The 1936 Federal Corporate Surtax

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THE 1936 FEDERAL CORPORATE SURTAX

By MERLE H. MILLER*

The corporate tax under former federal revenue acts was levied upon the net income received by a corporation, and the determination of that net income and the tax thereon was principally a question for the accountant. Under the new Revenue Act of 1936, however, a new surtax1 is levied which is dependent not upon the receipt of income, but upon the corporate action taken during the taxable year in regard to the disposition of that income.

In general the amount of surtax is determined by whether the corporation has retained its income, or has paid dividends in cash or securities or stock dividends that constitute taxable income to stockholders, or has retained the income pursuant to certain specific written contracts binding the corporation to so retain the yearly net income. Thus the questions arising under the new Act are questions primarily for the lawyer who in turn will find a working knowledge of the new Act indispensable in giving advice on any question which affects the capital structure of a corporation, its dividend policy, retirement of its debts, the incurring of new debts, or the issuing of new securities.

The new tax has been popularly called a corporate surplus tax and in the Act itself it is called a "surtax on undistributed profits." Neither of these names is entirely accurate, since the tax may be incurred when a corporation has a deficit, or a corporation may escape tax and yet retain a surplus many times its capital stock, and it is possible for a corporation to incur a surtax liability when it has no undistributed net profits.

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* Of the Indianapolis, Indiana, Bar.

1 The Revenue Act also imposes surtaxes on improper accumulations of surplus (Section 102) and on personal holding companies (Section 351), which taxes are outside the scope of this article.
The general nature of the new tax can be best understood by examining the method provided in the Act for the calculation of the tax. Let us compute the total federal tax liability for the Example Manufacturing Company for the year 1936. The net income is computed the same as in former years and fortunately for our purpose we find that the net income amounts to the even figure of $50,000. Let us assume that this net income is less than 10% of the declared value of the capital stock of the corporation, and that consequently there is no excess profits tax liability.2

Upon looking at the source of this income we find included therein $1,000 interest on United States Government obligations and $4,000 dividends received from domestic corporations. Section 13 of the new Act,3 which imposes the normal tax on corporate income, allows only deductions for

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2 Section 106 of the Revenue Act of 1935 imposes an excess profits tax of 6 per cent on all net income of a corporation in excess of 10 per cent and not in excess of 15 per cent of the adjusted declared value of its capital stock, and a tax of 12 per cent on all net income in excess of 15 per cent of the adjusted declared value. This was amended by Section 402 of the 1936 Act to permit deduction from net income of 85 per cent of the dividends received from domestic corporations.

3 Sec. 13. Normal Tax on Corporations.—(a) Definition.—As used in this title the term “normal-tax net income” means the net income minus the sum of—
(1) Interest on obligations of the United States and its instrumentalities.—The credit provided in section 26(a). (2) Dividends received.—The credit provided in section 26(b). Such credit shall not be allowed in the case of a mutual investment company, as defined in section 48. (3) Dividends paid.—In the case of a mutual investment company the credit provided in section 27, computed without the benefit of subsection (b) thereof (relating to dividend carry-over).

Sec. 26. Credits of Corporations.—(a) Interest on Obligations of the United States and Its Instrumentalities.—The amount received as interest upon obligations of the United States or of corporations organized under Act of Congress which is allowed to an individual as a credit for purposes of normal tax by section 25(a) (1) or (2). (b) Dividends Received.—85 per centum of the amount received as dividends from a domestic corporation which is subject to taxation under this title. The credit allowed by this subsection shall not be allowed in respect of dividends received from a corporation organized under the China Trade Act, 1922, or from a corporation which under section 251 is taxable only on its gross income from sources within the United States by reason of its receiving a large percentage of its gross income from sources within a possession of the United States.
interest from United States obligations\(^4\) and for 85% of dividends received from domestic corporations. All of the remaining net income is taxable regardless of its source. By making the above deductions we arrive at a figure which is designated in the Act as, “Normal Tax Net Income” computed as follows:

Net Income .......................................................... $50,000  
Minus:
Interest on U. S. Obligations.................................. $1,000  
85% of dividends from domestic Corporations (85%  
of $4,000) .......................................................... 3,400 4,400  

Normal Tax Net Income ......................................... $45,600

This last figure is subject to a graduated normal tax,\(^5\) ranging from 8% on the first $2,000 up to 15% on all over $40,000.\(^6\) The normal tax liability of our corporation would be $5,680, computed as follows:\(^7\)

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\(^4\) A taxpayer is required to include in his gross income any interest received from U. S. Government obligations issued after September 1, 1917, if the Act of Congress did not exempt the interest from tax (Section 22). The credit thus given by Sections 13 and 14 results in all interest received on any U. S. Government obligations being nontaxable under this Act for purposes of either the normal tax or the surtax.

\(^5\) Banks and trust companies are taxed on their “normal tax net income” at the flat rate of 15% instead of the graduated rates below (Sec. 104). Foreign corporations engaged in business in the U. S. pay a normal tax of 22% (Sec. 231). Neither banks, trust companies nor foreign corporations are subject to surtaxes on undistributed net income (Sec. 14-a). See note 9, infra.

\(^6\) Section 13. Normal Tax on Corporations—(b) Imposition of Tax.—There shall be levied, collected, and paid for each taxable year upon the normal-tax net income of every corporation, a normal tax as follows: Upon normal-tax net incomes of not in excess of $2,000, 8 per centum. $160 upon normal-tax net incomes of $2,000; and upon normal-tax net incomes in excess of $2,000 and not in excess of $15,000, 11 per centum in addition of such excess. $1,590 upon normal-tax net incomes of $15,000; and upon normal-tax net incomes in excess of $15,000 and not in excess of $40,000, 13 per centum in addition of such excess. $4,840 upon normal-tax net incomes of $40,000; and upon normal-tax net incomes in excess of $40,000, 15 per centum in addition of such excess.

