Washington Law Review

Volume 41 | Number 2

4-1-1966

Taxation of Corporate Stock Received by Sole Shareholders Upon Cancellation of Salary Obligations

anon

wife would end up receiving approximately three-quarters of her contribution to the community property. Although an adjustment might be made in the case of a divorce, there could be no adjustment if the community were terminated by death.[22]

Implicit in the principal case is a questioning of the validity of "marital bankruptcy." There is considerable doubt whether "marital bankruptcy" is suited to modern society, and there have been informal proposals to eliminate the doctrine.[23] "Marital bankruptcy" originated in the Spanish community property law, in which it was considered that the well-being and interest of the family were superior to the rights of creditors.[24] Such a doctrine was appropriate for the social and economic environment in which the concepts of community property developed. The interest and well-being of the family are still significant, but the conditions that fostered "marital bankruptcy" may no longer be present. Government welfare machinery and private charities provide substantial protection against the consequences of failure to protect the family. In addition, doctrines that add instability and uncertainty to credit transactions in a credit-oriented economy are inconsistent with the nature of that economy. Although "marital bankruptcy" does not seem well-adapted to the contemporary society, the proper remedial device is not the creation of ill-defined, piecemeal exceptions, but rather correction through comprehensive statutory change.

TAXATION OF CORPORATE STOCK RECEIVED BY SOLE SHAREHOLDERS UPON CANCELLATION OF SALARY OBLIGATIONS

Randall and Fender, sole and equal shareholders of Fender Sales, Inc., twice cancelled equal salary debts owned to them by their corporation.[1] As part of these transactions, the corporation issued $100 par value common stock for each $100 of salary debt owed. Neither the

[22] *Compare* WASH. REV. CODE § 26.08.110 (1958) (divorce), *with* WASH. REV. CODE § 11.04.050 (1956) (death).

[23] BROCKELBANK, *op. cit. supra* note 7, at 284-85; SPEER, LAW OF MARITAL RIGHTS IN TEXAS § 385 (3d ed. 1929); Cross, *supra* note 10, at 667; Cross, *Law Revision in Washington*, 27 WASH. L. REV. 193, 196 (1952).

[24] BROCKELBANK, *op. cit. supra* note 7, at 284; DE FUNIAK, *op. cit. supra* note 7, at 441.

[1] The transactions in question grew out of a suggestion by a bank-creditor of the corporation that its salary liabilities to Randall and Fender be capitalized in order to avoid potential priority over the bank's claim.

corporation, which had previously deducted the salary liabilities as expenses for federal income tax purposes, nor the individuals, who were cash basis taxpayers, reported any income as a result of these transactions. The Commissioner of Internal Revenue determined that the receipt of stock constituted taxable salary income to the individuals or, alternatively, that the cancellation resulted in income to the corporation. The Tax Court held that the transactions did not affect the taxable income of either the individual or the corporation.[2] On appeal by the Commissioner, reversed and *held:* Voluntary relinquishment by sole shareholders of salary debts owed to them by their corporation constitutes realization of income to the shareholder-creditors to the extent of the value of the obligations discharged; receipt of stock by employees in discharge of salary obligations owed to them constitutes a realization of income by the employees in the amount of the fair market value of the stock.[3] *Commissioner v. Fender Sales, Inc.,* 338 F.2d 924 (9th Cir. 1964), *cert. denied,* 381 U.S. 935 (1965).[4]

Under existing authority, a corporation does not realize taxable income when a shareholder-creditor gratuitously cancels a corporate obligation owed to him.[5] Rather, such cancellation is construed to be a contribution to capital. Consequently, a corporation may realize an unwarranted tax benefit by accruing and deducting expenses which it never pays. No prior decision has held that a shareholder-creditor realizes taxable income upon the voluntary relinquishment of a salary claim.[6] The additional factor of stock issuance as part of the can-

---

[2] Fender Sales, Inc., 32 P-H Tax Ct. Mem. ¶ 63,119 at 634 (1963):

> Fender and Randall were the sole shareholders of Sales regardless of whether they each owned 50 shares or 1,000 shares. Their wealth was no more increased by the issuance of additional shares than if the corporation had caused its stock to be split 20 for 1. The issuance of such additional shares to Fender and Randall did not constitute income to them within the meaning of the 16th Amendment to the Constitution regardless of whether it represented a stock dividend or represented compensation for services. Eisner v. Macomber [252 U.S. 189 (1920)]. See also Deloss E. Daggitt, 23 T.C. 31 (1954).

