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INCOME TAXATION—DEMAND NOTE AS DEDUCTIBLE SALARY PAYMENT

The interpretation of the word *'paid'* in the Internal Revenue Code furnishes a fertile ground for dissenting opinions. In *Anthony P. Miller, Inc. v. Commissioner of Internal Revenue,*[1] the Third Circuit Court of Appeals reversed the Tax Court's construction of that word by holding that demand promissory notes given by an accrual basis corporation to its cash basis president were such payment of his salary as to be outside the scope of the disallowance provisions of Section 24 (c) (1) of the Code.[2]

According to the Tax Court findings of fact, one A.P. Miller, a construction engineer, had organized the taxpayer corporation and was its controlling stockholder and president. He determined the salary he was to receive for his services in 1940, which amounted to a $12,000 regular salary and a $30,000 bonus. On January 1, 1941 the corporation delivered two negotiable demand promissory notes to Miller covering the above amounts, and deducted the $42,000 in its 1940 income tax return as an ordinary and necessary business expense. Section 23 (a) (1) (A) of the Code[3] allows a corporation to deduct a reasonable allowance for salaries, provided that such deduction is not disallowed by section 24 (c). In applying the latter subsection, all three subparagraphs must apply to the taxpayer before the deduction is disallowed.

The Tax Court held that subparagraph (3) applied because the relationship between Miller and his corporation was so close as to meet

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[1] 164 F.)2d) 268, (C.C.A. 3, 1947). Petition for certiorari filed February 16, 1948.

[2] Internal Revenue Code, Section 24 (c): "Sec. 24. Items Not Deductible.

(c) UNPAID EXPENSES AND INTEREST PERIOD AFTER INTEREST—In computing net income no deduction shall be allowed under section 23(a), relating to expenses incurred, or under section 23 (b), relating to interest accrued—

(1) If such expenses or interest are not *paid* within the taxable year or within two and one-half months after the close thereof; *and*

(2) If, by reason of the method of accounting of the person to whom the payment is to be made, the amount thereof is not, unless paid, includible in the gross income of such person for the taxable year in which or with which the taxable year of the taxpayer ends; *and*

(3) If, at the close of the taxable year of the taxpayer or at any time within two and one-half months thereafter, both the taxpayer and the person to whom the payment is to be made are persons between whom losses would be disallowed under section 24 (b)."

[3] I.R.C., Section 23 (a) (1) (A): "Section 23. Deductions From Gross Income. In computing net income there shall be allowed deductions:

(a) EXPENSES.—

(1) Trade or Business Expenses.—

(A) In General.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered;***"

the requirements of section 24 (b) (1) (B)[4]; that subparagraph (2) applied because the notes were delivered in 1941 and nothing in the record indicated that the money was unconditionally made available to him in 1940 (taxpayer's taxable year) so as to justify the application of constructive receipt to him as a cash basis creditor (the fact that Miller himself did actually erroneously include the $42,000 in his 1940 return was immaterial, since what he had a right to do and not what he did do governs in interpreting this paragraph); that paragraph 1 applied because the delivery of promissory notes did not constitute payment, especially as the notes themselves were not discharged until December 31, 1942, practically two years after delivery. The Court held in a ten to six decision that the reasonable allowance of $25,000 for Miller's salary—the entire $42,000 having been found unreasonably high for an executive in a position comparable to Miller's—was not properly deductible by the corporation in its 1940 return. The majority reasoned thus:

> "The word *'paid'* as used in this section (24 (c) (1)) means paid in actuality in cash or its equivalent,, and the giving of one's own note for one's obligation is not such payment. Giving a note is not the equivalent of payment in cash, nor is it constructive payment. The word *'paid'* has an accepted and customary meaning of paid in cash or its equivalent."[5]

Cases cited in support of the decision were *Helvering v. Price,*[6] *Cleaver v. Commissioner,*[7] and *Eckert v. Burnet;*[8] and the Tax Court

[4] I.R.C., Section 24 (b) (1) (B): "Section 24. Items Not Deductible.
(b) LOSSES FROM SALES OR EXCHANGES OF PROPERTY.—
(1) Losses Disallowed.—In computing net income no deduction shall in any case be allowed in respect of losses from sales or exchanges of property, directly or indirectly—
(B) Except in the case of distributions in liquidation, between an individual and a corporation more than 50 per centum in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual."

[5] 7 T.C. 729 (1946).

[6] 309 U.S. 409, 60 S. Ct. 763, 84 L. Ed. 836 (1940). Here the taxpayer had given his promissory note as guarantor of bank assets involved in a bank merger, as payment under his guarantor liability, and sought to deduct the amount of the note as a loss sustained in 1932, the year the note was delivered, although the note was not paid in 1932. The Court held that the giving of a note does not constitute a payment in cash or its equivalent so as to entitle the taxpayer to a deduction as for a loss in making an income tax return on the cash basis.

