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# THE TREATMENT ACCORDED PROMISSORY NOTES UNDER THE FEDERAL INCOME TAX

HENRY BRANDIS, JR.†

## I. INTRODUCTION

The purpose of this article is to identify, in some of the more commonly encountered contexts and in somewhat summary fashion, the federal income tax consequences ensuing when an obligor's note, as distinguished from cash or a check, is delivered to the obligee.<sup>1</sup> The consequences appear to vary, if not always justifiably, with the role of the taxpayer as payee or maker, with his accounting method (cash or accrual), with the words (if any) used by the payee in accepting the note, with the origin of the underlying obligation, or with the specifically applicable provisions of the Internal Revenue Code.

## II. THE PAYEE

### A. *Accrual Taxpayers*

"Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy."<sup>2</sup> Thus the receipt of a note, as distinguished from receipt of cash or a check, or as distinguished from allowing the obligation to be less formally represented by an open account, is not ordinarily, per se, the critical factor in determining the time for reporting income.<sup>3</sup> For example, if an employer is obligated to pay, but fails to pay, an accrual taxpayer's salary on December 31, the latter nevertheless includes the salary in his gross income at that time rather than when, at some later time, the obligation is more formally recognized by the giving of a note.<sup>4</sup>

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<sup>1</sup>As to a note of *B*, endorsed to a taxpayer by *A*, his obligor, see note 11 *infra*.

<sup>2</sup>Treas. Reg. § 1.446-1(c)(ii) (1957). A virtually identical statement is contained in Treas. Reg. § 1.451-1(a) (1957).

<sup>3</sup>To the extent that sale transactions may be subject to different rules, see the text, *infra*, under "Credit Sales." As to reporting the interest element on installment notes, see note 23 *infra*.

<sup>4</sup>If "no determination can be made as to the right to such compensation or the amount thereof until the services are completed, the amount . . . is ordinarily income for the taxable year in which the determination can be made." Treas. Reg. § 1.451-1(a) (1957).

## B. Cash Taxpayers

### 1. General rule

It is sometimes stated without qualification that cash taxpayers have reportable income upon receipt of a note, at least if it is negotiable, in the amount of its fair market value.<sup>5</sup> This, however, is an overstatement; also it is not so rational a proposition as to deserve general acceptance.

A note, particularly if negotiable, undoubtedly has certain advantages to the payee not inherent in an indebtedness less formally evidenced. It is, as a generality, more easily discounted or sold, but ordinarily an account receivable may also be sold, and in specific situations when the debtor is solvent and reputable, its fair market value may vary little from that of a note unless the note bears interest and the account does not or unless interest rates on the two differ.<sup>6</sup> Similarly, a note, though its value may be affected, is not automatically rendered non-saleable by virtue of being nonnegotiable.<sup>7</sup>

In any event, the obligee acquires an intangible asset when a debt-

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<sup>5</sup>See, e.g., the statement that "notes or other evidences of indebtedness received for services, rents, interest or royalties constitute income to the amount of their fair market value." *Musselman Hub-Brake Co. v. Commissioner*, 139 F.2d 65, 68 (6th Cir. 1943). Compare the compiler's explanation of § 451 of the code in 3P-H 1973 FED. TAXES ¶ 20,134, referring to cash taxpayers: "A negotiable note of a fair market value not less than its face amount is the equivalent of cash and includible in income in the year received."

<sup>6</sup>For recognition that a promise to pay, not evidenced by a note, may be the equivalent of cash when transferrable and of a kind acceptable in the market, see *Cowden v. Commissioner*, 289 F.2d 20 (5th Cir. 1961). There the indebtedness (a bonus to the lessor for an oil and gas lease) was, in fact, discounted to a bank in advance of the stipulated payment date. The court of appeals remanded the case for further findings on the ground that the Tax Court had overemphasized certain aspects of the facts. The Tax Court had previously held that the promise to pay, incorporated in the lease agreement, was equivalent to cash and reportable by the cash taxpayer when the agreement was made. On remand, the Tax Court, with minimal revision of findings, again held that the promise to pay was equivalent to cash and was reportable in the amount of its fair market value as determined by the Commissioner (approximately 95% of face value). *Frank Cowden, Sr.*, 30 P-H Tax Ct. Mem. 1237 (1961). The Tax Court did not invoke the constructive receipt doctrine, though some of the facts seemed to point in that direction; and the position of the court of appeals seems to indicate that it would not have accepted invocation of the doctrine. In the absence of a finding of constructive receipt the case seems to go beyond the decisions in a number of other cases cited herein; however, the recognition that open accounts and notes do not differ in all critical respects is soundly based. For the regulation dealing with constructive receipt, see *Treas. Reg. § 1.451-2* (1971). See also the compiler's explanation of constructive receipt in 3 P-H 1973 FED. TAXES ¶ 20,161.

<sup>7</sup>If a note is not assignable or transferrable, it ordinarily has no fair market value. See *Denver & R.G.W.R.R. v. United States*, 318 F.2d 923 (Ct. Cl. 1963); *Jay A. Williams*, 28 T.C. 1000 (1957).

edness to him arises, whether it be in form an open account, a non-negotiable note, or a negotiable note. In any form, dependent upon the solvency of the debtor and other factors, the indebtedness may have a value ranging from zero to more than face amount. It is not a valid basis for differing tax results to cash taxpayers that notes may, in general, have a value more nearly equivalent to face amount than open accounts. The fact that a particular open account may demonstrably be readily collectible, and thus have a value near or equal to its face amount, does not make it reportable by a cash taxpayer.<sup>8</sup>

A more nearly accurate statement of the judicially approved general rule is that a note is income to the cash payee at the time of its receipt only if it is accepted by him as "payment" of an obligation, as distinguished from acceptance as additional evidence of that obligation.<sup>9</sup> As to negotiable notes, in the absence of agreement that the note is "payment" in the sense that it will discharge the existing obligation altogether, "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."<sup>10</sup>

Whatever validity the distinction between "payment" and "additional evidence" may have in answering questions inescapably arising as to rights in commercial paper and as to priorities of creditors, to predicate upon the distinction a difference in tax consequences for the cash taxpayer seems so highly legalistic as to call for a re-examination grounded more solidly upon practicalities.

Assuming—certainly contrary to the fact in many situations—that the payee is so legally sophisticated as to understand the significance of this distinction as governing the theory upon which any suit against his debtor must be predicated, this distinction hardly justifies drawing a tax liability line between, on the one hand, acceptance of a second promise to pay in substitution for a first promise to pay and, on the other hand, acceptance of the second to supplement the first. For tax purposes, no

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<sup>8</sup>This is at least implicit in virtually all of the cases cited herein. *But see* Cowden v. Commissioner, 289 F.2d 20 (5th Cir. 1961).

<sup>9</sup>*See, e.g.,* Mellinger v. United States, 21 F. Supp. 964 (Ct. Cl. 1938) (interest); Robert J. Dial, 24 T.C. 117 (1955) (salary). Such cases, of course, do not rule out recognition of constructive receipt in specific situations, but it is implicit in them that receipt of a note is not, per se, such receipt. *See also* note 78 *infra*.

<sup>10</sup>*Anthony P. Miller, Inc. v. Commissioner*, 164 F.2d 268, 269 (3d Cir. 1947). The same general rule is reflected in the Uniform Commercial Code. *See* N.C. GEN. STAT. § 25-3-802 (Supp. 1971).

valid distinction may be drawn between these two situations on the ground of a difference between an open account and a note, because, whether the acceptance is "in payment" or otherwise, the taxpayer has received a note. The same note may, in fact, be accepted in either sense, and its value is most unlikely to be affected by the formula of acceptance. The basic premise of the cash method is, of course, that the taxpayer has no reportable income until he receives cash or its equivalent. As a practical matter, how can the cash equivalency of the same note vary?

