

3-1-1978

Scope of Tax Benefit Rule Limited

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Recommended Citation

Steven M. Harris and Ronald B. Ravikoff, *Scope of Tax Benefit Rule Limited*, 32 U. Miami L. Rev. 487 (1978)

Available at: <http://repository.law.miami.edu/umlr/vol32/iss2/11>

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Perhaps even more disturbing is that Revenue Procedure 64-19 is only one application of the Service's position which, if applied to other situations, could present insurmountable problems to estate planning in general. Thus, despite this apparent taxpayer's victory, the war is far from over. The Service will persist in its position until the issue is resolved in the Supreme Court or at least in most of the circuits. Until then, any estate planning must proceed on uncertain grounds at a time when the Tax Reform Act of 1976 presents enough uncertainty.

DAVID R. ROGOL

Scope of Tax Benefit Rule Limited

In Putoma Corp. the Tax Court decided that forgiveness of interest indebtedness owed by a corporation (which had deducted for the accrued but unpaid interest) to a shareholder did not result in taxable income to the corporation because the interest forgiveness was a contribution to capital. The authors dispute the court's analysis and suggest a framework for future decisions concerning this problem.

As a general proposition, when a deduction is followed in a subsequent year by a recovery in money or property of the previously deducted liability, the taxpayer must treat the recovery as gross income.¹ The item is deemed to be recovered when liability for the item terminates.² This judicial doctrine is known as the "tax benefit rule" and is composed of three distinct requirements: (1) an amount previously deducted, (2) which resulted in a tax benefit, and (3) which was recovered during the taxable year at issue.³

The Treasury Regulations provide that the tax benefit rule is applicable to recoveries of previously deducted bad debts, taxes, delinquency amounts, other expenditures or accruals, and all other

1. I.R.C. § 111; 1 MERTENS, LAW OF FEDERAL INCOME TAXATION § 7.4 (1974). I.R.C. § 111(a) provides: "Gross income does not include income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount." (emphasis added).

Recovery exclusion is defined in I.R.C. § 111(b)(4) to be that amount that did not result in a reduction of the taxpayer's tax. Treas. Reg. § 1.111-1(a) (1956) expands on the statutory language by providing that the rule of exclusion (and thus inclusion) applies equally with respect to all other losses, expenditures, and accruals made the basis of deductions from gross income for prior taxable years.

2. See *Bear Mfg. Co. v. United States*, 430 F.2d 152 (7th Cir. 1970), cert. denied, 400 U.S. 1021 (1971).

3. *Estate of David B. Munter*, 63 T.C. 663, 679 (1975) (Tannenwald, J., concurring).

losses similarly recovered during the tax year.⁴ Recoveries of specific items held to be within the purview of the tax benefit rule include charitable contributions returned to the contributor,⁵ officer's salaries returned to the corporate payor,⁶ and supplies and similar items expensed in the taxable year prior to an otherwise nontaxable liquidation.⁷

The logic behind the tax benefit rule is apparent when one considers the different accounting methods—cash and accrual—that are permitted under the Internal Revenue Code. The Code requires taxpayers to compute, on an annual basis, net income subject to tax ("taxable income").⁸ The income subject to tax may be computed by the use of cash, accrual or other acceptable methods of accounting.⁹ The method used by the taxpayer should be the same as that by which he computes income in keeping his books.¹⁰

If the accrual method of accounting is used, income must be reported for the period during which the right to the income becomes fixed¹¹ and its amount becomes determinable in light of the circumstances existing during the taxable year.¹² Deductions are allowable for those items which become liabilities during the year, even though payment is not made until a subsequent taxable period.¹³ Where a deduction is properly taken by an accrual basis taxpayer based on a computation made with reasonable accuracy and the exact amount is determined to be different in a later taxable year, the difference between these amounts must be accounted for when filing an income tax return in that taxable year in which the true amount is determined.¹⁴

A cash method taxpayer may not take a tax deduction until the liability or obligation of payment is fulfilled. The accrual basis taxpayer is permitted deductions for taxable years in which an expense

4. Treas. Reg. § 1.111-1(a) (1956).

5. *Alice Phelan Sullivan Corp. v. United States*, 381 F.2d 399 (Ct. Cl. 1967); Rev. Rul. 76-150, 1976-1 C.B. 38.