[3] Speaking to the Commissioner's alternative argument, the court states, 338 F.2d at 930:

> Whether viewed as payments for stock of the corporation or as the forgiveness by the shareholders of debts owed to them by the corporation, the transactions were nontaxable payments or contributions to capital from the point of view of the corporation's tax liability. 26 U.S.C. § 118; I.R.C. 1032(a); Reg. 1.1032-1; Reg. 1.61-12(a); Carroll-McCreary Co., Inc. v. Commissioner (2 CCA 1941), 124 F.2d 303; Helvering v. American Dental Co., 1943, 318 U.S. 322...; Commissioner of Internal Revenue v. Auto Strop Safety Razor Co. (2 CCA 1934), 74 F.2d 226, 227.

[4] 33 GEO. WASH. L. REV. 1142 (1965); 64 MICH. L. REV. 138 (1965); 20 RUTGERS L. REV. 130 (1965).

[5] See notes 18-22 *infra,* and accompanying text.

[6] In John Harvey Kellogg, 2 T.C. 1126 (1943), *acq.,* 1944-1 CUM. BUL. 16, an officer and board member of a charitable non-stock corporation waived his salary claims. The court rejected the Commissioner's argument that, under Helvering v.

cellation transaction would not modify the nontaxable result to either the corporation[7] or the shareholder-creditor.[8] In deciding to tax the shareholder-creditors, the court in the principal case failed to fill the gap in present tax law which permits a corporation to reduce its tax burden without the expenditure of funds. In addition, the court created doubt as to the tax incidents of debt cancellation.

Citing existing authority, the court in the principal case stated, without discussion, that no taxable income was realized by the corporation either upon cancellation of the accrued and deducted salary obligations or upon the issuance of stock in discharge of such obligations.[9] As to the shareholders, however, the court stated its disagreement with the theory that cancellation of a debt "which, if collected, would represent taxable income, is, in all circumstances, a non-taxable event,"[10] and reasoned that, when the taxpayers

> ... voluntarily elected to exercise their dominion and control over the choses in action ... for unpaid salaries by extinguishing them for the benefit of the corporation, of which they were sole owners, thereby augmenting the intrinsic worth of the capital stock they held ... [they] "realized" for their own benefit the value of the obligations discharged. . . .[11]

In so concluding, the court relied principally on the broad "power and

---

American Dental Co., 318 U.S. 322 (1943), and Helvering v. Horst, 311 U.S. 112 (1940), the creditor realized income and stated, 2 T.C. at 1127:

> When we come to apply the Commissioner's conception to the numerous easily imagined situations in which actual receipt or accrual would be constructed out of conduct amounting to realization because of satisfactions or enjoyments, there is a prohibitive difficulty in keeping the conception within rational limits. We find no authority in the revenue act for treating the relinquishment of an indebtedness by a cash basis creditor to his debtor as a realization of income by the creditor.

3 P.H. 1966 Fed. Tax Serv. ¶ 7.392 states, "Apparently a creditor does not receive income by relinquishing his debtor's debt," citing *Kellogg* and Helvering v. Jane Holding Corp., 109 F.2d 933 (8th Cir. 1940).

[7] INT. REV. CODE OF 1954, § 1032(a) (no gain or loss recognized to a corporation on receipt of money or other property in exchange for stock of such corporation).