Indeed, if there is to be a distinction, it should produce results converse to those currently recognized. The cash payee accepting the note as "payment" has rights *only* on the note. If he accepts it as additional evidence of the indebtedness, he has those same rights plus the possibility that his original rights may be resurrected. Incongruously the taxpayer with the greater bundle of rights is, by the current rule, also given the tax treatment which, under the usual circumstances, he regards as preferable. This incongruity has received little or no attention in the decided cases, but on more general grounds at least one judge of unusual eminence has questioned the validity of the distinction as currently applied.<sup>11</sup>

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<sup>11</sup>"Indeed, it is not at all clear that it [a note given by a corporation to an officer-stockholder for salary] would have been a cash item, even if it had in fact been taken as payment. It did not change the substance of the debt—not being endorsed or secured—and although it was more readily disposable, that single incident was scarcely enough. There must be more than difference in the mere form of property to justify a charge of income." Judge Learned Hand in *Schlemmer v. United States*, 94 F.2d 77, 78 (2d Cir. 1938).

The writer recognizes that the "payment" line seems consistent with the treatment accorded the cash taxpayer when *A*, his obligor, endorses to him a note of *B*. If he accepts it as in complete discharge of *A*'s obligation, as distinguished from accepting it as collateral for *A*'s continuing obligation, he is treated as having income in property equivalent to cash to the extent of the fair market value of the note. See Treas. Reg. § 1.61-2(d) (1966). Also, in the absence of a contrary showing, acceptance of *B*'s note ordinarily "operates as a payment and discharge" of *A*'s indebtedness. *Bratton v. Commissioner*, 283 F.2d 257 (6th Cir. 1960) (per curiam). See also *Herbert S. Witte*, 41 P-H Tax Ct. Mem. 1186 (1972). This, in some degree, is subject to the same criticism as the writer makes of the "payment" line as applied to the note of *A*, and the writer would certainly not object if the rule were changed to allow the cash taxpayer to defer reporting until he collects, sells, or discounts *B*'s note. There are, however, some significant differences between the two situations. The taxpayer receiving *B*'s note has acquired a new and different debtor—not merely a new promise to pay from the same debtor. In addition, unless the endorsement is without recourse or there is other special agreement, the taxpayer will have rights *on the note* against *A*. Further, *A* has parted with an asset of value which should entitle him, even if he is a cash taxpayer, to a deduction; and this is not the case when he gives his own note. Nevertheless, it is still difficult to conclude that the taxpayer accepting *B*'s note in payment merits less favorable tax treatment than if he accepts it as security only. Again, the taxpayer with the larger bundle of rights also receives the preferable tax treatment.

More specific applications of the "payment" doctrine will appear hereinafter. However, in any situation in which receipt of the note is not a reportable event, the cash taxpayer realizes income when the note is collected, sold, or discounted.<sup>12</sup> Moreover, if a note is included in gross income upon receipt, there may be additional reportable income or a deductible loss when the amount ultimately realized differs from the amount reported upon receipt.<sup>13</sup>

## 2. *Notes received for services rendered*

The regulations state:

Notes or other evidences of indebtedness received in payment for services constitute income in the amount of their fair market value at the time of the transfer. A tax payer receiving as compensation a note regarded as good for its face value at maturity, but not bearing interest, shall treat as income as of the time of receipt its fair discounted value computed at the prevailing rate. As payments are received on such a note, there shall be included as income that portion of each payment which represents the proportionate part of the discount originally taken on the entire note.<sup>14</sup>

Obviously, this regulation is intended to apply to notes of the employer and not merely to notes of others given or endorsed to the employee. While, on its face, the regulation does not differentiate between cash and accrual taxpayers, its principal application is necessarily to the former, because, as already pointed out, the accrual employee would normally report his salary as it becomes due, whether or not a note is provided.

By comparison to an earlier version, this regulation seems rather deliberately to de-emphasize the significance of the word "payment," since in the first sentence the word stands unexplained and in the second is dropped in favor of "receiving as compensation."<sup>15</sup> In an earlier ver-

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<sup>12</sup>This is implicit in such cases as those cited in notes 9 *supra* and 17 *infra*. See Treas. Reg. § 1.61-2(d)(4) (1957) quoted in text accompanying note 14 *infra*.

<sup>13</sup>In some situations some part of a partial payment may be reportable as income, though total payments do not yet equal the fair market value previously reported as income. Treas. Reg. § 1.61-2(d)(4) (1957), quoted in the text accompanying note 14 *infra*; cf. Revenue Rulings cited note 22 *infra*.

<sup>14</sup>Treas. Reg. § 1.61-2(d)(4) (1957).

<sup>15</sup>Of course, "payment" and "payments" are thereafter used in connection with the note, thereby necessarily conceding that "payment" of the original obligation by acceptance of the note has only conceptual existence.

sion it was stated that a note constituted income when "received in payment for services, and not merely as security for such payment."<sup>16</sup>

Be that as it may, the cases have adhered to the "payment" line.<sup>17</sup> The writer has already indicated his disagreement with the distinction so applied, and he regards it as particularly unfortunate as applied to notes given for personal services. In this context it is most likely to penalize ignorance of the legalistic significance of the accompanying incantation. Though in the case in which the statement appears it was not applied to the "acceptance in payment" situation, the writer would apply to that situation the Tax Court's statement: "A simple change in the form of indebtedness from an account payable to a note payable is insufficient to cause the realization of income to the creditor."<sup>18</sup>

As will hereinafter be pointed out, the cash maker of a note is ordinarily allowed no deduction, even if the note is accepted as "payment."<sup>19</sup> While there are situations in which it may be inappropriate to accord parallel treatment to obligor and obligee (notably, of course, when one uses the cash method and the other the accrual method), the rationale of denying the deduction in this situation—that the note is not the equivalent of cash—seems to the writer to point unerringly to postponement of the cash obligee's receipt of reportable income.<sup>20</sup> However, the difference in treatment seems now so firmly embedded in judicial tax lore that it is unlikely to be abandoned without further legislation.

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<sup>16</sup>Treas. Reg. 69, Art. 34, *quoted in* *Gates v. Helvering*, 69 F.2d 277, 279 (8th Cir. 1934).

<sup>17</sup>*Schlemmer v. United States*, 94 F.2d 77 (2d Cir. 1938); *Herbert C. Camien*, 37 P-H Tax Ct. Mem. 65 (1968), *aff'd without discussion of this question*, 420 F.2d 283 (8th Cir. 1970); *Jay A. Williams*, 28 T.C. 1000 (1957) (note not accepted as payment and had no fair market value; recipient's efforts to sell it in year of receipt unsuccessful); *Otho J. Sharpe*, 25 P-H Tax Ct. Mem. 1128 (1956) (commissioners; held no income when note received, but when stock later taken for the note, taxpayer had income); *Robert J. Dial*, 24 T.C. 117 (1955) (found, rejecting Commissioner's contrary contention based on corporate employer's resolution authorizing their issue, that notes or bonds given for salary were not accepted as payment; conceding that the wording of the resolution, standing alone, might support the Commissioner, the court concluded that the entire record clearly indicated that neither party to the transaction intended the notes to be payment); *A. Hovey-King*, 19 P-H Tax Ct. Mem. 277 (1950) (one note, subsequently forgiven in year of receipt, not accepted as payment; as to two other notes, held to contrary); *cf.* the discussion in the text *infra* under "Related Taxpayer Transactions."

