Hastings Law Journal

Volume 17 | Issue 4 Article 8

1-1966

May a Cancellation of Indebtedness be Income to the Creditor

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NOTES

MAY A CANCELLATION OF INDEBTEDNESS BE INCOME TO THE CREDITOR? *Commissioner v. Fender Sales, Inc.*[1]

From the time that the income tax was first levied under the sixteenth amendment, the Commissioner of Internal Revenue has taken the position that cancellation of indebtedness may result in taxable income to the debtor.[2] The simplest case is that used as an example in the current Treasury Regulations.[3] If a debtor performs services for his creditor, and in return the creditor cancels the debt, the debtor has realized income in the amount of the debt. The courts at first refused to accept this theory, and in the early cases held that the debtor did not "realize" taxable income from the cancellation.[4] The scope of the concept of income seems to have been restricted to some tangible gain out of which the tax could be paid.

The United States Supreme Court adopted the Commissioner's position in 1931 in *United States v. Kirby Lumber Co.*[5] The taxpayer had issued bonds at par value, then later in the same tax year purchased some of the bonds on the open market for less than par value. Justice Holmes' very short opinion states that a clear gain was realized because the dealings made available "assets previously offset by the obligation of bonds now extinct."[6]

The issue of the tax results of cancellation of indebtedness has been widely discussed since the decision of *Kirby*.[7] The courts have reached a number of different results from the multitude of fact situations presented by the cases. For example, the benefit flowing to the debtor may result in increase in net worth,[8] compensation for services,[9] a taxable dividend,[10] a reduction in purchase price of property,[11] a gift,[12] or a contribution to corporate capital.[13] This note will be primarily concerned with the last: the creditor's contribution of the debt to the debtor's capital.

Treasury Regulations section 1.61-12(a) states that discharge of indebtedness may result in realization of income, giving the example stated above. It goes on:

1 338 F.2d 924 (9th Cir. 1964), *cert. denied*, 381 U.S. 935 (1965).

2 Treas. Reg. 33, art. 135 (1913); expanded by Treas. Reg. 45, art. 544 (1918) and Treas. Reg. 45, art. 51 (1921).

3 Treas. Reg. § 1.61-12(a) (1957).

4 See Burnet v. John F Campbell Co., 50 F.2d 487 (D.C. Cir. 1931) and cases cited therein.

5 284 U.S. 1 (1931).

6 *Id.* at 3.

7 See, *e.g.*, Darrel, *Discharge of Indebtedness and the Federal Income Tax*, 53 HARV. L. REV. 977 (1940); Surrey, *The Revenue Act of 1939 and the Income Tax Treatment of Cancellation of Indebtedness*, 49 YALE L.J. 1153 (1940); Warren & Sugarman, *Cancellation of Indebtedness and its Tax Consequences* (pts. 1-2), 40 COLUM. L. REV. 1326 (1940), 41 COLUM. L. REV. 61 (1941).

8 United States v. Kirby Lumber Co., 284 U.S. 1 (1931).

9 Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929).

10 Fitch v. Helvering, 70 F.2d 583 (8th Cir. 1934).

11 Hirsch v. Commissioner, 115 F.2d 656 (7th Cir. 1940).

12 Helvering v. American Dental Co., 318 U.S. 322 (1943).

13 Commissioner v. Auto Strop Safety Razor Co., 74 F.2d 226 (2d Cir. 1934).

"In general, if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt." The first important case on this point was *Commissioner v. Auto Strop Safety Razor Co.*[14] In that case, one subsidiary corporation accrued debts for royalties, loans, and interest owing to another subsidiary of its parent corporation. The creditor was liquidated and all its assets were assigned to the parent corporation, which was the sole shareholder of the debtor. The Second Circuit held the subsequent cancellation of the entire debt to be a contribution to the capital of the debtor, and therefore not taxable as income to the debtor.[15] Apparently, no significance was placed upon the fact that part of the debt represented the principal of a loan and the rest was incurred as expenses of interest and royalties.

