CHALLENGE POINTS

EDITOR'S NOTE: We are pleased to be able to introduce a new feature, which will appear occasionally in the *NewsQuarterly*. This feature will highlight issues that formed a part of the **Law Student Tax Challenge**, organized and sponsored by the Young Lawyers Forum, but which are of general importance and worth sharing with the membership as a whole. We hope you find the feature interesting and useful. We welcome your comments and reactions, and encourage you to send ideas for issues to be featured in future Challenges to the YLF at mlloyd@milchev.com and LSTCcochairs@hotmail.com. —*Alice G. Abreu, Philadelphia, PA*

FORGIVEN EXECUTIVE LOANS: COMPENSATION INCOME WITH SOME UNSAVORY TWISTS

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This article analyzes the federal tax treatment of a discharge of loans made by a corporation to executive officers of the corporation's wholly owned subsidiary. This issue remains important even though section 402(a) of the Sarbanes-Oxley Act of 2002 ("SOX") prohibits a public company from extending credit to an executive officer or director of the company on or after July 30, 2002. While prospective loans may no longer be made by public companies to their executive officers and directors after July 29, 2002, section 402(a) of SOX grandfathers loans in existence on the date of enactment. In addition, section 402(a) of SOX does not apply to non-public companies. Accordingly, practitioners are likely to continue to face issues that arise in connection with employee loans.

THE TRANSACTION

Assume that a corporate parent ("Distributing") announces its intention to distribute the shares of stock in a wholly owned subsidiary ("Controlled") in a spin-off qualifying under section 355. Further assume that Distributing made loans to certain executive officers of Controlled to finance the purchase and retention of Distributing shares by those executive officers. Those loans are evidenced by notes issued to Distributing by the executives. In connection with the spin-off, Distributing wants to forgive the loans made to the executives following the spin-off, but it needs to establish the federal income and employment tax consequences of any such forgiveness. The executives would like to be able to take the position that the forgiveness constitutes neither income nor wages, but instead simply amounts to a purchase-price adjustment in the acquired shares pursuant to section 108(e)(5). If section 108(e)(5) applies, no amounts would need to be recognized; the question practitioners in such a situation will face is whether that result is correct.

THE ANALYSIS

Although treating the loan forgiveness as a purchase price adjustment would appear to have some merit given that the lender forgiving the obligation (Distributing) is also the seller of the property, section 108(e)(5) probably does not apply. The Service analyzed a similar situation in Rev. Rul. 2004-37, 2004-11 I.R.B. 1 and concluded that the tax consequences of such a scenario are governed by section 83 and Treas. Reg. § 1.83-4(c), not section 108(e)(5). In Rev. Rul. 2004-37 the Service treated the amount forgiven as compensation and explained its position as follows:

> Thus, if the reduction of the stated principal amount of the Note is a cancellation, forgiveness, or satisfaction of the indebtedness for an amount less than the amount of such indebtedness [with respect to the rules set forth in Treas. Reg. § 1.1001-3], the reduction of the stated principal amount is a medium for payment of compensation by Employer to Employee, and any income resulting from the reduction is not income to Employee from the discharge of indebtedness subject to the provisions of section 108. Accordingly, the tax consequences of the reduction are governed by § 83 and § 1.83-4(c), and not by § 108(a)(1)(B) or § 108(e)(5).

The Service issued Rev. Rul. 2004-37 in February of 2004 to address a fact pattern involving an employee who had issued a recourse note to his employer in satisfaction of the exercise price of an option to acquire the employer's stock. Subsequently, the employee and employer agreed to reduce the stated principal amount of the note. The ruling addressed whether the employee must recognize compensation income under section 83. The Service ruled that the employee must recognize compensation income under section 83 at the time of the reduction.

EMPLOYMENT TAX CONSEQUENCES

In Rev. Rul. 2004-37 the Service also stated that the compensation constituted wages for Federal employment tax purposes (*i.e.*, Federal Income Tax Withholding ("FITW") taxes, Federal Unemployment Tax Act ("FUTA") taxes, and Federal Insurance

1 The authors served as co-chairs of the 2004 Law Student Tax Challenge. The analysis provided here reflects only the individual views of the authors and does not represent the views held by the Internal Revenue Service.