\(^7\) This method of computation illustrates better the operation of the tax. The simple computation is of course to add the $4,840 normal tax on $40,000 as shown in the Act (note 3, supra) to 15% of the remaining $5,600 or $840, giving the total normal tax of $5,680.
Normal Tax Net Income.........................................................$45,600

<table>
<thead>
<tr>
<th>Rate</th>
<th>Amount</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>8% on first</td>
<td>$ 2,000</td>
<td>$ 160</td>
</tr>
<tr>
<td>11% on next</td>
<td>13,000</td>
<td>1,430</td>
</tr>
<tr>
<td>13% on next</td>
<td>25,000</td>
<td>3,250</td>
</tr>
<tr>
<td>15% on remainder</td>
<td>5,600</td>
<td>840</td>
</tr>
</tbody>
</table>

Total Normal Tax on $45,600.................................$5,680

In past years the federal tax return computed up to this point would merely have to be filed and the tax paid. Under the new Act, however, our computation is just beginning.

Section 14 of the Act provides that from the net income of the corporation shall be subtracted any interest from United States Government obligations and the normal tax as computed above. The figure thus obtained is called the "Adjusted Net Income" and with certain exceptions a surtax is imposed on any part of this sum which has not been paid out as dividends by the corporation during the taxable year, or retained by the corporation pursuant to written contracts executed prior to May 1, 1936, prohibiting the corporation from making dividend distributions out of the sums so retained.

8 Sec. 14. Surtax on Undistributed Profits.—(a) Definitions.—As used in this title—(1) The term "adjusted net income" means the net income minus the sum of—(A) The normal tax imposed by section 13. (B) The credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations. (C) In the case of a holding company affiliate (as defined in section 2 of the Banking Act of 1933), the amount allowed as a credit under section 26 (d). (D) In the case of a national mortgage association created under Title III of the National Housing Act, the amount allowed as a credit under section 26 (e).

9 Section 14—Surtax on Undistributed Profits.—(d) Exemption from Surtax.—The following corporations shall not be subject to the surtax imposed by this section: (1) Banks as defined in section 104. (2) Domestic corporations which for any portion of the taxable year are in bankruptcy under the laws of the United States, or are insolvent and in receivership in any court of the United States or of any State, Territory, or the District of Columbia. (3) Insurance companies subject to the tax imposed under section 201, 204, or 207. (4) Foreign corporations. (5) Corporations which, by reason of deriving a large portion of their gross income from sources within a possession of the United States, are entitled to the benefits of section 251. (6) Corporations organized under the China Trade Act, 1922. (7) Joint Stock Land Banks organized under the Federal Farm Loan Act, as amended.
The "Adjusted Net Income" of Example Manufacturing Company would be computed as follows:

Net Income ........................................................................... $50,000
Minus:
  Interest on U. S. Obligations........................................ $1,000
  Federal Normal Tax .................................................. 5,680 6,680

Adjusted Net Income............................................................ $43,320

The corporation is then taxable on any part of the above amount of $43,320 which has not been either paid out as dividends to stockholders or withheld by the corporation pursuant to a written contract executed prior to May 1, 1936, restricting the payment of dividends or requiring that a portion of the earnings be set aside to meet a debt incurred prior to May 1, 1936.

Our corporation paid out $10,000 in dividends during 1936, set aside $3,000 out of its earnings to meet the maturity of its bonds pursuant to an express provision in the bond indenture which was executed prior to May 1, 1936, and used $20,000 to pay off its debt to the bank, which debt was incurred in 1932.

The "Undistributed Net Income" of the corporation, on which the surtax is levied, would be $30,320, computed as follows:

Adjusted Net Income............................................................ $43,320
  (Net Income minus Interest on U. S. Obligations and Normal Tax)
Minus:
  Dividends Paid ......................................................... $10,000
  Set aside pursuant to bond indenture......................... 3,000 13,000

Undistributed Net Income.................................................. $30,320

The only credits given by the Act are the two shown above, dividends paid and amounts withheld pursuant to a written

Section 14—Surtax on Undistributed Profits.—(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (e), relating to contracts restricting dividends.
contract executed prior to May 1, 1936. So that it makes no difference how the remainder of the net income was used, whether for the payment of old debts, or set aside in a fund to meet future obligations, or for new buildings, the surtax would still be the same. The $20,000 used by our corporation to pay off its old bank indebtedness does not enter into the computation of the surtax.

This "Undistributed Net Income" of $30,320, is taxed on a graduated scale, ranging from 7% to 27%, the rate varying according to the ratio of this undistributed net income to the adjusted net income ($43,320) which the corporation is charged with distributing.11

We found that the adjusted net income of the corporation was $43,320 after deducting interest on government obligations and the normal tax from the net income of the corporation. The first 10% of this adjusted net income ($43,320) which is retained as undistributed net income by the corporation is taxed at the rate of 7%. The Act grants a specific credit whereby the first $5,000 retained by the corporation is taxed at only 7% even though this $5,000 may be greater than 10% of the adjusted net income.12

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11 Section 14—Surtax on Undistributed Profits.—(b) Imposition of Tax.—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c): 7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income. 12 per centum of the portion of the undistributed net income which is in excess of 10 per centum and not in excess of 20 per centum or the adjusted net income. 17 per centum of the portion of the undistributed net income which is in excess of 20 per centum and not in excess of 40 per centum of the adjusted net income. 22 per centum of the portion of the undistributed net income which is in excess of 40 per centum and not in excess of 60 per centum of the adjusted net income. 27 per centum of the portion of the undistributed net income which is in excess of 60 per centum of the adjusted net income.

12 Section 14 (c)—Adjusted Net Income Less than $50,000.—(1) Specific Credit.—If the adjusted net income is less than $50,000, there shall be allowed a specific credit equal to the portion of the undistributed net income which is in excess of 10 per centum of the adjusted net income and not in excess of $5,000, such credit to be applied as provided in paragraph (2). (2) Application of Specific Credit.—If the corporation is entitled to a specific credit, the tax shall be equal to the sum of the following: (A) A tax computed under
So that of our undistributed net income, the first $5,000 would be taxed at only 7%, although the first 10% of the adjusted net income would be only $4,332. The rates then increase as the percentage of our adjusted net income which has not been distributed increases, the rates going up to 27% on the last 40% of the adjusted net income which has not been distributed by the corporation.