[8] Gross income includes the fair market value of stock received by an employee as compensation for services. INT. REV. CODE OF 1954, § 61-a(1); Treas. Reg. § 1.61-2(d)(4) (1957). But it does not "include the amount of any distribution made by a corporation to its shareholders with respect to the stock of such corporation...." INT. REV. CODE OF 1954, § 305-a; Eisner v. Macomber, 252 U.S. 189 (1920). When a pro rata distribution of stock was made as payment for services rendered by shareholder-employees, the courts held that no income was realized by the recipient. Joy Mfg. Co. v. Commissioner, 230 F.2d 740 (3d Cir. 1956), *affirming* 23 T.C. 1082 (1955), 70 HARV. L. REV. 560 (1957); Deloss E. Daggit, 23 T.C. 31 (1954), *acq.*, 1955-1 CUM. BULL. 4; Note, *Application of Eisner v. Macomber to Pro Rata Stock Distributions in Payment of Salaries: an Opportunity for Tax Manipulation*, 64 YALE L. J. 929 (1955); Jacksonville Paper Co., 13 CCH Tax Ct. Mem. 728 (1954); Benjamin Josephson, 6 CCH Tax Ct. Mem. 788 (1947).

[9] See note 3 *supra*.

[10] 338 F.2d at 928.

[11] *Id.* at 929.

control" concepts of income realization enunciated in *Helvering v. Horst.*[12] As to the stock issuance, the court decided that the shareholders had realized income because the stock received was compensation for services rendered,[13] and not merely a nontaxable stock dividend.[14] Rejecting the shareholders' argument that they had not, in fact, been compensated by receipt of the additional shares of stock,[15] the court reasoned that, as a result of the debt cancellation, "the corporation was a substantially different corporation after the transaction than before" in that its net worth had been increased, and that the shareholders did, therefore, "receive something of value constituting taxable income under the Sixteenth Amendment to the Constitution"[16] when they received the additional shares of stock.

In dealing with the issue of debt cancellation vis-à-vis the corporation, the court in the principal case chose to follow precedent rather than policy. Ordinarily, cancellation of a debt will result in taxable income to the debtor.[17] However, if cancellation of a corporate debt is construed to be either a gift[18] or contribution to capital,[19] no taxable income will be realized by the corporation-debtor.[20] Since the 1943

---

[12] 311 U.S. 112 (1940) (taxpayer realized income when he transferred interest coupons from bonds to his son, the son subsequently receiving payment thereon). The court in the principal case stated, 338 F. 2d at 929:

> In Commissioner of Internal Revenue v. Lester, 1961, 366 U.S. 299, 304,... the Supreme Court approvingly quoted from Horst: "The power to dispose of income is the equivalent of ownership of it." We add, the exercise of the power to dispose of income is the equivalent of the realization of it.

[13] As authority for this proposition, the court cited INT. REV. CODE OF 1954, § 61, and Treas. Reg. § 1.61-2(d)(4) ("if 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 court summarily rejected the conclusions of two earlier cases that stock received under similar circumstances by shareholder-employees was nontaxable. 338 F.2d at 929. Those cases were: Deloss E. Daggit 23 T.C. 31 (1954), *acq.*, 1955-1 CUM. BULL. 4; Benjamin Josephson, 6 CCH Tax Ct. Mem. 788 (1947).

[14] See text accompanying notes 37-38 *infra*.

[15] The taxpayers argued that, because they were equal shareholders as well as employees, the stock they received was not compensensation because their ownership in the corporation was not changed by the transaction, and they therefore, "received nothing which they did not already possess, *i.e.*, the entire capital stock of Fender Sales, Inc." 338 F.2d at 927.

[16] *Id.* at 927.

[17] INT. REV. CODE OF 1954, § 61-a(12) (except as otherwise provided, gross income includes income derived from discharge of indebtedness); United States v. Kirby Lumber Co., 284 U.S. 1 (1931).

[18] INT. REV. CODE OF 1954, § 102-a (gross income does not include the value of property acquired by gift); Helvering v. American Dental Co., 318 U.S. 322 (1943) (gratuitous cancellation of previously accrued and deducted interest and rental indebtedness held to be a gift and not taxable income to the debtor-corporation).

[19] INT. REV. CODE OF 1954, § 118-a (gross income of a corporation does not include any contribution to capital).