Contribution Act ("FICA") taxes). For federal employment tax purposes, remuneration arising from the employer-employee relationship constitutes wages even though at the time of payment the individual is no longer an employee. *See* Treas. Reg. § 31.3401(a)-1(a)(5) (FITW); Treas. Reg. § 31.3121(a)-1(i) (FICA); Treas. Reg. § 31.3306(b)-1(i) (FUTA); *see also* Social Security Board v. Nierotko, 327 U.S. 358 (1946) (holding that back pay provided by an employer under the National Labor Relations Act to an illegally terminated employee for a period during which the individual performed no services for the employer was wages for social security benefit purposes). Thus, any debt-discharge income of the executives would constitute wages for federal employment tax purposes. Consistent with the Service's position in Rev. Rul. 2004-37, federal income tax and the employee share of FICA taxes should be withheld with respect to the deemed payment of the wage amount, and the employer's share of FICA taxes and FUTA taxes should be paid with respect to the same amount. *See*, *e.g.*, I.R.C. § 3402(a) and Treas. Reg. § 31.3402(a)-1(c) (requiring employers to deduct and withhold Federal income tax even if the wages are paid in a form other than money); I.R.C. §§ 3101 and 3111 (imposing FICA taxes on wages) and Treas. Reg. § 31.3102(a)-1(a) (requiring employers to deduct and withhold FICA tax regardless of the fact that the wages are paid in a form other than money); I.R.C. §§ 3301, 3306(b), and 3306(c) (combining to impose FUTA taxes on employers regardless of the fact that wages are paid in a form other than money).

Distributing is in a difficult position with respect to withholding and employment taxes arising from the debt discharge in a situation like this because although Distributing did not actually employ the executives (its subsidiary, Controlled, was the employer), Distributing was the party that exercised control over the "payment" of the wages in question (the debt discharge), and it will therefore be treated as the employer for withholding purposes. Section 3401(d)(1) provides that if the person (service recipient) for whom the individual performs or performed services does not have control of the payment of the wages for such services, the term "employer" means the person having control over the payment of such wages. Under case law, a similar result would be reached for FICA and FUTA tax purposes. *See*, *e.g.*, Otte v. United States, 419 U.S. 43 (1974); In re Armadillo Corp., 561 F.2d 1382 (10th Cir. 1977); Cencast Services, L.P. v. United States, 62 Fed. Cl. 159 (2004). In this case, then, Distributing will be treated as the employer for withholding and employment tax purposes because Controlled, the actual employer, did not control the payment of the wages attributable to the debt discharge. Distributing would thus be liable for FITW (most likely at supplemental rates of either 25 or 35 percent, as circumstances require) and FICA tax withholding in addition to paying the employer's share of Federal employment taxes for individuals whom it did not actually employ.

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2005-2006 **NOMINEES**

In accordance with sections 6.1 and 6.3 of the Section of Taxation Bylaws, the following nominations have been submitted by the Nominating Committee for terms beginning at the conclusion of the 2005 Annual Meeting in August. Under the Section Bylaws, the current Chair-Elect, Dennis B. Drapkin of Dallas, TX will become Chair at the conclusion of the 2005 Annual Meeting.

CHAIR-ELECT:	Susan Serota	New York, NY
VICE CHAIRS:	Jerald August	West Palm Beach, FL
	Charles Egerton	Orlando, FL
	Gregory Jenner	Washington, DC
	William Paul	Washington, DC
	Elinore Richardson	Toronto, Canada
	Sylvan Siegler	Kansas City, MO
SECRETARY:	Christine Agnew	Houston, TX
ASSISTANT SECRETARY:	Armando Gomez	Washington, DC
COUNCIL DIRECTORS:	Peter Connors	New York, NY
	Barbara Spudis de Marigny	San Antonio, TX
	Richard Gallagher	Milwaukee, WI
	Sharon Stern Gertsman	Buffalo, NY

In addition, Distributing will face a potential liquidity problem because there is no actual payment of wages from which to withhold. If Distributing ultimately chooses to drop the notes into Controlled in a section 351 contribution prior to the spin-off, it can solve the first problem because Controlled, the actual employer, will be forgiving the indebtedness which it now holds. Nevertheless, the liquidity problem will remain because there will be no payments from which taxes may be withheld by either Distributing or Controlled; there will only be a discharge of bona fide indebtedness. Thus, Distributing or Controlled, as appropriate, could not only suffer from an inability to collect on the notes from the executives, but Distributing or Controlled would be financially responsible through secondary liability for all of the related employment taxes to be withheld (*e.g.*, FITW and the employee share of FICA taxes) with no "payment" from which to withhold. See I.R.C. § 3403 (FITW) and Treas. Reg. § 31.6205-1(b)(1) (FICA).