In this case the corporation is charged with distributing $43,320, and after taking credits for dividends paid and amounts withheld pursuant to a written contract executed prior to May 1, 1936, the amount “undistributed” was found to be $30,320. The surtax on this “undistributed net income” would be $5,237, computed as follows:

<table>
<thead>
<tr>
<th>Amount</th>
<th>Rate</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>First 10% of $43,320 not distributed (Raised to $5,000 by specific credit)</td>
<td>7%</td>
<td>$350.00</td>
</tr>
<tr>
<td>Next 10% of $43,320 not distributed</td>
<td>12%</td>
<td>519.84</td>
</tr>
<tr>
<td>Next 20% of $43,320 not distributed</td>
<td>17%</td>
<td>1,472.88</td>
</tr>
<tr>
<td>Next 20% of $43,320 not distributed</td>
<td>22%</td>
<td>1,906.08</td>
</tr>
<tr>
<td>Remainder of $43,320 not distributed</td>
<td>27%</td>
<td>988.20</td>
</tr>
<tr>
<td>Total Surtax on $30,320</td>
<td></td>
<td>$5,237</td>
</tr>
</tbody>
</table>

In computing the surtax liability of this Example Manufacturing Company, we have taken the only credits allowed by the Act. It remains for us to investigate what written contracts will entitle the corporation to credit for sums not paid out as dividends and what corporate distributions will entitle the corporation to credit for dividends paid, within the meaning of the Act.

SUMS WITHHELD PURSUANT TO WRITTEN CONTRACTS

Subsections 26-c-1 and 26-c-2 of the Act are intended to give relief in those instances where a corporation is prevented from paying out dividends by the provisions of a written subsection (b) upon the amount of the undistributed net income reduced by the amount of the specific credit, plus (B) 7 per centum of the amount of the specific credit.
contract either restricting payment of dividends, or requiring a certain amount to be set aside for payment of a debt. It is not every contract which might operate to restrict the payment of dividends that will entitle the corporation to credit for the sums so withheld, but only those written contracts executed prior to May 1, 1936, which satisfy the conditions prescribed in the Act.

The first subdivision (Section 26-c-1)\(^{13}\) deals with written contracts restricting the payment of dividends by the corporation. The Commissioner of Internal Revenue has ruled in his “Undistributed Profits Tax Regulations,” hereafter referred to in the footnotes as TD 4674, that a contract does not restrict the payment of dividends within the meaning of this section if it restricts payment of dividends in one form only and leaves the corporation free to declare dividends in other forms. For example, a contract which merely restricts the payment of dividends in cash would not entitle the corporation to credit under this section of the Act if it were possible for the corporation to distribute dividends in other forms, such as stocks or bonds of the corporation.\(^{14}\)

Credit under this section is limited also to those written contracts containing a provision which “expressly deals with the payment of dividends.” The Commissioner has ruled\(^{15}\) that contract provisions merely requiring a corporation to set aside periodically a sum to retire its bonds does not meet the requirements of this section of the Act. On the other

\(^{13}\) Section 26—Credits of Corporations.—In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—(c) Contracts Restricting Payment of Dividends.—(1) Prohibition on payment of dividends.—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

\(^{14}\) TD 4674, Art. 26-3B.

\(^{15}\) TD 4674, Art. 26 (3).
hand, if the contract requires that a certain sum be set aside
out of earnings and profits before dividends can be paid,
then credit may be claimed under this section with limitations
to be shown hereafter.

It is under this subsection of the Act that credit must be
taken for sums set aside for retirement of preferred stock
issues, such as have been prevalent in Indiana, since the
obligation of a corporation to meet maturities on its preferred
stock is not a debt\(^1\) so as to entitle the corporation to credit
under the succeeding section of the Act for sums so set aside.\(^2\)
Under the Commissioner's ruling the test would be whether
the provisions of the contract prohibited the payment of divi-
dends until a certain sum had been set aside out of earnings
and profits to meet the preferred stock maturities. Even
though the contract might in effect prevent the payment of
dividends because of the requirement that certain sums be
set aside each year, yet unless the contract expressly dealt
with the payment of dividends or required the sums to be
set aside out of earnings and profits no credit would be allowed
under this section by the Commissioner.

There are other instances where a corporation might find
itself legally prevented from declaring dividends and yet
taxed for not declaring them. Such would be the case in
our original example if, being an Indiana corporation, the
Example Manufacturing Company had started the year 1936
with a deficit of $100,000 and had then had a net income
of $50,000 during the year. The existing deficit would not
affect our former computation of net income and the tax
thereon. We there found that the company would be charged
with distributing $43,320 and would have to pay a surtax
on any of that amount which was not paid out as dividends
or set aside pursuant to certain written contracts. Yet the
corporation would have a net deficit at the end of the year
and would be prevented by its charter from paying any divi-

\(^{16}\) In re Picadilly Realty Co., 78 Fed. (2d) 257; Star Publishing Co. v.
Ball, 192 Ind. 158, 134 N. E. 285.
\(^{17}\) TD 4674, Art. 26-3c.
dends which would impair its capital. If no dividends were paid, the surtax on its undistributed net income after deducting $3,000 set aside pursuant to written contracts, would be $7,937.

That the charter of a corporation is a contract was determined long ago in the famous Dartmouth College case, and the charter in the case of Indiana corporations contains provisions which "expressly deal with the payment of dividends."