[20] These two exceptions to the basic "income realization" principle of § 61-a(12) of the Code have been incorporated into Treas. Reg. § 1.61-12(a) (1957), which states,

decision of *Helvering v. American Dental Co.*,[21] the courts have consistently held that the nontaxable consequences of such cancellation transactions are not modified by the fact that the corporation-debtor had previously deducted such obligations from its gross income as expenses.[22] This tax advantage is eliminated in those cases that fall within the proscriptions of section 267 of the Code.[23] This section disallows deductions for expenses owed to a creditor who owns more than fifty percent in value of the outstanding stock of the corporation-debtor, unless the expense is paid within two and one-half months after the close of the corporation's taxable year and included within the same period in the gross income of the shareholder. As the shareholders in the principal case each owned only fifty percent of the stock, the provision is inapplicable. In the original drafting of the 1954 Code, there was an attempt to provide for comprehensive treatment of all transactions involving cancellation of indebtedness,[24] but this provision did not get out of committee. Such non-action may be interpreted in two ways: either Congress was satisfied with the extant line of authority which permitted corporations to realize this tax benefit, or it was unable to arrive at a satisfactory statement of what the law ought to be and therefore left development to the courts and the Commissioner.

> In general, if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to capital of the corporation to the extent of the principal of the debt,

and have been followed in decisions involving cancellation of salary expenses. Pondfield Realty Co. v. Commissioner, 43-2 U.S. Tax Cas. ¶ 9600 (2d Cir.), *reversing* 1 T.C. 217 (1943); Carroll-McCreary Co. v. Commissioner, 124 F.2d 303 (2d Cir. 1941); Tanner Mfg. Co., 2 CCH Tax Ct. Mem. 305 (1943); Midland Tailors, 2 CCH Tax Ct. Mem. 281 (1943); Brown Cab Co., 1 CCH Tax Ct. Mem. 450 (1943); Triple Z Products, Inc., 40-2 U.S. Tax Cas. ¶ 9705 (S.D.N.Y. 1940). *But cf.* Amsco-Wire Products Corp., 44 B. T. A. 717 (1941); Howard Paper Co.,, 43 B. T. A. 545 (1941); Beacon Auto Stores, Inc., 42 B.T.A. 703 (1940). The latter decisions were rendered prior to Helvering v. American Dental Co., 318 U.S. 322 (1943) (see text accompanying note 21 *infra*), and applied the reasoning of Helvering v. Jane Holding Corp., 109 F.2d 933 (8th Cir.), *cert. denied*, 310 U.S. 653 (1940), that expenses deducted from taxable income in previous years should be returned to income when cancelled. The Court of Appeals for the Eighth Circuit explicitly retreated from the position that it took in *Jane Holding* in Reynolds v. Boos, 188 F.2d 322 (8th Cir. 1951) (forgiveness of previously deducted expense item is a gift and not income to the debtor corporation), citing *American Dental* for the proposition that the tax benefit theory is not applicable to this type of transaction. For a definitive treatment of the subject, see Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 TAX L. REV. 225 (1959).

[21] 318 U.S. 322 (1943).

[22] See note 20 *supra*.

[23] All "Code" references are to the Internal Revenue Code of 1954, unless otherwise stated.

[24] H. R. Res. 8300, 83d Cong., 2d Sess. § 76 (1954); H. R. REP. No. 1337, 83d Cong., 2d Sess. (1954). For a comprehensive statement of the proposed provisions, see Eustice, *supra* note 20, at 272-74.