In 1940 the Eighth Circuit made a distinction between debts of principal and interest. In *Helvering v. Jane Holding Corp.*[16] a trust, sole shareholder of the debtor corporation, cancelled accrued interest debt so it could make distributions to beneficiaries. The trust instrument provided no distributions could be made while there were outstanding interest debts. It was held by application of the "tax benefit" rule that the cancellations were taxable income to the debtor.[17] The taxpayer had enjoyed the tax benefit of deductions for expenses in the amount of the interest as it was accrued—expenses which it was never required to pay. In order to recoup this tax previously avoided, the interest debt cancelled was treated as taxable income to the debtor, and not as a contribution to capital. It should be noted here that the stockholder-creditor reported income on a cash basis, and therefore had never reported the interest as income as it was never paid.

The question whether the cancellation of expense indebtedness is to be treated as income to the debtor corporation came before the Second Circuit again in *Carroll-McCreary Co. v. Commissioner.*[18] Three shareholders cancelled salary debts accrued and owing to them from the corporation. The corporation was insolvent, and the debts were forgiven pursuant to an agreement made by the shareholders with its creditors for extension of time on other debts of the corporation. The amount of the debts cancelled was held to be a contribution to capital, not taxable income to the debtor.[19] The creditors had reported income using the accrual method, and had included the salaries in their gross income for the years in which they were accrued.

It would seem that the result of *Carroll-McCreary* could have been reached on other grounds. Prior cases had established generally that there is no income realized if the debtor is insolvent both before and after the cancellation of indebtedness.[20] Since Carroll-McCreary Co., Inc. was insolvent both before and after the debt was cancelled, the decision that it realized no taxable income could have been reached without ever discussing the fact that the creditor was a share-

[14] *Ibid.*

[15] *Id.* at 227.

[16] 109 F.2d 933 (8th Cir. 1940).

[17] *Id.* at 941-42.

[18] 124 F.2d 303 (2d Cir. 1941).

[19] *Id.* at 305.

[20] *E.g.*, Dallas Transfer & Terminal Warehouse Co. v. Commissioner, 70 F.2d 95 (5th Cir. 1934).

holder. Nonetheless, the case has been regarded as binding precedent for the rule that indebtedness cancelled by a stockholder of the debtor corporation is a nontaxable contribution to capital.[21] Such a rule ignores the fact that the debtor may have received a "tax benefit" from the prior deductions of the debts as expenses—expenses which were never paid. This rule opens a tax loophole in cases where the debtor uses the accrual method for reporting its income, and the creditor reports income using the cash method. This loophole is particularly available where the debtor is a closely held corporation. By accruing salaries to shareholder-employees, the corporation is able to take advantage of sizable tax deductions. Payment of these expenses can be postponed indefinitely, or in a later year the creditor-shareholder may forgive the debt and treat it as a contribution to capital. The net result is a neat avoidance of income tax on otherwise taxable gains.

Congress partially closed this loophole in 1937[22] by refusing to allow a deduction if the expense or interest was not actually paid within two and one-half months after the close of the tax year of the debtor, and if the expense was not includible in the gross income of the creditor in the same tax year that it was accrued by the debtor. This provision applies only where the creditor owns or controls more than fifty per cent of the outstanding stock of the debtor, or where there are certain other relationships between the debtor and creditor. Where the creditor owns fifty per cent or less of the stock, this statute does not apply.

This tax loophole problem was raised in *Commissioner v. Fender Sales, Inc.*[23] Fender Sales, Inc., hereinafter called Sales, is a California corporation organized primarily to distribute the products of Fender Instrument Co., Inc. At the time of the transactions involved in the case, Sales' outstanding stock was distributed fifty per cent each to C. Leo Fender and Donald D. Randall. Fender and Randall were also employees of Sales, with salaries previously set at 15,000 dollars per year each, plus one per cent and four per cent, respectively, of annual sales.

