to exit and shift into tax-friendly investments such as government bonds, life insurance and real estate.[247]

During the 1920s, income tax rates were cut substantially from the levels in place in 1921,[248] which would have reduced the pressure on blockholders to exit. With the bull market of the 1920s boosting stock prices, a different incentive would have come into play, namely that the price potentially offered to sell out could be too good to ignore. Numerous blockholders apparently took advantage of the buoyant stock market conditions to liquidate at least part of the holdings through distributions of stock to the public, with the number of initial public offerings and amount of common stock issued both skyrocketing.[249]

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[241] HICKS *et al.*, *supra* note 41, at 123-24. On the fact that this tax was based on the British tax, *see* "Committee Plans Alternative Tax on War Profits", New York Times, July 30, 1918, 1.

[242] For an example illustrating the point, *see* BLAKEY/BLAKEY, The Revenue Act of 1918, 9 American Economic Review 213, 226-27 (1919).

[243] On the components as of 1919, *see* BLAKEY/BLAKEY, *id.*, at 228.

[244] BLAKEY/BLAKEY, *id.*, at 226 (indicating the tax rate on profits below 20% of invested capital was 30%, subject to an excess profits tax credit of $3,000).

[245] "Otto Kahn Attacks War Tax System", New York Times, September 2, 1919.

[246] "Otto Kahn", *id.*

[247] "Otto Kahn", *id.*; MEANS, Diffusion, *supra* note 139, at 587-89.

[248] MEANS, Diffusion, *supra* note 139, at 589-90.

[249] GEISST, Wall Street, A History, 178 (1997) (describing an eight-fold increase in I.P.O. activity between 1926 and 1928); MYERS, A Financial History of the United States, 297 (1970) (indicating the amount of common stock issued increased from $200 million in 1921 to $2.094 billion in 1928 before peaking at $5.062 billion in 1929).

Other blockholders exited all at once by way of a merger, with acquiring companies taking advantage of their high stock prices to raise capital to pay cash or to offer share-for-share exchanges on terms seemingly too generous to turn down. On the latter count tax came into play, since due to tax reform carried out between 1918 and 1924 share-for-share exchanges became tax-favored in a way that would have made offers put on the table easier to accept. When the federal government introduced the contemporary version of income tax in 1913 it considered the receipt of stock or securities in a merger, consolidation, or other acquisitive transaction to be a taxable event. There were concerns that, as one commentator later observed, stock ownership "would tend to become fossilized" under such circumstances.[250] In 1918, Congress began the process of classifying corporate reorganizations as "non-recognition" events,[251] and further liberalized the rules in 1921 and 1924, making it clear that those owning shares in a target company would not be taxed when they transferred their stock to an acquiror in a merger transaction in exchange for shares in the acquiring company.[252] As economist T.S. Adams testified in hearings prior to the 1921 amendments, the goal was to remove the obstacles for "desirable business readjustments."[253]

Between 1919 and 1930, nearly 12,000 manufacturing, mining, banking and public utility concerns disappeared as a result of approximately 2,100 mergers.[254] Many of these transactions presumably would have occurred regardless of the tax treatment of corporate reorganizations. Nevertheless, there likely were numerous instances where the classification of share-for-share exchanges in corporate acquisitions as non-recognition events helped to ensure the terms on offer were sufficiently attractive to induce blockholders to sell out.

The special treatment of share-for-share exchanges aside, capital gains tax reform in 1921 eliminated considerable uncertainty about the tax treatment of capital gains and provided a congenial environment in which blockholders could exit by selling their shares on the open market or in a cash merger. Despite case law potentially suggesting to the contrary, up to 1921 the federal government maintained capital gains were fully taxable as income under federal income tax, meaning those with high incomes would pay tax on capital gains at the top marginal rate (58% in

