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# Comments and Casenotes

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## Liquidating Dividends Under the Maryland Income Tax

By P. McEVOY CROMWELL\*

The Maryland tax treatment of liquidating dividends has furnished grist for discussion and debate ever since the Maryland Income Tax was enacted in 1937. A 1959 ruling by the Maryland Attorney General<sup>1</sup> has generated new interest in this area of our tax law.

Certain stockholders had purchased shares in a corporation for \$30.00 a share. Several years later the corporation sold all its assets and made a final liquidating distribution to its shareholders in the amount of \$22.00 per share. The corporation apparently had an original paid-in capital of \$1.00 per share. The Attorney General ruled that \$21.00 out of the \$22.00 received in redemption of each share were taxable under the Maryland Income Tax as a "dividend," even though it was perfectly clear that the stockholders in question had suffered a net loss of \$8.00 per share from their investment. It is our purpose to scrutinize this result in the light of the relevant sections of the Maryland Tax Law with particular regard to a determination of its validity when subjected to attack on constitutional grounds under our State and Federal Constitutions.

### I.

A brief general look at the relevant statutory sections and the various opinions of the Attorney General will be useful in setting up the background for our consideration of this problem.

The taxable status of liquidating dividends is controlled by a combination of several sections of Article 81 of the Maryland Code.<sup>2</sup> Section 288 imposes a tax on the taxable net income of individuals or corporations. Section 285 specifies that "taxable net income" is the gross income of the taxpayer less certain deductions and exemptions.

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<sup>1</sup> Daily Record, April 7, 1959.

<sup>2</sup> All section references to the Maryland Code will be to the 1957 Edition, unless otherwise indicated.

"Gross income" is defined in Section 280 to include dividends.<sup>3</sup> And Section 279(j) defines "dividend" as follows:

" 'Dividend' means any distribution made by a corporation (domestic or foreign) out of its net profits, whenever earned, to its stockholders or members, whether such distribution be made in cash or other property, except stock of the same class in the corporation. *Amounts paid in liquidation or dissolution of a corporation shall be treated as dividends to the extent that they represent earnings of the corporation.*"<sup>4</sup> (Emphasis added).

In 28 Opinions 254 (1943), the Attorney General of Maryland had occasion to analyze the nature of the "earnings" of a corporation out of which a distribution must be made in order to be taxable as a "dividend". In the case before him, liquidating distributions had been made by a corporation of the proceeds realized by the corporation from the sale of certain of its capital assets. The taxpayers argued that since under the Maryland Income Tax no taxable income results from the realization of capital gains,<sup>5</sup> the corporation had realized no "earnings" from the sale of its capital assets, and hence the distributions to the stockholders necessarily were not out of its "earnings". The Attorney General ruled that for this purpose, the earnings of a corporation include profits from the sale of capital assets, even though such profits are not taxable to the corporation. He concluded, therefore, that the distributions to the stockholders were taxable as dividends to them, having been made out of the corporation's earnings.

"The fact that the corporation is excused from paying income tax on it does not prevent accretion to net worth resulting from realized appreciation of assets from being net profits or earnings to the corpo-

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<sup>3</sup> " 'Gross income' means income from whatever source derived, including salaries, wages or compensation for personal services of whatever kind and in whatever form paid; alimony received, interest, *dividends*, rents, royalties and annuity income; and gains, profits and income derived from professions, vocations, trades, business and commerce." [Emphasis added].

<sup>4</sup> The italicized last sentence was inserted by MD. LAWS 1939, Ch. 277, § 12. Prior to that time, the following sentence had served in its place: — "It (dividend) includes such portion of the assets of a corporation distributed at the time of dissolution as are in effect a distribution of earnings." MD. LAWS 1937 (Spec. Sess.) Ch. 11, § 8(i).