<sup>18</sup>*Jay A. Williams*, 28 T.C. 1000, 1002 (1957).

<sup>19</sup>See text accompanying notes 60-62 *infra*.

<sup>20</sup>There has been some recognition that there should be a parallel treatment for cash makers and payees. "The taxpayers . . . did not receive the commissions when the notes were delivered to them. By a parity of reasoning, the petitioner in the instant case did not pay the item of interest in question when he gave his note therefor." *S.E. Thomason*, 33 B.T.A. 576, 585 (1935), *appeal dismissed per stipulation*, 90 F.2d 1019 (7th Cir. 1937) (*per curiam*). Five dissenters took exception to the "parity of reasoning" portion of the above statement.

### 3. Notes received for interest and loan fees

When, in an original loan transaction, the cash lender actually advances less than the face amount of the note, retaining some amount as interest or a "fee" or "commission," it is clearly accepted that he has, at that time, no reportable income.<sup>21</sup>

It is plain that until the loan is paid or rediscounted the respondent has earned no profit, but has simply parted with its funds on the faith of the security. The commission is not actually received until respondent gets back what it has previously paid out plus the commission. The deduction of the commission from the face of the loan brings nothing into the coffers of the bank.<sup>22</sup>

However, if such a discounted note is payable in installments, dependent upon the agreement of the parties or the absence thereof, some part or all of an installment actually paid may be reportable or deductible as interest by cash taxpayers, and some part or all of an installment becoming due may be so reportable or deductible by accrual taxpayers.<sup>23</sup>

When a cash lender takes a new note for interest already due on an existing note or other obligation, he has no reportable interest income unless the new note is received as "payment."<sup>24</sup> This is true

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<sup>21</sup>Commissioner v. Central Republic Trust Co., 75 F.2d 708 (7th Cir. 1935) (recognizing a distinction for sale transactions); Helvering v. Martin-Stubblefield, Inc., 71 F.2d 944 (8th Cir. 1934); Blair v. First Trust & Savings Bank, 39 F.2d 462 (5th Cir. 1930). This basic rule is plainly recognized by the Revenue Rulings, cited note 23 *infra*.

<sup>22</sup>Blair v. First Trust & Savings Bank, 39 F.2d 462 (5th Cir. 1930).

<sup>23</sup>In view of the foregoing, it is held that where a borrower and a lender designate, in a bona fide and arm's-length agreement, that loan installment payments by the borrower on a loan made at a discount, shall be applied first to loan principal, the lender employing the cash receipts and disbursements method of accounting, is not required to report any portion of such payments as interest income until after the amount he actually advanced to the borrower has been recovered. Conversely, no interest paid deduction will be allowed the borrower, on the cash receipts and disbursements method of accounting, until after the amount he actually received has been repaid.

Rev. Rul. 63-57, 1963-1 CUM. BULL. 103, 105. This last-mentioned Ruling is, in turn, interpreted and "clarified" in Rev. Rul. 72-562, 1972, INT. REV. BULL. No. 48, at 61.

Rev. Rul. 70-647, 1970-2 CUM. BULL. 38, requires cash taxpayers to treat partial payments actually made as applicable first to interest, but the ruling does not apply when the parties understand that a different application will be made. This is interpreted, and other acceptable methods, including the "Rule of 78's," are explained, with examples involving both cash and accrual taxpayers as makers and payees, in Rev. Rul. 72-100, 1972-1 CUM. BULL. 122. It is explicitly stated that the right of a borrower to employ the "rule of 78's" is not affected by the lender's use of some other method of allocation.

<sup>24</sup>Mellinger v. United States, 21 F. Supp. 964 (Ct. Cl. 1938) (a refund suit); Joe W. Scales, 18 T.C. 1263 (1952), *rev'd on other grounds*, 211 F.2d 133 (6th Cir. 1954); San Jacinto Life Ins. Co., 34 B.T.A. 186 (1936). See also John Laing, 22 B.T.A. 380 (1931) (no income when tax-



whether the new note is for the interest only,<sup>25</sup> for the original principal plus the interest,<sup>26</sup> or for the original principal of one note plus the interest on both that note and others.<sup>27</sup> Securing the new note by the same collateral as the old<sup>28</sup> or taking additional security<sup>29</sup> does not, per se, classify the new note as received "in payment" or require reporting of interest income. It seems that very explicit evidence of receipt as "payment" is required in this situation, though whether this requirement, in effect, gives the Commissioner the burden of proof on that issue (contrary to the usual rule in tax cases) is perhaps not clear.<sup>30</sup>

#### 4. *Notes received for advance rent*

The rules applicable when a note is received for advance rent are not crystal clear. When, at the time of making a ninety-nine year lease, the lessor received both cash and term notes which were held to be advance rent, the Eighth Circuit held that the notes need not be reported as income at that time.<sup>31</sup> The court said that the situation was not

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payer—whether cash or accrual not specified—accepted worthless bonds for interest on paid-in subscription for bonds of same issue). *But see* Charlotte L. Andrews, 46 B.T.A. 607 (1942), holding that, when debt contract specifically provided that payment of interest in debtor's securities should constitute payment to extent of amount or value thereof, cash recipient of debtor's scrip in "payment" of interest had income upon receipt to extent of fair market value. The case was reversed as to the amount of the fair market value in 135 F.2d 314 (2d Cir. 1943), and on remand fair market value was reduced from 35¢ to 20¢ on the dollar. 13 P-H Tax Ct. Mem. 609 (1944).

<sup>25</sup>*Mellinger v. United States*, 21 F. Supp. 964 (Ct. Cl. 1938) (new note for interest arrearages on two existing notes); *San Jacinto Life Ins. Co.*, 34 B.T.A. 186 (1936) (demand note for past due interest).

<sup>26</sup>*Joe W. Scales*, 18 T.C. 1263 (1952) (new note consolidating all existing obligations, and including \$4,815.37 in past due interest, plus \$3500 for a feed bill).

<sup>27</sup>*Mellinger v. United States*, 21 F. Supp. 964 (Ct. Cl. 1938).

<sup>28</sup>*San Jacinto Life Ins. Co.*, 34 B.T.A. 186 (1936).

<sup>29</sup>*Mellinger v. United States*, 21 F. Supp. 964 (Ct. Cl. 1938) (no difference between taking new note with additional security and taking latter without new note); *Joe W. Scales*, 18 T.C. 1236 (1952) (new collateral in substitution for part of original collateral improperly disposed of, plus remainder of old collateral).

<sup>30</sup>*Mellinger v. United States*, 21 F. Supp. 964 (Ct. Cl. 1938) (no evidence that it was taken as "payment," and usual rule is that in absence of agreement, it is not so taken; as to one of the transactions involved, there was no discussion as to whether it was received as "payment," but apparently the Commissioner did not seriously contest this item); *Joe W. Scales*, 18 T.C. 1263, 1277 (1952) ("There was no determination that the consolidated note . . . was the equivalent of cash or was given or accepted as payment"); *San Jacinto Life Ins. Co.*, 34 B.T.A. 186, 189 (1936) ("The note gave the petitioner no additional right to payment. It was nothing more than additional evidence of its claim to the overdue interest." This was said of a note given at the request of taxpayer's president to enable the taxpayer, in a report to a state insurance department, to reflect a more desirable fiscal picture by including the amount in mortgage loans instead of in accrued interest).

