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Taxation--Gross Income--Cancellation of Indebtedness as Constituting Taxable Income

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C.: Taxation--Gross Income--Cancellation of Indebtedness as Constitut

rate" results in an hourly rate less than the minimum, the statutory rate is the "regular rate," for the purposes of computation of overtime payments. *Carleton Screw Products Co. v. Fleming, supra.* But the "regular rate" for overtime compensation under the FLSA is not an arbitrary figure, being rather the actual amount determined by dividing all payments, except true overtime premiums, received by an individual employee as compensation for work performed, by the number of hours worked by the employee during the work week; the "regular rate" may vary from week to week. *Bay Ridge Operating Co. v. Aaron, supra; Landreth v. Ford Bacon & Davis Co.,* 147 F.2d 446 (C. C. A. 8th 1945). The FLSA imposes upon the employer an absolute duty to pay currently each of its employees, within the coverage of the Act, for overtime at a rate not less than one and one-half times the "regular rate." *Bay Ridge Operating Co. v. Aaron, supra.*

From the above, the conclusion can be drawn that for the purposes of computing overtime pay: (1) Each employee covered by the Act has a "regular rate" of pay. (2) The "regular rate" is not the equivalent of the statutory minimum. (3) It is immaterial that the total wages exceed the statutory minimum. (4) Anything of value received by the employee for his labors, including tips, is creditable as wages. (5) The "regular rate" is determined by dividing the total wages received during the work week (excluding true overtime payments) by the number of hours worked. (6) Employees covered by the Act are entitled to overtime pay at one and one-half times the "regular rate." In the instant case, if these shoe-shine boys are considered "employees" and covered by the FLSA, it would seem that their "regular rate" should be computed by dividing their total wages for the week (all amounts received from tips and for shining shoes) by the total hours worked during the week, and that they would be entitled to overtime pay at one and one-half times the "regular rate" thus calculated.

R. L. T.

TAXATION — GROSS INCOME — CANCELLATION OF INDEBTEDNESS AS CONSTITUTING TAXABLE INCOME. — Taypayer, a natural person, issued secured bonds evidencing his personal indebtedness to the holders thereof. After procuring an extension of the maturity date he, solvent though in "straitened financial circumstances,"

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repurchased the bonds from the holders, either directly or through a broker and bondholder's committee, at a discount before the extended maturity date. The Circuit Court of Appeals, treating the entire transaction as a direct one rather than an open market one, found that the discount did not represent a taxable gain since the sellers knew the bonds were being bought by or for the taxpayer. *Held,* the discount is a taxable gain under INT. REV. CODE §22 (a), which provides that "Gross income includes . . . gains and profits and income derived from any source whatever." Judgment reversed. *Commissioner v. Jacobson,* 69 Sup. Ct. 358 (U. S. 1949).

In 1931, the Supreme Court held that a solvent corporation realized a taxable gain under Section 22 (a) where it purchased its own bonds in the open market at a discount, on the theory that the diminution of liabilities had resulted in a freeing of the assets previously offset by the obligation of those bonds. *United States v. Kirby Lumber Co.,* 284 U. S. 1 (1931). This ruling has been generally followed with three notable exceptions: (1) Where the debt cancellation constitutes a reduction in the contract price after a sale, this is considered a readjustment of the contract and no income is realized. *Commissioner v. Sherman,* 135 F.2d 68 (C. C. A. 6th 1943); *Helvering v. A. L. Kilian Co.,* 128 F.2d 433 (C. C. A. 8th 1942); *Hirsch v. Commissioner,* 115 F.2d 656 (C. C. A. 7th 1940). But see *5th Ave. 14th St. Corp. v. Commissioner,* 147 F.2d 453, 456 (C. C. A. 2d 1945). (2) Where a corporation's debt to its shareholder is cancelled, this is considered a contribution to the capital of the corporation rather than income. *Carroll-McCreary Co. v. Commissioner,* 124 F.2d 303 (C. C. A. 2d 1941); *Commissioner v. Auto Strop Safety Razor Co.,* 74 F.2d 226 (C. C. A. 2d 1934). (3) Where the taxpayer is insolvent, taxable income is realized only to the extent that the debt cancellation makes the taxpayer solvent. *Haden Co. v. Commissioner,* 118 F.2d 285 (C. C. A. 5th 1941), *cert. denied,* 314 U. S. 622 (1941); *Lakeland Grocery Co.,* 36 B. T. A. 289 (1937). In 1943, the Supreme Court further infringed on the doctrine of the *Kirby Lumber* case by holding that a solvent corporation was not taxable for the amount of accrued rent and interest cancelled by its creditors, on the theory that such a cancellation constituted a gratuitous forgiveness of the debt regardless of whether the intent with which it was released was donative or business in nature, and was therefore a gift

within the meaning of INT. REV. CODE §22 (b) (3), which provides that "the value of property acquired by gift, devise, or inheritance" is to be exempt from taxation under Section 22 (a). *Helvering v. American Dental Co.*, 318 U. S. 322 (1943).

The cases following the *American Dental* case had distinguished it from the *Kirby Lumber* case on one of two major grounds. First, the *Kirby Lumber* case is applicable where the transaction is an "open market" one rather than a direct transaction between debtor and creditor as in the *American Dental* case. *Central Paper Co. v. Commissioner*, 158 F.2d 131 (C. C. A. 6th 1946); *5th Ave. 14th St. Corp. v. Commissioner*, 147 F.2d 453 (C. C. A. 2d 1945). Second, the *Kirby Lumber* case is applicable where there is an adequate consideration for the cancellation rather than a gratuitous forgiveness as in the *American Dental* case. *Chenango Textile Corp. v. Commissioner*, 148 F.2d 296 (C. C. A. 1st 1945). The Court in the *Jacobson* case pays heed to neither of these distinctions. Instead, it simply states that there was nothing to indicate that the seller was not getting all that he could for all that he had, with the result that the Court would not consider the cancellation a gift under Section 22 (b) (3), whereas the *American Dental* case had pointed out that intent or motive was immaterial so long as the forgiveness was gratuitous.

The Court in the *Jacobson* case finds further strength for its position by pointing out that INT. REV. CODE §22 (b) (9), as enacted in 1939 and amended in 1942, provides that, in the case of corporations, the amount of income attributable to the discharge of secured indebtedness is exempt from income tax if there is compliance with section 113 (b) (3), which requires that the amount so excluded shall be applied to reduce the basis of corporate property. The Court reasons that if such cancellations were already gifts within Section 22 (b) (3), there would have been no need for Section 22 (b) (9), and therefore Congress must have considered that prior to its enactment of Section 22 (b) (9) such cancellations were subject to taxation under Section 22 (a). And further, since Section 22 (b) (9) is applicable only to corporations, individual taxpayers must necessarily have been excluded, and are therefore subject to Section 22 (a).

Thus, it would seem that the Supreme Court has reaffirmed the principle of the *Kirby Lumber* case at the expense of its ruling in the *American Dental* case. It is quite possible that the only

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exceptions that will now be recognized to the *Kirby Lumber* ruling, in addition to the three enumerated above, are those made in favor of corporations by Section 22 (b) (9), those where the cancellation is made with a true donative intent, and those where the creditor's release is made because of his interest in the business as a going concern, as in the *American Dental* case, as distinguished from an arm's-length transaction in which the creditor's only interest is to exact from the debtor the best price available, as in the *Jacobson* case.

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