[7] 6 T.C. 452, (1946); affirmed 158 F. (2d) 342, (C.C.A. 7, 1946); cert. den., 330 U.S. 849, (1947). Here a cash basis taxpayer claimed a deduction for payment of interest, where a bank advanced him the balance of the amount of a note he gave to the bank less the interest discounted in advance, contending that he paid the interest withheld by the delivery of the note. The face of the note was not to be paid until five years in the future, and the appellate court held that no actual cash payment of interest had been made in the year the deduction was claimed, the note not sufficing.

[8] 283 U.S. 140, 51 S. Ct. 373, 75 L. Ed. 911, (1931). Here it was held that one making his income tax return on the cash basis who has given his own note in exchange for worthless notes on which he was indorser could not deduct

further saw no necessity for extending the usual and accepted meaning of the word *'paid'* to include *'constructively paid'* when such "unnatural construction would breed confusion and administrative difficulties and be subversive of the apparent purposes of the statute."

The majority opinion stressed legislative history:

> "Section 24(c) was first enacted in the Revenue Act of 1937. The principal purpose of adding this section is evident from its legislative history. Deductions were being taken by certain classes of debtors using the accrual method of accounting. These debtors took the deductions in the year of accrual. The amount of the deduction would not be includible in the cash basis creditor's income until actually received. When the creditor bore a certain relationship to the debtor, control and abusive manipulation of the time of receipt, if ever, by such creditor was possible and frequently exercised. Thus, the Government was in a position of permitting deductions to debtors for accrued items on which income tax was avoided altogether by the cash creditor or postponed to a taxable year selected by the creditor as being most advantageous to him taxwise."[9]

The six dissenting Tax Court judges thought that the notes, being *demand* negotiable notes with a readily realizable value of par were sufficient to render the salary *'paid'* within the meaning of section 24 (c)(1).

On appeal, the Third Circuit, speaking through Judge Goodrich, agreed with the dissenting judges of the Tax Court:

> "The legal rule is well recognized that the giving and acceptance of the negotiable instrument is conditional payment of the debt, and the creditor cannot proceed against the debtor on the original obligation until the instrument is either surrendered or dishonored. If the parties agree, the acceptance of the negotiable paper will discharge the original debt altogether. In either event, the creditor with the negotiable instrument in his hands is in a much better position than a creditor without one."

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from the gross income of the year in which he so gave his own note the amount thereof as a debt 'ascertained to be worthless and charged off within the taxable year,' the loss in such case not being sustained until his own note is paid. Said Mr. Justice Holmes: "The petitioner says that it was definitely ascertained in 1925 that the petitioner would sustain the loss in question. So it was if the petitioner ultimately pays his note."

[9] It was thought that section 24 (c) "should serve to stimulate reasonably prompt payment of such accrued expenses in order that the debtor may secure the allowance of the deductions. No hardship should result from the requirement that the amount be paid within 2½ months after the close of the year of accrual since expenses of this nature usually should be paid within that time in the ordinary course of business while this restriction would be applicable only to individuals and corporations in relationships covered by section 24 (a) (6)—(now 24 (b) (1) (B))—, this class represents the worst offenders in the use of this loophole." *Report of Joint Committee on Tax Evasion and Avoidance,* House Document 337, 75th Congress, 1st Sess., p. 16.

"Furthermore, as a matter of common parlance, we think it is most common to speak of 'paying' an obligation by giving one's check for it. That is the common method of paying bills in this country. The use of the demand negotiable note is not so frequent, but the two instruments have much in common, nevertheless. Each is payable at once. Each rests on the credit of the maker or drawer, respectively, for the bank is under no obligation to the holder to pay a check. Nor is the drawing of the check an assignment of the debtor's account with the bank."

"We think, therefore, that the taxpayer corporation paid its president's salary when, on January 1, 1941, it gave him negotiable demand promissory notes for the amount. Nor does this conclusion violate the spirit of the Act as found in its legislative history. Our brethren in the Sixth Circuit decision, already referred to,[10] discussed this point in some detail, and reference is made to the opinion in that case for its consideration."

The writer feels that the reasoning of the Tax Court majority is more persuasive, because the reality of a promissory note, even though negotiable and payable on demand, is that it is a promise to pay in the future, being given by its maker to postpone payment; and even though a demand note technically matures on delivery, in the normal situation both maker and payee contemplate that such demand will not be made immediately, but that discharge by actual cash payment will take place some reasonable future time after delivery. In the present case where the taxpayer and the corporation were so closely identified, it seems that the notes were merely more permanent evidence of the debt. A taxpayer in a situation such as this might never negotiate the notes, but would rather defer demand for payment until the corporation could comfortably pay. If the corporation became insolvent while the note was outstanding, the creditor could claim a refund on his own income tax, while the Government would have allowed a deduction for an expense that was never actually paid.[11] Even if Miller had negotiated

