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Congress has the power to grant such authority seems clear.²⁵ It is now becoming increasingly clear that in operating the Chapter X machinery the courts are progressively more willing to act on the theory that the necessary jurisdiction has been granted.

GIFT TAX LIABILITY OF STOCKHOLDER-CREDITORS WHO FORGIVE CORPORATE INDEBTEDNESS

JOHN B. COMAN†

It has become increasingly evident that tax-wise, as well as in popular advertisements, some words fool you. More precisely, G-I-F-T may spell "gift" under the income tax provisions of the Internal Revenue Code, but not pursuant to the gift tax sections of that statute. In short, even when the Supreme Court of the United States declares that a transaction is a gift, it is essential to inquire whether the controversy thus determined arose from the assessment of a deficiency in connection with an income tax return, or from a claim for additional gift tax.

I. FORGIVENESS NOT INCOME

Whatever doubts may have been entertained previously, for the past six years it has been well established that a corporation does not realize any income where its debts are forgiven, provided no consideration passes from the corporation to the creditor. Such was the principle enunciated by the frequently cited (albeit recently distinguished¹) *American Dental* case.² This determination had been preceded by the *Carroll-McCreary* opinion,³ which is authority for the proposition that the gratuitous character of the cancellation is not impaired by the fact that the forgiving stockholders obtain advantages. It was said that "an indirect benefit of this character always results to the shareholder from a gift to his corporation."⁴ A gratuitous forgiveness means only that "no consideration is paid by the corporation for release of the debt."⁵

As the title of this comment discloses, it does not purport to be a discussion of the *income* tax impact of the cancellation of indebtedness. That subject was covered in 1944 by a scholarly and distinguished leading article prepared by

26. See note 22 *supra*. See also *Shumacher v. Beeler*, 293 U. S. 367, 371 (1934). Subject to the due process requirement of notice and hearing, Congress can confer summary jurisdiction upon a bankruptcy court even over adverse claimants. *Taubel-Scott-Kitzmilller Co. v. Fox*, 264 U. S. 426 (1924).

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1. *Commissioner v. Jacobson*, 336 U. S. 28 (1949).

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

3. *Carroll-McCreary Co., Inc. v. Commissioner*, 124 F. 2d 303 (C. C. A. 2d 1941).

4. *Id.* at 305.

5. *Ibid.*

Joseph B. Lynch.⁶ The case of *Commissioner v. Jacobson*,⁷ mentioned obliquely above, will doubtless induce some to reexamine the topic, but it is here submitted that Mr. Lynch's conclusions are, even if a little bloody, still unbowed—that the *Jacobson* opinions, while hardly reenforcing the *American Dental* case, certainly do not overrule it.⁸

II. FORGIVENESS NOT A TAXABLE GIFT

If, then, the forgiveness of a corporate indebtedness by stockholder-creditors is a gift when considering the income of the corporation, is it equally a gift when computing the taxable gifts made by those stockholder-creditors? *It is submitted that it is NOT.*

To put the problem more graphically, let us assume that *A* and *B* own all the stock of *X*, a solvent corporation, and that they own it in equal shares. Let us further suppose that *X* corporation is indebted to *A* and *B* to the extent of \$100,000, and that each is a creditor to the same extent as the other.

Under the foregoing circumstances, if *A* and *B*, without any consideration passing to them from *X* corporation (other than the "indirect benefit" of the *Carroll-McCreary* type discussed above), forgive *all* of the indebtedness owing to them (thus avoiding even the discussion of the *Jacobson* problem), the corporation will say to the Collector of Internal Revenue, when he asks for his portion of the \$100,000 thus forgiven: this increase in the corporate assets is not income. The Supreme Court of the United States says that it is a gift.⁹

Doubtless the Collector would be pardoned by many if he thereupon turned to the donors and observed that, while the *American Dental* case might deprive him of *income* tax from the corporation, it surely would entitle him to

6. Lynch, *Some Tax Effects of Cancellation of Indebtedness*, 13 *FORD. L. REV.* 145 (1944). See also Mandell, *Forgiveness of Indebtedness*, 27 *TAXES* 31 (1949); Tarleau, *Federal Income Tax Considerations Applicable to Cancellation of Indebtedness* in 5th Annual N. Y. U. INSTITUTE ON FED. TAXATION 664 (1947).