<sup>5</sup> Art. 81, § 280(a).

ration, so as to make taxable dividends paid from that source."<sup>6</sup>

A subsequent ruling<sup>7</sup> held that distributions of property that was either contributed as original capital or was purchased by the corporation out of its original capital funds and which had appreciated considerably prior to the distribution could not be taxed as a dividend to the distributee shareholders because the appreciation in value did not result in income to the corporation and hence the distribution was not out of earnings but out of capital.<sup>8</sup> The Attorney General reasoned that the corporation had never realized income from this property because it had never sold it. The additional value which had attached to the property had never been converted into income to the corporation. No mention was made in this opinion of the presence or absence of an earned surplus derived independently of the distributed property. It might be inferred that the taxable status of a distribution was to be determined by referring to the actual property distributed in order to ascertain whether it constituted a part of the capital of the corporation as distinguished from corporate property that was purchased out of the corporate earnings.<sup>9</sup> However, a 1956 ruling<sup>10</sup> indicated that all distributions, including property that was part of the original corporate capital, will be considered as taxable dividends to the stockholders so long as, after the distribution the corporation still retains assets "properly valued at the amount of its paid-in capital."<sup>11</sup> The opinion states that "[a]ll

<sup>6</sup> 28 Op. Atty. Gen. 254, 257 (1943).

<sup>7</sup> 38 Op. Atty. Gen. 308 (1953).

<sup>8</sup> See *Sears, et al v. Commissioner*, 322 Mass. 446, 78 N.E. 2d 89 (1948) cited by the Attorney General to support this sound conclusion. But cf. *Collins v. Kentucky Tax Commission*, 261 S.W. 2d 303 (Ky. 1953), holding to the contrary.

<sup>9</sup> Such a determination could involve formidable problems of "tracing" to discover whether the distributed property was a part of or was acquired out of corporate capital or, on the other hand, was purchased with corporate earnings. Under the federal tax scheme, reference to the corporate source of the distribution is not necessary, since all distributions (no matter of what property) are considered to be out of earnings to the extent that an earned surplus exists, or to the extent the corporation has earnings in the year of distribution. Internal Revenue Code 1954, § 316.

<sup>10</sup> 41 Op. Atty. Gen. 343.

<sup>11</sup> Some cases refer to the possibility that property originally attributable to earned surplus may be subsequently "dedicated" to capital uses so as to thenceforth be considered as corporate capital for purposes of determining whether dividend distributions are out of corporate capital or earnings. See e.g. *Boston Safe Deposit & Trust Co. v. Commissioner*, 262 Mass. 1, 159 N.E. 536 (1928) and *Moore v. Tax Commissioner*, 237 Mass. 574, 130 N.E. 59 (1921).

distributions are presumed to be from earnings and profits as such existed (on the date of distribution)."<sup>12</sup>

The statutory definition of a dividend makes it clear that the entire earned surplus at the time of distribution (whether or not part or all of this surplus was accumulated prior to the passage of the Income Tax Act of 1937) is to be taken into account in ascertaining whether the distribution is out of "earnings".<sup>13</sup>

## II.

It has been suggested occasionally that despite the statutory definition of a dividend, the intent of the legislature was to tax distributions as dividends only to the extent that they result in "income" to the shareholder, and that

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<sup>12</sup> It should be noted that it is possible that after a distribution of property having a fair market value less than the corporate earned surplus there would remain in the corporation's hands property worth less than its paid in capital, although carried on the books at higher figures. In such a case, not all of the distributed property would constitute a dividend, if by the phrase "properly valued" the Attorney General was referring to fair market value. If this interpretation is correct, it is theoretically possible that a distribution worth less than accumulated earned surplus would be taxed only in part as a dividend with the remaining portion being regarded as a payment out of corporate capital. The Attorney General concluded that if capital was "unimpaired" immediately after the distribution, it should be regarded as a taxable dividend in its entirety. In analyzing the remaining corporate assets to discover whether capital is "unimpaired", the ruling is silent as to whether book values or market values should be used.

