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The Constructive Receipt Of Dividends By Stockholders Of A Closely Held Corporation

BY WILLIAM CHARLES BRAFFORD

I

INTRODUCTION

The Corporation as a Separate Tax Entity

For well over a century there has been much writing and discussion both as to the origin and nature of a corporation. The most often quoted definition is a statement of Chief Justice Marshall in the early Supreme Court case of Trustees of Dartmouth College v. Woodward,¹ where he stated: "A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law". This so called "fictional" theory of the nature of a corporation gave rise to the doctrine that a corporation is separate and distinct from its stockholders. It naturally lead to the conclusion that an individual stockholder, in the absence of special circumstances, was not liable either for the tort of the corporation or for a breach of contract by the corporation.² The

¹ This article is part one of a thesis submitted in partial fulfillment of the requirements for the degree of Master of Laws in the Graduate College of the University of Illinois, 1958. Parts two and three will be published in forthcoming issues of the Journal, and will discuss some tax problems of closely held corporations under the following headings: Compensation Paid to Stockholder Officers of the Corporation; Rentals and Royalties Paid to Stockholders; Distributions of Property and Bargain Sales and Purchases; Bargain Use of Corporate Property; Payments on Behalf of the Stockholder by the Corporation; and Purchase of Insurance by the Corporation’s Insuring the Lives of the Stockholders.

² LL.B., University of Kentucky, 1957; LL.M., University of Illinois, 1958.

¹ 17 U.S. (4 Wheat.) 518, 636 (1819).

² The court in Stone v. Cleveland, 202 N.Y. 352, 96 N.E. 816, 817 (1911), stated: “It is well established that the ownership of a majority of the stock of a corporation, while it gives a certain control of the corporation, does not give that control of corporate transactions which makes the holder of the stock responsible for the latter".
central feature of a corporation is, therefore, that it assures individual stockholders freedom from liability beyond their capital investment in the corporation—the corporate capital stands in lieu of individual liability of the participants. This "creature" may be distinguished from other forms of business organizations by the fact that in a corporation there is: (1) ownership by the corporate entity of property embarked in the undertaking; (2) centralization of management; (3) control of management through selection of directors by members; (4) continuity of enterprise without interruption by death of a member or transfer of stock; and (5) limited personal liability of the members. The fact that the corporation is a separate juristic entity does not mean, however, that it stands inviolable and immovable. Courts have often lifted the "corporate veil" and looked to the underlying owners in order to prevent injustice, fraud or the defeat of public policy.

In the administration of the tax laws, recognition of the separate corporate entity has not always been the general rule. The first federal income tax act ignored the corporate entity and taxed the stockholders directly on their distributive shares of the corporate income. This Civil War legislation was allowed to expire, however, and no subsequent Revenue Acts have attempted to tax in this manner. This is far from saying that the corporate entity remains unimpeached in the field of taxation. Even though the general rule is that the corporate entity will be recognized and the income of the corporation will not be taxed to the stockholders until a formal declaration of a dividend is made, exceptions to this rule have been, and are being made. An exception has arisen and is applied in cases where the courts determine that certain transactions between the corporation and its stockholders have as their purpose the avoidance of taxes. In this in-

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3 See Morrissey v. Commissioner, 296 U.S. 344 (1935), for a good discussion of the various characteristics of a corporation.
4 Luckenbach S. S. Co. v. Grace and Co., 267 Fed. 676 (4th Cir. 1920), where the corporation was inadequately capitalized to carry on the business for which it was organized, the controlling stockholder was denied limited liability.
5 Section 117 of an Act to provide Internal Revenue, etc., 13 Stat. 223, 282 (1864), directed that "the gains and profits of all companies, whether incorporated or partnership . . . shall be included in estimating the annual gains, profits, or income of any person entitled to the same, whether divided or otherwise". This legislation was sustained in Collector v. Hubbard, 79 U.S. (12 Wall.) 1 (1870).
stance the court will look to the "substance" of the transaction, rather than its "form" and apply the tax statutes accordingly.\(^6\) If the contention is made by the Government that the separate entity of the corporation should be ignored, it is usually for the purpose of supporting an argument that (1) the income of the corporation should be taxed to the stockholder or (2) that a transaction between the corporation and the stockholders should be disregarded for tax purposes. Of course ignoring the corporate entity can be an advantage to the stockholder,\(^7\) but it is usually to his disadvantage. In scrutinizing a particular transaction, the attitude which the courts will take was well stated in Weiss v. Stearn\(^8\) in the following language:

Questions of taxation must be determined by viewing what was actually done, rather than the declared purpose of the participante; and when applying the provisions of the Sixteenth Amendment and income laws enacted thereunder we must regard matters of substance and not merely form. (Emphasis added.)

This quotation is merely an express statement of the principle that the courts will look to the "substance" of a transaction rather than the "form" in determining tax questions, and serves as a warning that the corporate entity will not automatically insulate a transaction from the reach of the revenue laws.

\(^6\) In Linn Timber Co. v. U.S., 236 U.S. 574 (1915), the corporate entity was disregarded by the Court on a finding that the corporation was a "mere tool" of the organizing and controlling stockholder; U.S. v. Phellis, 257 U.S. 156 (1921).

\(^7\) Paymer v. Commissioner, 150 F. 2d 334 (2d Cir. 1945). In this case a partnership formed two corporations and transferred a piece of real estate to each, for the purpose of deterring creditors of one of the parties. The partners contended that the two corporations were mere "dummies" and that their separate entities should be disregarded, and that the income from the real estate should be taxed to the partners who were the sole stockholders. The Court upheld this contention as to one of the corporations, which did nothing but take and hold the title to the real estate conveyed to it. As to the other corporation, which engaged in some business, the Court held that its separate entity should not be disregarded; accord, Southern Pacific Co. v. Larne, 247 U.S. 330 (1918); cf. Moline Properties v. Commissioner, 319 U.S. 436 (1943), where the corporate entity was upheld as it served a business purpose and was not a mere "agent" of the stockholder. Eisner v. Macomber, 252 U.S. 189 (1920) has also been cited as standing for the proposition that the corporate entity may be disregarded to the stockholders advantage.

\(^8\) 265 U.S. 242 (1924).

