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## RECENT DEVELOPMENTS

### Stock Received in Lieu of Salary by Stockholder-Employees Whose Proportionate Interest Remains Unchanged Is Taxable Income— *Commissioner v. Fender Sales, Inc.*\*

Two stockholders were employed by a corporation in which each held fifty per cent of the outstanding shares. The corporation, an accrual taxpayer, deducted their identical salaries as a business expense, but its limited assets precluded payment. When it became necessary to reduce corporate liabilities to obtain bank financing, the stockholder-employees agreed to discharge the salaries payable in exchange for additional stock. The Commissioner of Internal Revenue determined that the receipt of stock constituted taxable income and, alternatively, that the corporation realized income from the cancellation of indebtedness. The Tax Court found neither the stockholder-employees nor the corporation liable.<sup>1</sup> On appeal to the Court of Appeals for the Ninth Circuit, *held*, reversed in part and affirmed in part, one judge dissenting. Stockholder-employees realize income when they acquire additional shares in lieu of salary even though their proportionate interests remain unchanged. The resultant increase in the corporation's net worth is, however, a non-taxable contribution to its capital.

Transactions involving forgiveness by stockholder-employees of corporate indebtedness are shrouded in legal uncertainty.<sup>2</sup> The conflicting positions espoused by the Commissioner, the Tax Court, and the circuit court in the principal case focus attention on a few salient problems. The Commissioner, in arguing that the receipt of stock by the individual taxpayers constituted taxable income, considered the individuals solely as employees, believing it immaterial that they were also stockholders. Thus, he reasoned that when they, as employees, received stock in payment of their accrued salaries, they realized income.<sup>3</sup> In contrast, the Tax Court viewed the individual taxpayers as stockholders who had received a stock

\* 338 F.2d 924 (9th Cir. 1964) *cert. denied*, 86 Sup. Ct. 29 (1965) [hereinafter cited as principal case].

1. *Fender Sales, Inc.*, 32 P-H Tax Ct. Mem. ¶ 63119 (1963).

2. See Dartell, *Discharge of Indebtedness and the Federal Income Tax*, 53 HARV. L. REV. 977 (1940); Dunham, *Cancellation of Adjustment of Indebtedness*, N.Y.U. 7TH INST. ON FED. TAX 1346 (1949); Lynch, *Some Tax Effects of Cancellation of Indebtedness*, 13 FORDHAM L. REV. 145 (1944); Warren & Sugarman, *Cancellation of Indebtedness and Its Tax Consequences*, 40 COLUM. L. REV. 1326 (1940); Wright, *Realization of Income Through Cancellations, Modifications, and Bargain Purchases* (pts. I & II), 49 MICH. L. REV. 459, 667 (1951); Note, *Taxation in Stockholders' Forgiveness of Accrued Salaries*, 9 CLEV.-MAR. L. REV. 362 (1960).

3. Brief for Petitioner, pp. 14-17, principal case.

dividend. Noting that their proportionate ownership interest in the corporation had not been affected, the Tax Court relied upon *Eisner v. Macomber*,<sup>4</sup> in which the Supreme Court held that receipt of a stock dividend was not a taxable event, to conclude that no income was realized.<sup>5</sup>

The circuit court majority, in agreeing with the Commissioner on the issue of individual liability and distinguishing *Eisner v. Macomber*, adopted the more rational solution. It is abundantly clear that the stockholder-employees received stock not because they were stockholders, but because they were employees to whom salaries were due for services rendered. Section 305(c)(3) of the Internal Revenue Code is specific statutory authority for the taxation of a stock distribution having the effect of compensation for services.<sup>6</sup> In addition, the Treasury Department Regulations providing for the inclusion in gross income of the fair market value of a corporation's own stock transferred to an employee as compensation for services<sup>7</sup> have consistently been upheld.<sup>8</sup> Moreover, *Eisner v. Macomber* is clearly inapposite. In *Macomber*, the distribution of a stock dividend was deemed not a taxable event because the stockholders' equity in the corporation remained constant. It is apparent from an analysis of the accounting entries reflecting the *Macomber* transaction that net worth<sup>9</sup> was not changed by the transfer of funds from the retained earnings account to the capital stock account.<sup>10</sup> The principal case, however, did not involve a stock dividend; rather, there was a discharge of salaries payable which significantly increased the stockholders' equity. From an accounting viewpoint, net worth increased as a result of the decrease

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4. 252 U.S. 189 (1920).

5. *Fender Sales, Inc.*, 32 P-H Tax Ct. Mem. ¶ 63119, at 634 (1963). See also *Josephson v. Commissioner*, 16 P-H Tax Ct. Mem. ¶ 47186 (1941).