<sup>13</sup> See the definition of a dividend contained in Art. 81, § 279(j), *supra*. The key phrase *whenever earned* was added by MD. LAWS 1939, Ch. 277, § 12. The constitutionality of taxing, as income to shareholders, ordinary dividend distributions made out of surplus accumulated before the passage of the Federal Income Tax Act of 1913 was sustained in *Lynch v. Hornby*, 247 U. S. 339 (1918). However, in *Lynch v. Turrish*, 247 U. S. 221 (1918), a companion case involving the same Income Tax Act, it was held that liquidating proceeds paid out of earned surplus resulting from the pre-1913 appreciation of corporate assets which were sold immediately before the liquidation in 1914 could not be taxed as dividends to the stockholders. The distributee shareholders had held their stock prior to the passage of the 1913 Tax Law. The Court decided that this distribution simply was not "income". The two decisions, both handed down on the same day, are difficult to reconcile. One might argue that the *Turrish* case casts a cloud on the constitutional capacity of the State of Maryland to tax liquidation proceeds as income to the extent they represent earned surplus accumulated before 1937, the year the Maryland Income Tax was enacted, but it appears that decision was based principally on a construction of the relevant language of the taxing act. Moreover, liquidating distributions out of earned surplus accumulated before the enactment of the controlling taxing act have been taxed elsewhere as dividends. See, e.g., *Follett v. Commissioner*, 267 Mass. 115, 166 N.E. 575 (1929); *Moore v. Commissioner*, 237 Mass. 574, 130 N.E. 59 (1921); *Reeves v. Turner*, 289 Ky. 426, 158 S.W. 2d 978 (1942). See also *Boston Safe Deposit & Trust Co. v. Commissioner*, 262 Mass. 1, 159 N.E. 536 (1928); *Trefry v. Putman*, 227 Mass. 522, 116 N.E. 904 (1917).

in order for "income" to be realized to the stockholder, the liquidating proceeds must be in excess of the cost basis of his shares. All proceeds received which do not exceed this cost basis are not "income," but simply a return of capital not intended to be subjected to tax. This theory has on its face a certain degree of plausibility.<sup>14</sup> And were it now being advanced for the first time, it would appear to hold considerable merit. Such, however, is not the case.

When the Maryland Income Tax was enacted in 1937,<sup>15</sup> the provisions governing the treatment of liquidating dividends were adopted in substantially the same form in which they persist to the present day. And at the date of enactment these provisions, though new in Maryland, had already experienced an extensive history elsewhere, particularly in the early Federal Income Tax Laws,<sup>16</sup> which established a statutory framework for taxing dividends very similar to Maryland's. Income was defined broadly to include dividends, and a dividend was described as *any*

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<sup>14</sup> Proceeds of life insurance contracts received other than by reason of death are treated in this manner. Only that sum which exceeds the amount of the total premiums paid is taxed as income to the taxpayer who turns in his policy for its cash surrender value. This treatment, however, is specially prescribed by Art. 81, § 280(c), which excludes an amount equal to the total premiums paid from "gross income". An intent to tax the entire proceeds as income might be inferred in the absence of this provision. See *Tawes v. Strouse*, 182 Md. 508, 512, 35 A. 2d 233 (1943), where the Court said:

"It is thus clear that the [entire] proceeds of the surrendered life policy involved in the instant case is included within gross income. . . . The next question for determination is to what extent the proceeds are exempted from taxation by the subsequent provisions [of the Code]."

"The Maryland Legislature has seen fit to exempt from gross income only a sum 'equal to the total amount of the premiums paid therefor'."

<sup>15</sup> MD. LAWS 1937 (Spec. Sess.), Ch. 11, § 8.

<sup>16</sup> § II of the Act of 1913, Subsection B, 38 Stat. 167, defined as net income subject to tax "gains profit and income derived from . . . dividends . . ." but did not contain any definition of "dividend". The Act of 1916, § 2(a), 39 Stat. 757 went on to define a dividend in the following manner:

". . . any distribution made or ordered to be made by a corporation, joint stock company, association, or insurance company, out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders. . . ."

The Act of 1917, § 1211, 40 Stat. 337, 338 contained this same definition of a dividend. The Act of 1918, § 201, 40 Stat. 1059 defined a dividend in the same manner but added a provision stating that liquidation proceeds were to be treated as payments in exchange for the stock. The Act of 1921, § 201, 42 Stat. 228, dropped this provision to return to the same status as under the 1916 and 1917 Acts. Finally in 1924, Congress reverted back to the treatment of liquidation proceeds as receipts from the sale of stock. Acts of 1924, § 201(c), 43 Stat. 255. This theory has remained intact since then in the Federal Tax Law. It is presently embodied in I.R.C. 1954, § 331. But *cf.* the present § 333 which allows a stockholder to elect to be taxed as under the 1916 and 1917 Acts with certain limitations and conditions.