This would seem sufficient compliance with the requirements of Subsection 26-c-1 of the Act to entitle the corporation to credit when it is prevented from paying dividends by the terms of its charter. The Commissioner has ruled, however, that a corporate charter does not constitute a written contract within the meaning of Section 26-c, so that in the above example the corporation would be forced to pay a surtax of $7,937 for not paying out dividends which it was restricted from paying out by the terms of the charter. To assess a tax in the form of a penalty for failure to do that which it is legally impossible to do is so repugnant to common standards of justice that it would not be surprising if the courts should overrule the Commissioner on this point and extend relief where perhaps none was intended but would be sorely needed.

This subdivision is so worded that the credit given is not the amount which is restricted by the terms of the contract, but is the difference between the adjusted net income which the corporation is charged with distributing, and the

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18 Ind. General Corporation Act, par. 12, Acts 1929, chapter 219, page 725:

"The directors of every corporation shall have power, subject to any restrictions contained in the articles of incorporation, to declare and pay dividends upon the shares of capital stock, out of the surplus earnings or net profits or surplus paid in in cash of the corporation." * * * "No dividend shall be paid if the corporation is, or is thereby rendered, insolvent or if its capital is, or thereby becomes, impaired." Restrictions under former Acts are the same in substance.


20 See note 18, supra.

21 TD 4674, Art. 26 (3).
total amount which can be distributed without violating the provisions of the written contract as specified in the Act.\textsuperscript{22}

This difference may be illustrated by the following example: X corporation has $50,000 surplus at the beginning of the taxable year, which surplus has been accumulated subsequent to February 28, 1913. During the taxable year the corporation earns a net profit of $100,000 after deducting the normal federal tax. Let us assume for present purposes that the net profits of the corporation are identical with its net income. On April 15, 1936 the corporation borrowed $300,000 and entered into a contract that until its outstanding indebtedness is paid it would not use more than 50\% of its yearly net earnings for the payment of dividends in any one year. It would seem that the corporation should be entitled to a credit of 50\% of the net profits which it must not pay out as dividends during the tax year, or $50,000. Actually the corporation would receive no credit under this section.\textsuperscript{23} The computation of the credit would be as follows:

\textbf{Adjusted Net Income} $100,000

\textbf{Total which can be distributed:}
- \textbf{Net Profits after normal tax} $100,000
- \textbf{Surplus at beginning of tax year} 50,000

\textbf{Total} $150,000

\textbf{Less:}
- \textbf{Amount restricted by written contract (50\% of $100,000)} 50,000 $100,000

\textbf{Credit allowed} None

It is the amount that a corporation can not distribute that is given as a credit, and in the illustration above the corporation may distribute the entire $100,000 with which it is charged by dipping back into its accumulated surplus, and still not violate the provisions of its written contract. Thus a corporation would have to use up its accumulated surplus out of which it could declare dividends, before it could obtain

\textsuperscript{22} See note 13, supra.

\textsuperscript{23} TD 4674, Art. 26 (3b).
the benefit of any credit under this section of the Act, unless the contract were so worded as to restrict dividends out of accumulated surplus.

The next subdivision, Subsection 26-c-2, gives credit for any sum required to be set aside out of the yearly earnings pursuant to the terms of a written contract executed prior to May 1, 1936, for the payment of a debt contracted on or before April 30, 1936. The credit here given is for the amount actually set aside and any existing surplus out of which dividends might be declared does not enter into the computation as it did under the former subsection (Section 26-c-1).

Also there is no limitation in this subsection for the number of credits which might be claimed for amounts set aside pursuant to the provisions of different contracts, whereas under the section dealing with contracts restricting the payment of dividends, only the largest single credit may be claimed regardless of how many of such written contracts there might be.

The Commissioner has ruled that it is only written contracts that expressly deal with the disposition of earnings and profits that may be the basis for credit under this section. The mere provision in a contract that the corporation shall retire annually a certain amount of its bonds or pay a certain amount into a sinking fund for the retirement of its bonds does not

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24 Sec. 26—Credits of Corporations.—In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax. (2) Disposition of profits of taxable year.—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word “debt” does not include a debt incurred after April 30, 1936.

25 See note 13, supra.

26 TD 4674, Art. 26-3.
sufficiently meet the requirements of this section. Such a contract would in effect prevent such sums set aside from being paid out as dividends, but unless the provision expressly dealt with "earnings or profits for the taxable year," there would be no credit allowed under this subsection, and although such a contract would in effect restrict the payment of dividends, credit could not be claimed under the preceding section (Section 26-c-1) unless some clause of the contract dealt expressly with the payment of dividends, according to present rulings of the Commissioner.

If a contract comes within the definition of both of the above subsections, then only that section which allows the greater credit shall be applied.

**Credit for Dividends Paid**

A dividend is defined in the Act as a distribution made out of earnings and profits of the corporation accumulated after February 28, 1913, or out of the earnings and profits of the taxable year. Thus it is possible for a corporation which has a deficit at the beginning of the taxable year to make a distribution out of its earnings and profits for the taxable year (unless prevented by its charter) which distribution would be counted as a dividend even though the earnings and profits were not sufficient to make up its preexisting deficit.

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27 TD 4674, Art. 26-3.

28 Sec. 26-c-(3) — Double credit not allowed. — If both paragraph (1) and paragraph (2) apply, the one of such paragraphs which allows the greater credit shall be applied; and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.

29 Sec. 115 (a) — Definition of Dividend. — The term "dividend" when used in this title (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

30 Sec. 115 (a) — Dividends Out of Current Earnings. — "In order to enable corporations without regard to deficits existing at the beginning of the
The term "earnings and profits" is not synonymous with "net income" as defined in the Act. The latter is an arbitrary figure arrived at by first adding the income of the corporation from all sources and from that total making certain statutory deductions. There are many deductions that a corporation must make in determining its earnings and profits which are not permitted in computing its net income. So that the "net income" of a corporation may far exceed its "earnings and profits" out of which dividends must be declared in order to entitle the corporation to credit for dividends paid. In such a case the corporation would be charged with distributing a certain amount as dividends, which amount even if distributed would not entitle the corporation to a dividend credit.

