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Ronald B. Cohen*

It is fairly well established that cancellation of indebtedness ordinarily will be treated as income to a debtor corporation unless the debt was forgiven by a stockholder.1 In the latter case, the corporation normally treats the resulting benefit as a contribution to capital.

This treatment does not seem unreasonable when the debt owed to the stockholder was created by a transfer to the corporation of money or property. However, there is a much more delicate situation when the debt is the result of unpaid salaries, interest, or other corporation expenses. In the typical case, these items would have reduced the income of the corporation in the year of accrual,2 but would not have been picked up as income by the cash basis stockholder. Therefore, the effective result of forgiveness of salaries and interest would be that a corporation could eliminate tax on the amounts accrued, while the stockholders would have no tax until dissolution, at which time they would receive a "return of capital" and pay only at the capital gain rates.

The specific problem is not mentioned in the Code and is likewise ignored in the Regulations. Consequently, a thorough look at what the case law has been is needed to see how current transactions of this nature are likely to be handled by the courts.

Case Law

When the Federal Income Tax was young, the collectors had a very difficult time trying to convince judges that any forgiveness of any debt could ever be called income to any debtor. The regulations insisted that certain types of forgiveness should be treated as income, but the courts continually opposed this concept, saying that voluntary forgiveness was a gift.3

Finally, in 1931, the Supreme Court decided *United States v. Kirby Lumber Co.*,4 and the confusion had begun. Although an

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2 The effect of accruals to stockholders owning more than 50% of the outstanding stock is discussed below.
3 The leading case was Bowers v. Kerbaugh-Empire Co., 271 U. S. 170 (1926).
4 United States v. Kirby Lumber Co., 284 U. S. 1 (1931). During the course of a single year, the corporation issued bonds at par and bought them back at a discount of $137,000.00. The Court held that this profit must be considered income and not a gift.
attempt was made at distinguishing Bowers v. Kerbaugh-Empire,\textsuperscript{5} it was effectually overruled. Justice Holmes easily brushed aside the long standing view of the courts by saying, "We see no reason why the Regulations should not be accepted as a correct statement of law."

The problem of how to treat the cancellation of accrued, previously-deducted expenses was first answered by the Circuit Court in the \textit{Auto Strop}\textsuperscript{6} case. The Commissioner argued strenuously that since the corporation had deducted the expenses and the cash basis, 100\% stockholder never reported the income, an unjust tax benefit would be realized unless the forgiveness was deemed to be income.

In his decision, Circuit Judge Chase reasoned, "When the indebtedness was cancelled, whether or not it was a contribution to the capital of the debtor depends upon considerations entirely foreign to the question of payment of income taxes in some previous year."

This was the law until the very important case of Helvering \textit{v. Jane Holding Corp.},\textsuperscript{7} the decision which promptly threw this area of the law into a turmoil. In this case, the corporation owed $2,500,000.00 in previously deducted interest to a cash basis trust that was the sole stockholder. This debt was forgiven, creating an enormous avoidance of income tax by the parties. In the court's decision, the primary reason for forcing inclusion of the cancellation as income was the tax benefit idea—that the items which were deducted when accrued should be taxed when cancelled.

The court did not, however, overrule the \textit{Auto Strop}\textsuperscript{8} case, but chose to distinguish it on the basis that the forgiveness by the trust was actually not gratuitous but motivated by other valid business reasons. As the law later developed this was established as a sufficient cause for calling the forgiveness income.

Nevertheless, several important cases\textsuperscript{9} were decided based on the premise that a tax benefit had been realized, on the authority of \textit{Jane Holding Corp.}\textsuperscript{10} In these cases, there was no claim that the cancellations were non-gratuitous and they clearly opposed the rule in the \textit{Auto Strop}\textsuperscript{11} case.

\textsuperscript{5} \textit{Supra}, note 3.
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\textsuperscript{6} Commissioner \textit{v. Auto Strop Safety Razor Co.}, Inc. 74 F. 2d 226 (2d Cir. 1935).
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\textsuperscript{7} 109 F. 2d 933 (8th Cir. 1940) \textit{Cert den.}, 311 U. S. 672.
\hfill
\textsuperscript{8} Commissioner \textit{v. Auto Strop Safety Razor Co.}, \textit{supra} note 6.
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\textsuperscript{9} Three of these cases were Beacon Auto Stores, Inc. \textit{v. Commissioner}, 42 B. T. A. 703 (1940); Howard Paper Co., Inc. \textit{v. Commissioner}, 43 B. T. A. 545 (1941), Amsco-Wire Products Corp. \textit{v. Commissioner}, 44 B. T. A. 717 (1942).
\hfill
\textsuperscript{10} \textit{Supra}, note 7.
\hfill
\textsuperscript{11} \textit{Supra}, note 6.
However, not all the courts swallowed this idea. In re Triple Z. Products, Inc. was decided shortly after the Jane Holding Corp. case and took a completely opposite view. District Judge Leibel stated in his opinion, "He [the Referee] cited the Jane Holding Corporation case as ruling that the controlling factors are the previous deductions offsetting income otherwise taxable and the subsequent release of indebtedness before payment, the means of cancellation being unimportant. I agree that they should be the controlling factors, but the Regulations do not so provide and the law of the Second Circuit is to the contrary." 14