\(^9\) Id. at 254.
Tax Problems of the Close Corporation

Nowhere has this "form versus substance" doctrine been more vigorously applied than in cases involving close corporations.\(^9\) The tax provisions of the Internal Revenue Code apply to the closely-held corporation in the same manner, with minor exceptions, as they do in the case of large public corporations. However, since the stockholders of a close corporation are few in number, the close relationship between the stockholders and the corporation give rise to tax problems unlike and in addition to those faced by large public corporations. Since corporate earnings may be taxed once at corporate rates and again when distributed as dividends, the total tax is less if such profits are distributed to stockholders in some form other than as dividends. Due to the fact that by their very nature greater opportunity exists for tax avoidance, transactions between stockholders and their close corporations have in recent years been scrutinized very carefully by the Internal Revenue Service and the courts to prevent the corporation from distributing profits in a form other than dividends. If corporate profits can be distributed in a form which is deductible from corporate income, the attributes of double taxation can be largely avoided. The stockholders would thus enjoy the security of the corporate form with its limited liability and in effect the taxability of a partnership with respect to the amounts distributed. In scrutinizing the various transactions that frequently occur between such a corporation and its stockholders, the courts have come up with the doctrine of "constructive receipt" of dividends. Thus a formal declaration of a dividend may not be necessary for a given distribution to be taxable as such. Book entries may be disregarded, and actual facts considered in determining whether the corporation has distributed a dividend to its stockholders.\(^11\) The following are among the most frequently occurring transactions that may give rise to the receipt of constructive dividends by the stockholders:

(1) stockholder advances and loans to the corporation;

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\(^9\) There is no unanimity of opinion as to the exact definition of a close corporation, but it is generally considered that this term includes corporations whose stock is owned by a sole stockholder, several unrelated stockholders or members of a family group.

\(^11\) John T. Kennedy, 16 B.T.A. 1372 (1929).
(2) advances and loans by the corporation to some or all of the stockholders;
(3) compensation paid to stockholder-officers of the corporation;
(4) rents and royalties paid to stockholders;
(5) distributions of property and bargain sales and purchases;
(6) bargain use of corporate property;
(7) payments on behalf of the shareholder by the corporation;
(8) purchase of insurance by the corporation upon the lives of the stockholders.

Although these transactions are not the only ones which may give rise to constructive dividends, the question arises more often in these cases. The question of whether a particular transaction results in a dividend may arise in several ways. However, it most frequently arises where the corporation is seeking to deduct a particular distribution to a stockholder from corporate income on the ground that it is a business expense, such as interest on loans, compensation for services, rents, royalties, etc. In all cases, the basic issue is the same, namely, whether the particular item constitutes a legitimate business expense, or whether it is in reality a distribution of a dividend to the stockholder in a disguised form. In many cases, whether a distribution is a dividend, salary, interest or royalty would make no difference to the stockholder inasmuch as all such payments would be taxable to him as ordinary income. However, in some situations to be noted later, the nature of payment may be very important to him for tax purposes.

In applying the substance test to the various transactions listed above, a vast area of confusion and uncertainty has arisen. This uncertainty has developed to such an extent that it is highly dangerous or disastrous tax wise for stockholders of a close corporation to enter into certain transactions with it. Unanticipated taxes may create financial hardship or ruin in many cases. It is the purpose of this paper to examine some of these transactions in an endeavor to evaluate present concepts and to suggest some modifications.

12 Section 116 of the Code allows, however, an exclusion from gross income of the first $50.00 of dividends received by an individual each year from a domestic corporation. Section 34 also allows as a tax credit 4% of dividends received by an individual each year in excess of $50.00.
STOCKHOLDER ADVANCES AND LOANS TO THE CORPORATION

Section 163 of the Code provides that, "there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness." Section 162 also allows as a deduction from corporate income "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." Thus, if a corporation borrows money for use in its business, any interest paid for the use of such money is deductible from the income of the corporation. To the extent that such loans are obtained from stockholders, taxes on corporate earnings and profits are accordingly reduced. These advances may be made at the time that the business is incorporated or sometime after incorporation. This technique of making advances to the corporation seems to be extremely attractive in the case of family or other closely held corporations. The advantages are obvious. In addition to deducting the interest paid on the obligation, it is possible to retain substantial amounts of the corporate earnings and profits in the corporate treasury to fund the indebtedness without incurring section 531 surtax liability. Also, in case the corporation is liquidated and loss occurs, the amount so advanced and not recovered can be taken as a bad debt deduction instead of as a capital loss.

The question of whether advances are bona fide debts or capital contributions usually arises in three major situations. First, the purported creditor (stockholder) may seek to take a bad debt deduction rather than a capital loss upon default or liquidation of the corporation without complete recovery of the principal sum. Second, the corporation may seek to take a deduction for payment of interest upon the purported loan. Thirdly, when repayments of the alleged loans are made, a question may arise as to whether the distribution is a capital recovery by the stockholder or in reality a dividend from the corporation. If the advance is held to be a capital contribution, the corporation will be denied an interest deduction and the shareholder will be deemed to have received a "constructive dividend" from the corporation. Regardless of which of these three questions is before the court,
the same issue is presented, namely, whether the transaction gives rise to a bona fide debt. Therefore no attempt will be made to classify the cases on the basis of the particular question which was before the court.

No problem is posed when stock or bonds are issued, clearly distinguishable as such. If the amount of the advance is reasonable and the security issued to evidence this indebtedness is clearly a bona fide note or bond, the interest paid will be deductible from corporate income. It follows that the stockholder will have a bad debt deduction instead of a capital loss upon default by the corporation, and any repayment will be a return of capital to him. Litigation in this area arises, however, as a result of the issuance of hybrid securities which have some of the characteristics of both indebtedness and stock. In this instance, the corporation attempts to combine some of the advantages of both stock and indebtedness for the benefit of the corporation or the stockholders or both. Until recently, the only question was one as to the nature of the securities issued. As soon as it was determined that the securities were either stock or indebtedness, the proper treatment for tax purposes was settled. This only required an intrinsic examination of the securities for the purpose of determining their true character. Even though no one factor was controlling, some of the most important factors in determining whether a particular security represented indebtedness or a contribution of capital included: (1) maturity date;\(^{13}\) (2) the extent of the obligation, that is, whether the issuer must pay a fixed interest rate regardless of earnings, or to pay only if the corporation has earnings;\(^{14}\) (3) right to share in profits;\(^{16}\) (4) whether the security is subordinate or superior to the claims of general creditors;\(^{16}\) (5) voting rights;\(^{17}\) and (6) whether the

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\(^{13}\) A definite maturity date is ordinarily the essential element of a creditor investment. In 241 Corporation, P-H 1956 T. C. Mem. Dec. sec. 56174, a security was held to be a stock investment when it contained no fixed maturity date.

\(^{14}\) Pocatello Coca-Cola Bottling Co. v. United States, 139 F. Supp. 912 (E.D. Ida. 1956), held a security to be stock when interest and principal was only payable if the corporation was insolvent.

\(^{15}\) When this factor is present in a particular security, it will almost always be held to be an equity investment. See Pottstown Finance Co. v. United States, 73 F. Supp. 1011 (E.D. Penn. 1947).

\(^{16}\) Wettsrau Grocery Co. v. Commissioner, 179 F. 2d 158 (8th Cir. 1950); Pocatello Coca-Cola Bottling Co., supra note 14.