6. See *Larchfield Corp. v. United States*, 373 F.2d 159 (2d Cir. 1966).

7. *Spitalny v. United States*, 430 F.2d 195 (9th Cir. 1970). For an excellent treatment of the tax benefit rule as applied to corporation-shareholder relationships, see *Anders v. United States*, 462 F.2d 1147 (Ct. Cl. 1972), cert. denied, 409 U.S. 1064 (1972); *Tennessee Carolina Transp. Inc.*, 65 T.C. 440 (1975); *Estate of David B. Munter*, 63 T.C. 663 (1975); O'Hare, *Statutory Nonrecognition of Income and the Overriding Principle of the Tax Benefit Rule in the Taxation of Corporations and Shareholders*, 27 TAX. L. REV. 215 (1972).

8. See I.R.C. § 441.

9. See I.R.C. § 446(c).

10. I.R.C. § 446(a).

11. See Treas. Reg. § 1.446-1(c)(ii) (1957).

12. Treas. Reg. § 1.451-1(a) (1957); see I.R.C. § 451.

13. I.R.C. § 461; Treas. Reg. § 1.461-1(a)(2) (1957).

14. Treas. Reg. § 1.461-1(a)(2) (1957).

liability arises but no payment is made. If an accrued liability is not paid, the tax benefit rule purports to place the accrual basis taxpayer on an equal footing with the cash basis taxpayer. It is well worth remembering that I.R.C. section 446(b) empowers the Commissioner of Internal Revenue to compute a taxpayer's income if the method used does not clearly reflect taxable income.¹⁵ Moreover, this authority can be exercised with broad power and discretion,¹⁶ and determinations of taxable income made on the basis of section 446(b) authority will not be overturned absent a showing by the taxpayer that the Commissioner has abused this power or acted arbitrarily.¹⁷

Given the above analysis, if a "properly" accrued item of expense is not paid in a later period,¹⁸ logic and technical authority would dictate a recapture of this deduction. Recapture would be effected in the taxable period in which the facts and circumstances reveal that the deduction was not warranted.¹⁹

15. It is acknowledged that this provision is intended to apply to a single taxable year and not span accrual and payment years to correct previous inaccurate accruals. It is suggested, however, that the Commissioner's broad authority might empower him to use § 446(b) to go back and correct the accrual year deduction. Notwithstanding the possible implications of this § 446(b) authority, it would seem that it is the tax benefit rule which is intended to reach parity in such a situation, and use of § 446(b) could create tension with the annual accounting concept, as well as creating statute of limitations (I.R.C. § 6501) problems.

16. See *Commissioner v. Hansen*, 360 U.S. 446, 467 (1959); *Stephens Marine, Inc. v. Commissioner*, 430 F.2d 679, 686 (9th Cir. 1970); *Fort Howard Paper Co.*, 49 T.C. 275, 284 (1967).

17. See *Schram v. United States*, 118 F.2d 541 (6th Cir. 1941). The Commissioner's authority under § 446(b) has recently been used to put a cash basis taxpayer on an accrual basis with respect to a prepaid interest item. *Andrew A. Sander*, 62 T.C. 469 (1974), *aff'd*, 536 F.2d 874 (9th Cir. 1976). See also *Commissioner v. Kuckenber*, 309 F.2d 202 (9th Cir. 1962); *Family Record Plan, Inc. v. Commissioner*, 309 F.2d 208 (9th Cir. 1962).

Since the Commissioner's use of § 446(b) has been sustained when applied to one item of deduction, he might assert that this authority could be used to defeat the result reached in *Putoma*, i.e., the taxpayer could be put on the cash basis for the interest payable and if the previous year were not barred by the statute of limitations an adjustment would then be required. See note 19 *infra*.

18. Naturally, it is assumed that the accrual was predicated on the intention that the liability would eventually be paid.

19. It is submitted that the filing of an amended tax return is not always the complete answer because of the limitations imposed by the annual accounting concept and the statute of limitations. See, e.g., *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931); I.R.C. § 6511. *Burnet* is the frequently cited Supreme Court decision which holds that taxable income is to be computed on an annual period so as to produce ascertainable and regular flows of tax revenue. Obviously, constant reopening of prior tax years cannot be acceptable if our tax system is to function. In *Burnet*, the taxpayer had recovered litigation losses suffered in previous years. The Fourth Circuit Court of Appeals held that the amounts recovered were not income. 35 F.2d at 312. The holding was based upon an agreement whereby the taxpayer would amend its tax returns for the years in which the payments were taken as deductions. The Supreme Court did not accept the rationale of the lower court and held that the amount was taxable in the year recovered. It is noted that the harsh result often produced by the

In a recent decision, *Putoma Corp.*,²⁰ the Tax Court's application of several divergent tax principles to an accrual method taxpayer has so eroded this logic that perhaps only Congress can resurrect it.