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[250] HENDRICKS, Developments in the Taxation of Reorganizations, 34 Columbia Law Review 1198, 1222 (1934).
[251] Revenue Act of 1918, ch. 18, § 202(b), 40 Stat. 1058 (1919).
[252] SANDBERG, The Income Tax Subsidy to "Reorganizations", 38 Columbia L. Rev. 98, 102 (1938); BANK, Mergers, Taxes, and Historical Realism, 75 Tulane Law Review 1, 9, 11 (2000).
[253] Hearings on H.R. 8245 Before the Senate Comm. on Finance, 67th Cong. 29 (1921) (statement of Dr. T.S. Adams, advisor to the Treasury Department).
[254] MARKHAM, Survey of the Evidence and Findings on Mergers, in: Business Concentration and Price Policy, 141, 168-69 (1955).

1921).[255] However, when the Supreme Court affirmed the legality of federal taxation of capital gains in a 1921 decision, Congress quickly eased the potential blow by introducing capital gains tax at a modest 12.5% rate, the "normal" rate of taxation for corporate income at the time. As Treasury advisor Randolph Paul later explained, "[i]t was believed that this provision would stimulate profit-taking transactions."[256] Blockholders, thus reassured, likely would have deduced that capital gains tax was not a serious deterrent to exit even if they could not postpone payment of the tax with a share-for-share exchange.

7.2 Tax and the Exercise of Control by New Owners

During the 1920s, the rise of the private investor provided the impetus behind the demand for shares that created such a promising environment for exit by blockholders in U.S. companies. The number of individuals owning shares grew dramatically, with one estimate being that while only a half million Americans owned shares of publicly traded stock as of 1900 and only 2 million did so in 1920, there were 10 million individuals owning stock by 1930.[257] As described earlier, middle class investors accounted for much of this increase, with part of the reason likely being that they were less affected by the tax factors that potentially motivated blockholders to exit.[258] Moreover, these new investors, due to a lack of information, time and expertise, combined with a rational reticence to be activist when they would incur the bulk of the costs and receive only a tiny fraction of the benefits, were not about to exercise control in any sort of meaningful way.[259]

Other potential types of new owners may have been better positioned to step forward but arguably were discouraged from doing so by an inhospitable regulatory environment, of which tax played a part. Mark Roe in his 1994 book *Strong Managers, Weak Owners* analyzes why outsider/arm's-length corporate governance became dominant in the U.S. and does so primarily by explaining why major financial players, such as banks, insurance companies and mutual funds, failed to step for-

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[255] On the position the federal government took, *see* "Income Taxpayers to Suffer Penalty", New York Times, Mar. 17, 1921, 17. On the doubts that existed about the tax status of capital gains under federal income tax legislation, *see* "To Ignore Tax Decision", New York Times, Feb. 12, 1921, 17. The cases which cast doubt on whether capital gains were taxable under income tax were *Gray v. Darlington*, 82 U.S. (15 Wall.) 63 (1872) (ruling on the tax status of capital gains under a Civil War income tax statute); *Hays v. Gauley Mountain Coal Co.*, 247 U.S. 189, 192-94 (1918); *Doyle v. Mitchell Bros.*, 247 U.S. 179, 183, 185 (1918) (both ruling on the Corporate Excise Tax Act of 1909, ch. 6, § 38, 36 Stat. 11, 112); *Brewster v. Walsh*, 268 F. 207 (D. Conn. 1920) (ruling on the federal income tax statute introduced in 1913).

[256] PAUL, Taxation in the United States, 129 (1954).

[257] BASKIN/MIRANTI, *supra* note 232, at 190. Other estimates vary substantially, but the trend is the same. Means estimated in his 1930 article that the number of stockholders rose from 4.4 million in 1900 to 8.6 million in 1917 to 14.4 million in 1923: MEANS, *supra* note 139, at 595. On the other hand, SOBEL, *supra* note 146, estimates there were 100,000 shareholders prior to 1900 and three million shareholders by 1929.

[258] *See supra* text accompanying notes 144 to 147.