\(^{17}\) Drayton Mills, 19 B.T.A. 76 (1930). One of the basic rights of a common stockholder is the right to vote. Thus, where this right accompanies a security, this strongly indicates a share of stock.
security is redeemable at the election of the holder.\textsuperscript{18} The way in which the advance is carried on the corporate books, although not controlling, has been considered significant.\textsuperscript{19}

Thus, early cases held that if a given security did not have the characteristics of stock, it was a true debt even though it comprised a very substantial portion of the operating funds of the corporation.\textsuperscript{20} In fairly recent years, however, the terms of the instrument have become increasingly less important. Even though a particular security has all of the attributes of an indebtedness, it may have to undergo additional tests to determine whether a bona fide debtor-creditor relationship exists or whether the stock holder has in reality made an equity investment in the corporation through an advance. Where the financing of the corporation is largely with borrowed capital, inadequate capitalization may result. The corporation is said to be "thin" if the ratio of debt to stock is considered too high. Where this occurs, it may be held that the advance by the stockholder was in reality an equity investment in the corporation and not a loan. Although inadequate capitalization was mentioned in the opinions of the Tax Court in several early cases,\textsuperscript{21} it was first definitely stated as a factor in Swoby Corporation,\textsuperscript{22} decided by the court in 1947. Although its decision was not based on inadequate capitalization alone\textsuperscript{23} inasmuch as there were features of the security which gave it resemblance to stock, the court insinuated that nominal stock investment is a significant factor in the determination of whether a particular security represents a debt or stock. The court expressly referred to the Supreme Court decision of John Kelly Company v. Commissioner,\textsuperscript{24} where in the course of its opinion that Court made the following comment:\textsuperscript{25}

\textsuperscript{18}Elko Lamoille Power Co. v. Commissioner, 50 F. 2d 595 (9th Cir. 1931).
\textsuperscript{19}The weight to be given this factor was considered in R. E. Nelson, 19 T.C. 575 (1952).
\textsuperscript{20}O.P.P. Holding Corporation, 30 B.T.A. 337 (1934), aff'd, 76 F. 2d 11 (2d Cir. 1935). There the capital of the corporation was paid in by the issuance of $10,000 in capital stock and $250,000 in debentures for a debt ratio of 25 to 1.
\textsuperscript{21}Edward G. Janeway, 2 T.C. 197 (1943), aff'd, 147 F. 2d 602 (2d Cir. 1945); 1432 Broadway Corporation, 4 T. C. 1158 (1945), aff'd, 160 F. 2d 885 (2d Cir. 1947).
\textsuperscript{22}9 T.C. 887 (1947).
\textsuperscript{23}There was only $200.00 in common stock compared with $250,000 in debentures.
\textsuperscript{24}326 U.S. 521 (1946).
\textsuperscript{25}Id. at 526. The statement of the Court in this case was purely dictum as there was no finding that the corporation was inadequately capitalized.
As material amounts of capital were invested in stock, we need not consider the effect of extreme situations such as nominal stock investments and an obviously excessive debt structure.

The Supreme Court thus indicated that inadequate capitalization may become an important factor justifying a contrary holding in extreme cases. In *Wilshire and Western Sandwiches, Inc.*, the Tax Court apparently thought this was such a case. Here it denied an interest deduction where the four stockholders advanced $55,000 of which $25,000 was evidenced by promissory notes issued by the corporation. The Court of Appeals for the ninth circuit reversed, refusing to attach importance to the facts relied on by the Tax Court and stated:

> It is not contended that a corporation is without the power to enter into a debtor and creditor relationship with its stockholders. The intent of the parties as to the nature of the transaction controls.

In spite of this early rebuff, however, many subsequent cases decided both by the Tax Court and the Courts of Appeal have sustained the element of inadequate capitalization as a factor. This has been especially true in the case of family or other closely held corporations. Although in most cases there are other factors present, these cases do show that debt ratio is something that cannot be ignored in the lending of money or in the initial capitalization of corporations. Just how important is not clear. This whole area is in a state of flux at this time. One thing is clear, however: There is definitely a maximum limit on indebtedness which a corporation can incur without a finding that an equity investment has been made. A debt to equity ratio of 2,500 to 1 is obviously excessive. The same can be said for a ratio of 1000 to 1. In many cases the courts have disapproved much lesser ratios where under the circumstances it was concluded that the stock investment, in itself, would be insufficient to carry on the business. In *Artistic Venetian Blind Corporation* interest

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27 175 F. 2d 718 (9th Cir. 1949).
28 Id. at 720.
31 P-H 1956 T.C. Mem. Dec. sec. 56043; Cohen v. Commissioner, 148 F. 2d 336 (2d Cir. 1945), where the ratio was only 15 to 1.
paid on a $100,000 note held by a majority stockholder was held nondeductible where the capital stock was only $10,400. The court stated that this latter amount was insufficient to carry on the business of manufacturing venetian blinds which required a large inventory.

The safe limits of debt to equity ratio are not clear. In Talbot Mills v. Commissioner,\textsuperscript{32} the Supreme Court approved a ratio of 4 to 1 between debentures and stock; and in Arthur McDermott,\textsuperscript{33} the Tax Court held the notes in question to be true debts even though the ratio was 19 to 1. The court, in Toledo Blade Co.,\textsuperscript{34} impliedly approved a ratio of 6 to 1 where, in order to meet notes due on which capital stock had been pledged as security, the corporation was recapitalized with stock of $500,000 and debentures of $3,000,000. Here the debentures were held by the sole stockholder. It has been generally thought that a ratio of 4 to 1 is safe,\textsuperscript{35} especially where the loans were not made proportionately by the stockholders.

One of the most important factors which is invariably taken into consideration by the courts is whether the alleged debt securities are held by the stockholders in the same proportion as their holdings of stock. In many cases this factor exists along with inadequate capitalization and may be taken as just another indication pointing to additional capital contributions. In other cases, it appears to have emerged as controlling and constitutes a test in and of itself. In 1432 Broadway Corporation,\textsuperscript{36} the corporation issued 390 shares of stock and debentures in the face amount of $1,170,000 for property worth at least $1,200,000 and $40,000 in cash. The debentures appeared to have all the indicia of debt. As the stock and debentures were issued proportionately to the stockholders, an interest deduction was denied to the corporation. The court stated:\textsuperscript{37}

\begin{quote}
The debentures are in approved legal form. . . . But, for tax purposes, their conformity to legal forms is not conclusive.
\end{quote}

\textsuperscript{32} 326 U.S. 521 (1946).
\textsuperscript{33} 18 T.C. 469 (1944).
\textsuperscript{34} 11 T.C. 1079 (1948), aff'd, 180 F. 2d 937 (6th Cir. 1950), cert. denied, 340 U.S. 811 (1950).
\textsuperscript{35} Greene and Palmer, Current Trends in Corporate Capitalizations and Recapitalizations, 8 J. Taxation 75 (1958).
\textsuperscript{36} Supra note 21.
\textsuperscript{37} Id. at 1165.
... The distribution... whether called interest or principal on debentures or dividends on shares, would go to the same persons in the same proportions since each had the same proportionate number of both, and it would not matter to them whether the distribution was called dividends or interest. (Emphasis added.)

