19 T.C. 887 (1953)

When accrued salary payments are disguised as part of the sale price of stock, the amount attributable to the salary is taxable as ordinary income, not capital gains.

Summary

Taxpayers sold their stock in a company, agreeing to forgive accrued salary payments as part of the deal. The Tax Court held that the portion of the sale price attributable to the forgiven salaries was taxable as ordinary income, not capital gains. The court reasoned that the forgiveness of salaries directly increased the stock's value, and the taxpayers effectively received their salaries in the form of an inflated sale price. This case clarifies that substance over form prevails, and attempts to recharacterize income will be scrutinized.

Facts

Three taxpayers (Lewis, Green #1, and Green #2) were shareholders and officers of Mainline Construction Company. The company accrued salary payments to these taxpayers and another individual (Green #3, now deceased). Due to internal disagreements, the taxpayers sold their stock to the remaining shareholders. As part of the sale agreement, the taxpayers forgave the accrued salary payments. The sale price of the stock was calculated based on the company's book value after disregarding the salary liabilities, effectively increasing the stock price.

Procedural History

The Commissioner of Internal Revenue determined that a portion of the amounts received by the taxpayers upon the sale of their stock constituted payment of the accrued salaries and was taxable as ordinary income. The taxpayers contested this determination in the Tax Court.

Issue(s)

Whether a portion of the amounts received by the taxpayers upon the sale of their stock interests in Mainline constituted payment of salaries accrued on the books of the corporation and is therefore taxable as ordinary income.

Holding

Yes, because the forgiveness of the accrued salaries was directly linked to the increased sale price of the stock, and the taxpayers effectively received their salaries in the form of an inflated sale price.

Court's Reasoning

The court emphasized that the negotiations regarding the forgiveness of salaries

© 2025 SCOTUSreports.com. All rights reserved.

and the sale of stock occurred simultaneously. The agreement to forgive the salaries increased the book value of the stock, which in turn increased the sale price. The court found that the purchasing shareholders would not have paid the agreed-upon price had the salary liabilities not been canceled. The actual cancellation of the salaries on the corporate books only occurred after the sale was completed and the inflated sale price was received. The court stated, “Petitioners received more for their stock than they otherwise would have received because the liability for their accrued and unpaid salaries was disregarded in computing the sale price of the stock. Hence petitioners in substance received their accrued salaries in the guise of an inflated sale price.” The court also noted that even though a portion of the forgiven salaries were due to a deceased individual (Green #3), the taxpayers, as heirs or beneficiaries, effectively controlled those claims.

Practical Implications

This case illustrates the “substance over form” doctrine in tax law. It provides a clear example of how the IRS and courts will scrutinize transactions where taxpayers attempt to recharacterize ordinary income as capital gains to reduce their tax liability. Legal practitioners should advise clients that agreements made contemporaneously affecting the valuation of assets sold will likely be viewed as a single transaction. Taxpayers should fully document the valuation of assets and be prepared to defend the true economic substance of a transaction. Later cases have cited Lewis to support the principle that the character of income is determined by its origin and that attempts to disguise income will be disregarded.

© 2025 SCOTUSreports.com. All rights reserved.