[259] ROE, Strong, *supra* note 21, at 6-7.

ward as activist owners.[260] In so doing, he focuses on regulatory constraints financial institutions faced, such as laws that precluded banks from owning and dealing in shares in industrial companies and imposed tight restrictions on stock ownership by insurance companies.[261]

Tax plays a role – if only of a supporting nature – in Roe's story. For instance, to explain why mutual funds did not step forward as activist investors he draws attention to rules adopted in the 1936 Revenue Act concerning the passing of income up to mutual fund investors.[262] With mutual funds there can in theory be triple taxation for the same income: when a corporation in a mutual fund's investment portfolio pays taxes on its earnings, when the fund pays taxes on dividends received from companies in its portfolio and when shareholders in the mutual fund pays tax on income derived from the fund. The 1936 Revenue Act eased the tax burden for "diversified" mutual funds by permitting them to pass income up to investors untaxed. Initially, a mutual fund could only qualify as diversified if no investment in a corporation constituted either more than 5% of the funds' investment portfolio or more than 10% of the corporation's shares. In 1942, Congress relented partly, permitting half of a mutual fund's portfolio to be more concentrated. Roe concedes the tax rules did not stymie fully corporate governance activism by mutual funds. Nevertheless, he claims they imposed costs on ownership of large blocks of shares and, in tandem with restrictions on mutual fund investment patterns imposed by the Investment Company Act of 1940, created "a framework that made it difficult or impossible for mutual funds to actively enter the governance structure of their portfolio firms".[263]

Roe, in *Strong Managers, Weak Owners*, also draws attention, albeit briefly, to tax changes introduced in the mid-1930s that discouraged public companies from holding substantial ownership blocks in other companies.[264] Corporate cross-ownership was an important feature of the corporate landscape in the U.S. during the 1920s. Berle and Means reported in their study of the ownership structure of the 200 largest companies in the U.S. finding many instances where immediate control was exercised by a corporation through a dominant minority stock interest.[265] Of 573 active corporations with securities listed on the New York Stock Exchange in 1928, 92 were pure holding companies, meaning they did nothing other than own shares in other firms, 395 were holding and operating companies, and only 86 were operating companies alone.[266] With manufacturing and industrial concerns, holding companies were generally only used for the sake of managerial or ownership con-

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[260] Roe implicitly treated this question as being the most important in the U.S. context, saying "I shifted the emphasis to what seems the deeper cause: the historical inability of major financial institutions to own big blocks of stock and to become active in the boardroom": *id.*, at xii. Some of the gaps in Roe's analysis are filled by BECHT/DELONG, *supra* note 31.

[261] ROE, Strong, *supra* note 21, at 55, 60-61, 80-88, 95-96.

[262] ROE, *id.*, at 106-7, 122-23.

[263] ROE, *id.*, at 102.

[264] ROE, *id.*, at 107.

[265] BERLE/MEANS, *supra* note 138, at 109.

[266] KLEIN, Rainbow's End: The Crash of 1929, 152 (2001).

venience but complex, pyramidal structures assembled to permit capital to be raised without compromising control were a hallmark of large railways and public utilities.[267]

During the 1930s, a number to changes were made to tax law to "strike at the holding company system".[268] For instance, the filing of consolidated tax returns, which were commonly used by holding companies, was prohibited for most companies until the early 1940s.[269] Using a consolidated return offers tax advantages for a parent company in a corporate group since the parent can offset the gains of one subsidiary against the losses of another as part of a single tax return. On the other hand, when corporations that are part of the same group are under an onus to file separate returns, profitable subsidiaries will potentially be subject to high rates of taxation on their income while subsidiaries that serve merely supporting roles will often be left with unused loss carry-forwards. The 1930s tax rules precluding the filing of consolidated returns thus should have discouraged use of corporate groups oriented around a holding company.[270]

The tax treatment of inter-corporate dividends was also changed in a way that discouraged complex holding company arrangements. In the opening decades of the 20th century, with federal taxes on corporate income, inter-corporate dividends were fully deductible, meaning that for a parent company in a corporate group there was no tax penalty imposed on dividends received from the companies in which the parent company owned shares.[271] The tax reforms introduced in the mid-1930s put in place a large but not full deduction, meaning dividends paid to parent companies by subsidiary companies were partially taxable in the hands of the parent company even though the subsidiaries would have each individually already paid tax on their profits.[272]

Policymakers defended the inter-corporate dividend reform partly on the basis that corporate pyramids, which were widely criticized in the wake of the 1929

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267 BERLE/MEANS, *supra* note 138, at 69-71; COCHRAN, American Business in the Twentieth Century, 42-43 (1972).