7. See note 1 *supra*.

8. It is perhaps interesting to note that six Justices joined in the majority opinion in the *American Dental* case—Stone, C.J., Roberts, Black, Reed, Douglas and Murphy, JJ., while two, Frankfurter and Jackson, JJ., dissented. Justice Rutledge took no part in the consideration or decision in this case. However, in concurring with the majority in the *Jacobson* determination, Justice Rutledge was "of the view that the result is essentially in conflict with that reached in *Helvering v. American Dental Co.*" Thus does Justice Rutledge tell us that if he had participated in the decision of the *American Dental* case, he would have dissented. Consequently, the real division in that situation was six to three. Moreover, two of the six—Stone, C.J., and Roberts, J.—are gone. Justice Burton, one of the replacements, wrote the majority opinion in the *Jacobson* case. In view of the Court's known disregard for the doctrine of *stare decisis*, these factors *could* be significant. On the other hand, the majority opinion in the *Jacobson* case (at page 51) does contain the following reassurance:

"The situation in each transaction is a factual one. It turns upon whether the transaction is in fact a transfer of something for the best price available or is a transfer or release of only a part of a claim for cash and of the balance 'for nothing.' The latter situation is more likely to arise in connection with a release of an open account for rent or for interest, as was found to have occurred in *Helvering v. American Dental Co.*, *supra*, than in the sale of outstanding securities, either of a corporation as described in § 22 (b)(9), or of a natural person as presented in this case."

9. *Commissioner v. American Dental Co.*, 318 U. S. 322 (1943).

gift tax from the stockholders. Nevertheless, the stockholders would refuse to pay any gift tax on such a transaction, *and very likely with good reason.*

A. *A Gift Defined*

A gift may be defined generally as a voluntary transfer of property without consideration.¹⁰ The cancellation of the indebtedness due from *X* corporation to *A* and *B* does not fall within that definition because each creditor would receive consideration through the appreciation in value of his stock.

The Internal Revenue Code adds another factor to the general concept of a taxable gift, namely, a transfer for inadequate consideration.¹¹

However, the contribution of each stockholder-creditor could not be isolated and partially taxed, *e.g.*, *A* could not be taxed on 50% of his contribution merely because his stock would benefit only to the extent of 50% of his contribution, since his contribution is made in consideration of the transfer by *B* and would not be made in the absence of that transfer. Hence, in return for his contribution, *A*'s stock appreciates in value to the extent of 50% of both the transfers, *i.e.*, the appreciation in value of his stock is equal to the amount of his entire contribution. Consequently, he has received full and adequate consideration in money's worth and has not made a gift for *gift tax purposes*, even though *X* corporation has received a gift and not income for *income tax purposes*.¹²

B. *A Gift Interpreted*

While no such clear-cut precedent as the *American Dental* case exists to negative the gift tax liability of the forgiving stockholder-creditors, the conclusion that no such liability will be incurred by those creditors is indicated by the recent adjudications and texts.

10. BOUVIER, LAW DICTIONARY 467 (Library ed. 1928).

11. INT. REV. CODE § 1002 provides:

"Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall, for the purpose of the tax imposed by this chapter, be deemed a gift, and shall be included in computing the amount of gifts made during the calendar year."

12. Similarly, a payment by a corporation to the widow of a deceased employee may be a gift and not income to the widow, yet not a gift but a fully deductible business expense to the corporation (I.T. 3329, 1939-2 CUM. BULL. 153). See also, Lynch, *Some Tax Effects of Cancellation of Indebtedness*, 13 *FORD. L. REV.* 145, 168 (1944), and Tarleau, *Federal Income Tax Considerations Applicable to Cancellation of Indebtedness* in 5th Annual N. Y. U. INSTITUTE ON FED. TAXATION 664 (1947). That distinction was made at the very outset of this comment, and its repetition here is not unintentional. Illustrative of the confusion that can arise is the opinion in *George Hall Corp. v. Commissioner*, 2 T. C. 146 (1943). There the court (at page 146) after accurately stating that a gratuitous cancellation of indebtedness "was a gift which was not taxable income to the petitioner corporation," added, somewhat loosely in the very next sentence but one, that the forgiveness was "a nontaxable gift," a phrase more appropriate in considering gift tax consequences to the donor than in determining (as the court did in that case) the income tax results to the donee.