For example: Suppose a corporation that had a deficit at the beginning of the taxable year should show net earnings of $50,000 from the operation of its business during the taxable year. However, the corporation sustains a capital loss of $100,000 on the sale of securities held by the corporation, of which loss it would be allowed to set off only $2,000 against the above earnings in computing its net income for federal tax purposes. Thus although the corporation had really lost $50,000 during the taxable year so far as net earnings and profits were concerned, yet it would be charged with a net income of $48,000 and would have to pay a corporate surtax on any part of this $48,000 which was not distributed after paying the normal federal tax thereon.

For example: Suppose a corporation that had a deficit at the beginning of the taxable year should show net earnings of $50,000 from the operation of its business during the taxable year. However, the corporation sustains a capital loss of $100,000 on the sale of securities held by the corporation, of which loss it would be allowed to set off only $2,000 against the above earnings in computing its net income for federal tax purposes. Thus although the corporation had really lost $50,000 during the taxable year so far as net earnings and profits were concerned, yet it would be charged with a net income of $48,000 and would have to pay a corporate surtax on any part of this $48,000 which was not distributed after paying the normal federal tax thereon.

Secs. 21, 22, 23.
But the corporation could not obtain a dividend paid credit even if it should make a distribution, since it has no earnings or profits either accumulated since February 28, 1913, or during the taxable year out of which distribution must be made in order to entitle the corporation to a dividend credit. The corporation would be faced with a surtax of $8,441 for not distributing its “adjusted net income” of $41,960 (net income less normal tax of $6,040), which sum if distributed would not be recognized as a distribution entitling the corporation to credit for payment of dividends under the Act.

**TIME OF PAYMENT**

Credit is given only for dividends actually paid during the taxable year. A dividend is regarded as paid when it is received by the stockholder. However, placing the dividend check in the mails so that it would normally reach the stockholder within the taxable year creates a presumption that the dividend was paid to the shareholder in such year.

Large corporations with stockholders in foreign countries may find it necessary to set ahead their last dividend date so that the dividend will be received during the taxable year. Or if such foreign stockholders could be induced to appoint a local agent to receive their dividend, then the corporation could obtain credit by payment to an authorized agent of the stockholder.

The same requirements must be met as to receipt by the shareholder whether the dividend is paid in money or some other medium, such as a stock dividend. The thing disbursed must be received by the shareholder during the taxable year, and mere crediting the shareholder on the books of the corporation is not sufficient.

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34 See note 29, supra.
35 Sec. 27—Corporation Credit for Dividends Paid.—(a) Dividends paid credit in general.—For the purposes of this title, the dividends paid credit shall be the amount of dividends paid during the taxable year.
36 TD 4674, Art. 27-1.
37 TD 4674, Art. 27-1, Avery v. Commr., 54 Sup. Ct. 674.
38 TD 4674, Art. 27-1.
39 TD 4674, Art. 27-1.
THE AMOUNT OF THE DIVIDEND CREDIT

If the distribution by the corporation is made in cash, then the dividend credit is the amount paid to the stockholders out of the earnings and profits of the corporation, provided the distribution results in taxable income to the stockholders during the taxable year.\(^40\) Or if the distribution is a liquidating dividend, then the corporation is entitled to a dividend paid credit for the portion of the liquidating dividend which is properly chargeable to earnings and profits accumulated after February 28, 1913, although the receipt of such liquidating dividend might not be taxable income to the stockholder,\(^41\) due to the fact that liquidating dividends are now treated the same as capital exchanges.\(^42\) Thus a stockholder might receive a dividend in complete liquidation of a corporation, which being less than the purchase price of his stock would not represent income to him, yet would entitle the corporation to a dividend paid credit to the extent that such liquidating dividend represented earnings and profits accumulated after February 28, 1913.

If the dividend is paid in some medium other than cash, then the dividend credit to the corporation is more difficult to determine. If the corporation should make a distribution in property which it owned, then the taxable income received by the stockholder would be the fair market value of the property at the time it was received.\(^43\) The dividend credit

\(^{40}\) Sec. 27 (h)—Nontaxable Distributions.—If any part of a distribution (including stock dividends and stock rights) is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under this title for the period in which the distribution is made, no dividends paid credit shall be allowed with respect to such part.

\(^{41}\) Sec. 27 (f)—Distributions in Liquidation.—In the case of amounts distributed in liquidation the part of such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913, shall, for the purposes of computing the dividends paid credit under this section, be treated as a taxable dividend paid.

\(^{42}\) Sec. 115-c.

\(^{43}\) Sec. 115 (j)—Valuation of Dividend.—If the whole or any part of a dividend is paid to a shareholder in any medium other than money the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder.
to the corporation, however, would be either the fair market value of the property distributed, or the cost of the property to the corporation, whichever figure is lower.\textsuperscript{44} Thus if a corporation had purchased stock of another corporation for $50,000, which it distributed as a dividend at a time when the fair market value of the stock was $75,000, the dividend credit to the corporation would be $50,000, since this cost is lower than the market value. The taxable income received by the stockholder would be $75,000, the fair market value at the time of distribution.\textsuperscript{46}

If a corporation had previously purchased its own stock as an investment and then distributed such stock as a stock dividend, the same rule would be applied,\textsuperscript{46} although if it were to issue new stock as a stock dividend, then the dividend credit to the corporation would be the fair market value of the new stock in the hands of the stockholders.\textsuperscript{47} Thus if a corporation that had purchased its own stock at $50,000 were to distribute the stock so purchased as a dividend at a time when the fair market value of the stock had risen to $75,000, then the dividend paid credit to the corporation would be only $50,000. Whereas if the same corporation were to issue new stock as a taxable stock dividend, then the dividend paid credit to the corporation would be $75,000, the fair market value.\textsuperscript{48} The taxable income received by the stockholders would be the same in either case, the fair market value of the stock received.\textsuperscript{49}

\textsuperscript{44} Sec. 27 (c)—Dividends in Kind.—If a dividend is paid in property other than money (including stock of the corporation if held by the corporation as an investment) the dividends paid credit with respect thereto shall be the adjusted basis of the property in the hands of the corporation at the time of the payment, or the fair market value of the property at the time of the payment, whichever is the lower.