268 "Tax Bill Changes Offered by Borah", New York Times, March 2, 1934, 38.

269 From 1932 to 1934, companies paid high rates of corporate tax for the privilege of filing a consolidated return and in 1934 this option was denied to all companies except railway corporations. *See* BANK, Tax, Corporate Governance, and Norms, 61 Washington & Lee Law Review 1159, 1164 n. 13 (2004). The rules precluding the use of consolidated returns was reversed partially in 1940 and then completely in 1942: MUNDSTOCK, Taxation of Intercorporate Dividends Under an Unintegrated Regime, 44 Tax Law Review 1, 10 (1988). The 1942 change, though, effectively introduced a 100% exclusion for inter-corporate dividends in companies filing a consolidated return. *Id.*, at 11.

270 MAGILL, Effect of Taxation on Corporate Policies, 1938 United States Law Review 637, 642.

271 MORCK, How to Eliminate Pyramidal Business Groups: The Double Taxation of Inter-corporate Dividends and Other Incisive Uses of Tax Policy, working paper (published in 2005 NBER Tax Annual), 8-9 (2004).

272 The legislation lowered what was called the dividends received deduction from a 100% exclusion to a 90% exclusion. *See* Revenue Act of 1935, Pub. L. No. 74-407, § 102(h), 49 Stat. 1016 (reducing the dividends received deduction from 100% to 90%). In 1936, the exclusion was further reduced to 85%. *See* Revenue Act of 1936, Pub. L. No. 74-740, § 26(b), 49 Stat. 1648, 1664.

stock market crash, would be discouraged.[273] Roe argues the change helped to deter companies from acquiring large ownership blocks in other companies, reasoning that subsidiaries in a holding company structure would only rarely deliver sufficient benefits to compensate for the tax penalty on dividends paid out.[274] Economist Randall Morck has similarly identified the abolition of consolidated tax returns for corporate groups and the introduction of taxation of inter-corporate dividends as agents of change, saying they do much to explain the current absence of corporate pyramids in the U.S., a hallmark of blockholder-oriented corporate governance.[275]

As Morck notes, a rapid dissolution of pyramidal groups followed on the heels of the changes to the tax rules abolishing the use of consolidated returns and introducing the taxation inter-corporate dividends.[276] One cannot take a causal connection for granted, given that the tax burden on inter-corporate dividends was not hefty and that other reforms, such as strict federal regulation of public utilities companies, helped to discourage the use of corporate pyramids.[277] Morck nevertheless argues that tax was the key, noting the absence of renewed pyramiding after public utility holding company regulation declined in importance.[278] Morck maintains the tax on inter-corporate dividends was especially important, saying it "was largely responsible for producing the country's highly exceptional large corporate sector composed of free-standing widely-held firms."[279] The fact a number of companies that unwound complex corporate structures after the tax changes in the mid-1930s explicitly cited the new law as the impetus lends credence to this claim,[280] as do assertions by contemporary commentators that the tax change had reduced the attractiveness of the holding company structure.[281]

8. Conclusion

This paper has drawn upon the historical experience in the two countries where the widely held company is most dominant – the United Kingdom and the United States – to argue that tax can help to explain ownership structures in large companies in a particular country. The evidence presented here suggests tax indeed might matter, but certainly cannot be taken as settling the issue. Instead, further investigation of