(1) *The Scanlon Case*

Perhaps the leading case on this subject is *Scanlon v. Commissioner*¹³ in which the Commissioner has acquiesced.¹⁴ Scanlon was the sole stockholder in a corporation. He made certain transfers to that corporation, receiving nothing from the corporation in return. The Commissioner assessed a gift tax against Scanlon. In expunging the alleged deficiency, the Board of Tax Appeals said:

"We think it clear that there was full and satisfactory compensation to petitioner, through the corresponding enhancement in the value of his shares even though it be conceded that this was a transfer by one person to another. . . .

"We do not say, disregarding the corporate entity, that petitioner made a transfer to himself, so much as we do that, having due regard to the realities, petitioner's interest as sole stockholder in the corporation's property gave him a corresponding compensation for the transfer, which prevents it from being a true gift within the meaning of the gift tax law."¹⁵

In the instant case there is not a sole stockholder, but rather two stockholders. However, since each proposes to make a ratable contribution in proportion to his stock holdings, the reasoning applicable to the sole stockholder is apposite here, *i.e.*, as in the *Scanlon* case, each stockholder's interest in the corporate property gives "him a corresponding compensation for the transfer."¹⁶

Distinguishing *Thompson v. Commissioner*¹⁷ the Board in the *Scanlon* case took up the case of a corporation having more than one stockholder, where some of those stockholders did *not* transfer their ratable shares of the contribution to the corporation. With respect to such a situation the Board said:

"If petitioner were not the sole shareholder a different question would arise. For other shareholders would benefit proportionately from the receipt of the property by the corporation. As to them, particularly members of the transferor's family, there is no reason to disregard the gift theory. And if to that extent the transfer is a gift there may be no practical method of adminis-

13. 42 B. T. A. 997 (1940).

14. 1941-2 CUM. BULL. 11.

15. 42 B. T. A. 997, 999 (1940). Before this statement appeared in the *Scanlon* case many had thought (and some still contend!) that, since the Regulations (U. S. Treas. Reg. 108, § 86.2) provide that a gift *by* a corporation is a gift by its stockholders, a gift *to* a corporation is a gift to its stockholders. That conclusion was supported by the language of the Congressional Committee Reports [H. R. REP. No. 708, 72d Cong., 1st Sess. 27 (1932), 1939-1 CUM. BULL. (Part II) 476; SEN. REP. No. 665, 72d Cong., 1st Sess. 39 (1932), 1939-1 CUM. BULL. (Part II) 524] relating to the gift tax provisions of the Revenue Act of 1932 (which reintroduced the gift tax into the federal revenue system, after an absence of six years). Those reports said:

"For example, (1) a transfer of property by a corporation without a consideration, or one less than adequate and fully in money or money's worth, to B would constitute a gift from the stockholders of the corporation to B; (2) a transfer by A to a corporation owned by his children would constitute a gift to the children. . . ."

16. *Id.* at 999.

17. 42 B. T. A. 121 (1940).

tering the act save to treat the tax as applying to the whole. *Frank B. Thompson*, 42 B. T. A. 121. But no such difficulty need disturb us here, since no one but petitioner was interested in either the property transferred or its recipient."¹⁸

(2) *The Thompson Case*

At this point, some attention should be given to the *Thompson* case, which preceded the *Scanlon* determination by four months. In a corporation which issued only 100 shares of stock, Thompson held 50 for his own account and 40 as trustee of four equal trusts for the benefit of his four children. His wife owned the remaining 10 shares. Thompson made various transfers to his corporation and, when the Commissioner assessed a gift tax against him, Thompson advanced two contentions: (1) that only one-half of the transfers was taxable, since the donor owned one-half of the stock in the corporation, and (2) that there should be a \$5,000 (now \$3,000)¹⁹ exclusion for each of the other five stockholders and not just one exclusion for the corporation as donee.