In *Putoma*, a shareholder sold machinery to the taxpayer corporation, taking in return an interest bearing note and a chattel mortgage. The corporation deducted accrued but unpaid interest on the note.²¹ Some time later, the shareholder, out of concern for the viability of the corporation, cancelled the debt owed him for the unpaid interest. The Internal Revenue Service (the Service) contended that the forgiveness of the debt resulted in cancellation-of-indebtedness income to the corporation or, alternatively, in income to the shareholder for the exercise of his right to forgive the debt owed him. On petition, the United States Tax Court *held, inter alia*:²² The forgiveness of accrued interest constitutes a nontaxable contribution to corporate capital and not a recovery of a previously deducted item within the meaning of the "tax benefit rule." *Putoma Corp.*, 66 T.C. 652 (1976). It is the contention of the authors of this article that the Tax Court in *Putoma* has threatened to emasculate the tax benefit rule with the concomitant result of taxpayer windfall, by blending the principles of cancellation-of-indebtedness income, exclusion from income of gratuitous contributions to corporate capital, and the tax benefit rule.

According to the majority in *Putoma*, when the three tax principles enumerated above have been applied to similar facts, "the tax benefit rule has disappeared under the canopy of the cancellation of indebtedness rule, and the cancellation of indebtedness rule has disappeared under the canopy of the contributions to capital rule."²³

annual accounting concept is alleviated somewhat by provisions permitting carryover of net operating losses; see I.R.C. § 172. *But see Foster Lumber Co. Inc. v. United States*, 429 U.S. 32 (1976).

20. 66 T.C. 652 (1976).

21. Generally I.R.C. § 267(a) disallows a deduction for business expenses under I.R.C. § 162 if, within the taxpayer's taxable year in which these deductions are accrued plus two and one-half months after the close thereof, these deductions remain unpaid. See Treas. Reg. § 1.267(a)-1(b)(1)(iii) (1960). This provision is qualified in that it applies only to "related" taxpayers. For a corporation and an individual to be "related," the individual must own more than 50 percent of the outstanding stock of the corporation. I.R.C. § 267(b)(2). Because each shareholder owned exactly 50 percent of *Putoma's* outstanding stock, § 267 was inapplicable.

22. The case involved three other issues which will not be discussed: deductions for accrued compensation, commissions, and bad debts. *Putoma Corp.*, 66 T.C. 652 at 659-63 and 672-75.

23. 66 T.C. at 662. Prior to developing the majority's analysis, a brief overview of the tax principles involved is in order. Gross income includes income from the discharge of indebtedness owed the taxpayer, under I.R.C. § 61(a)(12). Thus, for example, if an individual performs services for a creditor who in consideration thereof cancels the debt, income is

Therefore, only an income *exclusion* rule, contributions to corporate capital under I.R.C. section 118, remains. Given this line of reasoning the outcome becomes predictable. The court held forgiveness of the accrued interest to constitute a nontaxable contribution to corporate capital and not a recovery of a previously deducted item within the meaning of the tax benefit rule.²⁴

Before dissolving the tax benefit rule into the cancellation of indebtedness rule and in turn into the contribution to capital rule, the majority identified the three requirements of the tax benefit

realized by the debtor in the amount of the debt. See Treas. Reg. § 1.61-12(a) (1968). See generally Denburg, *Income From the Discharge of Indebtedness: Planning and Opportunities*, 41 J. TAX. 108 (1974). Taxpayers may avoid being taxed on discharge of indebtedness income under certain circumstances by making a timely election to reduce the basis of property they hold. See I.R.C. §§ 108, 1017. The *Putoma* court noted that the taxpayer had failed to make a timely election pursuant to Treas. Reg. § 1.108(a)-2 (1967). 66 T.C. at 668, n.21. The Service holds in *Rev. Rul. 67-200*, 1967-1, C.B. 15, that the benefits of §§ 108 and 1017 are available to an accrual basis taxpayer who deducts interest which is unpaid and later forgiven. The Ruling states that any portion of the forgiven interest which did not give rise to a tax benefit is excludable under § 111, and any which did is excludable under § 108, provided a basis adjustment is made pursuant to § 1017. The majority, in acknowledging the election available under § 108, raises, but does not answer, the question of whether such an election would be pre-empted by the tax benefit rule in situations such as that encountered in *Putoma*. However, the minority distinguished the two concepts in a manner which seems to suggest that the accounting adjustment required by the tax benefit rule would override the benefits allowed by § 108:

[I]n the cases, there has arisen some unfortunate confusion between the tax benefit rule and the rule that income may result from the cancellation of indebtedness. The tax benefit rule is in effect an accounting rule. On the other hand, the cancellation of indebtedness may, in effect, be viewed as a substitute for the transfer of money, property, or other things of value, or it may be viewed as the nongratuious receipt of the goods or services which underlies the indebtedness—in either event, it may give rise to taxable income.