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[273] MORCK, How, *supra* note 271, at 9, 11-12.
[274] ROE, Strong, *supra* note 21, at 107-8.
[275] MORCK, How, *supra* note 271; MORCK/YEUNG, Dividend Taxation and Corporate Governance, 19 Journal of Economic Perspectives 163 (2005).
[276] MORCK, How, *supra* note 271, at 9-13, 27, 35.
[277] *See* SCHAFFER, The Income Tax on Intercorporate Dividends, 33 Tax Lawyer 161, 164 (1979) (noting that with a 90% exclusion for inter-corporate dividends, the tax cost to dividends was likely offset by the savings from not having income subject to the higher marginal corporate income tax rates).
[278] MORCK, How, *supra* note 271, at 28.
[279] MORCK, *id.*, at 27.
[280] MORCK, *id.*, at 13, 35.
[281] MAGILL, *supra* note 270, at 642.

the interaction between tax and the evolution of ownership patterns is required to establish the extent to which tax is a determinant of ownership structure in larger companies.

Case studies from additional countries constitute one promising line of inquiry. There already is fragmentary cross-border evidence indicating that tax may help to determine the extent to which the widely held company moves to the forefront within a particular country. For instance, Randall Morck, Michael Percy, Gloria Tian and Bernard Yeung have argued that in Canada a temporary shift towards dispersed ownership and a subsequent retreat to blockholding can be accounted for partly by succession taxes taking a substantial bite out of corporate groups in the 1950s and by the 1972 abolition of estate duties making it easier for family business dynasties to endure generational transitions.[282] Similarly, Germany's 2002 abolition of a capital gains tax of 50% for profits generated when companies sold shares they owned in other companies has been frequently cited as a key catalyst for a widespread unwinding of cross-holdings occurring.[283] On the other hand, the cohesion and density of the German network of interlocking ownership – sometimes characterized as "Germany Inc." or "Deutschland AG" – was already decreasing prior to 2002, so tax's contribution to changes occurring in Germany cannot be taken for granted.[284]

The experience with inter-corporate dividend taxation also reveals how case studies can serve to shed light on the potential impact of tax on ownership structure. Morck draws on comparative evidence to buttress his claim taxation of inter-corporate dividends discouraged corporate pyramids in the U.S., citing the fact that in other developed countries corporate pyramids are commonplace and tax is typically not levied on inter-corporate dividends received by a parent company once the parent's stake in the subsidiary exceeds a minimum designated threshold (generally 10% or 20%).[285] The comparative evidence does not all go one way, however. In Italy, inter-corporate taxation of dividends was introduced in 1955 and abolished in 1977, and these changes to the law failed to have a marked impact on extensive pyramiding in Italian public companies.[286]

On the other hand, a country Morck concedes creates some problems for his argument – Britain – is not as troublesome as he fears. The received wisdom is that

[282] MORCK/PERCY/TIAN/YEUNG, The Rise and Fall of the Widely Held Firm: A History of Corporate Ownership in Canada, in: MORCK, History, *supra* note 5, at 65, 113-15.

[283] PFEIFER, "Anglo-Saxon Attitudes are Forced on Deutschland AG", Telegraph, May 15, 2005; DAUER, "Corporate Germany Ups Pace on Disposal of Cross Holdings", Business, July 3, 2005, 10; DOUGHERTY, "Less 'Germany Inc.' More Openness", International Herald Tribune, September 3, 2005, 9.

[284] FOHLIN, The History of Corporate Ownership and Control in Germany, in: MORCK, History, *supra* note 5, at 223, 233 (Table 4.2, providing percentages of shares owned by non-financial companies 1990-98), 245.

[285] MORCK, How, *supra* note 271, at 5-7; MORCK/YEUNG, *supra* note 275, at 176.