Sales had always been solvent, but from its inception it had been plagued by a shortage of cash. This financial predicament was caused by a requirement that it pay for its purchases upon receipt from the manufacturer, while it was often required to extend credit to its own customers. The cash shortage induced Fender and Randall to forbear drawing their salaries for fiscal years 1954-1956. Sales accrued the salaries on its books and deducted the 30,000 dollars as expenses on its income tax returns for those years. Fender and Randall, using the cash basis, reported no income from the salaries in the years they were accrued by the corporation.

In 1955 Sales found its working capital so low it turned to bank financing for additional cash. Originally, the bank did not ask for security, but later required the subordination of other liabilities to the notes, and personal guarantees on the notes from the corporate officers. In addition, it became concerned about the outstanding salary obligations, which by 1956 had reached a total of 90,000 dollars. The bank believed these liabilities may represent potential priority claims over its claim, so suggested the liabilities be capitalized.

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21 Commissioner v. Fender Sales, Inc., 338 F.2d 924, 933 (9th Cir. 1964) (dissenting opinion).

22 Int. Rev. Code of 1936, § 24(a), as amended, ch. 815, § 301(c), 50 Stat. 828 (1937) (now INT. REV. CODE OF 1954 § 267(a)(2)).

23 338 F.2d 924 (9th Cir. 1964), *cert. denied*, 381 U.S. 935 (1965).

To comply with the bank's request, Sales issued additional stock to Fender and Randall, on a dollar-for-dollar exchange for salary debt. Thus Fender and Randall each received 450 shares of 100 dollar par value stock and cancelled 45,000 dollars of salaries owed to them. In 1958 another 150 shares of 100 dollar par value stock was issued to Fender and Randall each in discharge of 15,000 dollars of salaries accrued to each in 1957. Neither Fender nor Randall included these transactions in his income tax returns for 1956 and 1958, and Sales did not report any income resulting from the cancellation of these salary debts. The Commissioner took the position that the receipt of stock constituted taxable salary income to Fender and Randall, or in the alternative, that Sales realized taxable income upon the cancellation of the salary debt.[24]

The Tax Court held that the transaction did not result in taxable income either to Fender and Randall or to Sales.[25] Its opinion was that the issuance of additional shares in proportions equal to their original interest in the corporation did not constitute a taxable gain to Fender and Randall. Rather, the transaction was held analogous to a stock dividend, and within the rule of *Eisner v. Macomber*[26] that a stock dividend is not "income" within the taxing power conferred by the sixteenth amendment.[27] As to the tax liability of Sales, the Tax Court followed the prior cases in holding the gratuitous forgiveness by a shareholder of the corporation's debt was a non-taxable contribution to capital.[28]

The Ninth Circuit reversed the Tax Court and held that Fender and Randall realized taxable income in the tax years in which the additional stock was issued to them.[29] The court rejected the contention of the taxpayers and the holding of the Tax Court that because the stock ownership percentage of Fender and Randall remained equal after the additional stock was issued, they received nothing which they did not already possess; *i.e.*, the entire capital stock of Sales. The majority believed the case within Treasury Regulations section 1.61-2(d)(4), which provides: "[I]f a corporation transfers its own stock to an employee as compensation for services, the fair market value of the stock at the time of transfer shall be included in the gross income of the employee " The *Eisner* stock dividend situation was said to be "not even apposite."[30] When a stock dividend is made, the net worth of the corporation, excluding capital accounts as liabilities, is not changed. The stockholders retain an equal interest in the same investment. But in *Fender Sales*, "the stockholders have retained an equal interest in a substantially different investment."[31] The net worth of Sales was increased by 120,000 dollars. The interests of Fender and Randall substantially increased in value and they received a gain constituting income taxable under the sixteenth amendment.

