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STOCK DISTRIBUTIONS IN DISCHARGE OF SERVICE OBLIGATONS: *FENDER SALES* LIMITS TAXPAYER'S *JOY*

If ever a contented man who had taxes to pay existed, it most assuredly was one who successfully contrived a means to convert ordinary income into capital gains. A limited opportunity for the accomplishment of this desired result was presented by the Third Circuit Court of Appeals' decision in *Joy Manufacturing Co. v. Commissioner.*[1] Joy Manufacturing Company and its English subsidiary, Joy Sullivan, Ltd., were engaged in the manufacture and sale of mining and construction equipment. It was the practice of the parent corporation to render services to Joy Sullivan in return for a specified engineering and service fee that was customarily allowed to accrue on the books of the subsidiary and was presumably discharged at the end of the year.[2] The necessity arose of providing Joy Sullivan with additional working capital, and an English lending institution was consulted to obtain a loan. The English lender consented to furnish the needed funds only on the stipulation that the parent corporation receive stock in lieu of money as compensation for services to be rendered during the term of the loan. The taxpayer continued to render services to its English subsidiary and, pursuant to the agreement, accepted stock of Joy Sullivan, Ltd. with a fair market value equal to the accrued liability for services rendered. Joy Sullivan deducted this amount as a current operating expense on its British income tax return. However, Joy Manufacturing Company did not report the fair market value of the stock received as income, and the Commissioner asserted a deficiency against the taxpayer as to the tax on this amount. The court of appeals, reversing the Tax Court,[3] held that Joy Manufacturing Company had not realized income from the receipt of stock for the services rendered. The court noted that the parent corporation owned one hundred per cent of the stock of Joy Sullivan, Ltd. both before and after the distribution and, therefore, it had received nothing more than it had previously possessed in return for its services to the subsidiary. While the net value of the investment in Joy Sullivan was increased by the discharge of the liability for the services rendered, the court relied on the broad holding of *Eisner v. Macomber*[4] that a prorata distribution of stock to the shareholders of a corporation is not gross income to those shareholders. Under the assumption that an increase in the net value of Joy's investment in its subsidiary will be reflected in the fair market value of its Joy Sullivan stock, the court's decision had the effect of allowing Joy Manufacturing Company to postpone recognition

1. 230 F.2d 740 (3d Cir. 1956).

2. Although Joy Manufacturing Co. utilized an accrual basis of accounting, it did not recognize income when it rendered services to the subsidiary corporation because of its prior agreement to accept stock in lieu of money as compensation. The court determined that the distribution of stock by the subsidiary did not amount to a realization of income and, therefore, no income accrued to Joy. This issue was the basis of the Tax Court's decision in favor of the Commissioner but the decision was reversed on other grounds by the court of appeals.

3. 23 T.C. 1082 (1955).

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

of its gain until it disposed of the Joy Sullivan stock – a result that effectively transformed ordinary income into capital gains.[5] Earlier 1939 Code cases involving issues similar to those in *Joy* were in accord,[6] and the Service acquiesced in the rationale of these cases.[7]

The ecstasy of the taxpayer who found himself in the position to take advantage of the *Joy* holding was soon dampened by a directly contrary decision rendered by the Court of Appeals for the Ninth Circuit in *Commissioner v. Fender Sales, Inc.*[8] In *Fender Sales,* two taxpayers each owned fifty per cent of the stock of Fender Sales, Inc. and, in addition, were salaried employees of that corporation. Fender Sales, Inc., while solvent throughout the years in question, was continuously plagued by a shortage of working capital and thus was in a plight similar to that which Joy Sullivan, Ltd. had encountered. To aid the cash position of Fender Sales, both taxpayers did not withdraw any salaries due from the corporation but instead allowed a salary liability to accrue on the books of the corporation.[9] This step proved inadequate to remedy the cash shortage and the corporation was forced to seek bank financing. Sufficient financing was obtained, but the bank, fearing the possible priority of the salary liabilities, required as a condition to its loan that the accrued salary obligations be capitalized. This capitalization was accomplished by the issuance of stock with a value equal to the accrued salaries payable in discharge of that liability account. The taxpayers did not not report the fair market value of the stock as income on their returns for the year, but Fender Sales deducted this amount as a current expense in computing its taxable income. This procedure was followed for several ensuing years with the taxpayers reporting no income from the receipt of the stock in any year. The Commissioner asserted a deficiency to the extent of the tax on the fair market value of the stock received, but the Tax Court, following the *Joy* rationale, held that no income had been realized.[10] The Court of Appeals for the Ninth Circuit, employing two separate lines of reasoning, reversed the Tax Court. The court first stated that although the issuance of the stock was prorata and the taxpayers held all of the stock of Fender Sales, both before and after the distribution, the value of their

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5. This is based on the *theoretical* supposition that the increase in net worth will be reflected in the market value of the Joy Sullivan stock. This may or may not be the case, and it is conceivable that the market value would not reflect much, if any, of this gain that would allow Joy Manufacturing Co. to escape taxation entirely.