\textsuperscript{45} See note 43, supra.

\textsuperscript{46} TD 4674, Art. 27-3.

\textsuperscript{47} Sec. 27 (e)—Taxable Stock Dividends.—In case of a stock dividend or stock right which is a taxable dividend in the hands of shareholders under section 115 (f), the dividends paid credit with respect thereto shall be the fair market value of the stock or the stock right at the time of the payment.

\textsuperscript{48} See note 47, supra.

\textsuperscript{49} See note 43, supra.
If the corporation pays a dividend in its own obligations then the "dividend paid" credit is the face value of the obligation or the fair market value, whichever is lower. If the fair market value is lower, then the corporation would receive an additional dividend credit of the difference between the fair market value and the face value whenever the obligations were redeemed by the corporation.\(^{50}\) So that if a corporation issued $100,000 of its bonds as dividends to its stockholders, and the fair market value of the bonds was 90 at the time of distribution, then the corporation would be entitled to a dividend paid credit for that year of $90,000. When the bonds were redeemed at par, the corporation would receive an additional credit of $10,000 for "dividends paid."

**Stock Dividends**

A corporation may obtain a credit for dividends paid by issuing its own stock as a dividend provided the stock dividend represents taxable income to the stockholder.\(^{51}\) In the case of Eisner v. Macomber\(^{52}\) the United States Supreme Court held that a dividend in common stock issued to common stockholders did not constitute taxable income to the stockholder, the court holding that the common stockholder has no more after the stock dividend than he had before. Then recently the court ruled in the case of Koshland v. Helvering\(^{53}\) that

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\(^{50}\) Sec. 27 (d)—Dividends in Obligations of the Corporation.—If a dividend is paid in obligations of the corporation, the amount of the dividends paid credit with respect thereto shall be the face value of the obligations, or their fair market value at the time of the payment, whichever is the lower. If the fair market value is lower than the face value, then when the obligation is redeemed by the corporation, the excess of the amount for which redeemed over the fair market value at the time of the dividend payment (to the extent not allowable as a deduction in computing net income for any taxable year) shall be treated as a dividend paid in the taxable year in which the redemption occurs.

\(^{51}\) Sec. 27 (e), note 47, supra.

Sec. 115 (f) (1)—General Rule.—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution.

\(^{52}\) 252 U. S. 189, 64 L. Ed. 521, 40 Sup. Ct. 189.

\(^{53}\) 56 Sup. Ct. 767 (May 18, 1936).
a dividend paid in common voting stock to nonvoting preferred stockholders, constituted income to the taxpayer, since the new stock gave the stockholder an interest different from that which his former stockholdings represented.

On the basis of the latter decision the Commissioner has stated in the new regulations that where there is outstanding common and preferred stock, a stock dividend of common stock to preferred stockholders constitutes a taxable dividend to the holders of the preferred stock, and that a stock dividend of preferred stock issued to common stockholders constitutes a taxable dividend to the holders of the common stock. No indication is given as to what would be the attitude of the Department in the case where only one class of stock was outstanding and a dividend is paid in stock of a new class. For example, if the corporation had only common stock outstanding and were to issue a stock dividend of preferred stock to the common stockholders, there is no indication as to whether such stock dividend would be regarded as taxable income to stockholders.

If the preferred stock declared as a dividend should give the stockholders only the right to a preference in the earnings and assets of the corporation, then the common stockholder would be receiving only the right to be preferred over himself, which could hardly be classed as a new right. However, if the preferred stock should give the holder the right to have dividends paid thereon each year out of any earnings available, or if the stock contained the provision for a fixed maturity at which time the holder would be entitled to a specified amount of cash or other property, then the stockholder would be receiving new rights which were not represented by his former holdings in common stock. While the interests of the common stockholder remain proportionately the same after the distribution and are changed only if he should sell either his common or preferred stock, yet he has acquired new rights different from that which his former stock holdings represented. But whether it would

54 TD 4674, Art. 115-3.
55 TD 4674, Art. 115-3.
constitute taxable income to the stockholder so as to entitle the corporation to a dividend paid credit is not covered by any of the decisions of the Supreme Court, or by the Regulations of the Commissioner.

If, however, an election is given to the stockholder to receive stock or cash, then the entire distribution is a taxable dividend regardless of whether the stock with respect to which the option is given would constitute a taxable dividend if distributed without the option, and irrespective of whether the election is exercised.56 The option may even be so worded as to provide that the dividend will be paid in one medium unless the shareholder specifically requests payment in the other.57 Thus a corporation having only common stock outstanding could obtain a dividend credit for a stock dividend of common stock by merely adding the provision that the stockholder may at his option obtain a specific amount of cash instead of the stock dividend, although the stock dividend alone would not constitute a taxable dividend.

The amount of the dividend credit in the event of a dividend of stock or rights to acquire stock is the fair market value of the stock or rights at the time the distribution is made,58 excepting in the case of distribution by a corporation of its own capital stock held as an investment as discussed supra, pp. 15 and 16.

Where a stock dividend is accompanied with an option to the stockholder to obtain cash instead of the dividend, no method is provided in the Act for the computation of the dividend credit. If the stock dividend were taxable irre-

56 Sec. 115 (f) (2)—Election of Shareholders as to Medium of Payment.—Whenever a distribution by a corporation is, at the election of any of the shareholders (whether exercised before or after the declaration thereof), payable either (A) in its stock or in rights to acquire its stock, of a class which if distributed without election would be exempt from tax under paragraph (1), or (B) in money or any other property (including its stock or in rights to acquire its stock, of a class which if distributed without election would not be exempt from tax under paragraph (1)), then the distribution shall constitute a taxable dividend in the hands of all shareholders, regardless of the medium in which paid.