distribution out of corporate earnings and profits. It was quite clear that liquidating distributions were intended to be included in the general statutory definition of a dividend, and the courts consistently sustained the taxation of liquidation proceeds under these early laws. Often, the taxpayer realized income and loss from the same liquidating distribution. Income resulted from that portion of the proceeds which did not exceed the earned surplus of the corporation; a capital loss resulted to the extent the taxpayer's cost basis for the shares exceeded that part of the liquidation distribution not taxed as a dividend, i.e., that part of the proceeds which was regarded as a return of capital.<sup>17</sup> The income tax cases dealing with liquidating dividends under the early federal tax law are particularly significant in view of Maryland's express statutory direction that the Comptroller "shall apply as far as practicable the administrative and judicial interpretations of the federal income tax law."<sup>18</sup>

Tax statutes similar to Maryland's have been construed in other states to require that all liquidating proceeds not in excess of the corporation's earned surplus be subjected to tax as dividend distributions. The great weight of authority makes it clear that in determining whether a liquidating distribution is a return of "capital" to the stockholder, reference must be made to the corporation's affairs,—not the stockholder's. "Capital" means corporate capital. The price at which the shareholder purchased his stock is irrelevant as is the fact that this purchase price was partly attributable to earnings accumulated at that time.<sup>19</sup>

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<sup>17</sup> Appeal of James Dobson, 1 B.T.A. 1082 (1925), construing the Acts of 1916 and 1917; Frank D. Darrow v. Commissioner, 8 B.T.A. 276 (1927), construing the Act of 1921; Philetus W. Gates v. Commissioner, 9 B.T.A. 1133 (1928), construing the Act of 1921; Eric A. Pearson v. Commissioner, 16 B.T.A. 1405 (1929), construing the Act of 1921; Haystone Securities Corporation, 19 B.T.A. 954 (1930), construing the Act of 1921; Hamilton Woolen Co. v. Commissioner, 21 B.T.A. 334 (1930), construing the Act of 1921; McCaugn v. McCahan, 39 F. 2d 3 (3rd Cir. 1930), construing the Act of 1921; Commissioner v. Sansome, 60 F. 2d 931 (2d Cir. 1932), construing the Act of 1921. See also Darrell, *Corporate Liquidations and The Federal Income Tax Law*, 89 Univ. of Pa. L. Rev. 907 (1941); Magill, *Realization of Income through Corporate Distributions*, 36 Col. L. Rev. 519 (1936); Note, *Stock Redemption or Cancellation Taxable as Dividend*, 49 Harv. L. Rev. 1344 (1936); Note, *Income Taxation of Liquidating Dividends*, 47 Yale L. J. 1146 (1938); Powell, *Income from Corporate Dividends*, 35 Harv. L. Rev. 363 (1922); Magill, *The Income Tax Liability of Dividends in Liquidation*, 23 Mich. L. Rev. 565 (1925).

<sup>18</sup> Art. 81, § 304, cited and applied in *Tawes v. Strouse*, 182 Md. 508, 35 A. 2d 233 (1943); *Fleischmann v. Lacy*, 191 Md. 648, 62 A. 2d 561 (1948).

<sup>19</sup> In *Boston Safe Deposit & Trust Co. v. Commissioner*, 262 Mass. 1, 159 N.E. 536, 538 (1928), the Court said:

There is, however, one Iowa decision<sup>20</sup> holding that liquidation proceeds did not constitute dividends but were instead the proceeds of a sale or exchange of the stock and were exempt under a provision of the Iowa law excluding capital gains from income. The Court reached this conclusion in spite of the statutory definition of a dividend as any distribution made by a corporation out of its earnings as profits. The case seems patently unsound.<sup>21</sup>

In view of the cases interpreting the early Federal tax laws, and those out of state decisions construing statutes very similar to Maryland's and of the Maryland Attorney General's opinion already discussed, it is very difficult to escape the conclusion that the Maryland Legislature intended by its statutory definition of "dividend" to tax as income liquidation proceeds to the extent they represent earned surplus, without regard to the cost basis of the shares in the hands of the distributee shareholder. Let us turn now to the constitutionality of this result.