6. *See* Daggitt v. Commissioner, 23 T.C. 31 (1954); Josephson v. Commissioner, 6 CCH Tax Ct. Mem. 788 (1947).

7. 1955-1 CUM. BULL. 4, *acquiescing in* Daggitt v. Commissioner, 23 T.C. 31 (1954).

8. 338 F.2d 924 (9th Cir. 1964).

9. Although the corporation, which was on the accrual basis of accounting, had the benefit of a tax deduction for the amount of the salary expense, the taxpayers did not have to report this as taxable income since they were on a cash basis of accounting. INT. REV. CODE of 1954, §267 (a) (2) (A), which disallows a deduction to the corporation where an expense is not actually paid within two and one-half months after the close of the taxable year, does not apply in this instance because the relationship test of section 267 (b) is not met.

10. 22 CCH Tax Ct. Mem. 550 (1963).

investment in the corporation was enhanced by the amount of the salary liability discharged. The court determined that the stock distribution coupled with this increment in value was income subject to taxation under the sixteenth amendment to the Constitution and was not a stock dividend under *Eisner v. Macomber*.[11] Second, the court stated that one of the components of the transactions between Fender Sales, Inc. and the taxpayers was the cancellation of an indebtedness that, if collected, would have resulted in the realization of income to the taxpayers. The court characterized this as an assignment of previously earned income that, under the authority of *Helvering v. Horst*,[12] was taxable to the two shareholders to the extent of the fair market value of the shares received in discharge of this indebtedness.

After the decision in *Fender Sales* the Service withdrew its earlier acquiescence in the *Joy* cases and ruled that it would follow the holding in *Fender Sales*.[13] The new ruling stated that a prorata stock distribution issued to shareholder-employees in discharge of salary obligations owed to them represents an enhancement in the value of their corporate investment and, as such, is a realization of income to the recipients.

THE *Eisner v. Macomber* AREA

The genesis of the Internal Revenue Code with respect to whether an item is taxable income is section 61, which provides that "gross income means *all* income from whatever source derived."[14] Consequently, an examination of the taxation of prorata stock distributions in discharge of obligations for services rendered must begin with the presumption that stock distributions are income unless otherwise excluded. Section 305 of the Code, which purports to deal with distributions of stock and stock rights, contains the following statement: "[G]ross 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*."[15] The italicized portion of the statute indicates that a stock distribution must be to the shareholders in their capacity as shareholders and not to creditors, employees, or others to escape taxation under section 305. In both *Joy* and *Fender Sales* the shareholders received stock in their capacity as employees and not as shareholders, and section 305 would therefore be inapplicable in both situations. Congressional intent to tax such distributions might be implied from a cross reference in section 305 (c) (3) to section 61. The clear implication of this cross reference is that in the case of a distribution that has the effect of the payment of compensation, the distribution would be gross income. However, section 7806 (a) indicates such cross references are for convenience only and do not have the effect of law. The Treasury regulations categorically interpret

11. 252 U.S. 189 (1920).
12. 311 U.S. 112 (1940).
13. Rev. Rul. 67-402, 1967-2 CUM. BULL. 135.
14. INT. REV. CODE of 1954, §61 (a) (emphasis added).
15. INT. REV. CODE of 1954, §305 (a) (emphasis added). Section 305 (b) provides for two exceptions to the rule of §305 (a), but neither is relevant here.

section 61 as encompassing transfers by a corporation of its own stock to employees for services rendered and would tax the employee to the extent of the fair market value of the stock receivd.[16]

The taxpayers in both *Joy* and *Fender Sales* sought to escape the tentacles of section 61 under the broad rationale of one of the most celebrated cases in the annals of tax history – *Eisner v. Macomber.*[17] In *Eisner* the Supreme Court held that a stock dividend made against the accumulated earnings of a corporation is not taxable income under the sixteenth amendment of the Constitution. It would appear that if *Eisner v. Macomber* were confined to this narrow holding, section 305 would be the statutory enactment of the Court's decision and the taxpayers in both *Joy* and *Fender Sales* would be taxed to the extent of the stock received. This was, in effect, the position of the circuit court in *Fender Sales,* which stated that *Eisner* was "not even apposite, let alone controlling."[18] The court reasoned that a stock dividend, as dealt with in *Eisner,* represented nothing of value when issued proportionately to all shareholders and was not a realization of income. But the court went on to say that this was because the basic net worth of the corporation remained the same. This was distinguished from the situation in *Fender Sales* by pointing out that, although the shareholders' proportionate interests in the corporation remained unchanged after the stock distribution, the corporate net worth had increased as a result of the discharge of the salary obligations. The court concluded that the value of the shareholders' investments was, therefore, increased by the issuance of the stock and this was a realization of income.