With respect to the tax effect of the transaction to Sales, the debtor, the Tax Court's holding was affirmed. The Court of Appeals agreed that the prior cases, *Carroll-McCreary* and *Auto Strop*, have established a controlling precedent for

[24] *Id.* at 926.
[25] 22 CCH Tax Ct. Mem. 550 (1963).
[26] 252 U.S. 189 (1920).
[27] *Id.* at 219.
[28] 22 CCH Tax Ct. Mem. at 562.
[29] 338 F.2d at 929.
[30] *Id.* at 927.
[31] *Ibid.*

the rule that cancellation by a shareholder of debts owed him by his corporation must be treated as nontaxable contributions to capital.

The basic issue presented by this case is whether either of the parties realized a taxable gain from the transaction. At first glance this appears to be a simple case of payment of salaries with stock rather than money; indeed the court based its decision on this theory. The complication is that equal shareholders received equal amounts of additional stock. Before the transaction Fender and Randall each owned fifty per cent of the outstanding stock in Sales, and after the transaction they each still owned fifty per cent. Neither has increased his proportionate ownership in the corporation. The situation thus presented is quite similar to that of a stock dividend. The distinction made by the court between this case and the *Eisner* stock dividend is that here the value of the shareholders' interest in the corporation actually increased, due to increase in the net worth of the corporation from the cancellation of a part of its liabilities. This distinction needs further examination.

The book value of a shareholder's equity in a corporation increases with any increase in net worth of the corporation. But such increases in the value of a shareholder's interest are ordinarily not recognized as a taxable gain to the shareholder until he "realizes" income by some tangible event, such as payment of a dividend other than a stock dividend, or by selling the shares at a profit.[32] As Judge Barnes points out in his dissenting opinion, Fender and Randall might have contributed their services to Sales without any provision for salaries. The net worth of the corporation would have increased as a result of their efforts, and the value of their stock in the corporation would have increased. But they would not have "realized" any income, and would not be subject to tax on this gain.[33] The majority opinion distinguishes that situation from the case under consideration on the ground that in the case there was a present, not an antecedent, increase in the net worth of the corporation as a result of the discharge of its salary debts. The court held that where additional stock is issued to shareholders in discharge of salary debts, the event is sufficient for the resulting increase in the net worth of the corporation to constitute a "realization" of income by the shareholders within the meaning of the sixteenth amendment. Therefore, section 61 of the Internal Revenue Code of 1954 and Treasury Regulations section 1.61-2(d) are applicable and Fender and Randall are subject to tax on the stock notwithstanding the fact that their proportionate interest in the corporation was not increased.

The taxpayers had argued: first, the receipt by equal stockholders of equal additional shares, without more, is not a taxable event; second, the cancellation of a debt does not constitute taxable income to the creditor; and therefore, the simple combination of the two in a single transaction does not generate a taxable event. The court could easily have dismissed this contention on the ground that the case involved was a single event—the discharge of a salary debt by issuance of additional shares of stock—which the court holds to be a taxable event. But the court did not stop there. It went on to say, "We are not prepared to hold that the voluntary surrender or forgiveness by a taxpayer of a receivable which, if collected, would represent taxable income, is, in all circumstances, a nontaxable event."[34]

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[32] Eisner v. Macomber, 252 U.S. 189, 214 (1920).
[33] 338 F.2d 924, 931 (9th Cir. 1964) (dissent).
[34] 338 F.2d at 928.