The Board decided against Thompson on both issues. It stated:

"We see no reason in the language of the statute for holding that the petitioner's voluntary contribution to the corporation for which he received nothing, albeit the value of his shares was *pro tanto* enhanced, may be regarded as other than a gift."²⁰ (citing a number of *income tax cases* wherein the basis of property gratuitously transferred to a corporation was held to be the same as that of the transferor, on the ground that the transfer was a gift).

It should be noted, however, as said by Rabkin and Johnson in their work on *Federal Income, Gift and Estate Taxation*:

"... that the *Thompson* case was settled by excluding the portion of the property attributable to the taxpayer's own stock, and that the Board's decision on this point would probably not be followed today. It should be noted also that the Board allowed only one exclusion, despite the fact that there were several benefited stockholders; that phase of the decision appears to be overruled by *Helvering v. Hutchings*, 312 U. S. 393,"²¹ (which held "that the beneficiaries, not the trustee, were the donees; and that the donor was entitled to an exclusion with respect to the value of each beneficiary's interest"²²).

Dealing with the question of how much of a gift is taxable where *only one of several stockholders* makes the transfer, the CCH Federal Estate and Gift Tax Reporter says:

"The question has not been definitely settled but there is ground for claiming

18. 42 B. T. A. 997, 999 (1940). This distinction would appear to be valid as to the portion of the cancellation which benefited those stockholders who made no such contribution to the corporation. It is, however, questionable and unconvincing with respect to that portion of the cancelled debt which was returned to the donor through the enhancement in the value of his stock. In this connection, see note 24 *infra*.

19. See INT. REV. CODE § 1003 (b)(3).

20. 42 B. T. A. 121, 122 (1940).

21. RABKIN & JOHNSON, FEDERAL INCOME, GIFT AND ESTATE TAXATION 2916b (1944).

22. *Id.* at 2926.

that the gift is in the amount of the transferred property reduced by the percentage of stock owned by the transferor. Thus, if the transferor owns 25% of the stock, the gift amounts to 75% of the amount transferred. The basis for this is a compromise agreement in *F. B. Thompson*, 42 B. T. A. 121, Dec. 11, 1923. The agreement was the basis for an order by CCA-6, remanding the case to the Board of Tax Appeals. . . . By recomputing the tax on the basis of the amounts by which deficiencies were reduced under the agreement it appeared that the tax was finally charged against only 50% of the amount which taxpayer transferred to the corporation in which he owned 50% of the stock."²³

Since the Commissioner, after winning the *Thompson* case in the Tax Court, entered into a compromise, upon appeal,²⁴ which deprived him of the fruits of his victory, it must be concluded that the *Thompson* opinion does not represent the law at present.²⁵ Since, in addition, he has acquiesced in the *Scanlon* determination, it must also be concluded that the *Thompson* opinion does not even represent the current policy of the Bureau.

(3) *The Bothin Case*

The opinion in the *Scanlon* decision found it necessary to distinguish one further determination, namely *Bothin Real Estate Co. v. Commissioner*.²⁶ There the sole stockholder of corporation *A* transferred to corporation *A* without consideration shares of stock in corporation *B*. This transfer was held to be a gift. The court concluded that the enhancement of the value of the sole stockholder's shares in corporation *A* did not constitute consideration. With respect to this determination the Board said:

"We are not unmindful that in *Bothin Real Estate Co. v. Commissioner*, 90 F. 2d 91, the Circuit Court of Appeals, Ninth Circuit, affirming the Board, applied the rule of the *Rosenblum* decision [66 F. 2d 556] to the case of a sole stockholder in holding that the basis of his transferee corporation was the same as his own. But the conclusion there expressed that the transfer was a 'gift' seems to have rested principally on the taxpayer's concession of fact that consideration was lacking."²⁷

The *testimony* contained some justification for the Board's distinction, although the *Bothin* Company's counsel argued vigorously that the enhancement in value of its shares constituted consideration. However, (1) this determination antedated the *Scanlon* opinion by more than three years, and (2) the *Bothin* decision was an *income tax case* and *not a gift tax case*. Accordingly, for gift tax purposes, the *Scanlon* case would seem to take precedence over the *Bothin* opinion, even though the latter was written by a Circuit Court of Appeals (Ninth Circuit).