Although the court of appeals in *Fender Sales* confines *Eisner v. Macomber's* application to stock dividends accompanied solely by a capitalization of retained earnings, the ramifications of *Eisner v. Macomber* are much broader in scope. The Court in *Eisner* defined income as[19]

> [N]ot a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *from* the capital however invested or employed, and *coming in,* being *"derived,"* that is *received* or *drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal; – *that* is income derived from property.

The position of the court in *Fender Sales* that the net worth of the taxpayers' holdings in the corporation had increased as a result of the discharge of the debt is not disputed, but is this equivalent to a *realization* of income? The quoted portion of the opinion in *Eisner v. Macomber* states that income is not merely an increment in value but rather is something separate from the capital and that proceeds from capital. In the facts at hand, the taxpayers held the same one hundred per cent interests in their respective corporations both before and after the stock distributions. These interests had appreciated

16. Treas. Reg. §1.61-(2)(d)(4) (1966).
17. 252 U.S. 189 (1920).
18. 338 F.2d 924, 927 (9th Cir. 1964).
19. 252 U.S. 189, 207 (1920).

in value because of the discharge of the debt liabilities and the concomitant increase in net worth of the corporation. In applying the *Eisner v. Macomber* income concept to these facts, no realization of income has occurred. The result is only an unrealized gain in the form of an appreciated interest in the corporation. It is admitted by the court in *Fender Sales* that the stock issued by the corporation and distributed to the shareholders was nothing more than an indicator of a capital investment in the corporation.[20] Consequently, the proportionate distribution of stock to shareholders *who already owned all of the stock of the corporation* cannot in and of itself be deemed "something of value" as required by the *Eisner v. Macomber* criterion. If it is therefore to be asserted that the taxpayers in *Joy* and *Fender Sales* have realized income solely on the grounds that they have received stock that represents an increase in the net worth of their corporate investments, as the Internal Revenue Service ostensibly does in Revenue Ruling 67-402,[21] then such an assertion is not in keeping with the concept of income as expressed in *Eisner v. Macomber* and should not be upheld.

Assignment of Income and Other Considerations

The opinion of the Court of Appeals for the Ninth Circuit in *Fender Sales* contains a discussion of the assignment of income aspect of the discharge of the service liabilities, but the discussion is inserted in such a manner that there exists the inescapable conclusion that the court considered it only as a secondary feature of its argument. Nevertheless, this aspect of the court's opinion becomes the focal point of examination in regard to both *Fender Sales* and *Joy*.

The basic thrust of the assignment of income concept is that income should be taxed to those who earn or otherwise create the right to receive it.[22] This concept had its beginnings in the case of *Lucas v. Earl*[23] in which an agreement between a husband and wife that the husband's salary would be divided equally between them was held invalid for tax purposes, and the entire amount was deemed taxable to the husband. This case was followed ten years later by the decision of the Supreme Court in *Helvering v. Horst*,[24] in which a father was held liable for the tax on income received by his son on the redemption of coupons the father had detached from his negotiable bonds and given to the son. The Court in *Horst* made clear that actual receipt of money or property is not a necessary prerequisite to the realization of income but realization can occur when "the last step is taken by which [the taxpayer] obtains the fruition of the economic gain which has already accrued to him."[25] The Court also adds that "[t]he power to dispose of

20. 338 F.2d 924, 927 (9th Cir. 1964).
21. Rev. Rul. 67-402, 1967-2 Cum. Bull. 135.
22. Helvering v. Horst, 311 U.S. 112, 119 (1940).
23. 281 U.S. 111 (1930).
24. 311 U.S. 112 (1940).
25. *Id.* at 115.

income is the equivalent of ownership of it."[26] In *Helvering v. Eubank,*[27] the Supreme Court reaffirmed the *Horst* decision and held that an assignment of insurance renewal commissions to another would not allow the assignee to escape income tax liability since the taxpayer had created the right to receive these payments by services previously rendered.