Assuming, for purposes of this analysis, the validity of the latter of these two explanations,[25] the court in the principal case might have deviated from precedent and taxed the corporation. It could have reasoned that, although the cancellations per se resulted in a nontaxable gift or contribution to capital of the corporation, the prior deductions of expenses (which now need not be paid) resulted in the release of income not previously taxed. In so ruling, the court would have taxed the one entity that had realized a present and tangible benefit from the "accrual-deduction-cancellation" transactions, and, at the same time, would have closed an unwarranted tax loophole. Additionally, such a ruling would have reflected the broad income tax principles of section 61 of the Code, which provides that *all* income other than that specifically excluded is subject to tax.[26]

Having decided not to tax the corporation, the court was faced with the issue of whether the cancellation, alone, resulted in income realization to the shareholder-creditors. In *John Harvey Kellogg*,[27] the Tax Court stated that there is "no authority in the revenue act for treating the relinquishment of an indebtedness by a cash basis creditor to his debtor as a realization of income by the creditor."[28] No other decision dealing with cancellation of salary claims has intimated a contrary conclusion.[29]

The court in the principal case, in its decision to tax the shareholder-creditors, relied on the "dominion and control" rationale of *Helvering v. Horst*.[30] This rationale is sound when applied to assignment-of-income cases, the proposition being that a taxpayer may not avoid income realization by diverting what would be his income to a third party. But the instant salary cancellations did not divert income to a third party; they merely modified the *form* of the corporate interest

[25] See Eustice, *supra* note 20, at 284:

> One might justifiably conclude that Congress had decided to "wash its hands" of responsibility in this area and delegate the problem to the courts and the Commissioner to be solved in a case-by-case approach or appropriate Regulations, as the case may be.

[26] The court would have found further support for this proposition in § 111, which incorporates the tax benefit principle. Although this is an exclusionary provision, the court could have argued its applicability by analogy.

[27] 2 T.C. 1126 (1943), *acq.*, 1944-1 CUM. BULL. 16.

[28] *Id.* at 1127.

[29] The courts have, however, recognized that such cancellations result in an increase in the value of the shareholder's interest in the corporation. Carroll-McCreary Co. v. Commissioner, 124 F.2d 303, 305 (2d Cir. 1941) ("an indirect benefit... always results to the shareholder from a gift to his corporation"); Triple Z Products, Inc., 40-2 U.S. Tax Cas. ¶ 9705 at 10,777 (S.D.N.Y. 1940) ("If it be argued that the forgiveness was not gratuitous because the stockholder was benefited in that the equity represented by this stock would be enhanced, the answer is that such would naturally be the result of any contribution to the capital of the corporation.")

[30] 311 U.S. 112 (1940).

held by the shareholders. The taxpayers' interest in their totally owned corporation before cancellantion was represented by both debt and equity; their interest after cancellation was represented by equity alone. However, the total value of this interest remained constant. Nevertheless, the court decided that the shareholder-creditors did realize income since the cancellation effectuated an increase in the intrinsic worth of their capital stock.[31] Yet shareholders of close corporations constantly modify the worth of their stock,[32] and such modifications have not heretofore been taxed until there has been either a sale, exchange, or other disposition of stock, or a dividend paid.[33]

It is evident that the court in the principal case was concerned with possible opportunities for tax manipulation. Arguably, a shareholder-creditor with an enforceable salary claim against his corporation could be in a position to convert to capital gains what would otherwise be ordinary income.[34] By releasing the claim and subsequently selling shares in the corporation, the income, which would have been taxed as ordinary income if it had been paid as salaries, would be taxed at capital gains rates. However, given the usual absence of a buying market for the shares of a close corporation, it is unlikely that such gain would be realized without dissolution or sale of the corporation. If the corporation was sold and there was evidence that the shareholders intended to sell out at the time of cancellation, the court could look through form to substance, include the cancellation as part of the sale transaction, and allocate a portion of the purchase price to payment of the salary claims.[35] Such facts were not present in the principal case.

[31] The court recognized the difficult valuation problems which could arise in future cases, stating that, "fortunately, under the agreed facts of this case, we have no problem respecting the taxable value of the income thus realized...." 338 F.2d at 929.

[32] For example, by contributing property, services, and ideas to their corporation.