<sup>31</sup>*Gates v. Helvering*, 69 F.2d 277 (8th Cir. 1934). The transaction was, in form, a sale of a

governed by the rules applicable to sales or by the then existing regulation regarding acceptance of notes "in payment" for services.<sup>32</sup> Conceding that the question was not free from doubt, the court was impressed by the consideration that had the future payments been called for by the lease, as distinguished from being represented by notes delivered immediately but payable in the future, they would not have been income at the time of making the lease.

While the opinion gave no attention to whether the taxpayer was using the cash or accrual method, this last-mentioned consideration is clearly applicable to an accrual taxpayer, who, upon leasing his property, in the absence of any payment of rental in advance, reports the stipulated rental as it becomes due (whether then paid in cash or not) and not in its entirety, upon making the lease. On the other hand, by ruling out the regulation regarding acceptance of notes for personal services, the court implied that the cash taxpayer has no income at the time of receipt of a note for advance rental, even if he accepts it "in payment." In light of the cases invoking the "payment" line in other contexts, it seems doubtful that the case should be accepted as intending to make a definitive exception in the advance rental situation. Obviously, however, when no prior event has occurred to require earlier reporting, it would be odd if a cash taxpayer were required to report as income a note which would not be reportable by an accrual taxpayer.

In a subsequent case, the Fifth Circuit applied the rule that even an accrual taxpayer must report advance rent when "received."<sup>33</sup> The court's opinion gives the impression that the receipt was in cash, though in the opinion of the Board of Tax Appeals, which was affirmed, it clearly appears that, at the end of the tax year, a part was still represented by the lessee's notes, and the Board held that this part, as well as the cash received, was reportable at the time of receipt.<sup>34</sup> In effect, this draws a line between a lease stipulation for future rental payments and present receipt of a note representing the obligation to pay in the future. In turn, at least to some extent, this implies that a cash taxpayer

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building and simultaneous lease of the land, with the notes taken as part of the sale price of the building. The combination of sale and lease was held to be, in substance, a single lease transaction, with the "sale price" of the building being advance rent. The cash received was reportable.

<sup>32</sup>Treas. Reg. 69, Art. 34, *quoted in* Gates v. Helvering, 69 F.2d 277, 279 (8th Cir. 1934).

<sup>33</sup>Astor Holding Co. v. Commissioner, 135 F.2d 47 (5th Cir. 1943).

<sup>34</sup>Astor Holding Co., 11 P-H B.T.A. & Tax Ct. Mem. 1084 (1942). The Board said that the right to receive was fixed and there was no question as to the financial ability of the lessee. The notes were sold at par in the next tax year. *Cf.* Cowden v. Commissioner, 289 F.2d 20 (5th Cir. 1961), discussed *supra* note 6, where no note was involved.

accepting such a note "in payment" of the future rent would have reportable income.

### 5. *Wage withholding*

Construing the Code provision regarding "all remuneration paid in any medium other than cash," the Service has ruled that the fair market value of a negotiable note of the employer, accepted by the employee as "remuneration for employment," is "wages" for withholding purposes.<sup>35</sup> This matter lies on the periphery of this article's sphere of interest.<sup>36</sup> However, it may be pointed out that the ruling makes no attempt to indicate whether the quoted phrases equate with the "payment" line invoked in the cases dealing with the time at which the cash method taxpayer must report income. If the two are equivalent, it seems that the employer must ascertain the nature of each employee's acceptance, or require acceptance as "payment." If the two phrases are not equivalent, then compensation for withholding purposes and compensation includible in gross income may differ.

### C. *Credit Sales*<sup>37</sup>

With the principal exception of installment sales, the statutory general rule is that a sale of property is a closed transaction, reportable at the time of sale, with profit or loss determined at that time by comparing adjusted basis with the total of cash and fair market value of property (including obligations of the purchaser) received by the seller.<sup>38</sup> Neither the statute nor the regulation thereunder<sup>39</sup> differentiates on its face between cash and accrual taxpayers. However, the Tax Court has repeatedly held that the "fair market value" provision is not applicable, and face amount governs, when an accrual method seller

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<sup>35</sup>Rev. Rul. 71-117, 1971-1 CUM. BULL. 279, *construing* INT. REV. CODE OF 1954, § 3401(a). The Ruling states that it also applies for purposes of the Federal Insurance Contributions Act and the Federal Unemployment Tax Act.

<sup>36</sup>This is true if for no other reason than that the writer will confidently match his ignorance of the law of withholding with that of any author of any tax article published since withholding was inaugurated.

<sup>37</sup>"Exchange" situations are not within the purview of this article.

<sup>38</sup>"The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of property (other than money) received." INT. REV. CODE OF 1954, § 1001(b). Section 453(b)(2), dealing with installment sales, makes explicit what is implicit in § 1001(b)—that obligations of the purchaser are "property" for purposes of determining the amount realized. Of course, the amount realized may be reduced by legitimate selling expenses.

<sup>39</sup>Treas. Reg. § 1.1001 (1957). *See also* § 1.453 (1957).

takes an unconditional obligation to receive money in the future, whether that obligation is represented by a note,<sup>40</sup> or otherwise.<sup>41</sup> The Tax Court has said:

Section 1001(b) of the Code provides that the amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. However, an accrual basis taxpayer does not treat an unconditional right to receive money as property received, but rather as money received to the full extent of the face value of the right . . . . The fact that there is always the possibility that a purchaser or debtor may default in his obligation is not sufficient to defer the accruing of income that has been earned.<sup>42</sup>

To the writer this is a most curious exercise in statutory construction. The statute (set out verbatim in the first sentence of the above quotation) plainly refers to "property (other than money)." The Tax Court does not say that the purchaser's obligation *is* money. It says only that the accrual taxpayer treats the obligation as money. However accurate such an assertion may be as a description of the *result* of normal accrual accounting, good accrual accounting in no way requires recognition of factual identity between cash and either accounts receivable or notes receivable—as witnessed by the universal practice of separating them in the accounting records. The Tax Court, in effect, reads the statute as if it specified "property (other than money or property which,

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<sup>40</sup>First Savings & Loan Association, 40 T.C. 474 (1963); *George L. Castner Co.*, 30 T.C. 1061 (1958) (note taken on sale of personal property; facts indicated note had fair market value equal to face amount).

<sup>41</sup>*See, e.g.*, *Western Oaks Building Corp.*, 49 T.C. 365 (1968) (also holding inapplicable the reference to fair market value in *Treas. Reg. § 1.453-6(a)(1)* (1957), dealing with credit sales not qualifying as installment sales; the opinion reviews the prior cases at some length); *Warren G. Morris*, 32 P-H Tax Mem. 746 (1963). The rule of these cases and of those cited *supra* note 40, which, in effect, make value irrelevant, is easily distinguished from the proposition that a seller receives the equivalent of cash when he takes well secured notes obviously worth at least face amount. *See*, as to the latter, *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933).

<sup>42</sup>*First Savings & Loan Association*, 40 T.C. 474, 487 (1963). It is tempting to label this as dictum, since it is followed in the opinion by: "In any event, the petitioner has not shown that the notes, which carried interest at 6 percent per annum, which were secured by first mortgages or first deeds of trust, and which were endorsed and guaranteed . . . , did not have a fair market value equal to their face amounts." However, the cases cited *supra* note 41 preclude affixing the dictum label.