Examining the facts of *Fender Sales* in light of the assignment of income decisions, it is evident that the taxpayers had performed services for the corporation and had thereby created a right to compensation. This right to compensation was unquestionably unexercised prior to the stock distributions, and no amount was includable in the income of the taxpayers during that period since they were on a cash basis of accounting and no payments had been received.[28] The transaction in which stock was issued to the taxpayers by the corporation to discharge the debt effected a contribution to the capital of the corporation consisting of the amount due them for the services previously rendered. The contribution to the capital of Fender Sales, Inc. amounted to a diversion of previously earned income from the taxpayers to the corporation – an occurrence that was nothing more than an assignment of a naked right to income. Such a transfer is clearly within the principles enunciated by the Supreme Court in *Eubank* and *Horst* and would result in a tax liability to the taxpayers on the amount of income assigned to the corporation. Judge Barnes, in a separate opinion in *Fender Sales,* argued that no assignment of income was present on the grounds that there existed no diversion of income for the benefit of the taxpayers in a manner that was equivalent to ownership.[29] This loses sight of the fact that the taxpayers, who already possessed a fixed right to receive compensation for services previously rendered, *voluntarily* relinquished their claims in exchange for a stock that was of no value to the taxpayers.[30] The intended effect of this relinquishment was to divert the amount of this compensation to *their* corporation to enable it to obtain credit, thereby benefiting themselves. Such a voluntary diversion was equivalent to ownership of the compensation and certainly benefited the taxpayers. Professors Lyon and Eustice, in an excellent article on the assignment of income, [31] support this conclusion by stating that "compensation for personal services performed by the tax payer is an inherently non-assignable gross income item."[32] The diversion of previously earned compensation to Fender Sales, Inc. by the taxpayers, despite the fact that it was carried out under the guise of a stock dividend, was nevertheless an assignment of a right to income and should be taxed to the shareholders of Fender Sales, Inc. on that basis.

The application of the assignment of income principles to the *Joy* facts

26. *Id.* at 118.
27. 311 U.S. 122 (1940).
28. Section 267 (b) is not applicable. *See* note 9 *supra.*
29. 338 F.2d 924, 930, 931 (9th Cir. 1964) (dissenting in part and concurring in part).
30. *See* text accompanying notes 14-21.
31. Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P. G. Lake Case,* 17 TAX L. REV. 293 (1962).
32. *Id.* at 388, 389.

takes a different twist from the almost conventional application in *Fender Sales*.[33] The distinction lies in the manner in which the rights to payments were transferred in *Joy*. It will be remembered that the taxpayers in *Fender Sales* "assigned" their income to the corporation *after* the actual rendering of the services. In *Joy*, however, an agreement to accept stock rather than money for services rendered to the subsidiary corporation was made *before* the performance. Ordinarily, it is immaterial whether the assignment of compensation occurs before or after the services are performed and the income would be taxed to the person who earned it.[34] However, a decision by the Court of Appeals for the Ninth Circuit in *Commissioner v. Giannini*[35] places *Joy* in a different light. In *Giannini*, the taxpayer, who served as president of a small corporation, informed his corporation that he would accept no compensation for the services to be performed in a future period and suggested that it do something worthwhile with the money. The corporation contributed the sum to a charity and the taxpayer included no part of this in his income for that year. The court rejected the Commissioner's argument that this was an assignment of income, distinguishing *Horst* and other cases on the grounds that the taxpayer did not receive money or other property and did not direct its disposition. The court said that Giannini simply refused in advance to accept future compensation and "so far as the taxpayer was concerned, the corporation could have kept the money."[36] The holding in *Giannini* that a refusal to accept compensation prior to the rendering of services is outside the assignment of income area is further substantiated in a revenue ruling pertaining to fiduciaries of estates.[37] Here, the Service ruled that a timely waiver of a fiduciary's right to compensation for future services to an estate would not subject the fiduciary to any tax on the value of his services since, it was said, he would be rendering them gratuitously. It is in light of *Giannini* and this ruling that the timing of the agreement in *Joy* becomes important. The agreement between Joy Manufacturing Company and Joy Sullivan, Ltd., which preceded the actual rendition of services by the parent corporation, was to accept stock in lieu of money as compensation. It has previously been determined that the receipt of stock by a party who already owns all of the stock of the corporation has no tax significance under *Eisner v. Macomber*.[38] The receipt of stock in such an instance is nothing of value to the shareholders. Since Joy Manufacturing Company effectively relinquished all right to any *real* compensation for the services it was to render to its subsidiary in the future, it must be deemed to have performed the services gratuitously as in *Giannini*.