6. INT. REV. CODE OF 1954, § 305(c)(3) provides: "In the case of a distribution which has the effect of the payment of compensation, see section 61(a)(1)." INT. REV. CODE OF 1954, § 61(a)(1) provides: "[G]ross income means all income from whatever source derived, including (but not limited to) . . . compensation for services . . ."

7. The current provision reads as follows: "[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." *Treas. Reg. § 1.61-2(d)(4)* (1957), as amended, T.D. 6416, 1959-2 CUM. BULL. 126, T.D. 6696, 1963-2 CUM. BULL. 23.

8. See, e.g., *Mason v. Commissioner*, 125 F.2d 540 (6th Cir.), *cert. denied*, 317 U.S. 657 (1942); *Bothwell v. Commissioner*, 77 F.2d 35 (10th Cir. 1935); *Olson v. Commissioner*, 67 F.2d 726 (7th Cir.), *cert. denied*, 292 U.S. 637 (1934); *Crowell v. Commissioner*, 62 F.2d 51 (6th Cir. 1932); *Old Colony Trust Co. v. Commissioner*, 59 F.2d 168 (1st Cir. 1932); *Rodrigues v. Edwards*, 40 F.2d 408 (2d Cir. 1930).

9. Net worth, stockholders' equity, shareholders' equity, capital, capital stock and surplus, and proprietorship are all accounting terms used to describe the right or interest of the proprietor in the properties owned by a business. See generally FINNEY & MILLER, *PRINCIPLES OF ACCOUNTING—INTRODUCTORY* (6th ed. 1964).

10. 252 U.S. 189, 210 (1920).

in the salaries-payable account.<sup>11</sup> Thus, the shareholder-employees' interests, although remaining proportionately equal, were substantially increased. Finally, the overall practical effect of the transaction is no different than if the stockholder-employees had received salaries and immediately returned them to the corporation in exchange for stock certificates.

In holding the stockholder-employees liable, the circuit court was confronted only with an actual transfer of stock. Other prob-

11. The following hypothetical balance sheets illustrate the accounting distinctions between *Eisner v. Macomber* and *Commissioner v. Fender Sales, Inc.*:

BEFORE				
		<i>Eisner v. Macomber</i>		
Assets		Liabilities		
Cash	300,000	Salaries Payable	100,000	100,000
		Net Worth		
		Capital Stock	100,000	
		(1000 sh. @ \$100 par value)		
		Retained Earnings	100,000	200,000*
	<u>\$300,000</u>			<u>\$300,000</u>
		<i>Fender</i>		
Assets		Liabilities		
Cash	300,000	Salaries Payable	100,000	100,000
		Net Worth		
		Capital Stock	100,000	
		(1000 sh. @ \$100 par value)		
		Retained Earnings	100,000	200,000**
	<u>\$300,000</u>			<u>\$300,000</u>
AFTER				
		<i>Eisner v. Macomber</i>		
Assets		Liabilities		
Cash	300,000	Salaries Payable	100,000	100,000
		Net Worth		
		Capital Stock	200,000	
		(2000 sh. @ \$100 par value)		
		Retained Earnings	0	200,000*
	<u>\$300,000</u>			<u>\$300,000</u>
		<i>Fender</i>		
Assets		Liabilities		
Cash	300,000	Salaries Payable	0	0
		Net Worth		
		Capital Stock	200,000	
		(2000 sh. @ \$100 par value)		
		Retained Earnings	100,000	300,000**
	<u>\$300,000</u>			<u>\$300,000</u>

\* In *Eisner v. Macomber*, net worth remained constant.

\*\* In *Fender*, net worth increased.

lems would arise if the impact of the principal case could be avoided by stockholder-employees who forgave salary indebtedness, but who did not receive stock certificates in return. However, an analysis of the substance of the transaction indicates that this loophole has already been closed. Clearly, when a closely held corporation accrues salaries, the stockholder-employees acquire creditors' claims which would represent taxable income to them if paid. Consequently, the effect of the stockholder-employees' forgiveness of the debt is to transfer to the corporation their right to receive income. Since it is well settled that the economic satisfaction implicit in an assignment of the right to receive income constitutes a realization of that income,<sup>12</sup> the stockholder-employees should be taxed whether or not they receive certificates.