The court did not expressly hold that the debt ratio was excessive here, but considered as controlling the fact that after payment of the interest or principal of the debentures, the stockholders would have the same proportionate interest in the corporation. Likewise, in *Kipsborough Realty Corporation*, no interest deduction was allowed where the purported loans were in proportion to the holdings of the stockholders, each bearing a 1000 to 1 relationship to the value of the stock. Thus, where loans are made in proportion to stockholdings, this factor, coupled with an excessive debt ratio, is almost certain to be fatal to an interest deduction. It appears that the courts at times attach too much importance to the fact that the loans are proportionate. It is not uncommon for stockholders of closely held corporations to make loans in proportion to their stockholdings, even where it is their intent to make bona fide loans. Such corporations must frequently turn to their stockholders when they need additional funds either for operating expenses or expansion. In fact, in many cases this is the only source of additional capital.

A fairly recent case has further added to the confusion in this area. In *Gooding Amusement Company*, a partnership consisting of a husband, wife, and infant daughter having, respectively, 4/7, 2/7 and 1/7 interests was dissolved. A new corporation was formed. The assets, with an approximate book value of $281,000, were transferred to the corporation for $49,000 in no-par common stock and $232,000 in interest bearing notes. The partners received stock and notes in the same proportion as their respective interests in the partnership. Other sums were borrowed from the stockholders from time to time totaling $77,000. Most of these sums were repaid. The questions presented to the Tax Court were whether the corporation could deduct the interest on the notes and whether the repayments of the notes was a taxable dividend.

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38 Supra note 30.
39 23 T.C. 408 (1955), aff'd, 236 F. 2d 159 (6th Cir. 1955).
to the stockholders. The court held that the interest payments were not deductible and that the principal payments constituted dividends. During the years in question, corporate employees other than the three principal stockholders owned from 24.39 percent to 22.3 percent of its outstanding stock. Employee stockholdings were, however, redeemable at the option of the corporation. The court said that the fact that the payments were not made pro rata among the stockholders was immaterial and did not alter the effect of what was done. The language of the court appears to have introduced a new test to the thin corporation problem. The court stated: 40

This is another in a long series of cases wherein the stockholders of a closely held corporation have attempted to establish between themselves and the corporation the relationship of creditor-debtor.

The court stated that the formal criteria of indebtedness were unquestionably satisfied but stated: 41

The most significant aspect of the instant case, in our view, is the complete identity of interest between and among the three noteholders, coupled with their control of the corporation. . . . It is, in our opinion, unreasonable to ascribe to the husband petitioner, F. E. Gooding, an intention at the time of the issuance of the notes ever to enforce payment of his notes, especially if to do so would either impair the credit rating of the corporation, cause it to borrow from other sources the funds necessary to meet the payments, or bring about its dissolution. (Emphasis added.)

In answer to the argument that the initial financial structure did not reveal an excessive ratio of debt to stock, 42 the court stated: 43

The "thin capitalization" factor is only one of the indicia from which the presence or absence of a debtor-creditor relationship may be determined. We do not consider it decisive of the present issue.

Under the court's reasoning, it would seem almost impossible for any closed corporation to issue bonds or notes to its

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40 Id. at 417.
41 Id. at 418.
42 On the contrary, it appeared that if good will was attributed to the stock the debts would probably not exceed the value of the stock.
43 Supra note 39 at 419.
shareholders, whether at the time of incorporation or subsequent to its incorporation. Determination of the stockholder's state of mind or intent at the time the bonds or notes are issued is not so much a finding of fact as an irrebuttable presumption or inference drawn from the stockholder-corporation relationship in these cases. If the court's reasoning is to be taken literally, then it would appear that this case is a step in the direction of cutting off from close corporations a large source of their loans. This line of reasoning could be used to strike down all such loans. Quite naturally the stockholders of such a corporation have no intent to enforce the obligation if to do so would ruin the corporation's credit or bring about its dissolution. In a recent article evaluating the effect of the Gooding case, it was stated:

\[\ldots\] Tax Court is continuing to follow the intent test laid down in Gooding case \ldots where it found the debtors never intended to enforce their rights as creditors to the detriment of the corporation.

In spite of the Gooding decision and the above statement as to its effect, subsequent cases have allowed deductions of interest. In John V. Rowan v. United States,\(^4\) the corporation's capitalization was $9,000. Husband and wife, sole stockholders of the corporation advanced sums totaling about $125,000 to the corporation. The court held that the advances were bonafide loans and that the interest was deductible by the corporation. Likewise, in the recent case of Bakhaus and Burke, Inc.,\(^6\) a corporation was organized with capital of $30,000 and the three organizers who were partners transferred to the corporation $131,670.16 in undistributed partnership assets and treated this sum as accounts payable. An interest deduction was allowed by the court even though the ratio of debt to stock was approximately five to one. The court held that it was the intent of the parties to treat these assets as loans and that there was no basis for concluding that the corporation was thinly capitalized inasmuch as a material amount of capital was invested in the stock and this was sufficient to carry on the corporate business.

It is too soon to tell just how strongly the Tax Court will

\(^4\) 7 J. Taxation 70 (1957).
\(^6\) 219 F. 2d 51 (5th Cir. 1955).
apply its language in the Gooding case to subsequent transactions. One thing is certain, however; the decision in that case has added to the uncertainty. The tax consequences are severe for taxpayers who have made a wrong estimate of the permissible amount of debt which the courts will sanction. Courts have not as yet allocated a portion of the indebtedness to be a bona fide loan, considering the remainder as an equity investment. A constructive dividend is now imposed as to the full amount, instead of allowing an interest deduction, bad debt or capital recovery as to the part that was not excessive. The taxpayer either wins or loses with respect to the whole amount. It would appear more equitable to determine how much of the debt is allowable and then disallow the balance instead of disallowing all when a smaller debt would have been recognized if the stockholders had not been so ambitious or had not inadvertently exceeded the permissible limit. While this method would be more just, it still would not give a clear and definite answer to the problem. Litigation would still be necessary to determine the permissible amount in a particular case. Legislation thus appears to be the obvious solution.