Under the application of *Giannini* to *Joy*, it would seem that Joy Manufacturing Company could "have its cake and eat it too," reporting no income

33. The court of appeals in *Joy* did not deal with the issue of assignment of income.
34. Lyon & Eustice, *supra* note 31, at 388, 389.
35. 129 F.2d 638 (9th Cir. 1942). *But see* Hedrick v. Commissioner, 154 F.2d 90 (2d Cir. 1946), which held that a refusal to accept payment *after* the services have been rendered will not protect the taxpayer.
36. Commissioner v. Giannini, 129 F.2d 638, 641 (9th Cir. 1942).
37. Rev. Rul. 56-472, 1956-2 CUM. BULL. 21.
38. *See* text accompanying notes 14-21.

from the services it rendered to its foreign subsidiary, while the subsidiary nevertheless takes a deduction on its British tax return for those same services. However, the Commissioner has an alternative that he might successfully utilize to prevent Joy Manufacturing Company from achieving this result. Under section 482,[39] when two or more business organizations are owned or controlled by the same interests, the Service is invested with the power to allocate or apportion income to one or more of these businesses to prevent the evasion of taxes or to reflect income clearly. This section expressly includes all business organizations regardless of whether they are organized in the United States or elsewhere.[40] Therefore, the fact that Joy Sullivan, Ltd. is a British corporation would not prevent the application of section 482. The two corporations meet the common control test of the statute since the shareholders of Joy Manufacturing Company directly or indirectly control the wholly owned subsidiary.[41] Consequently, if it could have been determined that there was no clear reflection of income with regard to the service transactions between the parent and the subsidiary,[42] the Commission could have allocated income to Joy Manufacturing Company. Although there are few cases in this area, the regulations provide that whenever one member of a group of business organizations performs marketing, managerial, administrative, or technical services for the benefit of another member of the group, the Commissioner may make appropriate allocations to reflect an "arm's length" charge for such services.[43] The services rendered by Joy Manufacturing Company to its subsidiary were of a technical nature and were gratuitous under *Giannini*. Consequently, it appears that section 482 would apply in the *Joy* situation. The fact that the subsidiary deducted the "expenses" incurred for these services on its tax return presented the Service with a strong case under section 482 to allocate a corresponding amount as income to the parent corporation. It is therefore unlikely that Joy Manufacturing Company should escape tax liability, but rather should suffer the same fate as the taxpayers in *Fender Sales*.

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39. INT. REV. CODE of 1954, §482. Although *Joy* was decided under the 1939 Code, this provision existed in substantially the same form. *See* Int. Rev. Code of 1939, §45.

40. *See* Treas. Reg. §1.482-1 (a) (1) (1968). *See also* Hall v. Commissioner, 294 F.2d 82 (5th Cir. 1961); Asiatic Petroleum Co., Ltd. v. Commissioner, 79 F.2d 234 (2d Cir. 1935), *cert. denied*, 296 U.S. 645 (1935); Surrey, *Treasury's Need To Curb Tax Avoidance in Foreign Business Through Use of 482*, 28 J. TAXATION 75 (1968).

41. Treas. Reg. §1.482-1 (a) (3) (1968).

42. It is assumed that no "evasion of tax" motive is present since Joy Manufacturing Co. had a legitimate business reason for its action.

43. Treas. Reg. §1.482-2 (b) (1) (1968). *See also* Treas. Reg. §1.482-2 (b) (2) (1968), which applies a benefit test; Treas. Reg. §1.482-2 (b (3) (1968), which defines an "arm's length" charge.

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CONCLUSION

The *Joy Manufacturing Company-Fender Sales* area is no longer even the limited haven for taxpayers that it was once thought to be. The fears of the court in *Fender Sales* that a loophole might exist are without basis.[44] There is very little opportunity even for the fertile imagination of the contemporary taxpayer to convert this previously earned income for services rendered into capital gains via stock distribution. The Service has a much better case than the one it presents in Revenue Ruling 67-402 (which indeed is no case at all). In addition to the assignment of income concept and section 482, the Commissioner might well raise the tax benefit argument with respect to the corporation rather than the shareholders.[45] In short, the Commissioner appears to be well prepared for the taxpayer who would be so bold as to seek to capitalize on the conflict in the *Joy* and *Fender Sales* decisions.

CHARLES H. EGERTON

44. The dissent refers to the majority's fear that a loophole might exist.

45. *See* Commissioner v. First State Bank, 168 F.2d 1004, 1011 (5th Cir. 1948) (concurring opinion) for a good discussion of the tax benefit theory.

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