66 T.C. at 677.

In the case of a corporation, I.R.C. § 118 provides an exclusion from gross income with respect to any contribution of money or other property to the capital of the corporate taxpayer. Treas. Reg. § 1.118-1 (1960). See generally Behrsin, *What Constitutes Contributions to Capital is Still Unclear—Can it Be Treated as Gift?*, 44 J. TAX. 270 (1976). Section 118 applies to contributions from both shareholders and nonshareholders. Generally, contributions excludable under the provisions of § 118 are shareholders' contributions, whether in exchange for stock or not, and for land or other property contributed by a governmental authority to induce the corporation to locate within a particular community. I.R.C. § 362(c) provides for the computation of basis of property received from nonshareholders. Generally the basis of property other than money received from a nonshareholder will be zero. I.R.C. § 362(c)(1)(B).

24. The Service contended that the accrued interest was income to the shareholder when he cancelled the debt, relying on *Commissioner v. Fender Sales, Inc.*, 338 F.2d 924 (9th Cir. 1964). However, the Tax Court distinguished *Fender Sales* in which, unlike *Putoma*, stock was received for the cancelled debt and the shares received had a stipulated fair market value. This approach treats the accrued interest as being paid to the shareholder and then contributed back to the corporation. It is suggested that even an acceptance of the opinion in *Fender Sales* does not bear on the issue presented by *Putoma*. For a discussion of how the *Fender Sales* issue has been treated see articles at note 55, *infra*.

rule.²⁵ While finding that these requirements were clearly met, the court stated that the cancellation of indebtedness principle, when applied to a corporate-debtor and shareholder-creditor situation, will permit a nontaxable contribution of *both principal and interest* to corporate capital rather than income to the corporation. In order to support this conclusion the court relied heavily on *Helvering v. American Dental Co.*²⁶ In *American Dental* the taxpayer accrued and deducted rent and interest payable on obligations incurred in the purchase of merchandise, both of which were never fully paid. The unpaid obligations were eventually paid in part, in return for which the creditors cancelled the debts in full. The taxpayer credited the difference between the amounts paid and the full indebtedness to earned surplus. None of the cancelled debts were returned to income, although some of the debts were previously deducted in computing taxable income. The Commissioner determined that the cancellations which had resulted in offsets to income in prior years should increase the taxpayer's income in the year of cancellation. The Board of Tax Appeals sustained the Commissioner's determination.²⁷ The Court of Appeals for the Seventh Circuit reversed, holding that the cancellations were nontaxable gifts.²⁸ The Supreme Court affirmed, concluding that, notwithstanding any business or selfish motives, the forgiveness was gratuitous and sufficient to make the cancellation a gift within the meaning of section 22(b)(3)²⁹ of the 1939 Internal Revenue Code. Although the *American Dental* decision did not discuss the applicability of the tax benefit rule, the Court did observe that the cancelled indebtedness had been used to offset income in prior years.³⁰ *American Dental* has since been frequently cited to preclude taxation of similar cancellations.³¹

Finally, the majority in *Putoma* felt obliged to remind the Service that it was again rejecting the argument which had been consistently advanced by the Service for over fifty years—that the tax

25. See text accompanying note 3 *supra*.

26. 318 U.S. 322 (1943).

27. 44 B.T.A. 425 (1941).

28. 128 F.2d 254 (7th Cir. 1942).

29. Section 22(b)(3) is similar to I.R.C. § 102(a) of the 1954 Code. The current judicial definition of the term "gift" as announced in *Commissioner v. Duberstein*, 363 U.S. 278 (1960), probably precludes "gratuitous" treatment for shareholder forgiveness situations. Thus, the gratuitous element of *American Dental* might no longer be viable authority.

30. 318 U.S. at 324.