In 1943 the Supreme Court decided Helvering v. American Dental Co. case, which has been the leading case in the entire forgiveness field since that time. Although the case did not involve stockholders, the issues were clear and the results analogous. For many years rent and interest had been accrued and deducted. When the indebtedness was forgiven, the corporation treated it as a gift. In upholding the taxpayer, the court felt that no gratuitous cancellation could possibly be taxable.

The dynamic effect that this case had was evident in Brown Cab Co., Inc. where accrued salaries were forgiven by stockholder-employees. The Tax Court vacated its prior decision in the same case and held, on the authority of American Dental Co., that there was no income realized. No subsequent case involving stockholders has varied from this holding. 18

The last important case concerning the problem was Commissioner v. Jacobson, which limited the broad scope of American Dental Co. In that case the taxpayer bought back indebtedness from bondholders at far less than par. The court reasoned that the difference was not a gratuitous forgiveness, but resulted because the bonds were sold at the best available price. In determining that the difference was taxable, the court laid down the most significant rule to date: There must be donative intent.

Legislation

It is very likely that the resulting tax benefit arising from stockholder's forgiveness is not an intended one. If carried to its extreme, most closely held corporations could effectively trans-

13 Supra, note 7.
14 A similar view was adopted in Carroll-McCreary Co., Inc. v. Commissioner, 124 F. 2d 303 (2nd Cir. 1941).
15 318 U. S. 322 (1943).
16 1 T.C.M. 450 (1943).
17 Supra, note 15.
18 Another early case that followed American Dental Co. was Pancoast Hotel Co., v. Commissioner, 2 T.C. 362 (1943).
20 Supra, note 15.
fer current profits into paid-in capital without ever subjecting them to any income tax.

However, the Code\textsuperscript{21} has eliminated any chance of this type of tax avoidance for most closely held corporations, merely by saying that rent, salaries, interest, etc. accrued to majority stockholders (attribution rules applying) cannot be deducted unless paid within seventy-five days after the close of the corporate year.

This eliminated the possibility of any one family using the forgiveness angle as a means to save taxes. However, since the "seventy-five day rule" applies only to holders of more that 50\% of the outstanding stock, what is to stand in the way of the corporations and the stockholders where there are two, three, or four equal owners? As far as Case Law, Code, or Regulations are concerned, the answer is "nothing." Nevertheless, good old common sense might discourage many from taking this course where the forgiveness is the culmination of a scheme to effect tax savings.

In the original drafting of the 1954 Code, Section 76\textsuperscript{22} provided a comprehensive treatment of all forgiveness of indebtedness which would have eliminated the tax benefit involving these accruals. However, this provision was killed in committee without explanation before reaching the floor of the Senate. The Conference Committee, in a later bill,\textsuperscript{23} noted the elimination, requiring that current rules be followed in this area.

Subchapter S Corporations

It seems probable that any of these rules which apply to conventional corporations will be extended to those electing to have their stockholders taxed directly.\textsuperscript{24} Consequently, an electing corporation that breaks even could show a loss by accruing officers' salaries to stockholders. This loss could be currently deducted from the income of the individuals, and forgiveness at a later date would create income neither to the stockholders nor to the corporation.

Conclusion

It seems that this area of the income tax law might represent to some taxpayers an honest-to-goodness, old-fashioned loophole; one that should be closed soon by statute or regulation. However, until that day, all practitioners should be aware of its existence, and of the two requirements which must be met before the benefits can be safely assured.

\textsuperscript{22} HR Rep. No. 1337, 83d Cong. 2d Sess. at 709 (1954).
\textsuperscript{23} HR 2534, 83d Cong. 2d Sess. 23 (1954).
The first is that the accrual must be a bona fide one and not set up with the expectation that it will be forgiven tax-free at a later date. If that is done the expense is not deductible since it is not an ordinary and necessary expense of the corporation.

The second is that there be a genuine donative intent. Whether the desire to make a gift because of the beneficial tax results shows "donative intent" cannot be answered here. It is fairly certain, though, that the precarious financial position of a corporation is a natural cause for a completely gratuitous forgiveness.

Once both these requirements are met, it appears that forgiveness of accrued, previously deducted expenses will not create taxable income to the corporation.