It appears that the court went out of its way to discuss the cancellation of indebtedness issue in order to give its answer to a question not actually presented by the case. That is the question of the tax effects of a voluntary cancellation by a shareholder of his corporation's debt which would be income to him if paid. If Fender and Randall had merely cancelled the salary debts without taking more stock in exchange, the net worth of the corporation would have made the same increase as it did in the case before the court. The value of the shareholders' interest would also increase by the same amount. The question would then be whether the cancellation of the salary debt constitutes a realization of taxable income to either the debtor corporation or the creditor shareholder. If the transaction is not treated as income to either of the parties, then a simple device for tax avoidance is available whenever the corporate employer uses the accrual method for reporting income and its shareholder-employee uses the cash method for reporting income and owns fifty per cent or less of the stock in the corporation. Under such circumstances, the corporation may accrue salaries to its shareholder-officers and deduct these salaries as operating expenses in the year accrued. These salaries will not be included in the income of the employee because they are not paid. In a subsequent tax year the employee will cancel the debts. The net effect will be that the corporation has received tax-free income to the extent of the salary deductions.

The most realistic and reasonable solution would seem to be that of recognizing income to the corporation. The court believes existing case law precludes this solution and requires that the corporation treat the cancellation as a nontaxable contribution to capital. Thus the court would stretch the "dominion and control" theory of *Helvering v. Horst*[35] to impose tax liability on the shareholder-employees, in a case where no stock is issued in exchange for the cancellation of their salary claim. Its theory is that since the creditor benefitted the debtor by relinquishing his rights, the creditor has exercised dominion and control over the disposition of assets to such an extent as to amount to "realization of income." That reasoning is sound as applied in *Horst*. There the owner of coupon bonds gave the coupons to his son, then contended the interest paid on the coupons was income to the donee. The United States Supreme Court held the income taxable to the donor, stating that the income tax applies "to income derived from interest or compensation when he who is entitled to receive it makes use of his power to dispose of it in procuring satisfactions which he would otherwise procure only by the use of the money when received."[36] The Ninth Circuit felt that the shareholder-creditors would have "more surely 'realized' for their own benefit the value of the obligations discharged than did Horst in his gift of interest coupons to his son."[37]

But in the creditor-shareholder case, the creditors would not have diverted their assets to anyone else. In effect, they have merely changed the form of their assets from a receivable to a capital interest. If a gain is actually realized later, they will still be the persons who realize it and who will be taxed on it.

If they receive no stock, they as individuals have had no increase in net worth at the time of the cancellation of their claims. If anything their net worth is decreased. The salary debt had a priority at least equal to that of other unsecured

[35] 311 U.S. 112 (1940).
[36] *Id.* at 119.
[37] 338 F.2d at 929.

claims, and would be paid along with the claims of general creditors if the corporation were forced to liquidate. But as shareholders, their assets are subjected to the future success or failure of the corporation. After their salary claims are cancelled, it becomes less certain how much gain will ever be realized. They would receive nothing from a liquidation until all creditors have been paid.

Instead of stretching *Horst*, a more realistic view would be to apply the tax benefit rule of *Jane*,[38] in a case where the stockholder employee has not received shares for the cancellation of his salary claim. Since the corporation has had the benefit of deductions for the salaries which now will never be paid, it is just and equitable to require it to pay the tax previously avoided. This is in effect treating the cancellation as a rescission of the agreement to pay salaries.

It has been thought that *Jane* was overruled and the view of *Carroll-McCreary* implicitly adopted by the Supreme Court in *Helvering v. American Dental Co.*[39] In that case the creditor, who was not a shareholder of the debtor corporation, forgave debts for rent and interest. The forgiveness was held not taxable as income to the debtor corporation, notwithstanding tax benefits from prior deduction of the expenses from gross income, on the theory that the transaction constituted a gift. A gift by a creditor with no proprietary interest in the debtor differs substantially from a stockholder's cancellation of his corporation's debt, made to enhance the capital position of the corporation. In the gift case, the creditor has diverted his assets to some third person. In the shareholder's case the creditor's asset is not diverted, but merely changed in form. The holding of *American Dental* does not necessarily apply to the situation presented where the creditor is also a shareholder, as in *Fender Sales*, nor to a situation where a shareholder-employee cancels his salary claim without receiving stock or other compensation in exchange.