31. In support of its interpretation of *American Dental*, the *Putoma* court cited, *inter alia*, *Reynolds v. Boos*, 188 F.2d 322 (8th Cir. 1951); *Commissioner v. Auto Strop Safety Razor Co.*, 74 F.2d 226 (2d Cir. 1934); *Hartland Assoc.*, 54 T.C. 1580 (1970); *Utilities & Indus. Corp.*, 41 T.C. 888 (1964); *McConway & Torley Corp.*, 2 T.C. 593 (1943); *George Hall Corp.*, 2 T.C. 146 (1943).

benefit rule had superiority to the contribution to capital rule.³² The court then suggested that the Service "play [its old record] in a different forum."³³

The dissent voiced strenuous objection to the majority's superficial treatment of the intended scope of the tax benefit rule,³⁴ noting first that the objective of tax accounting is to compute annually net income subject to tax.³⁵ Thus the deduction is allowed on the assumption that the expense will eventually be paid. However, if the debt is modified such that it will not be paid, the taxpayer has received a *tax benefit* to which he is not entitled. Given this principle of tax accounting, the dissent found "that when the grounds for a deduction are modified by subsequent events, there must be an *adjustment* in income to reflect the changed circumstances."³⁶ In further support of its proposition, the dissent cited recent case law applying the tax benefit rule to situations generally considered to be governed by Code provisions allowing otherwise nontaxable treatment of certain types of transactions.³⁷

The dissent also differed with the majority as to the proper

32. The current position of the Service with respect to inclusion of cancelled indebtedness and interest thereon is found in Treas. Reg. § 1.61-12(a):

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 (emphasis added).

See also Rev. Rul. 76-316, 1976-2 C.B. 22, superseding Rev. Rul. 73-432, 1973-2 C.B. 17.

33. 66 T.C. at 668. Nevertheless, one might still infer that the court was somewhat sympathetic to the Service's position by its comment: "[W]hile a theoretically correct statement might indeed have merit considered *de novo*, we hardly write on a clean slate." *Id.*

34. *Id.* at 676-77.

35. *Id.* (citing *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931)). See text accompanying notes 8-17 *supra*.

36. 66 T.C. at 676 (emphasis added), citing *Mayfair Minerals, Inc. v. Commissioner*, 456 F.2d 622 (5th Cir. 1972), *aff'g per curiam* 56 T.C. 82 (1971); *Bear Mfg. Co. v. United States*, 430 F.2d 152 (7th Cir. 1970), *cert. denied*, 400 U.S. 1021 (1971); *West Seattle Nat'l Bank v. Commissioner*, 288 F.2d 47 (9th Cir. 1961), *aff'g* 33 T.C. 341 (1959); *Merchants Nat'l Bank v. Commissioner*, 199 F.2d 657 (5th Cir. 1952), *aff'g* 14 T.C. 1375 (1950); *Alice Phelan Sullivan Corp. v. United States*, 381 F.2d 399 (Ct. Cl. 1967); *Motor Products Corp.*, 47 B.T.A. 983 (1942), *aff'd per curiam*, 142 F.2d 449 (6th Cir. 1944). These cases involve accrual basis taxpayers who were required to include in income amounts accrued and deducted in previous years and "recovered" in a later year. In *Bear Mfg.* the court held that royalties accrued and deducted as expense in a prior year but unpaid were income in the year the taxpayer adjusted its books to eliminate the liability. In *Merchants Nat'l Bank* the taxpayer was required to include in income the amount of notes previously charged off as bad debts when sold in a liquidation transaction. In *Mayfair Minerals* the taxpayer took a deduction for contingent refunds which it was required to return to customers by order of the Federal Power Commission. When a rate increase was granted the taxpayer by the FPC and the refund liability terminated, the court held the taxpayer had to report in income the amount previously deducted. The inclusion was required over the taxpayer's assertion that the statute of limitations barred assessment of additional tax. See note 19 *supra*.

37. See cases cited in note 7 *supra*.

interpretation to be accorded the cases³⁸ cited by the latter in support of overriding the tax benefit rule in favor of the contributions to capital principle. According to the dissent, in *American Dental* and the cases that have since been decided on its authority, the question for decision was whether cancellation of indebtedness income was realized and *not* whether an *accounting adjustment* was required as a result of a recovery of an item previously deducted. Thus, the dissent felt that the court should not be constrained by its earlier decisions or those of other courts to conclude that the forgiveness of indebtedness in *Putoma* resulted in a nontaxable contribution to corporate capital. The dissent suggested an example to illustrate the distinction between the tax benefit rule,³⁹ and the rule that income may result from the cancellation of indebtedness:⁴⁰

[I]f a taxpayer, who uses the accrual method of accounting, incurs a liability to pay \$100 of rent in 1976, the deduction results in a tax savings for him. If the liability for rent is forgiven in 1977, there must be an accounting adjustment. If the cancellation of the liability was gratuitous, the accounting adjustment is the only tax consequence of such cancellation. The taxpayer is then in the same situation as a taxpayer who used the cash method of accounting and who would therefore never have been entitled to the deduction and the tax saving. On the other hand, if the liability was forgiven as a means of paying the debtor for services rendered, the debtor is required to report \$100 as income in such year and pay a tax on it. In effect, the debtor has fulfilled his obligation to pay rent for the preceding year, and the creditor has handed that money back to him as payment for services rendered. Although the debtor is required to pay an additional tax in 1977 in *both* situations, that result comes about for different reasons.⁴¹