### III.

The only constitutional challenges possible under the Maryland Constitution would appear to emanate from Articles 15 and 23 of the Declaration of Rights. The first establishes a requirement of uniformity with respect to the levy of property taxes. The latter is our so-called "due process" article. It is settled that the Maryland Income Tax is not a property tax and therefore is without the scope of Article 15.<sup>22</sup> Since the rights protected by Article

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"In the light of [the statute] . . . plainly it is an immaterial circumstance whether the stockholder made an investment of his own capital in the hope of receiving a dividend of accumulated profits. The Legislature, acting within its power, has stamped such dividend of accumulated profits as income and taxable as such."

See also *Follett v. Commissioner*, 267 Mass. 115, 166 N.E. 575 (1929); *Falk v. Wisconsin Tax Commission*, 218 Wis. 130, 259 N.W. 624 (1935); *Reeves v. Turner*, 289 Ky. 426, 158 S.W. 2d 978 (1942); Annotation, *Liquidation Dividends as Taxable Income*, 65 A.L.R. 148; Lockyer, *Kentucky Income Tax Compared with Federal Income Tax*, 42 Ky. L. J. 368, 381; Note, *Virginia Taxation — Deductibility of Earnings Received as Liquidation Distribution*, 40 Va. L. Rev. 519, 525 et seq. (1954).

<sup>20</sup> *Lynch v. State Board*, 228 Iowa 1000, 291 N.W. 161 (1940).

<sup>21</sup> The Court leaned heavily on *Lynch v. Turrish*, 247 U. S. 221 (1918), *supra*, n. 13, which held only that that part of the corporation's earned surplus which was attributable to the appreciation of its assets occurring before the enactment of the Income Tax Act was not to be regarded as income when distributed as a liquidating dividend. Properly interpreted, *Turrish* is not authority for the proposition that no part of any liquidating dividend is to be regarded as income.

<sup>22</sup> *Oursler v. Tawes*, 178 Md. 471, 481, 485, 486, 13 A. 2d 763 (1940); *Harmon v. M. & C. C. of Baltimore*, 189 Md. 191, 197, 55 A. 2d 491 (1947). See *Kelly, Maryland Classified Income Tax of 1939*, 5 Md. L. Rev. 77, 87 et seq. (1940); *Cairns, History and Constitutionality of the*

23 of the Maryland Declaration of Rights have been construed to be identical with those embodied in the "due process of law" clause in the 14th Amendment of the United States Constitution,<sup>23</sup> we will at this point direct our attention to the 14th Amendment. Whatever conclusions we are able to reach will be applicable equally to Maryland's Article 23.

Is it violative of due process to tax as income to a shareholder those liquidation proceeds which are attributable to earned surplus accumulated by the corporation prior to the date the shareholder purchased his shares? In such a case, is not the tax unlawfully measured and imposed on income which is attributable to predecessor shareholders, and which, if taxed at all, should have been taxed to them? Is it within the bounds of due process to tax as income liquidation proceeds receipt of which results in no gain or profit to the shareholder on his original investment? Can one have income without gain consistently with due process?

The case which sheds most light on these questions is *United States v. Phellis*,<sup>24</sup> decided by the Supreme Court in 1921. In 1915, a New Jersey corporation underwent a reorganization pursuant to which most of its properties were transferred to a newly formed Delaware corporation, in return for which stock and securities of the new corporation were issued to the old corporation. This stock in turn was passed on to the stockholders of the New Jersey corporation which continued in existence. The government taxed the entire value of the stock distributed to the New Jersey corporation shareholders as a dividend to them under the Federal Income Tax Act of 1913. It was conceded that the accumulated surplus of the New Jersey corporation exceeded the value of the new Delaware stock distributed. The taxpayers' brief contained the following argument:

"As an illustration: An investor bought on September 25, 1915, one share of the New Jersey company for \$795.00, its then alleged market value. This stockholder's income from other sources was such that if the present law had then been in effect he would have

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*Maryland Income Tax Law*, 2 Md. L. Rev. 1 (1937); Lewis, *Tax Articles of the Maryland Declaration of Rights*, 13 Md. L. Rev. 83 (1953).

<sup>23</sup> *County Commissioners of Anne Arundel County v. English*, 132 Md. 514, 35 A. 2d 135 (1943); *Oursler v. Tawes*, 178 Md. 471, 13 A. 2d 763 (1940); *Home Utilities Co., Inc. v. Revere Copper & Brass, Inc.*, 209 Md. 610, 122 A. 2d 109 (1956).