57 TD 4674, Art. 115-4.

58 Sec. 27 (e)—note 47, supra,
spective of the option, then the dividend credit to the corporation might well be the fair market value of the stock retained by the stockholders, plus the amount of cash paid them by virtue of their exercise of the option. If, however, the stock dividend were not taxable apart from the accompanying option to obtain cash instead of the stock dividend, then the only new right received by the stockholder is the right to obtain a dividend in cash. Although by retaining the stock he impliedly places a higher value on the stock than the cash amount offered as a dividend, yet since this stock dividend would not be taxable apart from the option to obtain cash, it is the value of the option which should determine the taxable income of the stockholder and not the value of the stock dividend which he retains but which in itself would not be taxable to him. As has been stated, however, the Act does not provide what would be the dividend credit in such a case and the Commissioner has not issued any ruling covering the question.

**DIVIDEND CARRY-OVER**

If a corporation should pay dividends in excess of its adjusted net income for the taxable year 1936, or any year thereafter, the extra credit may be carried forward and used as a dividend credit to the extent needed during the following two years.\(^{59}\)

Suppose a corporation following a fixed policy of distributing $50,000 dividends each year, were to have an adjusted net income of $25,000 for 1936, $60,000 for 1937, and $70,000 for 1938. The excess dividends paid in 1936 would give the corporation a dividend credit of $25,000,

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\(^{59}\) Sec. 27 (b)—Dividend Carry-Over.—In computing the dividends paid credit for any taxable year, if the dividends paid during the taxable year are less than the adjusted net income, there shall be allowed as part of the dividends paid credit, and in the following order: (1) Dividends paid during the second preceding taxable year in excess of the adjusted net income for such year, to the extent not needed as a dividends paid credit for the taxable year preceding the taxable year the tax for which is being computed; and (2) Dividends paid during the first preceding taxable year in excess of the adjusted net income for such year. No credit shall be allowed for dividends paid by a corporation prior to its first taxable year under this title.
of which credit it could use the $10,000 needed in 1937 and the remaining $15,000 in 1938. No credit is given for dividends paid prior to the corporation's first taxable year under this Act.

RETENTION OF CORPORATE EARNINGS

The most frequent criticism leveled at the new Revenue Act is that it prevents corporations from retaining earnings to meet future contingencies. There may be instances, such as we have discussed heretofore, where a corporation may be caught with no way of escaping the surtax, but such instances will doubtless prove to be the exception, and minor changes in the Act should relieve against those injustices. In the great majority of cases corporations are not prevented from retaining their earnings for proper corporate purposes, although such retention without incurring a surtax has been rendered complicated and frequently difficult.

Let us take the case of an average corporation with earnings which it wishes to retain for proper corporate purposes. Let us be specific and suppose that Y Corporation has $100,000 remaining after paying the federal normal tax, which amount it wishes to retain for corporate purposes. The corporation could elect to retain the entire amount and pay the full surtax on its undistributed net income. The surtax in that case would amount to $20,500, so that the corporation would have left only $79,500 after paying the surtax. The corporation would really be electing to keep $79,500 instead of paying $100,000 dividends to the stockholders.

It might be cheaper to distribute the earnings and borrow the money needed from outside sources. Apart from the practical difficulties involved, this procedure only temporarily solves the surtax problem. Sums used in the payment of debts or which are set aside for the payment of debts pursuant to contracts executed after May 1, 1936 are taxable as undistributed net income. Thus some surtax would ultimately be paid if this method were adopted, which surtax would be lessened however by spreading over a number of
years the payments so made and thus paying at the lower surtax rates. For example: if the $100,000 borrowed were to be repaid at the rate of $10,000 a year, then the surtax on this amount would be $700 a year for the 10 years, if the earnings of the corporation remained the same as above. If the earnings decreased, then the surtax would be greater, since the percentage of the income required to be retained to meet the debt would be increased. If the net income after paying the normal tax were to shrink to $10,000 and this all had to be used to pay an instalment of the debt, the surtax would be $1,250 for that year.

However, a corporation could retain the entire $100,000 and yet avoid the payment by the corporation of any surtax thereon by any one of the following methods:

1. Retain the $100,000 and declare a dividend in obligations of the corporation.
2. Retain the $100,000 and declare a stock dividend in a different type of stock such as would represent taxable income to the stockholders.
3. Retain the $100,000, declare a stock dividend of the same type of stock as that outstanding, and with the stock dividend give the stockholder an option of obtaining cash instead of the stock.
4. Retain the $100,000 and issue to the stockholders rights to subscribe for new stock, which rights would have a value equal to the earnings so retained.
5. Distribute the $100,000 as a cash dividend and prevail upon the stockholders to reinvest the amount received by them in the corporation.

Each of the above methods will afford the corporation opportunity to obtain money for its corporate purposes, although obviously not all of them are open to every corporation. Apart from business considerations, which will vary in each instance, some of the general legal merits of the above alternatives are set forth in the above order named.

1. A dividend paid in obligations of a corporation might be subject to the same objections as noted heretofore where the corporation borrows funds for its purposes, so far as retirement features are concerned, excepting that more flexible provisions for retirement could probably be used when secur-
ities are issued as a dividend, than when offered for sale to the public. This method is subject to the further objection that the actual dividend credit obtained by the corporation will not be known definitely in advance, since it may be dependent upon the fair market value of the obligation at the time of its issue. The fair market value of obligations of a small unknown corporation might be difficult to estimate in advance, so that the dividend might or might not be sufficient to avoid surtax liability. But ultimately the corporation would obtain the full dividend paid credit for the face amount of the obligations so distributed, and the variance between face value and market value should not make a great difference in the surtax liability.

2. The dividend credit on stock dividends is likewise determined by the fair market value at the time of distribution and therefore is subject to the above objections to dividends in obligations of the corporation. In addition if the corporation has only common stock outstanding, there is as yet no assurance that the Commissioner will recognize stock dividends as taxable income.

3. Where an option to obtain cash accompanies the stock dividend, then the amount of the credit to be obtained by the corporation is not certain, since the Act does not provide a method of computing the dividend credit of the corporation in such a case. Furthermore the corporation would not know how much cash would be left at its disposal until after the expiration of the period for exercising the option.