In concluding, the dissent noted that the Tax Court was expected to have expertise in tax matters and to apply properly the principles of tax law. Moreover, the dissent indicated that the failure to clarify the application of the tax benefit rule invites unnecessary and complex congressional action.⁴²

Although the majority opinion is well reasoned and initially appears defensible, it is submitted that the holding misperceives

38. See cases cited at note 3 *supra*.

39. The tax benefit rule was characterized as an *accounting rule*. 66 T.C. at 677.

40. This rule was characterized as a substitute for the transfer of money or the nongratiuitous receipt of goods or services which underlies the indebtedness, resulting in the application of the contribution to capital rule. *Id.*

41. *Id.* at 677-78 (emphasis added).

42. *Id.* at 679-80.

judicial precedent and violates fundamental tax accounting principles in favor of historical commentary.⁴³

The majority's reliance upon *American Dental* and its successors seems misplaced, since the creditors in *American Dental* were not shareholders. The distinction is not one without a difference, given that the peculiar relationship between closely held corporations and shareholders is one often subject to Code restrictions aimed at discouraging tax avoidance schemes.⁴⁴ Furthermore, it is suggested that an extended discussion of the cases on point discussed in *Putoma* is not necessary to formulate a persuasive rule to be used in future decisions, including the instant case's appeal.⁴⁵ If a simple analysis of the issue is made, a simple answer emerges. If a creditor-shareholder forgives a debt, the result is a contribution to capital under I.R.C. section 118, but only of the principal of the debt. The accrued interest upon such debt is not covered by section 118, and is therefore not a contribution to capital. For this reason, the tax benefit rule should not, in the words of the majority, "disappear under the contribution to capital canopy,"⁴⁶ and the taxpayer should be taxed to the extent of his previous deductions for accrued interest. This line of reasoning is supported by case law.⁴⁷

43. The majority opinion phrased it thusly: "a page of history is worth a volume of logic." *Id.* at 666. One cannot seriously doubt the theoretical merit of this statement, but one must remember that a "page" is without meaning when the purpose of the "volume" is overlooked.

44. The unfortunate interpretation accorded *American Dental* is best seen in an opinion filed only two months later. In *Brown Cab Co.* [1943] 1 Tax Ct. Mem. Dec. (CCH) 450, the Tax Court, without substantive discussion, vacated its prior well-reasoned decision ([1943] 1 Tax Ct. Mem. Dec. (CCH) 448) which had held that principal indebtedness is distinguished from interest and held under *Jane Holding Corp.*, that the cancellation of the latter is income.

45. *Appeal docketed*, No. 77-1591 (5th Cir. 1977).

46. 66 T.C. at 666.

47. *Helvering v. Jane Holding Corp.*, 109 F.2d 933 (8th Cir. 1940), *rev'g* Edward Malinckrodt, Jr., 38 B.T.A. 960 (1938). In *Jane* the court held that there was a distinction between the debt principal and interest accrued thereon, and thus the cancellation was taxable. The court said: "An obligation, once deducted but not paid, represents income when, because of subsequent circumstances, it is cancelled or . . . will never be enforced." 109 F.2d at 941-42. The court in *Jane* indicated in dicta that its opinion would be apposite to that of *Commissioner v. Auto Strop Safety Razor*, 74 F.2d 226 (2nd Cir. 1934), if that court meant not to distinguish between principal and accrued interest. In *Auto Strop Safety Razor* an accrual basis subsidiary owed over two million dollars in royalties, interest and principal indebtedness to its cash basis parent. The court held that the cancellation of such indebtedness did not result in income to the subsidiary, but rather a contribution to the capital of the corporation. In response to the Commissioner's assertion that the indebtedness had served to reduce taxes in previous years, the appellate court refused to decide the case on that point as the Board of Tax Appeals had not made any findings of fact on the point. In dicta however, the court expressed its opinion that such fact would not change its decision. Also in dicta, the court expressed the following theory which could lend some support for overruling *Putoma*: "When the indebtedness was cancelled whether or not it was a contribution to the

Numerous authors have recognized that the judicial treatment of the forgiveness of shareholders' accrued and deducted salaries and interest as nontaxable contributions to corporate capital provides taxpayers with an unintended windfall.⁴⁸ Requiring the application of the tax benefit rule at the corporate level to force inclusion of income to the extent of the previous tax benefit comports with economic reality and tax equity, and respects the separateness of the corporate entity.⁴⁹ The *Putoma* decision increases the opportunity for inequity via tax avoidance and disrespect for the separate entities of corporation and shareholder. This is evident when the parties' positions are analyzed following the forgiveness and the finding of no liability under the *Putoma* court's analysis of the tax benefit rule.

capital of the debtor depends upon considerations entirely foreign to the question of the payment of income taxes in some previous year." 74 F.2d at 227. This statement might be used to support the application of the tax benefit rule in *Putoma*.