A possible answer to this problem is to impose on stockholder's loans an absolute limitation, disallowing any interest deduction, bad debt loss or capital recovery on any indebtedness in excess of the stipulated ratio to capital investment. Setting a permissible limit is not an innovation in this area. Recognizing that the income of a corporation could be drawn out in the form of interest, Congress early sought to prevent this by setting a limit on the amount of indebtedness which would be recognized for tax purposes. The Revenue Act of 1909, imposing a tax on the net income of corporations, allowed a deduction from income for "interest actually paid within the year on its bonded or other indebtedness not in excess of the paid-up capital stock of such corporation." The 1913 Act allowed an interest deduction upon the amount of the indebtedness not to exceed one-half of the sum of its interest bearing indebtedness and its paid up capital stock outstanding at the close of the taxable year. The Act of 1916 allowed a deduction for interest on indebtedness not to exceed

48 Revenue Act of 1913, sec. 11 G(b), 38 Stat. 173.
the sum of paid up capital stock and one half of the interest bearing indebtedness.\textsuperscript{49} With World War I and the adoption of an excess profits tax, it was considered unfair not to allow a deduction of the entire indebtedness of the corporation since borrowed capital was not includable in computing capital for the purpose of the war profits and excess profits tax. When the excess profits legislation was repealed, no attempt was made by Congress to reinstate the prior limitation. The problem thus seemed to have been dormant until the Supreme Court issued its famous dictum in the \textit{John Kelly} case. None would contend that there should be no limits upon corporate indebtedness. Failure to establish a limitation would allow corporate profits to be distributed to the stockholders from the corporation largely free of corporation income taxes. Taxation of the income of corporations would thus be a useless gesture. The crucial question is what should be the rule governing this problem?

Many proposals have been made as to how to handle this problem. Notable among these is that recommended by the American Law Institute in 1952. Under this proposal it is provided that interest shall be deductible upon indebtedness which is defined as follows:\textsuperscript{50}

“Debt” or “indebtedness” shall include in all events, but shall not be limited to, any unconditional obligation to pay a sum certain in money—

(1) which will mature on or before a fixed date;

(2) which is undertaken in return for an adequate consideration in money or money’s worth or which is distributed as a dividend to the shareholders of a corporation;

(3) which is not subordinated to the claims of trade creditors generally;

(4) which, if undertaken by the corporation, does not entitle the obligee to vote for directors of the obligor, except in the event of default; and

(5) payments, if any, for the use of the principal amounts of which are not dependent in amount upon the earnings of the obligor and are unconditionally payable not later than the maturity date of the principal amount.

\textsuperscript{49} Revenue Act of 1916, sec. 12(a) Third, 39 Stat. 768.

\textsuperscript{50} ALI Fed. Income Tax Stat. sec. x500(g) (Feb. 1952 Draft).
Thus, if the terms of a particular instrument meet the conditions stated above, it would automatically be regarded as a debt instrument, with the consequence that interest paid would be deductible and, if the instrument should become worthless, the holder would be allowed a bad debt deduction. If an instrument failed to meet these requirements, its status as a debt or equity instrument would be determined from the facts and circumstances on the basis of existing case law. It will be noted that the drafting committee made no provision covering cases where there was pro rata ownership by the stockholders of such debt instruments. It was their conclusion that pro rata ownership should not occasion nonrecognition as indebtedness of otherwise unobjectionable instruments. In this respect it is believed that The American Law Institute is right. More significant, however, is the fact that no limitation was set on the amount of indebtedness which could be incurred. The committee stated as its reason that “analysis of the cases indicates that, except for the Tax Court cases of Isidor Dobkin, 15 T.C. No. 6 (1950), and George L. Sogg, 9 T.C.M. 927 (1950), a limitation of this sort is not a part of present law.”

Hindsight now shows that this conclusion is wrong. Inadequate capitalization is definitely with us and must be coped with. It is not enough to state as the committee did that “the tax saving or tax avoidance made possible by further increasing the debt ratio is hardly significant.” While the tax saving might be small in any one year, this amount is cumulative in that there is an interest deduction every year. Moreover, upon maturity of the instruments, the tax savings upon redemption could be substantial by reason of the treatment of the payment as a return of capital rather than as a divided. It is believed that some limitation should exist. In setting any limit, however, care must be exercised not to set the limitation too low. The need for debt financing varies among different industries and in particular situations within a given industry. The Taxation Section of the American Bar Association has recently drafted a proposal to deal with the “thin” incorporation problem. The proposal submitted by this organiza-

51 Id. at 263. It was, however, recognized that where the amount of the indebtedness is so great that there is no equity interest, such indebtedness should not be recognized.
52 Id. at 264.
tion states that a corporation would not be too “thin” provided:

1. Shareholder notes are not subordinated to the claims of the other trade creditors;
2. Repayment of the principal amount of the notes is not dependent upon corporate earnings and the notes are unconditionally payable at maturity;
3. When qualifying under some but not all of the above requirements, the taxpayer can establish by a preponderance of the evidence that the failure to qualify was due to the corporation’s business requirements;
4. If the ratio exceeds ten to one based on book values, the excess debt will not qualify as a bona fide debt.

Upon examination, it appears that the above proposal has real merit. First, it would provide certainty in an otherwise clouded area of the tax law. Secondly, the ratio is not so high as to allow corporations to distribute all their earnings to stockholders in the guise of interest, but high enough to provide the flexibility which is needed in the financing of some corporations. If it is found necessary to exceed the ratio in particular circumstances, the burden of not being able to take the full interest deduction or the full amount of the loan as a bad debt loss should not be great.

III

ADVANCES AND LOANS BY THE CORPORATION TO SOME OR ALL OF THE STOCKHOLDERS

As in the case of shareholder advances to a corporation, it is settled that a corporation may make advances and loans to its stockholders. If the loans are bona fide, the consequences are the same as in the case of loans to outsiders. This area, however, appears to be as unsettled and uncertain as stockholder loans to the corporation. Moreover, the tax consequences of this transaction appear to be more severe. Since it would be a violation of the rights of minority stockholders for withdrawals to be made by the majority or controlling stockholders in a corporation, such a transaction almost always occurs in the case of closely held

53 Greene and Palmer, supra note 35, at 77.
corporations where there is only one or a few stockholders. When the Commissioner challenges a purported "loan" he does so for the purpose of preventing the corporation from distributing its earnings in the guise of loans. As in the case of loans by stockholders, the determination of whether a particular withdrawal is a loan or a distribution of a taxable dividend depends on the facts and circumstances of each case. The primary question to be determined, therefore, is one of intent: Was it the intent of the stockholders and of the corporation to make a loan or to pay a dividend at the time the withdrawal occurred? Any subsequent attempt to treat as a loan what was in reality a dividend when made, will be disregarded.