[33] Judge Barnes, in his dissenting opinion in the principal case, stated this proposition in the following manner, 338 F.2d at 930:

> This majority opinion is the first I have encountered which recognizes a realization of income by shareholders upon an increase in corporate net worth, *where no dividend has been declared or capital gain yet realized* by the shareholders. Shareholders' interests in corporations change every day. The net worth of corporations is in a constant state of flux. Surely, when it increases, the shareholders are not *yet* deemed to have made a taxable gain. Rather the increase in corporate net worth is merely a paper increase of the shareholders' equity, not taxable until such time as the shareholders realize the increase by virtue of a dividend or the sale or exchange of the security investment above cost. Then, and only then, have the courts traditionally recognized "a taxable event."

[34] A similar possibility already exists under current tax law. A taxpayer, by accelerating or postponing the disposition of "§ 1231 property" may control whether his gains or losses are subject to capital or ordinary tax treatment.

[35] Additionally, if a corporation over an extended period of time deducts expenses which it need never pay because of their consistent cancellation, the Commissioner

By its decision that the creditor-shareholders realized income solely by releasing their claims, the court created an uncertainty as to the tax consequences of all future cancellations of obligations which, if paid, would result in ordinary income,[36] and which, when cancelled, cause an increase in the intrinsic worth of the capital stock held. There are many situations in which debt obligations are accrued in good faith, and subsequently cancelled because of changes in the financial ability of the corporation-debtor. Frequently a new corporation will be organized with the intention that part of the profits of the corporation will be withdrawn by way of salaries rather than dividends. Subsequent financial inability to pay such salaries, coupled with a need for additional capital, will lead to the release of such salary obligations by the shareholder-creditors. Such cancellations are not motivated by an intent to reduce the tax liability of the shareholder, but rather by the desire to help sustain the life of the corporation. Many parties other than the owners benefit from the success of a going corporation. The tax law should not be used to discourage good faith cancellations of corporate obligations when such transactions are necessary to sustain the life of a corporation.

As to the stock issuance, the court in the principal case rejected *Eisner v. Macomber*[37] as inapposite, and distinguished the nontaxable stock dividend in that case on three grounds. First, a stock dividend is evidence of an *antecedent* increase in the value of the stockholder's capital interest, rather than a contemporaneous quid pro quo increase. Second, a stock dividend is merely bookkeeping that does not affect the aggregate assets of the corporation or its outstanding liabilities. Third, after a stock dividend the stockholders retain an equal interest in the same investment, rather than an equal interest in a substantially different investment.[38] The court gave recognition to the fact that the pro rata ownership of the shareholders remained constant, but concluded that, since the corporation was a substantially different corporation after the transaction (its net worth having increased due to the decrease in liabilities), the shareholders had received something of value when they received the stock. The increase in net worth upon which the court relied in distinguishing the stock distribution of the principal case from the nontaxable stock dividend of *Macomber* was not a consequence of the stock issuance, but resulted from the debt

could disallow such deductions as not being "ordinary and necessary expenses paid or incurred during the taxable year. . . ." INT. REV. CODE OF 1954, § 162(a).

[36] *E.g.*, interest on mortgages, notes, and bonds.

[37] 252 U.S. 189 (1920).

[38] 338 F.2d at 927.

cancellation. Merely by cancelling debts at a time prior to stock distribution or not distributing any stock, parties in future transactions may avoid this aspect of the non-qualifying results of the principal case.

The court did not cite section 305-a of the Code, which provides that "gross income does not include the amount of any distribution made by a corporation to its shareholders, with respect to the stock of such corporation, in its stock. . . ." This section may not apply to stock received by creditors or employees who happen to be shareholders as well.[39] Although the transaction in the principal case was categorized as an exchange of stock for salary claims,[40] it may also be viewed as a cancellation resulting in a contribution to capital followed by a stock distribution to the taxpayers as shareholders. If the latter interpretation is unacceptable, parties in subsequent transactions may again avoid disqualification merely by separating in time the cancellation and stock issuance transactions.

Satisfied that the stock distribution did not fall within *Macomber,* the court went on to conclude that the issued stock was compensation, and therefore taxable income under sections 61-a(1) of the Code and 1.61-2(d)(4) of the Regulations. In factually similar cases, courts have refused to look merely at form and have held that such pro rata stock distributions are nontaxable events.[41] In *Joy Mfg. Co. v.*

---

[39] See H. R. Rep. No. 1337, 83d Cong., 2d Sess. A81 (1954):

> Where mention is made of an issuance or a distribution "with respect to stock" in this section... such phrase means the issuance or distribution to a holder of such stock by reason of his rights as a holder of such stock....