The second sentence of the quotation in the text is rather odd in ostensibly distinguishing between "property" and "money", since the statute plainly treats the latter as a subdivision of the former.

under the taxpayer's method of accounting, is treated as money)"—something which Congress no doubt could have provided but in fact did not. Futile as it now may be to attempt to make the point, it seems fair to say that the Tax Court has here engaged in judicial legislation.<sup>43</sup> The ultimate consequences of its version of the Code to taxpayers and Treasury are not wholly predictable.<sup>44</sup>

The distinction between fair market value and face amount, of itself, affects only the number of dollars to be reported and not the time for reporting. The Code provides, as a general rule, that the year of sale is the time for reporting gain or loss, again ostensibly making no distinction between cash and accrual taxpayers.<sup>45</sup> There are, nevertheless, situations in which the cash taxpayer has been allowed to defer reporting,

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<sup>43</sup>The Tax Court cases have consistently relied upon *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182 (1934), which dealt with the ordinary application of the accrual method, and more recently on *Commissioner v. Hansen*, 360 U.S. 446 (1959). *Hansen* involved the discount, by dealers to finance companies, of motor vehicle purchase notes—the specific issue being whether the amount withheld by the finance companies as security for the dealers' guarantee was income to the dealers in the year of discount. The Supreme Court held that it was. Though the matter might have been viewed as a sale transaction, the Court's opinion made no mention of the 1939 Code equivalent to present section 1001(b) or of any possible distinction between face amount and fair market value. It did suggest the relevance of, and quote in a footnote, section 42(a) of the 1939 Code, corresponding to present section 451(a)—the general provision to the effect that items of gross income are to be reported when received, unless the applicable method of accounting requires otherwise. This hardly seems intended as an implied modification of the quite specific provision in section 1001(b).

<sup>44</sup>Of course, in a case in which fair market value equals face amount, there is no difference in consequences. However, if (as with cash taxpayers) a fair market value lower than face amount were accepted for the note of an individual, and the face amount were ultimately collected from the debtor, the seller would then have ordinary income in the amount of the difference, even if the original sale was a long term capital gain transaction. See INT. REV. CODE OF 1954, § 1232(a)(1); Rev. Rul. 58-402, note 54 *infra*. This would ordinarily be to the Treasury's advantage. On the other hand, if insistence that face amount be reported increases gain or decreases loss in a long term capital transaction, and the note subsequently becomes worthless, the seller may have an ordinary deduction unless the debtor is a corporation or government, and the note is in registered or coupon form, or unless the seller is non-corporate, and the note is classified as a non-business debt. See INT. REV. CODE OF 1954, §§ 165(g), 166(d), (e). This would be to the Treasury's disadvantage. These examples, however, do not take account of other complications that could arise under other Code provisions.

Both Commissioner and taxpayers are inclined to seek any immediately available benefit, hoping devoutly that it will not boomerang.

<sup>45</sup>"Except as otherwise provided in this subtitle, on the sale or exchange of property the entire amount of the gain or loss, determined under section 1001, shall be recognized." INT. REV. CODE OF 1954, § 1002. "The exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception." Treas. Reg. § 1.1002-1(b) (1971). It seems plain that the Treasury has characteristically reserved the option to stress either form or substance.

as an amount realized in the year of sale, something which an accrual taxpayer would then be required to report. This result is based on the theory that the item is not the equivalent of cash.<sup>46</sup> Ordinarily this would not be applicable to notes, since the test enunciated for determining cash equivalency is whether the debtor's promise to pay is embodied in notes, mortgages, or other evidences of indebtedness such as commonly change hands in commerce.<sup>47</sup> However, the fact that a note is non-negotiable has been regarded as a factor to be considered, along with other circumstances, in determining whether the cash taxpayer must take it into account, as the equivalent of cash, in determining the amount realized.<sup>48</sup>

In specific situations the non-equivalence to cash may be so extreme as to justify the conclusion that the receipt has no fair market value.<sup>49</sup> However, it is apparently unnecessary for the taxpayer to demonstrate that fair market value is zero in order to prove non-equivalence to cash.<sup>50</sup>

As the above summary indicates, fair market value (if any) re-

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<sup>46</sup>Western Oaks Building Corp., 49 T.C. 365 (1968). On identical transactions, involving sellers of homes who received, as part of the sale prices, restricted accounts or restricted shares in a savings and loan association, two accrual taxpayers were required to report face amount in the year of sale, while a cash taxpayer was not required to report anything as realized from receipt of such accounts and shares. Thus what the accrual taxpayer is required to treat as "money" (not "property"—see the text accompanying notes 39-42 *supra*) the cash taxpayer need not report at all, since it is not the equivalent of cash. The latter conclusion is as difficult to draw as the former from the statutory "fair market value of property (other than money)." The Commissioner has refused to acquiesce in that part of the decision dealing with the cash taxpayer (Donald I. Brown). See 1968-2 CUM. BULL. 3; cf. *Cowden v. Commissioner*, 289 F.2d 20 (5th Cir. 1956), discussed *supra* note 6.

<sup>47</sup>Western Oaks Building Corp., 49 T.C. 365, 377 (1968), *relying upon* Harold W. Johnston, 14 T.C. 560, 565 (1950), where funds still in escrow at the end of the tax year of sale were involved.

<sup>48</sup>Sam C. McIntosh, 36 P-H Tax Ct. Mem. 1278 (1967) (non-negotiable note bearing no interest; stock sold to be delivered only as future payments made; and doubtful that any fair market value could be assigned); Stuart A. Courtis, 26 P-H Tax Ct. Mem. 375 (1957) (unsecured non-negotiable note, bearing no interest, given by taxpayer's son and another, plus other circumstances); Edward J. Hudson, 11 T.C. 1042 (1948), *aff'd without discussion of this point*, 183 F.2d 180 (5th Cir. 1950) (note subject to many complex agreements and conditions); Mainard E. Crosby, 14 B.T.A. 980 (1929) (liability on note subject to contingencies).

<sup>49</sup>Cf. Sam C. McIntosh, 36 P-H Tax Ct. Mem. 1278 (1967), *supra* note 48.

<sup>50</sup>Western Oaks Building Corp., 49 T.C. 365 (1968), *supra* note 46 recognized that an item may not be equivalent to cash despite the fact that it may have a fair market value for other purposes, citing *Estate of Cold Hurlburt*, 25 T.C. 1286 (1956), where a contract of sale listed a schedule of future payments, not represented by notes. It was there held that the obligations need not be reported by the cash taxpayer though, when he died, they were given a value for state inheritance purposes. This holding is supported by *Burnet v. Logan*, 283 U.S. 404 (1931). Had the late Gertrude Stein observed that "fair market value is fair market value is fair market value," she would manifestly have been in error. At any rate, none of these cases involved notes.

mains, for the taxpayer, an element in measuring the amount that he reports in the year of sale.<sup>51</sup> The Treasury, classifying the determination of fair market value as a question of fact, insists that only "in rare and extraordinary cases" does property have no fair market value.<sup>52</sup>

The regulations also state:

If the obligations received by the vendor have no fair market value, the payments in cash or other property having a fair market value shall be applied against and reduce the basis of the property sold and, if in excess of such basis, shall be taxable to the extent of the excess. Gain or loss is realized when the obligations are disposed of or satisfied, the amount thereof being the difference between the reduced basis as provided in the preceding sentence and the amount realized therefor.<sup>53</sup>

To the extent that this indicates that the sale transaction will remain open, with loss or additional gain to be recognized at some future time, it probably should be read as applying only when the property received by the seller has no *ascertainable* fair market value but presumptively has some value,<sup>54</sup> and a seller receiving a note with a value which is demonstrably zero still has a closed transaction.

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<sup>51</sup>Technically, fair market value is a measure of amount realized, but the basic rule is that comparison of adjusted basis with amount realized determines profit or loss to be recognized. *See* note 45 *supra*.