Still another problem is whether the stockholder-employees' closely held corporation should be liable. Since the Commissioner did not contend that both the stockholder-employees and the corporation were taxable, the circuit court majority, having taxed the stockholder-employees, was not forced to resolve this question.<sup>13</sup> However, the Tax Court and the dissenting circuit court judge, after denying individual liability, squarely faced the corporate issue. The Commissioner argued that if the stockholder-employees were correct in their contention that they had received no income, then their contribution to the corporation should be viewed as gratuitous service, for which the corporation would be allowed deductions for accrued salaries.<sup>14</sup> Consequently, he reasoned, the forgiveness of accrued salaries should be governed by the tax benefit doctrine,<sup>15</sup> which provides for the restoration to income of accrued liabilities subsequently extinguished without payment.<sup>16</sup> The Tax Court and the dissenting circuit court judge rejected the tax benefit argument and concluded that the forgiveness constituted a nontaxable capital

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12. *Helvering v. Horst*, 311 U.S. 112 (1940); *Helvering v. Eubank*, 311 U.S. 122 (1940); *Smith's Estate v. Commissioner*, 292 F.2d 478 (3d Cir. 1961); *Galt v. Commissioner*, 216 F.2d 41 (7th Cir. 1954). See also Rev. Rul. 225, 1964-2 CUM. BULL. 15.

13. The majority did, however, conclude in a single sentence that the entire transaction resulted in a nontaxable contribution to corporate capital. Principal case at 930.

14. *Cf. Joy Mfg. Co. v. Commissioner*, 230 F.2d 740 (3d Cir. 1956), where the taxpayer-corporation entered into a contract with its wholly owned subsidiary under which it was to perform certain services for the subsidiary. Since it was agreed before the beginning of the taxable year that the subsidiary's obligation to compensate the taxpayer-parent would be discharged by the issuance of additional stock to the taxpayer, the services were treated as a capital contribution by the taxpayer to its subsidiary and the value of the services was not a realized gain. See also *Daggitt v. Commissioner*, 23 T.C. 31 (1954), *acq.*, 1955-1 CUM. BULL. 4.

15. Plumb, *The Tax Benefit Rule Today*, 57 HARV. L. REV. 129 (1943); Plumb, *The Tax Benefit Rule Tomorrow*, 57 HARV. L. REV. 675 (1944); Tye, *The Tax Benefit Doctrine Re-examined*, 3 TAX L. REV. 329 (1948); Tye, *Tax Benefit Developments*, 2 TAX L. REV. 106 (1946).

16. Brief for Petitioner, p. 24, principal case.

contribution. This conclusion was based on section 1.61-12(a) of the Treasury Regulations, which provides in part that "[I]f 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."<sup>17</sup> This section is not clear authority in support of the Tax Court's position, however, because it is the subject of a possible split of authority between the Second and Eighth Circuits. The Second Circuit, in *Commissioner v. Auto Strop Safety Razor Co.*,<sup>18</sup> felt that the regulation was clear on its face and accordingly held the corporation not taxable. Five years later the Eighth Circuit, in the factually similar case of *Helvering v. Jane Holding Corp.*,<sup>19</sup> reversed a Board of Tax Appeals decision which had been based on the *Auto Strop* interpretation of section 1.61-12(a). The *Jane Holding Corp.* court upheld the imposition of the corporate tax after determining that the corporation, by taking an expense deduction, had been availed of a tax benefit when the debt was forgiven. While it might seem that there is some merit in a tax benefit approach, the Second Circuit has clearly rejected it in cases subsequent to *Jane Holding Corp.*<sup>20</sup> Furthermore, even the Eighth Circuit has apparently withdrawn its support for the tax benefit rule in forgiveness cases.<sup>21</sup>

At least one commentator has suggested that the corporation rather than the stockholder-employees should have been taxed because the corporation benefited from the transaction.<sup>22</sup> This analysis has emotional appeal, since it seems harsh to place the tax burden on individuals whose tax bracket could well be higher than that of their corporation; however, as sole owners of the corporation the individuals were benefited by the deductions for accrued salaries and the subsequent reduction in corporate liabilities. Moreover, since stockholder-employees of a closely held corporation are in control of salary policy and accounting procedures, it would seem only fair that they should be required to reflect accurately its actual financial situation or suffer the consequences.

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17. Treas. Reg. § 1.61-12(a) (1957), as amended, T.D. 6653, 1963-1 CUM. BULL. 15.

18. 74 F.2d 226 (2d Cir. 1934).

19. 109 F.2d 933 (8th Cir. 1940).

20. *Carroll-McCreary Co. v. Commissioner*, 124 F.2d 303 (2d Cir. 1941); *In re Triple Z Products, Inc.*, 40-2 U.S. Tax Cas. ¶ 9705 (S.D.N.Y. 1940). See also *Pondfield Realty Co.*, 1 T.C. 217 (1942), *rev'd mem.*, 43-2 U.S. Tax Cas. ¶ 9600 (2d Cir. 1943).

21. *Reynolds v. Boos*, 188 F.2d 322, 325 (8th Cir. 1951).

22. 22 J. TAXATION 88 (1965).