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[10] *Musselman Hub-Brake Co. v. C.I.R.*, 139 F. (2) 69 (C.C.A. 6, 1943). Here the corporation also gave its controlling stockholder demand promissory notes within the 2½ month period, and the court held such notes such payment as to entitle the corporation to take the deduction. The court said: "There was no tax evasion in fact, and the evil sought to be remedied is not present. Clearly under the rule of constructive payment, the notes with a readily realizable value of par were more than a mere accrual of indebtedness on the books of petitioner." In the *Miller* case, the Tax Court fretted under this reversal and remarked that the Sixth Circuit was confusing constructive payment with constructive receipt, because in the asymmetrical revenue statutes the one is not the corollary of the other, each fiction being erected by the courts for independent reasons to frustrate multiform evasion schemes; and even if there were constructive payment here, what warrant is there for so extending the meaning of the word *'paid'?*

[11] Compare *Schlemmer v. U.S.*, 94 F. (2d) 77, (C.C.A. 2, 1938), where the taxpayer claimed and received a refund on his income tax because he had included as income a note given him by the corporation he headed for his 1927 salary, the corporation becoming insolvent. The note was never paid. Judge Learned Hand commented: "It (the note) did not change the sub-

the note within the 2½ month period, would he actually have been paid his salary in the event that the maker failed to pay and his indorsee held him liable on his indorsement? In the analogy which the Circuit Court drew between a demand note and a check, it recognized that payment by either could be conditional, and not absolute. In the statute being construed, Congress simply used the word *'paid'* without any such qualifying adverbs as 'constructively' or 'conditionally'. Furthermore the Tax Court decision seems more in line with the long standing policy to construe strictly statutes permitting deductions.[12] If deductions are privileges and must be narrowly construed,[13] it seems to the writer that a statute specifically aimed at disallowing a deduction should, a fortiori, be strictly construed also, without judicial addition of qualifying words.

In cases involving the right of a cash basis taxpayer to take a deduction where he has undertaken payment of an expense by note actually discharged in a later year, the courts have denied such deduction, in the year of delivery, the language used by Chief Justice Hughes in *Helvering v. Price*[14] being typical:

> "We think that this (Eckert) decision[15] is controlling here. As the return was on the cash basis, there could be no deduction in the year 1932, unless the substitution of taxpayer's note in that year constituted a payment in cash or its equivalent. There was no cash payment, and under the doctrine of the Eckert case, the giving of the taxpayer's own note was not the equivalent of cash to entitle the taxpayer to the deduction. Taxpayer urges that his not was secured, but the collateral was not payment. It was given to secure taxpayer's promise to pay, and if that promise to pay was not sufficient to warrant the deduction until the promise was made good by actual payment, the giving of security for performance did not transform the promise into the payment required to constitute a deductible loss in the taxable year."

It is submitted that the Congressional intent in drafting section 24 (c) was to change the accounting basis of an accrual basis corporation when paying the salary of a controlling officer, that is, to put it on the cash basis for this limited purpose, and therefore the principles of cash

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stance of the debt.*** and although it was more readily disposable, that single incident was scarcely enough.*** Indeed, it is not at all clear that it would have been a cash item, even if it had in fact been taken as payment." It was held that the taxpayer was entitled to his refund, as the note was not payment.

[12] *Deputy v. DuPont,* 308 U.S. 488, 60 S. Ct. 363, 84 L. Ed. 416, (1939); *U.S. v. Stewart,* 311 U.S. 60, (1940), where the Court said: "Those who seek an exemption from a tax must rest it on more than a doubt or ambiguity"; and *White v. U.S.* 305 U.S. 281, (1938); "A taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms."

[13] Mertens, Law of Federal Income Taxation, Vol. 1, Section 3.08, (1942).

[14] See note 6, supra, for facts.

[15] See note 8, supra.

basis accounting should apply.[16] One of the root principles of the cash basis is that a deductible expense is not sustained until actually paid in cash or its equivalent, and a promise to pay which may never be paid ultimately will not suffice. In any event, the Third Circuit's interpretation of the word *'paid'* should be confined to section 24 (c) (1), and not extended to other sections of the Code in which the word appears, as for instance section 23 (b) relating to payment of interest, or else the confusion and conflict of authority predicted by the United States Supreme Court in the *Dobson* case[17] will, as it appears to the writer, be enhanced.

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[16] *Hart v. Commissioner,* 54 F. (2d) 848 (C.C.A. 1, 1932), where a cash basis taxpayer attempted to pay an interest debt by means of a promissory note, the parties considering the debt discharged by the delivery of the note. The court said: "A promise to pay is not cash, and a deduction for interest is permissible only in the taxable year in which the taxpayer pays cash." In *Quinn v. C.I.R.,* 111 F. (2d) 372, (C.C.A. 5, 1940), the taxpayer on a cash basis was not allowed to deduct, as a business expense, the amount of an obligation to an accounting firm which was discharged by borrowing money on taxpayer's secured note, the note not being paid during the taxable year.

[17] *Dobson v. Commissioner,* 320 U.S. 489, 64 S. Ct. 239, 88 L. Ed. 248, (1943).