[286] AGANIN/VOLPIN, The History of Corporate Ownership in Italy, in: MORCK, History, *supra* note 5, at 325, 348-50.

corporate pyramids do not exist in the U.K.[287] From the 19th century onwards, British tax law exempted inter-corporate dividends from taxation.[288] Morck concedes accordingly that developments in Britain indicate "business groups can be eliminated in more than one way".[289]

In fact, the situation in the U.K. can be squared quite readily with Morck's argument that inter-corporate taxation of dividends discourages the use of corporate pyramids. While in both the U.S. and the U.K. the norm is for public companies to be widely held, in both countries a significant minority of public companies do have blockholders.[290] According to Morck "(f)inding anything approximating a business group in the United States is a painstaking labor".[291] The British situation is different. Contrary to the received wisdom, the available data suggests when British public quoted companies have blockholders pyramids as control devices are used as often as they are elsewhere in Europe.[292] This suggests that a country can develop an "outsider/arm's-length" system of ownership control without taxing inter-corporate dividends but corporate pyramids may nevertheless continue to remain part of the corporate governance landscape. More broadly, the experience in Britain shows care must be used in drawing suitable inferences from case studies on tax and ownership structure.

Researchers seeking to investigate tax's impact on ownership structure should also consider empirical tests. A potential stumbling block will be a lack of suitable data. In principle, a good way to test to our conjectures would be to carry out time-series analysis to find correlations between changes in ownership structure and tax policy. Mihir Desai, Dhammika Dharmapala and Winnie Fung's work on the relationship between the progressivity of U.S. income tax and the dispersion of stock ownership across households illustrates, as they use dividend income reported in individual tax returns to calculate stock ownership for five different income fractiles from 1916 to 2000.[293] However, for researchers wanting to test potential determinants of blockholding, there is a dearth of empirical data on the ownership structure of large companies. For instance, the few studies that purport to offer any sort of rep-

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287 FRANKS/MAYER/ROSSI, Spending, *supra* note 5, at 582.
288 MORCK, How, *supra* note 271, at 7.
289 MORCK, *id.*, at 7.
290 On the U.S., *see* HOLDERNESS/SHEEHAN, The Role of Majority Shareholders in Publicly Held Corporations: An Exploratory Analysis, 20 Journal of Financial Economics 317 (1988) (reporting that as of 1984, 663 of 5240 companies traded on national stock markets had a majority owner); ANDERSON/DURU/REEB, Corporate Opacity and Family Ownership in the U.S., unpublished working paper (2006) (finding that of the largest 2000 U.S. firms as of 2001-03, 48% had continued family involvement, with family ownership averaging 20%). On the U.K., *see* FACCIO/LANG, The Ultimate Ownership of Western European Corporations, 65 Journal of Financial Economics 365 (2002) (reporting that of 1,953 U.K. public companies 63% were widely held in the sense they lacked a 20% shareholder, 24% had a family owner, 9% had a public company blockholder and 4% had a blockholder of a different sort).
291 MORCK, How, *supra* note 271, at 5.
292 FACCIO/LANG, *supra* note 290, at 389.
293 DESAI/DHARMAPALA/FUNG, Taxation and the Evolution of Aggregate Corporate Ownership Concentration, NBER Working Paper Series No. 11469 (2005).

resentative coverage of the corporate population in the U.K. and U.S. simply provide "snap-shots" for a tiny number of individual years rather than the continuous coverage that is required for econometrically sound time-series research.[294] The situation is much the same with other countries. In their study of the history of corporate ownership in Canada, Morck, Percy, Tian and Yeung do offer data on the percentage of companies that were widely held, part of a pyramid, family controlled and state owned over time, but it is unclear whether this could form the basis for methodologically sound time-series analysis.[295]

Another challenge for researchers is that a wide array of tax rules potentially affect companies and investors, and selecting those most likely to "matter" for ownership structure is not straightforward. The survey provided here has identified a wide range of potential candidates, including personal income tax, estate tax, taxation of corporate income, the tax treatment of institutional investment and taxation of inter-corporate dividends. Thus, researchers cannot simply begin investigating on the basis of the intuition that tax "matters". Instead, careful thought will be required to identify the types of tax that could play a role, including taking into account the interaction of tax rules that might not make an impact in isolation (*e.g.* high rates of income tax operating in tandem with tax breaks for institutional investment).