In *Walker v. Commissioner*, 88 F.2d 170 (5th Cir. 1937), *cert. denied*, 302 U.S. 692 (1937), interest paid on partnership indebtedness was taken as a tax deduction in the years paid. A subsequent agreement executed between the partnership's successor (of which Walker was a partner) and the previous creditors provided for the issuance of a non-interest bearing note and the crediting of all interest previously paid to the outstanding balance of the principal indebtedness. The appellate court held the cancellation of the liability and the surrender of the note which evidenced the liability resulted in taxable gain to the taxpayer partnership and thus its partners.

United States v. Little War Creek Coal Co., 104 F.2d 483 (4th Cir. 1939), *rev'g in part* 25 F. Supp. 764 (S.D.W. Va. 1938), is also enlightening. The taxpayer gave a promissory note to a creditor in 1922. In 1926 an auditor entered on the taxpayer's books the amount of \$22,599.57, the amount of the indebtedness plus accrued interest to that date. A controversy arose between the creditor and the taxpayer. While a suit was pending to determine that taxpayer's liability, the taxpayer charged the payable account off its books and reported the amount as income. Reporting this amount as income on its tax return did not result in the payment of any tax since the tax return reflected a loss for the year. In 1929 the taxpayer settled the account with its creditor for \$20,000, deducting this amount as a *loss* for that year. The court held that the charging off of the debt did not result in income as included by the taxpayer. Additionally, the court found that \$2,599.57 (the difference between the amount owed and the final settlement) should be recognized in the year of the settlement. The inclusion of this amount was based upon the fact that the amount set up on the taxpayer's books was settled for less than face amount. With regard to the issue that the indebtedness involved both principal and accrued interest, the court stated: "[i]t is true . . . that a part of the \$22,599.57 indebtedness was interest; but this interest was just as much a part of the indebtedness owing by taxpayer as the principal, and presumably covered items of accrued interest for which credit had been taken in prior returns" 104 F.2d at 484 (emphasis added).

See also *Howard Paper Co., Inc.*, 43 B.T.A. 545 (1941); *Amsco-Wire Products Corp.*, 44 B.T.A. 717 (1941); *Beacon Auto Stores, Inc.*, 42 B.T.A. 703 (1940); *Edward Mallinckrodt, Jr.*, *supra* (Sternhagen, J., dissenting).

48. 9 CLEV.-MAR. L. REV. 362, 364-65 (1960); see also articles cited note 49 *infra*.

49. 17 HAST. L.J. 784, 786, 789, 790 (1966); see Darrell, *Discharge of Indebtedness and the Federal Income Tax*, 53 HARV. L. REV. 977, 996 (1940); Surrey, *The Revenue Act of 1939 and the Income Tax Treatment of Cancellation of Indebtedness*, 49 YALE L.J. 1153, 1177 (1940); Comment, *Taxing Salary Forgiveness*, 13 U.C.L.A. L. REV. 833, 851 (1966).

When the debt is extinguished by the shareholder, the basis for his capital investment would be increased by the basis he had in the accrued and forgiven indebtedness. In the case of a cash basis taxpayer, there would be no basis in the unpaid obligation and thus its forgiveness would not increase the basis of his capital investment. Accordingly, upon sale, liquidation, or other disposition of his stock, the shareholder would recognize gain—probably capital in nature—that would include an increased corporate worth based upon the accrued but never paid deduction which was transferred to capital as a contribution by the shareholder. The corporation, of course, has had a tax deduction and resulting decrease in tax liability without the burden of paying the accrued obligation upon which the deduction was founded. Clearly, an increase in its net worth is the result of the forgiveness of the accrued item. It may be mere speculation (or even error) to assert that the increase is the full amount of the forgiven item, but it is beyond doubt that the net worth has increased to the extent of the tax avoided and an ordinary corporate deduction has been transformed into a shareholder capital gain. Moreover, the shareholder can control the year in which he will be taxed.⁵⁰ Assuming proper counselling, this will occur in the year most favorable in view of the individual's particular circumstances. While generally the incidence of taxation should be a function of the taxpayer's ability to pay, in *Putoma* the corporation's ability suffered nothing by the accounting accrual and forgiveness yet its tax liability was reduced. Of course, it can be argued that section 267⁵¹ will generally preclude the unintended tax windfall encountered in *Putoma*.⁵² But, as the decision clearly demonstrates, section 267 is