This "intent" determination is complicated somewhat by the fact that the corporation may be under the exclusive control of the stockholder and, therefore, the intent of the stockholder. However, control is not significant in this determination. In Carl L. White, the Tax Court stated:

The important fact is not . . . [taxpayer's] measure of control over the company, but whether the withdrawals were in fact loans at the time they were paid out. . . . The character of the withdrawals depends upon petitioner's intent and whether he took the company's money for permanent use in lieu of dividends or whether he was then only borrowing. . . .

The question of whether a particular withdrawal is a loan or a dividend may arise at the time of withdrawal or shortly thereafter, or it may not arise until many years later. When the transaction comes to the attention of the Commissioner prior to the expiration of the three year statute of limitations, his contention is almost invariably that the withdrawal was actually constructive dividends and income to the stockholder as defined in the Internal Revenue Code. No comprehensive rule has been stated to gov-

56 Regensburg v. Commissioner, 144 F. 2d 41 (2d Cir. 1944).
57 17 T.C. 1562 (1952).
58 Id. at 1568.
59 Int. Rev. Code of 1954, sec. 316(a), which is almost identical with 115(a) of the 1939 Code stated that: "... the term 'dividend' means any distribution of property made by a corporation to its shareholders—(1) out of its earnings and profits accumulated after February 28, 1913, or (2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made, . . ."
ern this situation. Certain factors have, however, been considered by the courts in either sustaining or overruling the Commissioner's contention. In some cases it appears that the courts have considered one of several factors to be controlling, while in others the courts have reached their conclusion by a consideration of several factors in combination. The factors which have been deemed significant enough for the courts to mention include the following:

1. *Corporate formalities.* Where a corporation by formal resolution of the board of directors declares a dividend, there is no doubt as to taxability provided there is sufficient earned surplus or current profits to cover the distribution. Where, however, a withdrawal has been made without a formal dividend declaration, the stockholder will point to this fact in attempting to show that the withdrawal constituted a loan by the corporation. Recognizing that profits can be withdrawn in the absence of a formal declaration, particularly in the case of close corporations, courts have consistently held that it is not necessary that a dividend be formally declared before a withdrawal can be taxed as a dividend.\(^{60}\) Such evidence has not been considered material to the issue, and stockholders are held to have received a "constructive dividend" if other factors point to such a result.\(^{61}\)

2. *Corporate treatment of withdrawals.* The treatment of the withdrawal by the corporation in its books and accounts has been considered significant in almost every case. Since the basic issue is one of the stockholder-corporate intent, the treatment by the latter is of course very significant. In cases where the withdrawals are held to be loans, the courts almost invariably point to the fact that they were carried on the corporate books as loans, notes receivable or accounts receivable.\(^{62}\) On the other hand, when there is no evidence as to how the withdrawals were handled, this may justify a finding that they were dividends.\(^{63}\) Thus, lack of corporate treatment as a bona fide loan is almost always detrimental to the stockholder's case. Bookkeeping entries are not

\(^{60}\) Christopher v. Burnet, 55 F. 2d 527 (D.C. Cir. 1931).
\(^{61}\) Rollin C. Reynolds, 44 B.T.A. 342 (1941).
\(^{62}\) Herman M. Rhodes, 34 B.T.A. 212 (1936); Estate of Isadore Benjamin, 28 T.C. 101 (1957).
\(^{63}\) Christopher v. Burnet, supra note 60.
conclusive, however, and even if the withdrawals are carried on the corporate books as a loan, other factors may be considered controlling and the withdrawal taxed as a dividend. In Ben E. Meyer, the Tax Court in discussing this factor stated that “book entries cannot be used to conceal realities.” Thus, it would appear that the lack of “loan” treatment is detrimental to the stockholder’s case, while its presence, though not controlling, is a strong corroborating circumstance.

3. Issuance of promissory notes or other security. The absence of a promissory note is not necessarily detrimental to the stockholder’s contention that the withdrawal was a loan. The absence or presence of notes is merely another factor in determining whether a debtor-creditor relationship exists. Thus, in H. C. Thorman, the taxpayer was the sole stockholder and retained certain corporate income as he collected it without turning any part over to the corporation. He did, however, pay corporate accounts as they became due out of these sums. No notes of indebtedness were given nor did he ever pay any interest. However, very accurate records were kept of these transactions. The Tax Court held that these sums were, nevertheless, valid loans stating that, “notes do not create an indebtedness, but only evidence it.” The court further concluded that the controlling factors in this case were the statements of the taxpayer, plus the fact that the accounts were kept so meticulously. Likewise, in several other cases, withdrawals have been held to be valid loans in spite of the absence of promissory notes or other evidence of indebtedness.

On the other hand where notes were given, this has been a strong but not conclusive factor in sustaining the stockholder’s case. In Daniel Hunt, notes were issued by a stockholder who

64 In George P. Marshall, 32 B.T.A. 956 (1935), the withdrawals were carried on the corporate books as an account receivable from the stockholder, but the court held it to be a dividend because no interest was charged and other evidence showed that there was no intention to repay; Ben E. Meyer, 45 B.T.A. 228 (1941).
65 45 B.T.A. 228 (1941).
68 In Victor Shaken, supra note 2, the Tax Court said that the execution of a note cannot be ignored. See also, Herman M. Rhodes, supra note 9; Corporate Investment Company, 40 B.T.A. 1156 (1939).
69 6 B.T.A. 558 (1927).
withdrew large sums but the court, nevertheless, held the withdrawals to be dividends where other evidence showed that there was no intention to repay the alleged loans. Since the stockholder is usually in complete control of the corporation in these cases, notes may be little more than a paper transaction; it may be highly improbable that the stockholder would ever cause the corporation to enforce the notes if he defaulted in payment. In Ben E. Meyer, the court in discussing the weight to be attached to notes stated:

> We do not regard the giving of . . . notes . . . of weighty significance . . . since the collection of these demand notes as well as the making of some, was under the absolute control of the petitioner through control of the corporation and the notes could at their will, never become actually due and payable.

In spite of these statements, however, it is not without significance that very few cases have been litigated where notes or other evidences of indebtedness were present. This suggests that the Commissioner is more willing to treat transactions evidenced by notes as bona fide loans.

4. Payment of interest. Where interest is paid upon corporate withdrawals, this is strong corroborating evidence that the parties considered the withdrawals to be bona fide loans. However, failure to pay interest will not prevent a withdrawal from being considered a bona fide loan if the transaction is otherwise in proper form and in good faith. In discussing the lack of interest payments in Victor Shaker, the Tax Court stated that, “failure to charge interest is not determinative here.” In spite of this language, however, interest payments constitute good evidence in favor of the stockholder. In practically all cases where the withdrawals have been held to be dividends, lack of interest payments has been mentioned by the court as another factor tending to show that the parties did not intend to create a bona fide indebtedness.  