<sup>24</sup> 257 U. S. 156 (1921).

been required to pay fifty per cent of the income received as a tax. On October 1, 1915, there were issued to him two shares of the Delaware company worth at the time \$347.50 per share, and he still held his one share in the New Jersey company of the par and market value of \$100.00; the result of which was that he had three certificates representing his investment worth exactly the same amount as he had paid for the one certificate in the New Jersey company. The Government's contention now is that both shares of the Delaware company are income, and that one share must be sold and the \$347.50 realized therein must be paid to the Government as income tax, and then the stockholder would have left one share of the New Jersey company worth \$100.00, and one of the Delaware company worth \$347.50, a total of \$447.50, in place of the \$795.00, which he had paid for the share of the New Jersey company. Yet the Government urges that this stockholder has received in the calendar year by this transaction a gain or profit on his investment."<sup>25</sup>

Despite the common-sense appeal of this argument, the Court held in favor of the Government. The opinion (Justice Pitney) stated:

"The possibility of occasional instances of apparent hardship in the incidence of the tax may be conceded. Where, as in this case, the dividend constitutes a distribution of profits accumulated during an extended period and bears a large proportion to the par value of the stock, if an investor happened to buy stock shortly before the dividend, paying a price enhanced by an estimate of the capital plus the surplus of the company, and after distribution of the surplus, with corresponding reduction in the intrinsic and market value of the shares, he were called upon to pay tax upon the dividend, it might look in his case like a tax upon his capital. But it is only apparently so. In buying at a price that reflected the accumulated profits, he of course acquired as a part of the valuable rights purchased the prospect of a dividend from the accumulations; — brought 'dividend on' as the phrase goes — and necessarily took subject to the burden of the income tax properly to be assessed against him by reason of the dividend if and when made. He simply

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<sup>25</sup> *Ibid.*, 163, 164.

stepped into the shoes, in this as in other respects, of the stockholder whose shares he acquired, and presumably the prospect of a dividend influenced the price paid, and was discounted by the prospect of an income tax to be paid thereon. In short, the question whether a dividend made out of company profits constitutes income of the stockholder is not affected by antecedent transfers of the stock from hand to hand.<sup>26</sup>

The constitutionality of the requirement that a succeeding owner of stock be compelled to assume the place occupied by his predecessor for purposes of taxation was reaffirmed in *Taft v. Bower*,<sup>27</sup> which sustained a federal statute assigning to the donee of certain shares their basis in the hands of the donor, for purposes of computing the gain to be taxed to the donee upon the sale by him of the shares. Other cases have affirmed the application of the income tax transactions which have produced "income" without gain.<sup>28</sup>

It would appear that the 14th Amendment imposes no bar to the taxation of liquidation proceeds as dividends to the extent attributable to corporate earned surplus,—without regard to the cost basis of the redeemed shares in the hands of the distributee stockholders; but however justifiable this result may be from a constitutional point of view, it is indefensible from the standpoint of sound tax policy. To require a taxpayer to return as income upon liquidation sums which are in excess of the actual gain realized by him on his stock investment is patently unfair and inequitable. It cannot fail to produce the conviction in the taxpayer that he has been wronged. It breeds disrespect (and, perhaps, disregard) for the Tax Law in its entirety. It should be changed.<sup>29</sup>

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<sup>26</sup> *Ibid*, 171, 172. This case has aptly been referred to as "the miracle of income without gain". Powell, *Income from Corporate Dividends*, 35 *Harv. L. Rev.* 363, 370 (1922).

<sup>27</sup> 278 U. S. 470 (1929).

<sup>28</sup> See e.g. *Helvering v. Midland Mutual Life Insurance Co.*, 300 U. S. 216 (1937); *Burnet v. Sanford & Brooks Co.*, 282 U. S. 359 (1931). But cf. *Bowers v. Kerbaugh-Empire Co.*, 271 U. S. 170 (1926); and *Parker v. United States*, 88 F. 2d 907 (7th Cir. 1937).

<sup>29</sup> Probably the simplest change would be to amend Art. 81, § 279(j) to read somewhat as follows:

"Amount paid in liquidation or dissolution of a corporation shall be treated as dividends only to the extent that they represent earnings of the corporation and are in excess of the stockholder's basis for the shares with respect to which the dissolution is being made. For purposes of this subsection, the stockholder's basis for