Bittker, Federal Income Taxation of Corporations and Shareholders 172 (1959); Note, *Application of Eisner v. Macomber to Pro Rata Stock Distributions in Payment of Salaries: an Opportunity for Tax Manipulation,* 64 Yale L. J. 929, 933 (1955).

[40] 338 F.2d at 925.

[41] In Deloss E. Daggit, 23 T.C. 31 (1954), *acq.,* 1955-1 Cum. Bull. 4, Note, *Application of Eisner v. Macomber to Pro Rata Stock Distributions in Payment of Salaries: an Opportunity for Tax Manipulation,* 64 Yale L. J. 929, 933 (1955), the two principal stockholders received a pro rata distribution of stock for services rendered to the corporation and reported the stock as income. In a deficiency suit brought by the Commissioner, who argued that the shareholders had not properly valuated the stock received, the Tax Court held that the distribution was nontaxable under *Macomber.* In Benjamin Josephson, 6 CCH Tax Ct. Mem. 788 (1947), the president and sole shareholder forgave accrued salary claims, the corporation increased capital stock, and a stock dividend was declared—all within seventeen days. In issuing the stock, the corporation debited the salary accrued account and credited the capital stock account. The Commissioner argued that the transaction was a sham, that there was neither a forgiveness nor a stock dividend, but rather that the stock had been issued in payment of salary and therefore was includable in the gross income of the shareholder-creditor. The court rejected this argument, stating, *id.* at 789:

> His wealth was not increased by the issuance of the 200 additional shares. The issuance of such shares to him did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution, regardless of whether it was a stock dividend or for salary. *Eisner v. Macomber,* 252 U.S. 189 (1920).

Commissioner,[42] a decision not cited in the principal case, the court rejected the Commissioner's argument that stock received by a parent corporation for services rendered to its wholly-owned subsidiary was taxable income, stating:

> After such a transaction is fully executed, the parent has more shares of stock than before and the value of its holdings has been increased by whatever economic benefit the subsidiary has realized from the parent's services. But it is also true that before such a transaction, no less than after, all the stock of the subsidiary belongs to the parent. Therefore, the increase in the total value of the parent's stock caused by the parent's services is the same whether the subsidiary does or does not issue additional stock to the parent. In substance the services rendered by the parent have amounted to a capital contribution to the subsidiary.
>
> While the services of the parent enrich the subsidiary, the additional stock . . . in [the] subsidiary does not and cannot in any way enrich the parent. The parent obtains an economic advantage in the increased value of its wholly owned subsidiary, but the value is created directly by the parent's services. It is not a realized gain and its character taxwise is not affected by the issuance of additional stock of the subsidiary. Here, as in the cases which apply the doctrine of Eisner v. Macomber, the peculiar circumstances under which additional stock is issued to a stockholder prevent the . . . transfer of the additional paper from amounting to a realization of gain.[43]

The reasoning of the court in *Joy* is sound, given the realization concept of *Macomber*. In determining the tax consequences of a pro rata stock distribution a court must ascertain whether "the distribution . . . constituted a realized gain to the shareholder, or changed 'only the form, not the essence,' of his capital investment."[44] Since the shareholders in the principal case owned the entire enterprise both before and after the "cancellation-stock issuance" transaction, it is unclear how the stock issuance alone could be anything other than a change of form. The real party benefiting from the transactions was the corporation, and it was the party, if any, which should have been taxed by the court.

---

[42] 230 F.2d 740 (3d Cir. 1956), 70 HARV. L. REV. 560 (1957), *affirming* 23 T.C. 1082 (1955).

[43] *Id.* at 742.

[44] Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 430-31 (1955) (speaking to the issue of the Court's endeavor in *Macomber* to determine the taxability of a stock dividend).