4. By issuance of stock rights a corporation may obtain a dividend credit equal to the fair market value of the rights at the time they are issued. If the stock of the corporation is listed on a stock exchange, then the amount of the dividend credit which the corporation could obtain by the issuance of stock rights might be estimated with some degree of certainty. But less than 1% of the corporations filing federal tax returns are listed on any stock exchange.\[60\] To the other

\[60\] Approximately 4,000 corporations have securities listed on exchanges. More than 500,000 corporations filed Federal Income Tax Returns for the year 1935.
99% the issuance of stock rights offers a very doubtful method of obtaining a dividend credit. If the value of the stock right is to approximate the earnings per share of the corporation, then the value of the rights to the small stockholder would be negligible and might result in a very low market value, upon which the dividend credit is based.

In our case, suppose the earnings of the corporation amount to $1.00 per share. If rights were issued to the stockholders of this approximate value, then the owner of 10 shares of stock, who did not desire to take advantage of the stock rights and invest more money in the corporation, would find himself the owner of a right to obtain non-listed stock which rights if exercised would have a theoretical value of $10. If the stockholder did not care to exercise the rights, they would have very little value to him and he might be quite willing to sell them for half their theoretical value, or $5. Small stockholders thus might establish a market value of the stock right which would result in a dividend credit to the corporation far below what was intended, leaving the corporation subject to surtax on the difference between the amount of earnings retained and the "fair market value" of the rights. In our case if stockholders not desiring to exercise their rights were to sell them at half their mathematical value, the corporation would be faced with a surtax on $50,000 "undistributed net income." The dividend credit to the corporation in such a case is determined by those stockholders who do not want to exercise the stock rights.

5. The ideal method would be to pay out the dividend in cash and have the stockholders directly either buy more stock or make a contribution to surplus in the amount needed by the corporation. In the case of a close corporation such procedure would be easy. Whether it would be desirable would be dependent upon the rate of tax which the individual stockholder will have to pay on the receipt of such a dividend.

The same result can be reached in the case of other than close corporations by having the stockholders deposit their stock with a trustee with power in the trustee to reinvest such sums received as dividends as might be requested by
the board of directors of the corporation, and distribute
the remainder to depositing stockholders. The power thus
given is no more than the power which the law now gives
to directors of a corporation. The board of directors could
then declare a dividend of the total earnings of the corporation
for the year. Then on determining the amount needed by
the corporation, they could so advise the trustee who could
reinvest the required sum in the corporation and distribute
any remaining cash to the depositing stockholders.

The dividends paid on the stock held in trust would be
income to the trust and being a revocable trust, for the
benefit of the grantor, would therefore be taxable to the
beneficiaries.\(^6\) Also the Commissioner has ruled that pay-
ment to an agent of a stockholder is sufficient to entitle the
corporation to a dividend paid credit.\(^2\) Consequently there
should be no question as to the dividends so paid to the
trustee being taxable to the stockholder and so entitling the
corporation to a dividend paid credit. Since the purpose
of the Act is not to prevent additions to the capital of the
corporation but merely to force payment of taxable income
to stockholders, such a device would not run foul of the
true purpose and intent of the Act.

If all of the stockholders of a corporation deposited their
stock in trust, then the matter would be easy. Or if a new
corporation were being formed, then the stock could be issued
to a trustee and certificates of beneficial interest could be
issued to the purchasers.

Where it is impossible to obtain the deposit of all of the
stock in trust but a large majority of it can be obtained,
even then this plan may be worked by declaring a dividend
in cash and having the trustee purchase securities of the
corporation in the amount desired. This would enable the
corporation to obtain money without the expense of selling
its securities to the public. Also on any long time expansion
project the corporation would find it inconvenient to issue

\(^6\) Sees. 161, 166, 167.
\(^2\) TD 4674, Art. 27-1.
a stock dividend or securities to all of the stockholders each year and the corporation could instead merely issue one certificate or obligation to the trustee each year. In this manner a corporation could make certain that it would incur no surtax liability for undistributed net profits, and at the same time be assured of having available the yearly earnings of the corporation for corporate purposes. The corporation could operate exactly as it had in the past, paying only the normal tax, with the stockholders paying a tax on the earnings of the corporation just as though they were partners in the business.

**CONCLUSION**

Perhaps we have drawn rather freely on exceptional cases to prove what we believe to be some of the rules under this new legislation. This we have felt free to do since it is not the purpose of this article to discuss other than legal aspects of the new Revenue Act. From this standpoint alone there are many rough spots to be ironed out, but that has been true of every Revenue Act. In this case the wonder is that they are not more numerous considering the history of its enactment.63

It was the announced purpose of this Act to force distribution of earnings by corporations to stockholders in such a form as would constitute income to the stockholder.64 The

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63 In a message to Congress on March 3, 1936, the President recommended that all existing corporate taxes be repealed and that there be substituted therefor a single corporate tax on undistributed profits. On April 21, 1936, the Ways and Means Committee of the House introduced the Revenue Bill of 1936, which was later passed by the House. On June 1, 1936, the Senate Committee made a report completely redrafting the House bill. The Senate passed this bill as amended on June 5, 1936, when it was referred to the conference committee. The bill as revised by the conference committee was passed by the Senate and House and signed by the President on June 22, 1936.

64 The principle of the new Act is not new in the minds of Federal tax officials. In his report to Congress in 1920 Secretary of Treasury Houston recommended the adoption of legislation that would tax undistributed profits of corporations. In 1924 the Senate passed an Act taxing undistributed profits on a graduated scale ranging from one-fourth of one per cent up to 40%, which measure failed to pass in the House.
Act appears likely to accomplish that purpose. Whether that purpose be economically sound or ultimately wise, we shall leave to the economists and the historians. This much we will venture—no better way could have been devised for bringing the lawyers into the field of federal corporate taxation.
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