50. The apparent windfall and shareholder ability to control the timing can be seen in *Dwyer v. United States*, 439 F. Supp. 99 (D. Ore. 1977). In *Dwyer* a corporation was liquidated and its obligation to pay a shareholder accrued interest was forgiven. Under the authority of *Fender Sales* and *Putoma* the district court held that the liquidation distribution was entirely attributable to the retired stock and not in part payment of the accrued interest. Thus, the Service's recharacterization of the proceeds from long-term capital gain to interest income was rejected and the inequity suggested in the text immediately preceding this note occurred. The tax benefit issue at the corporate level was not in issue because I.R.C. § 267 was applicable and therefore the corporation was not allowed a prior deduction for the unpaid interest. However, it does not appear from the opinion that the result would have differed if § 267 was inapplicable.

It is submitted that any item accrued with the intent of latter forgiveness, to effect a *Putoma*-like result, could be effectively disallowed as being neither ordinary nor necessary under I.R.C. § 162. This position was not asserted by the Commissioner in *Putoma*.

51. See discussion note 21 *supra*. In a recent case, *Dwyer v. United States*, [1977] 77-2 U.S. Tax Cas. 9618 (D.C. Ore. Aug. 3, 1977) the *Putoma* windfall was held not available because I.R.C. § 267 was deemed applicable.

52. The exact problem in *Putoma* arises only when a corporation uses the accrual method of accounting and its shareholder uses the cash method. Where the shareholder uses the accrual method of accounting the accrued interest would be includable in gross income when

no panacea for forgiveness situations involving "closely-held" corporations.

The *Putoma* holding may have been predictable in light of *Hartland Associates*⁵³ in which the Tax Court overruled the tax benefit rule and applied the contribution to capital principle. *Hartland* should not have been controlling, however, since the court there noted that where a shareholder-creditor's forgiveness was not gratuitous, the rule enunciated in *Helvering v. Jane Holding Corp.* might apply.⁵⁴ If courts in the future feel constrained to apply the gratuitousness test advanced in *Putoma*, it is submitted that the forgiveness encountered in these situations should never be considered gratuitous. These cases typically involve an insolvent or failing corporate taxpayer, to which shareholders, out of fear for its viability, transfer the debt owed them to capital. The shareholders are then receiving their quid pro quo—an increased value of corporate investment by furtherance of corporate life.⁵⁵ An innovative and logical court would realize that the issue of gratuitousness is irrelevant to the applicability of the tax benefit rule because the tax benefit rule is simply an accounting adjustment.⁵⁶

The decision in *Putoma* has limited the otherwise correctly expanding judicial application of the tax benefit rule.⁵⁷ It is submitted that the result in *Putoma* is not required by the decision in *American Dental*, and that any judicial constraint felt by the Tax Court is self imposed and unnecessary. In addition, the court has *sub silentio* invalidated Treasury Regulation section 1.61-12(a) (1968).⁵⁸

The Service's appeal of *Putoma* to the Fifth Circuit is a last attempt to win judicial approval for its position. If the Fifth Circuit affirms, the Service will undoubtedly seek congressional action to close the "loophole" created by this historical anomaly. However, legislative correction is slow in the tax realm. Thus, the judiciary

deductible to the corporation, and such inclusion might alter the necessity for the accounting adjustment espoused in this article. See O'Hare, *supra* note 7, at 240-44. Although this theory would respect tax equities, it ignores the separateness of the corporate entity and allows the corporation to retain a tax benefit to which it is no longer entitled.

53. 54 T.C. 1580 (1970). But see Rev. Rul. 76-316, 1976-2 C.B. 22, which indicates that the Service will not follow *Hartland Associates*.

54. 54 T.C. at 1586 n.3. See note 47 *supra*.

55. See, e.g., *Carroll-McCreary Co. v. Commissioner*, 124 F.2d 303 (2d Cir. 1941).

56. See note 1 *supra*, and text accompanying note 49 *supra*. As indicated in note 29 *supra*, Duberstein probably precludes a finding of gratuitousness and, therefore, the same result is reached.

57. See *Tennessee Carolina Transp. Inc.*, 65 T.C. 440, 454 (1975).

58. See note 32 *supra*.

would do well to appreciate the tax benefit rule for what it is—an accounting adjustment—and not compound the rule with other statutory tax principles so as to produce taxpayer windfalls.

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