<sup>52</sup>Treas. Reg. § 1.1001-1(a) (1957). A similar statement, more specifically applied to the purchaser's obligations, is contained in Treas. Reg. § 1.453-6(a)(2) (1957); *see* note 53 *infra* dealing with credit sales which do not qualify for installment sale treatment. As to how the fair market value of a note is determined, *see* 10 J. MERTENS, *THE LAW OF FEDERAL INCOME TAXATION*, § 59.51 (1970).

The Commissioner is capable of discovering such a rare and extraordinary case for himself. *See, e.g.,* J. Piner Powell, 31 P-H Tax Ct. Mem. 1163 (1962) (when the taxpayer offered no evidence as to fair market value, the Tax Court sustained the Commissioner's determination that the purchaser's notes, secured by a second lien, had no fair market value); *cf.* Abe Pickus, 32 P-H Tax Ct. Mem. 2038 (1963).

<sup>53</sup>Treas. Reg. § 1.453-6(a)(2) (1957). This is specifically applied only to sales of real property, but it has been said that under ordinary cash accounting principles the same rule applies to cash taxpayers selling personal property. *George L. Castner Co.*, 30 T.C. 1061 (1958). The same case indicates that an accrual taxpayer may escape realization of face amount only if the obligation is uncollectible when it accrues and there is little or no likelihood of collection in the future.

<sup>54</sup>*See* Rev. Rul. 58-402, 1958-2 CUM. BULL. 15, *construing* *Burnet v. Logan*, 283 U.S. 404 (1931), and numerous other cases. The Ruling deals with rights to receive "indefinite amounts of income" (which could rarely describe any note and could never describe a negotiable note). The reluctance of the Service to treat the transaction as still open is frankly explained in the Ruling:

The results, for purposes of capital gains or ordinary income, are that if the sale or exchange remains an open transaction, because of unusual uncertainties with respect to valuation . . . the subsequent payments received . . . will be subject to the appropriate

When the special rules governing installment sales are satisfied,<sup>55</sup> reporting of a pro rata part of sale profit may be deferred. However, in determining whether one limitation is satisfied—that limiting year of sale payments to no more than 30% of the selling price—evidences of the purchaser's indebtedness are not classified as payments<sup>56</sup> unless they are payable on demand or are corporate or governmental obligations of a described or otherwise readily tradable type.<sup>57</sup>

### III. THE MAKER

#### A. *Accrual Taxpayers*

In general an accrual taxpayer takes a deduction when all events have occurred which fix the amount and the fact of liability.<sup>58</sup> Whether or not the liability is evidenced by a note is not significant unless perhaps, in a particular case, the giving of the note or (more likely) its terms or the terms of some contemporaneous agreement provide some evidence as to whether such events have occurred. The right to deduct may be deferred when the liability is for benefits to be received in the future, but this result cannot be avoided by giving a note.<sup>59</sup>

#### B. *Cash Taxpayers*

##### 1. *In general*

In general a cash taxpayer may not take a deduction until he makes payment in cash or its equivalent, and his own note is not the equivalent of cash.<sup>60</sup> Since, as already pointed out, the cash payee of a note is

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capital gains provisions . . . but, if not . . . the subsequent payments in excess of basis . . . constitute ordinary income. Generally, when a taxpayer makes a gain from the sale or exchange . . . if it is not a substitute for ordinary income, this is taxable as a capital gain; while if the gain results from collection . . . it is taxable as ordinary income.

<sup>55</sup>These are outlined in INT. REV. CODE OF 1954, § 453 and elaborated ad infinitum in Treas. Reg. § 1.453 (1960).

<sup>56</sup>INT. REV. CODE OF 1954, § 453(b)(2)(A)(ii).

<sup>57</sup>INT. REV. CODE OF 1954, § 453(b)(3), inserted by the Tax Reform Act of 1969. For the Treasury's idea of the meaning of this provision, see Treas. Reg. § 1.453-3 (1972).

<sup>58</sup>*Dixie Pine Products Co. v. Commissioner*, 320 U.S. 516 (1944).

<sup>59</sup>See, e.g., *Lichtenberger-Ferguson Co. v. Welch*, 54 F.2d 570 (9th Cir. 1931) (accrual taxpayer had no deduction until 1920 for price of advertising purchased for that year though, pursuant to contract, it gave its notes for the advertising in 1919). As to when accrual method borrowers deduct interest on discounted installment notes, see Revenue Rulings cited in note 23 *supra*.

<sup>60</sup>*Helvering v. Price*, 309 U.S. 409 (1940) (rule applicable to both loss and bad debt theories); *Eckert v. Burnet*, 283 U.S. 140 (1931); *Baltimore Dairy Lunch, Inc. v. United States*, 231 F.2d 870 (8th Cir. 1956) (salaries of taxpayer's officers); *Donald M. Perry*, 49 T.C. 508 (1968) (tax-



directed to report income if the accepts the note as "payment,"<sup>61</sup> and since the payee's receipt as "payment" does not entitle the cash maker to a deduction,<sup>62</sup> it seems that the note becomes the equivalent of cash somewhere between the hand of the maker and the hand of the payee—a metamorphosis which this writer cannot accept on faith and, indeed, accepts only under judicial compulsion. However, as already explained, it is the requirement that the payee report, rather than the denial of the deduction to the maker, with which he disagrees.

## 2. Notes given for interest

A number of cases have dealt specifically with interest and lender's fees equated with interest. Their clear consensus is that: (a) if cash taxpayer gives his one-year note for one thousand dollars, receiving nine hundred and forty dollars from the lender (in effect discounting it at a six percent interest rate), he has no interest deduction at the time the note is given;<sup>63</sup> and (b) if he borrowed one thousand dollars for a year at six percent, has paid neither principal nor interest at maturity, and then gives his creditor a new note for one thousand and sixty dollars,

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payer's note given to cover his obligation as guarantor; rule applies though note secured, and there is no prospect of recovery from the primary obligor); *Demor, Inc.*, 37 P-H Tax Ct. Mem. 1631 (1968); *Stanley C. Warrick*, 20 B.T.A. 220 (1930) (business expense). For comment on the inadequacy of the term "equivalent of cash," see 2 F. MERTINS, LAW OF FEDERAL INCOME TAXATION § 11.02 (1967).

<sup>61</sup>See text accompanying note 9 *supra*.

<sup>62</sup>*Helvering v. Price*, 309 U.S. 409 (1940); *Eckert v. Burnet*, 283 U.S. 140 (1931); *Quinn v. Commissioner*, 111 F.2d 372 (5th Cir. 1940) (note given to taxpayer's accountant for past services); *Hart v. Commissioner*, 54 F.2d 848 (1st Cir. 1932) (interest); *San Diego Trust & Savings Bank v. United States*, 28 Am. Fed. Tax R.2d 71-5526 (S.D. Cal. 1971) (interest); *Demor, Inc.*, 37 P-H Tax Ct. Mem. 1361 (1968); *James T. Benn*, 32 P-H Tax Ct. Mem. 802 (1963), *aff'd per curiam*, 366 F.2d 778 (5th Cir. 1966), *cert. denied*, 389 U.S. 833 (1967); *S.E. Thomason*, 33 B.T.A. 576 (1935), *appeal dismissed per stipulation*, 90 F.2d 1019 (7th Cir. 1937). Occasionally a court refers to the fact that there is no evidence that the note was received as payment by the payee. See, e.g., *John Hoskins*, 7 B.T.A. 299 (1927). However, the rule as stated in the text is adequately supported by the other cases cited in this note.