It would not be rational in every case automatically to treat a gratuitous cancellation of indebtedness by a shareholder of the debtor corporation as a contribution to capital. A noted authority[40] suggests the example of three creditors who forgive debts owed them by a corporation. If one had a small holding of the corporation's stock, but the other two had none, it should not be proper to hold the shareholder's cancellation as a contribution to capital, while the others' cancellations are treated as taxable income or gifts. No fixed rule can properly be applied to all the possible fact situations.

In the specific situation presented when the creditor has not treated the debt as income when accrued, it seems more rational to treat the cancellation as a retroactive rescission of the original agreement to pay salary, interest, or whatever expense was involved. A similar approach has been taken in related cases. For example, where the debt was incurred in a sale of property, the subsequent cancellation was treated as a retroactive reduction in the purchase price.[41] And where bonds were issued as dividends on common stock, a subsequent purchase by the issuer on the open market at less than face value was treated as a reduction in the amount of the dividend distributed, rather than as income to the debtor.[42]

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[38] Helvering v. Jane Holding Corp., 109 F.2d 933 (8th Cir. 1940).

[39] 318 U.S. 322 (1943).

[40] Surrey, *The Revenue Act of 1939 and the Income Tax Treatment of Cancellation of Indebtedness*, 49 YALE L.J. 1153, 1171 (1940).

[41] Hirsch v. Commissioner, 115 F.2d 656 (7th Cir. 1940).

[42] Commissioner v. Rail Joint Co., 61 F.2d 751 (2d Cir. 1932).

It would be appropriate similarly to treat the shareholder's voluntary annulment of his claims against the corporation as a reduction in the amount previously agreed upon to be paid for his services or for the use of his property.

The theory just stated is consistent with the shareholder's intent when he releases the debt. He has found the corporation unable to pay the debt, and in financial difficulty because it was incurred in the first place. He is now able to see that both parties would be better off if they had originally made some other arrangement. That other arrangement can be simply made by a rescission of the original agreement and annulment of the accrued debt. By requiring the debtor to make up the tax avoided by taking prior deductions, all parties will be restored to the *status quo ante.*

In *Auto Strop* and *Carroll-McCreary* it was proper to treat the cancellation as a contribution to capital. There was no opportunity for tax avoidance, as the creditor, using the accrual method, had reported the salary as income in the years it was accrued and had been taxed upon it. In such a case rescission is not possible because the creditor cannot get back the money he has paid to the government as tax. He must give up that amount, and to that extent is actually contributing more of his assets to the corporation.

In contrast to this situation, we have the situation presented in *Jane.* There the creditor used the cash method for reporting income, and had not reported the debts as income in the years in which they accrued. The debts were for interest and had been deducted by the debtor as expense in the year accrued. The court taxed the debtor on the cancellation, applying the tax benefit rule, rather than holding that the cancellation constituted a realization of income by the creditor. This case would provide authority for a holding that the cancellation of salary debts by shareholders results in taxable income to the debtor corporation to the extent of the tax benefit, rather than contributions to capital and a realization of income by the creditor.

This result may not be any more or less just than that stated by the court in *Fender Sales.* The government is going to collect a tax either way. But it takes a more realistic view of the effect of the transaction on both the creditor and the debtor. It does not require fine legal theories as to what constitutes "realization" of taxable gain. It does not require the apparently illogical holding that the cancellation of a debt constitutes income to the creditor, who in fact receives no present gain. And it would free the businessman to reorganize his business accounts to correct prior mistakes which may in some cases determine the success or failure of the enterprise. At the same time, the state of the law on this subject would be clarified, and a potential loophole for improper tax avoidance would be closed. As the situation now stands, a closely held corporation may still be able to avoid income tax if the corporation reports income on the accrual method and accrues expense debts to shareholders who hold fifty per cent or less of its outstanding stock and report income on the cash method. If the dictum in *Fender Sales* is followed the creditor will be assessed an income tax on a debt he has forgiven—on gain he has never received.

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