23. CCH FED. EST. & GIFT TAX REP. ¶ 5060.285.

24. *Thompson v. Commissioner*, 30 A. F. T. R. 1534 (C. C. A. 6th 1942).

25. To this effect, see *Gregory v. State*, 77 Cal. App. 2d 26, 174 P. 2d 863 (Dist. Ct. App. 1946).

26. 90 F. 2d 91 (C. C. A. 9th 1937).

27. 42 B. T. A. 997, 1000 (1940).

(4) *The Rosenblum Case*

In the language of the *Scanlon* opinion last quoted above, mention was made of *Commissioner v. Rosenblum Finance Corporation*.²⁸ There, under circumstances similar to the *Thompson* case, the court held that a gratuitous transfer by one of several stockholders was in its entirety, a gift. However, the *Rosenblum* case, like the *Bothin* case, involved *income tax* and not *gift tax*.

In view of the compromise in *Thompson v. Commissioner*, the *Rosenblum* holding may no longer be sound. However, it should be observed that both the *Thompson* and the *Rosenblum* rulings are distinguishable from the instant problem since, in each of those two determinations, minority stockholders *who made no ratable contribution* benefited in proportion to their stock.

(5) *Donative Intent*

A false reliance upon the donative intent²⁹ argument must be avoided in the instant situation.

The element of donative intent is required only when the transfer occurs amid a "commercial context."³⁰ "The Treasury Regulations make clear that no genuine business transaction [regardless of disparity of price] comes within the purport of the gift tax."³¹ But "on finding that a transfer in the circumstances of a particular case is not made in the ordinary course of business, the transfer becomes subject to the gift tax to the extent that it is not made 'for an adequate and full consideration in money or money's worth,'"³² regardless of the absence of donative intent.

Could the subject forgiveness be regarded as "a transfer in the ordinary course of business"? Probably not. The relationship between the two stockholder-creditors and their corporation is more analagous to a family situation than it is to a "commercial context." Indeed, in commenting upon *Collins v. Commissioner*³³ wherein *only one* of the common stockholders gratuitously forgave a dividend owing to her as a preferred stockholder, Paul says:

"to find a business transaction here is probably to torture 'the meaning of ordinary speech.'"³⁴

(6) *The Collins Case*

A brief discussion of the *Collins* decision is necessary to complete this comment. There the Commissioner determined that the petitioner made a gift of \$38,000 to the corporation by waiving the accumulated dividends on her preferred stock.

28. 66 F. 2d 556 (C. C. A. 3d 1933).

29. For an interesting distinction between intent and motive, see the opinion of the Circuit Court of Appeals in *American Dental Co. v. Commissioner*, 128 F. 2d 254, 256 (C. C. A. 7th 1942).

30. Cf. PAUL, FEDERAL ESTATE AND GIFT TAXATION 695 (Supp. 1946).

31. *Commissioner v. Wemyss*, 324 U. S. 303, 306 (1945).

32. *Ibid.*

33. 1 T. C. 605 (1943).

34. PAUL, FEDERAL ESTATE AND GIFT TAXATION 697 (Supp. 1946).

The Tax Court decided that:

" . . . a transfer to be donative in character must be made for altruistic reasons, out of pure generosity or solicitude for the welfare of the recipient rather than for some selfish reasons as, for example, a business benefit which the transferor may hope to receive. . . .

"We conclude for the reasons above indicated that there was not in this case a transfer of property by gift to the corporation within the meaning of section 501(a)." ³⁵

It should be observed that while the *Collins* case finds no gift to have been made under its facts, it relies heavily upon the lack of donative intent. This reliance is doubtless misplaced, as indicated (1) by the *Wemyss*³⁶ case coupled with the above quotation from Paul's work³⁶ and (2) by the fact that upon the Commissioner's appeal to the Circuit Court of Appeals, a stipulation in compromise was executed, vacating the decision of the Tax Court.³⁷

III. CONCLUSION

Pursuant to definition and to the requirements of Section 1002 of the Internal Revenue Code,³⁸ there cannot be a taxable gift unless property is transferred for no consideration or for less than adequate and full consideration in money or money's worth.