<sup>63</sup>*Cleaver v. Commissioner*, 158 F.2d 342 (7th Cir. 1946), *cert. denied*, 330 U.S. 849 (1947) (bank deducted interest for five years); *Burton Foster*, P-H TAX CT. REP. & MEM. DEC. ¶ 73,053 (March 5, 1973) (loan fee deducted by lender from proceeds of note secured by realty mortgage, proportion deductible as installment payments made); *Sanford Campbell*, 39 Tax Ct. Mem. 594 (1970) (lender on mortgage loan deducted loan fee agreed to be, in essence, additional interest); *Harchester Realty Corp.*, 30 P-H Tax Ct. Mem. 1008 (1961) (cash taxpayer borrowed \$200,000, giving note for \$250,000; amortization deduction not allowable).

This rule is also reflected in the Revenue Rulings cited in note 23 *supra*, dealing with the portion of payments on installment notes deductible as interest as such payments are made. See also *Burton Foster*, P-H TAX CT. REP. & MEM. DEC. ¶ 73,053 (March 5, 1973).

or gives two notes—one for one thousand dollars and one for sixty dollars—he has no interest deduction upon giving the new note or notes.<sup>64</sup>

### 3. Notes given to cover losses

There is the highest authority for the proposition that when a cash taxpayer is obligated to make a payment which, when made, will result in a deductible loss, but he covers the loss by giving his note, he realizes that loss and may deduct it only as the note is paid; moreover, this is true whether or not the note is secured and whether or not the payee accepts the note as “payment” of the obligation.<sup>65</sup> This tax consequence

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<sup>64</sup>Hart v. Commissioner, 54 F.2d 848 (1st Cir. 1932) (taxpayer, presented with bill for interest on another note, gave lender a new interest-bearing note in payment of the bill); San Diego Trust & Savings Bank v. United States, 28 Am. Fed. Tax R.2d 71-5526 (S.D. Cal. 1971) (new note for old note and interest thereon); Nat Harrison Associates, Inc., 42 T.C. 601 (1964) (taxpayer, owing interest on outstanding note, negotiated new loan from same lender, with same collateral, with new note incorporating interest due on the one outstanding; fact that lender drew two checks—one to itself for the interest and one to the taxpayer for the balance—made no difference; opinion expresses doubt as to practicality of the rule as so applied, but accepts it because so often applied); James W. England, Jr., 34 T.C. 617 (1960) (new note to creditor for interest owed; creditor considered interest paid upon receipt of note; court rejected taxpayer's contention that he was entitled to use accrual method); Joseph S. Freeland, 29 P-H Tax Ct. Mem. 1618 (1960) (that part of payments on note which were attributable to interest was deductible as payments made); Samuel Eugene Bramer, 6 T.C. 1027 (1946), *aff'd per curiam*, 161 F.2d 185 (3d Cir. 1947), *cert. denied*, 332 U.S. 771 (1947) (same); S.E. Thomason, 33 B.T.A. 576 (1935), *appeal dismissed per stipulation* 90 F.2d 1019 (7th Cir. 1937) (new note given for old note, interest thereon, and new loan from same lender; five dissenters believed that deduction should be allowed when, as in this case, a new transaction with the same creditor is involved); Utah Orpheum Co., 3 B.T.A. 1041 (1926) (note given for existing debt and interest thereon). *See also* Keith v. Commissioner, 139 F.2d 596 (2d Cir. 1944); Rev. Rul. 70-647, 1970-2 CUM. BULL. 38 (similar to S.E. Thomason, *supra*); *cf.* Newton A. Burgess, 8 T.C. 47 (1947). A cash taxpayer owed interest on a note to A. He had also borrowed \$3,000 from a bank. On December 20, 1941 he borrowed an additional \$4,000 from A (who charged lower interest than the bank), depositing that sum. On December 26, 1941, when he had \$3,180.79 in his checking account, not including the \$4,000 he had received from A, he gave A a check for \$4,219.33 in payment of interest. This was held to be deductible in 1941, the majority reasoning that the taxpayer did not borrow solely to pay interest, as he had other bills outstanding, and that the proceeds of the new loan from A were commingled with other funds, their identity as such was lost, and they could not be traced to payment of interest. Six judges dissented.

<sup>65</sup>Helvering v. Price, 309 U.S. 409 (1940) (cash taxpayer, giving his secured note to cover his obligation as guarantor, had no deduction at that time on either loss or bad debt theory, though the Board of Tax Appeals had found that both he and the creditor regarded the note as payment of the existing obligation); Eckert v. Brunet, 283 U.S. 140 (1931) (similar as to endorser). Many decisions of lesser courts stand for the same proposition. *See, e.g.,* Joe Balestrieri & Co. v. Commissioner, 177 F.2d 867, 870-71 (9th Cir. 1949) (“The giving of a note by a cash basis taxpayer in the discharge of a secondary liability is not equivalent to a cash payment”); Donald M. Perry, 49 T.C. 508 (1968) (rule applies to guarantor even though his note is secured and there is no

emphasizes the incongruity of requiring the payee to report income when he accepts the note as "payment."

If, in making an investment, the cash taxpayer borrows from and gives his note to one not his vendor, and the investment is subsequently sold at a loss or becomes worthless, the proper time for his entire loss deduction is the time of sale,<sup>66</sup> or of worthlessness,<sup>67</sup> even though some part or all of the note remains unpaid. This, in effect, is treated as a borrowing-from-Peter-to-pay-Paul transaction—a category hereinafter more generally discussed. However, if the transaction is not classified as within that category, to the extent that the loss is represented by the outstanding note, the taxpayer's deduction is deferred and taken as payments on the note are made.<sup>68</sup>

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prospect of recovery from primary obligor); Frederic W. Gray, 18 P-H Tax Ct. Mem. 615 (1949) (deduction allowed when note paid, rejecting Commissioner's contention that taxpayer was otherwise using accrual method); George S. Silzer, 39 B.T.A. 841 (1939) (note for taxpayer's liability as endorser); Frank Kuhn, 34 B.T.A. 274 (1936) (no deduction for secured note to cover liability as endorser, even if primary obligor becomes bankrupt).

In Richard D. Lord, 39 P-H Tax Ct. Mem. 723, 728 (1970), applying the rule as stated in the text, the opinion explains the inapplicability of that part of Treas. Reg. § 1.461-1(a)(1) (1967) which states that a cash taxpayer "may also be entitled to certain deductions in the computation of taxable income which do not involve cash disbursements during the taxable year, such as the deductions for . . . losses under sections 167, 611, and 165, respectively."

For examples of cases determining when a taxpayer has paid an obligation from other available funds, as distinguished from a new borrowing from the same creditor, see Thomas Watson, 8 T.C. 569 (1947); O.L. Burnett, 11 P-H Tax Ct. Mem. 1344 (1942).

<sup>66</sup>Samuel Eugene Bramer, 6 T.C. 1027 (1946), *aff'd per curiam*, 165 F.2d 185 (3d Cir.), *cert. denied*, 332 U.S. 771 (1947) (original note, given to bank, signed by taxpayer as member of syndicate; stock purchased with loan proceeds to be owned by syndicate, though pledged to bank as collateral; taxpayer's loss occurred when bank sold the stock and applied proceeds to the loan, and not when taxpayer later paid the new note he gave the bank for his share of the remaining indebtedness); J.J. Larkin, 46 B.T.A. 213 (1942), *appeal dismissed per stipulation*, 129 F.2d 1020 (10th Cir. 1942) (stock, held as collateral, sold by creditor and later in same tax year became worthless). The facts of the *Bramer* case, as summarized above, were also involved, as affecting a later year when payments were made on the second note, in *Bramer v. United States*, 259 F.2d 717 (3d Cir. 1958). As to this cause of action it was held that the taxpayer was estopped to relitigate the question, but enough was said in the opinion to indicate the court's belief that the earlier decision was correct.

