***Braddock Land Co. v. Commissioner, 75 T. C. 324 (1980)***

Debt forgiveness by shareholders during corporate liquidation can be disregarded as a sham transaction if it lacks economic substance and is solely for tax avoidance.

**Summary**

Braddock Land Co. , Inc. was liquidated under IRC Section 337, and its shareholders, who were also employees, forgave accrued salaries, bonuses, and interest to avoid ordinary income tax on these amounts, aiming to receive the proceeds as capital gains. The Tax Court found this forgiveness to be a sham transaction lacking economic substance, as it did not alter the liquidation plan or the company's financial situation. Consequently, the court ruled that payments made to the shareholders during liquidation should be treated as ordinary income to the extent of the forgiven debts, with only the excess treated as a liquidating distribution.

**Facts**

Braddock Land Co. , Inc. , a Virginia corporation, was owned and operated by Rothwell J. Lillard, Anne E. Lillard, Loy P. Kelley, and Ima A. Kelley. The company accrued salaries, bonuses, and interest to the Lillard and Kelley families but paid only part due to cash shortages. In 1972, Braddock adopted a liquidation plan under IRC Section 337. In January 1973, the shareholders forgave part of the accrued debts, aiming to reduce their tax liability by treating the distributions as capital gains rather than ordinary income. Braddock completed its liquidation within the required 12 months, distributing assets to the shareholders.

**Procedural History**

The Commissioner determined deficiencies in the shareholders' and corporation's federal income taxes, asserting that the forgiveness was a sham transaction. The case was brought before the U. S. Tax Court, where the parties consolidated their cases. The court ruled in favor of the Commissioner, disregarding the forgiveness and treating the payments as ordinary income to the extent of the forgiven debts.

**Issue(s)**

1. Whether the forgiveness of accrued salaries, bonuses, and interest by the shareholders during the liquidation process should be disregarded as lacking economic substance and constituting a sham transaction.

2. Whether the payments made to the shareholders during the liquidation should be treated as ordinary income to the extent of the forgiven debts.

**Holding**

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1. Yes, because the forgiveness lacked economic substance and was solely for tax avoidance, serving no other purpose in the liquidation process.

2. Yes, because the payments made to the shareholders were first applied to satisfy the outstanding debts, resulting in ordinary income to that extent, with the excess treated as a liquidating distribution.

**Court’s Reasoning**

The court applied the sham transaction doctrine from *Gregory v. Helvering*, which disregards transactions lacking economic substance and conducted solely for tax avoidance. The forgiveness did not aid Braddock financially, as the company was not insolvent and had sufficient assets to pay creditors, including the shareholders, if they had accepted payment in kind. The court noted that the forgiveness did not alter the liquidation plan or the form of the final distributions, indicating its sole purpose was tax avoidance. The court also relied on corporate law principles that prioritize creditor claims over shareholder distributions, affirming that the payments should first satisfy the debts, resulting in ordinary income. The court cited numerous cases supporting this treatment of payments to shareholder-creditors during liquidation.

**Practical Implications**

This decision emphasizes the importance of economic substance in tax transactions, particularly in corporate liquidations. Practitioners must ensure that any debt forgiveness or similar transactions have a valid business purpose beyond tax avoidance. The ruling clarifies that during liquidation, payments to shareholders who are also creditors must first be applied to outstanding debts, resulting in ordinary income tax treatment. This case has influenced subsequent cases involving the characterization of payments in corporate dissolutions and underscores the need for careful planning and documentation to withstand IRS scrutiny. Future cases have cited *Braddock Land Co.* to distinguish genuine from sham transactions in the context of corporate reorganizations and liquidations.

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