What the Congress seeks to tax is a diminution of the transferor's estate. Under the foregoing authorities and in all logic, a transfer is exempt to the extent that the estate is simultaneously replenished.

"The section taxing as gifts transfers that are not made for 'adequate and full [money] consideration' aims to reach those transfers which are withdrawn from the donor's estate."³⁹

As Paul puts it:

"Finally, if a taxable gift is effected by a surrender of economic benefits and control rather than by a mere shift in legal title, a true gift seems to be lacking to the extent that the donor owns stock in the corporation."⁴⁰

To the same effect are the words of the Supreme Court in *Helvering v. Hutchings*:

"The gift tax provisions are not concerned with mere transfers of legal title to the trustee without surrender by the donor of the economic benefits of ownership and his control over them. A gift to a trustee reserving to the donor the economic benefit of the trust or the power of its disposition, involves no

35. 1 T. C. 605, 608 (1943).

35a. *Commissioner v. Wemyss*, 324 U. S. 303, 306 (1945).

36. See note 34 *supra*.

37. 5 P-H FED. TAX SERV. ¶ 71,025 (1945).

38. See notes 10 and 11 *supra*.

39. *Commissioner v. Wemyss*, 324 U. S. 303, 307 (1945).

40. 2 PAUL, FEDERAL ESTATE AND GIFT TAXATION 1088 (1942).

taxable gift. It is only upon the surrender by the donor of the benefit or power reserved to himself that a taxable gift occurs. . . .⁴¹

The recent decision of *Estate of Edwin W. Rickenberg v. Commissioner*⁴² offers a persuasive analogy. There the Commissioner had assessed an estate tax upon property transferred by the decedent less than two years before his death. The petitioner urged, among other arguments, that the transfer was a bona fide sale for an adequate and full consideration in money or money's worth. The court said:

"The third reason for our holding that the transfer on December 2, 1942, to the decedent's wife was not a bona fide sale for adequate and full consideration in money or money's worth is that *such consideration has been held to be one which leaves intact the estate of the decedent*. In short, the intent of the exception stated in section 811 (c) is that *if the transfer of property from a decedent brought into his estate the equivalent thereof, the estate, of course, was not diminished*."⁴³

It will therefore be observed that, under the *estate tax* (whose concepts are much closer to the *gift tax* than are those of the *income tax*), adequate and full consideration "has been held to be one [*i.e.*, a consideration] which leaves intact the estate."⁴⁴

Clearly, the cancellation of indebtedness in the instant case leaves intact the estates of the forgiving stockholder-creditors because of the enhancement of the value of their stock. Moreover, the subject forgiveness would not benefit any one other than those making the cancellation. Each would receive adequate and full consideration in money's worth through the enhancement in the value of his stock.

Neither in law nor in logic, therefore, should any gift tax attach to such a transaction.⁴⁵

41. 312 U. S. 393, 396 (1941).

42. 11 T. C. 1 (1948).

43. *Id.* at 12 (italics supplied).

44. *Ibid.*

45. As indicated at the outset (subdivision I, second paragraph), the *income tax* consequences of this transaction to the *donee* have been eschewed. So, too, the *income tax* consequences to the *donors*. Nevertheless, it may be observed, briefly and with generality, that, since X corporation is by hypothesis solvent, the stockholder-creditors are not entitled to a bad debt deduction. Since there has been no sale or exchange, and since the debt has not become wholly worthless, the stockholder-creditors have not suffered a capital loss. However, they could properly view the cancellation as a contribution to capital and hence increase the basis of their stock by an amount equal to their basis for the *principal* of the debt forgiven (*Kasle v. United States*, 75 F. Supp. 340 (N. D. Ohio 1947)). No such increase would be permissible with respect to any *interest* forgiven, unless the stockholder-creditors filed their returns on an accrual basis and took the interest into income as it became due, even though it was not paid.