DEPOSIT AND PAYMENT OF TAXES

To make matters worse, the Service could take the position that the deposit rules set forth in the regulations under section 6302 apply to the debt-discharge event, which would likely require Distributing or Controlled, as appropriate, to deposit the Federal employment taxes on the day after the liability date (*i.e.*, the date of the compensation) if the amount of the liability equals or exceeds $100,000. Such a failure would likely trigger the late deposit penalties under section 6656. Nevertheless, the debt-discharge income might constitute a form of non-cash compensation to executives, which may provide some flexibility with regard to when the related federal employment taxes may be deposited. *See* Ann. 85-113, 1985-31 I.R.B. 31 (permitting employers to elect to treat non-cash fringe benefits as paid on a pay period, quarterly, semi-annual, annual, or other basis, provided that the non-cash benefits are treated as paid no less frequently than annually). Under this Announcement, employers must treat all such benefits as paid prior to December 31 of the calendar year in which they provide the benefits. Because the executive's debt discharge income is tantamount to a non-cash fringe, it may be possible for Distributing or Controlled to treat the deemed payment as a non-cash fringe for purposes of the deposit rules under section 6302.

COMPENSATION DEDUCTION

As a result of a debt discharge, Controlled would likely qualify for an additional compensation deduction under section 83 because it was the recipient of the executive officer's services and because the indebtedness was incurred to pay for section 83 property. *See* Treas. Reg. § 1.83-4(c), which provides as follows:

> If an indebtedness that has been treated as an amount paid under §1.83-1(a)(1)(ii) is subsequently cancelled, forgiven or satisfied for an amount less than the amount of such indebtedness, the amount that is not, in fact, paid shall be includible in the gross income of the service provider in the taxable year in which such cancellation, forgiveness or satisfaction occurs.

It therefore follows that Controlled, the recipient of the services, would be entitled to a corresponding deduction for the compensation paid.

JUDICIAL RELIEF

In connection with the imposition of employment taxes on the debt discharge income of the executive officers, Controlled or Distributing may attempt to argue that there is judicial authority that would mitigate the imposition of such taxes. In particular, Controlled or Distributing might argue that the Supreme Court's holding in Central Illinois Public Service Co. v. United States, 435 U.S. 21 (1978) demands more clarity in the obligation to withhold than exists under the instant facts. In *Central Illinois*, the Court held that if the employer is to function as the Government's tax collector with respect to taxes owed by the employee, the withholding obligation must be clearly apparent. Since the Court's holding in *Central Illinois*, other courts have followed this reasoning. *See*, *e.g.*, General Elevator v. United States, 20 Cl. Ct. 345 (1990); McGraw-Hill, Inc. v. United States, 623 F.2d 700 (Cl. Ct. 1980); Marquette University v. United States, 645 F.Supp. 1007 (E.D. Wis. 1985).

Nevertheless, the issuance of Rev. Rul. 2004-37 could undercut such an argument; the ruling puts taxpayers on notice of the Service's position with respect to the treatment of debt discharges for employees.

CONCLUSION

Despite the issuance of Rev. Rul. 2004-37, an important legal question remains: that is, whether the Service may impose a withholding obligation on an entity when bona fide indebtedness of a former employee or of an individual who was never actually employed by the entity is discharged, and there is no actual payment from which the entity may reasonably extract the amounts to be withheld. This question is one that the Service has, to date, failed to answer directly. While Rev. Rul. 2004-37 answered the question of how to characterize the amounts forgiven by concluding that the amounts should be treated as wages, that ruling did not grapple with the issues raised by a fact pattern in which the individual is not employed by the entity that forgives the obligation. While it seems to us that existing authority combines to produce the result set forth here, the issues raised suggest that additional guidance would be welcome and that there is at least some risk that a court would decline to impose Federal employment tax obligations on an employer in such a situation. ■