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70 Supra note 64.  
71 Id. at 240.  
72 Corporate Investment Co., supra note 68; George S. Graves, 38 B.T.A. 727 (1938).  
73 John Hamilton Perkins, supra note 54.  
74 Supra note 55.  
5. Collateral security. Since the deposit of collateral security in connection with stockholder withdrawals from a close corporation would be unnecessary and impractical in many cases, this factor rarely appears for discussion in the reported cases. However, where collateral security has been pledged in sufficient amount to secure the repayment of the withdrawal, it should be strong evidence in favor of the stockholder. In Al Goodman, an advance of $145,000 to the sole stockholder was secured by stock in the corporation having a value in excess of $290,000. The court in concluding that the withdrawal was a loan did not give this factor controlling significance but did indicate that generally security was a factor tending to show a loan. Since stock of the corporation was pledged as collateral by the sole stockholder, it is believed that the court was right in considering this of little significance. Here, it is questionable whether the corporation, with the consent of the stockholder, will enforce the collateral. If it did so in the Goodman case it would force a sale of the stockholder's interest. Thus, the only significance that can be attached to collateral security is showing some evidence of intention and good faith. Where the collateral is put up by one of several stockholders to secure a withdrawal, the likelihood of its ultimate enforcement increases and the courts should accordingly attach more importance to it.

6. Purpose of the Withdrawal. Although this factor should not logically have any bearing on the issue of whether a bona fide loan was made, it has been mentioned in several cases before the Tax Court. In George P. Marshall, where withdrawals were held to be dividends, the court pointed out among other things that the corporation had sufficient funds to declare a dividend and stated that the sole stockholder "used the money for living and personal expenses". In the Goodman case, the advances had been made to the sole stockholder so he could pay his individual tax liability. The court in holding this withdrawal to be a valid loan stated that, "the advance was not for personal living expenses or the like. . . . It was, for Al, an unusual, nonrecurring emergency situation." These cases seem to indicate that if withdrawals are made for personal living expenses or the like, courts will be

76 T.C. 228 (1955).
77 Supra note 64.
more inclined to treat these sums as constructive dividends to the stockholder. Several other cases, however, have held withdrawals to be loans even though made for a personal reason, such as to remodel the principal stockholder's residence, or to gamble. The only case in which the Court of Appeals has considered this point was in Regensburg v. Commissioner. The court there held that it was error to admit evidence that the stockholder used the advances for gambling, as the use to which the money was put had no relevancy on the issue of loans versus dividends. The court did not, however, consider its admittance so prejudicial as to require reversal of the Tax Court.

7. Repayments and ability to repay. Where there has been full repayment of an advance, no question will ordinarily arise as to the treatment of the transaction as a loan. Where no payments or only partial repayments have been made, however, courts have found some difficulty in evaluating this fact and giving it proper weight. Lack of any payments at all by the stockholder will not necessarily be detrimental to his position if other factors overcome this missing element. However, where the repayments are only made after the Commissioner has contended that the withdrawals were dividends, they will be regarded as of little significance. Also where the repayments or credits are insignificant considered in relation to the size of the withdrawals, they will be held to be designed merely to give "color" of loans. Thus, if repayments are made, this adds to the weight of the stockholder's case, but they must not be made as an afterthought and must be reasonable considering the amount of the withdrawal.

Intertwined with the fact of actual repayments is the financial position of the stockholder. This question bears strongly on the determination of whether he had an intention to repay the withdrawal. A stockholder who was insolvent or practically so, could hardly be said to have any intention or expectation of repaying withdrawals, particularly if they are large. In H. L. Gumbiner,

80 Supra note 56.
81 Courtemanche v. Earle, supra note 78.
82 Regensburg v. Commissioner, supra note 56.
83 Ben E. Meyer, supra note 64.
the corporation made advances of approximately $61,000 to a stockholder at a time when he had other large outstanding liabilities. A small credit of $200 was made in one year and $8,154 was credited the next year out of the stockholder's salary. In holding the withdrawal a dividend, the Tax Court stressed the fact that, "petitioner apparently had no funds with which to repay any loans made to him by the corporation." In the Regensburg case, the four stockholders over a period of 40 years made withdrawals of approximately $3,000,000. In holding these sums to be dividends the court observed that the stockholders had nothing but their stock with which to repay these alleged loans which was of much less value. A similar observation was made in William C. Baird, where two stockholders made withdrawals totaling approximately $98,000 in the years 1946 to 1951. No dividends had been paid by the corporation since 1931. In sustaining the Commissioner's contention that this sum was a taxable dividend the court stated:

It is also significant that there was no apparent ceiling for such withdrawals, nor did the brothers [stockholders] have ready resources available with which to reimburse the company.

In this case it was also significant that notes were not given as evidence of the alleged loans until the Revenue Service had checked the taxpayers' returns and suggested that these sums should be treated as dividends. The language of these cases indicates, however, that ability to repay is in the opinion of the courts a significant factor in determining the intention of the stockholder and the corporation at the time of withdrawal. Where the stockholder is insolvent or practically so, it would only be the extraordinary case where other factors would be sufficient to outweigh this fact and sustain a holding that the withdrawals were bona fide loans.

8. *Ratio of withdrawals to earnings and profits.* Where the withdrawals exhaust the net profits of the corporation, it would appear that this fact is strong evidence of the distribution of a dividend. Thus in C. W. Murchision, the stockholder in accord-

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86 Id. at 396.
87 32 B.T.A. 82 (1935).
 ance with a long standing practice of making substantial withdrawals from the corporation withdrew the sum of $115,170.37 in a year in which the corporation had profits of only $135,933.83. The Tax Court held that the substance of the plan was to make a dividend distribution in the guise of a loan for the purpose of avoiding high surtaxes. Likewise, payments by the corporation of $18,086.14 in discharge of the stockholder’s obligations, such payments representing the approximate net income of the corporation for a period of several years, were held to be a dividend distribution to the stockholder.\textsuperscript{88} Where the corporation has declared no dividends in the year in question or for many years, this fact strengthens the Commissioner’s position that the withdrawals should be treated as a taxable dividend.

9. Ratio of loans to stockholdings. Where there is only one stockholder, the ratio of loans to the number of shares held is of no significance. However, where there are several stockholders, this factor takes on added importance and may even be decisive. Disproportionate withdrawals will not necessarily support the stockholders’ contention that they are not taxable dividends.\textsuperscript{89} Courts usually point out that the fact that other stockholders did not object is immaterial. This factor is not without significance, however, and courts have occasionally pointed to it along with other factors in support of a conclusion that the withdrawals were bona fide loans.\textsuperscript{90} Where the withdrawals are in exact proportion to stockholdings, it is very strong evidence that they are dividends.\textsuperscript{91} In this instance a proportionate distribution would point to a dividend because it is unlikely that all stockholders would need to borrow funds from the corporation in the exact ratio of their stockholdings.