Further complicating the analysis are potential feedback loops between tax and ownership structure. It may well be the case that the manner in which companies and investors conduct themselves helps to determine the nature of tax policy, as well as vice versa. For instance, the rise of retained earnings as a financing strategy at the beginning of the 20th century in the U.S. may have prompted the federal government to develop the country's "stand alone" classical system for taxation of corporate profits, with the objective being to ensure retained earnings would be taxed but without crippling corporate investment by imposing the high rates applicable to well-paid individuals.[296]

While ascertaining with precision the impact tax has on corporate ownership structures will no doubt be a challenging exercise, the evidence presented here suggests that further investigation would indeed be worthwhile. In both the U.K. and the U.S., debates about corporate governance generally take as their departure point the

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[294] On the U.K., for example, the only systematic study from prior to the 1970s offered only data for 1936 and 1951: FLORENCE, Ownership, *supra* note 14. FRANKS/MAYER/ROSSI, *supra* note 9, offers data on trends throughout the 20th century, but the sample size is far too small (40 companies incorporated around 1900, 20 of whom survived to 2000, and 20 incorporated around 1960 that survived to 2000) to offer any sort of representative picture of ownership patterns in U.K. companies. In the U.S., there were only three pre-1970 studies of the ownership structure of large companies, in each instance focusing on the ownership patterns in the 200 largest non-financial companies. These were BERLE/MEANS, *supra* note 138; TEMPORARY NATIONAL ECONOMIC COMMITTEE, *supra* note 236 (offering data for 1937) and LARNER, Ownership and Control in the 200 Largest Nonfinancial Corporations, 1929 and 1963, 56 American Economic Review 777 (1966) (offering data for 1963).

[295] MORCK/PERCY/TIAN/YEUNG, *supra* note 282, at 100 (providing a graph). A key potential difficulty is that they were only able to compile data for every ten years until 1960, and every five years thereafter – *id.*, at 98.

[296] *See* BANK, Capital Lock-In Theory, *supra* note 240, at 914.

widely held company,[297] and this paper has shown that tax rules likely contributed to the rise of this particular form of business organization to prominence in both countries. Tax also seems likely to continue to influence corporate ownership structures going forward. In the U.K. and the U.S. there is currently much speculation that buy-out activity by private equity firms could displace the publicly quoted company as the centerpiece of the corporate economy,[298] and private equity's rise to prominence has been partly tax driven. For instance, the ability of private equity funds to finance their deal-making is dependent partly on the tax deductibility of debt interest payments and the fact that "carried interest", the key performance-related means by which private equity partners are remunerated, is taxed as capital gains rather than income due to the tax status of partnerships helps to explain why private equity firms are organized as partnerships rather than public companies.[299] Hence, despite methodological challenges, researchers seeking to understand the configuration of corporate ownership in large companies should in the future take tax into account as part of their investigations.

[297] CHEFFINS, Current Trends in Corporate Governance: Going from London to Milan via Toronto, 10 Duke Journal of Comparative and International Law 5, 13-26 (1999) (U.K.); DENT, Corporate Governance: Still Broke, No Fix in Sight, 31 Journal of Corporation Law 39, 40-45 (2005) (U.S.).

[298] SEARJEANT, "Plc is Ready to Join Mutuals in Land of the Dodo", Times, April 21, 2006, 71; JENKINS, "The Market to End All Markets", Wall Street Journal, December 6, 2006, A17.

[299] HARDING, "Unions Expose Inequity in U.K. Corporate Taxation", Times, February 8, 2007 (discussing the tax subsidy to private equity from the interest deduction); FLEISCHER, Two and Twenty: Taxing Partnership Profits in Private Equity Funds, University of Colorado Law Legal Studies Paper No. 06-27, 20 (2006). *Cf.* RIBSTEIN, The Important Role of Non-Organization Law, 40 Wake Forest Law Review 751, 767 (2006) (arguing that partly for tax reasons managers of public companies want the businesses to continue to operate as incorporated entities rather than converting to partnerships).