Since all the above factors may be considered in determining whether a withdrawal is a loan or a dividend (with varying weight attached in different cases), the line is often vague and

\textsuperscript{88} H. L. Gumbiner, supra note 84; In Eugene Vassallo, 23 T.C. 656 (1955), the fact that the taxpayer withdrew substantially all the net earnings of the corporation was deemed a significant factor in the court’s determination that these sums were dividends.

\textsuperscript{89} Christopher v. Burnet, supra note 60.

\textsuperscript{90} Kate E. Ryan, supra note 54.

\textsuperscript{91} Chattanooga Savings Bank v. Brewer, 17 F. 2d 79 (6th Cir. 1927); R. E. Nelson, 19 T.C. 575 (1952).
uncertain. When it is found necessary to make withdrawals from
the corporation, care must be taken to insure that the trans-
action points to a bona fide debtor-creditor relationship. Since it
is a common practice for stockholders of a closely held corpo-
ration to borrow funds from their corporation instead of from out-
side sources, this problem is particularly important to them. If
the three year statute of limitations has expired, this does not
mean that the question has been closed. Where the distribution,
which is ultimately held to be a dividend, exceeds 25% of the
reported gross income of the stockholder for the years in which
the withdrawals were made, the statute of limitations runs for 6
years. In this case, all that is required is that the notice of
deficiency be mailed by the Commissioner within 6 years from the
time that the returns were filed.

Cancellation by the Corporation of Stockholder's Indebtedness
Created by Withdrawals.

It frequently happens that the withdrawals are not checked
by the Internal Revenue Service until after the expiration of the
statute of limitations. In this situation, if the withdrawal was a
dividend when made, the shareholder will escape tax thereon.
In these circumstances, however, it is likely that the Commissioner
will take the position that the withdrawals were loans. This is
particularly so where the withdrawals have been subsequently
cancelled by the corporation. In this situation, it is settled that
the cancellation of a stockholder's indebtedness to the corporation
will give rise to a taxable dividend if the stockholder is solvent
and the corporation has sufficient earnings and profits to support
a dividend.

Where a solvent taxpayer settles a debt for less than the full
indebtedness, the amount saved constitutes income to him. However, in Helvering v. American Dental Company it was
held that there is no income to the debtor where the debt can-

94 Hugh R. Miller, 25 B.T.A. 418 (1932); Clair D. Reason, P-H 1942 T.C.
Carl G. Ortmayer, 28 T.C. 64 (1957).
96 318 U.S. 322 (1943).
cellation is a gift arising out of the voluntary forgiveness by the creditor, provided that no consideration moved from the debtor. It appears to be settled, however, that there is no voluntary forgiveness within the American Dental Company decision where a stockholder of a corporation causes his corporation to forgive his indebtedness. In F. W. Leadbetter, the court in discussing the forgiveness of a debt owed to his corporation stated:

There was no voluntary act on the part of the . . . company which may be construed to constitute a voluntary forgiveness of part of the debt. The act of the company was the act of the petitioner. . . . The parties to the transaction were not dealing at arm's length. (Emphasis added.)

Thus, it would seem almost impossible for a corporation to forgive the indebtedness of its stockholders without the shareholders realizing a taxable dividend.

The stockholder, however, is almost invariably contending that the distribution was a dividend and is therefore barred by the statute of limitations. He usually fares no better with this argument than he does when he is taking the position that the distribution is a loan prior to the expiration of the statute of limitations. The position of the courts as to such a contention on the part of the stockholder was made clear by statements in the recent case of Wentworth. In this case the stockholder withdrew $90,000 which he charged against the capital of the corporation. The court held that it was improper to charge capital in the absence of a redemption of stock or a partial liquidation. The taxpayer contended alternatively that the advance to him was in reality a dividend from the corporation and should have been taxed as such when received. After observing that the taxpayer did not so treat them upon receipt since he did not report these sums as taxable income, the Tax Court stated:

We are not so naive as to think petitioner would ever claim the unclear book entries show a dividend distribution to

97 Supra note 94.
99 Id. at 1224.
100 Such an argument was made in Hirsch Improvement Co., P-H 1942 T.C. Mem. Dec. sec. 42559, by the stockholder while the Government was contending that the distribution was a loan.
101 25 T.C. 1210 (1956), aff'd, 244 F. 2d 874 (9th Cir. 1957).
102 Id. at 1215.
him, were it not for the fact that the income tax on such
distribution is now barred by the statute of limitations.

Thus, the stockholder is put in the position of having to argue
that a sum which he did not report as income when received, was
nevertheless income at that time and that the subsequent can-
cellation of the advance cannot, therefore, be treated as a realiza-
tion of income. It is not surprising that the courts are unsym-
pathetic to his position. It is held that cancellation gives rise to
a dividend, not in the year of withdrawal but in the year in which
the cancellation occurs. In *Wiese v. Commissioner*, the stock-
holder was held to have realized a dividend in 1932 when the
corporation cancelled his indebtedness and not during the years
1926 to 1932 when the withdrawals were made. This is under-
standable as nothing would be gained by holding that a dividend
was realized when the withdrawals occurred as these years would
still be largely barred by the statute of limitations.

Not only may the stockholder be held to have received a con-
structive dividend upon withdrawals from his corporation or on
subsequent cancellation, but where the withdrawals render the
corporation unable to pay its taxes, the stockholder may be taxed
upon the full amount of the withdrawal as a dividend and also
liable as a transferee of the corporation for the amount of the
taxes the corporation was unable to pay. In this area, therefore,
care must be taken where withdrawals are necessary to insure
treatment of the transactions as bona fide loans by observing all
of the qualifying factors. In considering any cancellation of the
stockholder’s indebtedness, consideration should be given to the
possible adverse tax consequences that may result, and the parties
should select a year in which the cancellation would produce the
least unfavorable tax consequences.

103 *93 F. 2d 921 (8th Cir. 1938).*
104 Section 108(a)(1)(b) of the Internal Revenue Code of 1954 provides
for a specific exclusion from gross income resulting from the cancellation of an
indebtedness for which the taxpayer is liable, or subject to which the taxpayer
holds property, “if the indebtedness was incurred or assumed by an . . . individual
in connection with property used in his trade or business.” To take advantage of
this section, however, the taxpayer must consent to a reduction of the basis of
such property. While the provisions appear sufficiently broad enough to cover the
situation where a corporation cancels the indebtedness of its stockholders, it is
believed that this section was not intended to apply. If such cancellation gives
rise to a dividend within sec. 301(a) and sec. 316 (a)(1) and (2), then it would
appear that this situation could not be brought under the 108 provisions. It is not
the type of bona fide indebtedness cancellation contemplated by 108.
105 *Eugene Vassallo, supra note 88.*