<sup>67</sup>*Bramer v. United States*, 259 F.2d 717 (3d Cir. 1958); M.H. Jacobs, 21 P-H Tax Ct. Mem. 651 (1952) (when cash taxpayer borrowed money to start a business, which failed and was terminated in 1946, loss occurred then, and not in 1947 when the note was paid); Charles D. Carter, 19 P-H Tax Ct. Mem. 639 (1950), *aff'd per curiam*, 194 F.2d 537 (6th Cir. 1952); A.W.D. Weis, 13 B.T.A. 1284 (1928) (similar to M. H. Jacobs *supra*).

<sup>68</sup>*Jenkins v. Bitgood*, 101 F.2d 17 (2d Cir. 1939), *cert. denied*, 307 U.S. 636 (1939) (a bank owned depreciated securities; in 1931, to protect their investment in stock of the bank, a cash taxpayer and other directors purchased the securities, taxpayer giving his secured note for \$25,000 for securities then worth \$5,500; bank stock became worthless in 1932; held that, while the \$25,000 was in essence an additional investment in the bank stock, the \$19,450 difference could not be taken

When the cash taxpayer does not become the owner of property acquired in a transaction but enters into an agreement to share profit or loss with the person taking title, his giving of his note to the owner when a loss occurs does not entitle him to a loss deduction at that time.<sup>69</sup>

It is apparent that the lines drawn in the loss cases are fine, and at the time the critical events occur, the lines are unlikely to be fully appreciated by any but exceptionally knowledgeable or expertly advised individuals. Indeed, some of the cases seem to demonstrate that the post-event significance extracted from the facts by judicial acumen has surprised either a financially sophisticated taxpayer or that most experienced of all tax litigants, the Commissioner. It must be conceded, however, that some line drawing is inescapable and that the results have been produced by a reasonably consistent judicial concept of the burdens and benefits incident to cash accounting.

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as a deduction in 1932 when the stock became worthless, as the note had not then been paid); *Miniger v. Denman*, 15 Am. Fed. Tax R. 593 (N.D. Okla. 1930) (no loss deduction allowable to cash taxpayer, upon stock becoming worthless, for that part of purchase price represented by an unpaid \$60,000 demand note given to his vendor); *Joseph C. Boyer*, 24 P-H Tax Ct. Mem. 292 (1955) (cash taxpayer bought stock in 1935, giving his \$13,000 note in part payment; paid \$7,800 on note in 1935-39 and the balance of \$5,200 in 1944; held that Commissioner was correct in disallowing deduction of entire basis for worthlessness in 1945 as worthlessness occurred prior to 1942, but taxpayer was entitled to \$5,200 deduction in 1944 since he could not have claimed that at any earlier time). In *Jenkins v. Bitgood*, *supra* note it appears that the payee bank transferred the note to another bank. It seems that had the taxpayer borrowed the \$25,000 from the other bank initially, and used the proceeds to pay the first bank, his deduction would have been proper. See text accompanying notes 70-71 *infra*.

See also *Bramer v. United States*, 259 F.2d 717 (3d Cir. 1958) (*F* put up stock as collateral for taxpayer's margin account with a broker; when broker notified *F* of intent to sell, *F* paid the broker \$84,000—the fair market value of the stock—and took back the stock; taxpayer thereupon gave *F* his note for that amount; held, favorably to taxpayer, that this part of the taxpayer's loss on liquidation of the margin account was deductible as payments were made on the note); *Page v. Rhode Island Hospital Trust Co.*, 88 F.2d 192 (1st Cir. 1937) (while ordinarily losses on sales of stock in a brokerage account give rise to an immediate deduction, where a cash taxpayer had no margin and gave the broker his notes, he sustained no deductible loss until the notes were paid, even though they were secured).

For an unusual situation, in which, because of the taxpayer's predilection for fraudulent dealing, his notes given for purchases were denied recognition as basis for the properties purchased, see *James T. Benn*, 32 P-H Tax Ct. Mem. 802 (1963), *aff'd per curiam*, 366 F.2d 778 (15th Cir. 1966).

<sup>69</sup>*Oscar M. Burke*, 34 Am. Fed. Tax. R. 1614 (S.D.N.Y. 1945); *Irving B. Hexter*, 19 P-H Tax Ct. Mem. 409 (1950); *Samuel Eugene Bramer*, 6 T.C. 1027 (1946) (transaction related to that described in note 66 *supra*, but in which taxpayer made an agreement to share loss, without acquiring ownership of the stock); cf. *Max Gross*, 36 B.T.A. 759 (1937). *L* purchased 50 shares of stock "for" cash taxpayer, who agreed to share any loss; loss occurred and taxpayer gave *L* his note. Held, no deduction at that time, the opinion stating that since taxpayer used the cash method, whether or not be owned the stock made no difference.

#### 4. *Borrowing from Peter To Pay Paul*

As already indicated, a cash taxpayer who has incurred an indebtedness may not ordinarily entitle himself to a deduction by giving his note to his creditor, whether the latter accepts it only as additional evidence of the debt or as "payment." In other words, the mere substitution of one promise to pay for another promise to pay is not enough. However, he can win the game by following the proper ritual of substituting one creditor for another. For example, if he owes sixty dollars in interest to *A*, he cannot make it currently deductible by giving *A* his note therefor; however, if he borrows sixty dollars from *B*, giving his note to the latter, and uses the proceeds to pay *A*, he has his deduction.<sup>70</sup>

Indeed, it is a general principle, applied in various factual contexts, that payment to the original creditor with money borrowed from some one other than the payee is, for the cash taxpayer, the equivalent of payment with funds already on hand.<sup>71</sup>

In one sense, and particularly in a simple example such as that given above, this treatment seems inconsistent with the basic concept of cash accounting, since the results of the alternative forms of the transaction are identical in terms of the taxpayer's cash position and outstanding indebtedness. Acceptance of the principle also means that the knowledgeable taxpayer who has sufficient credit rating to enable him to find a new creditor, or who has a pecunious friend unconcerned about credit

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<sup>70</sup>E. Gordon Perry, 28 B.T.A. 497 (1933) (when corporation—not the mortgagee—advanced interest on the mortgage on cash taxpayer's home, and taxpayer repaid the corporation in a later year, interest was deductible when paid by the corporation as, in effect, taxpayer then paid the interest with borrowed money); William D. Hutchings, 14 B.T.A. 421 (1928) (to same effect); cf. S.E. Thomason, 33 B.T.A. 576 (1935).

<sup>71</sup>Humphrey v. Commissioner, 91 F.2d 155 (9th Cir. 1937) (cash taxpayer gave his note for stock subscription to issuing corporation; corporation in turn borrowed from a bank, giving its note, with taxpayer's note as collateral; taxpayer later borrowed from same bank, using proceeds to pay the corporation, which in turn paid them to the bank; held, two to one, that this was borrowing from another to pay the original creditor and taxpayer had a loss deduction when he paid the corporation, though his note to the bank was paid later); Crain v. Commissioner, 75 F.2d 962 (8th Cir. 1935) (the case relied upon by the majority but disapproved by the dissenter in Humphrey v. Commissioner, *supra*; taxpayer and *W* were liable for the debts of a corporation; *W* paid the entire amount, taxpayer giving *W* his note for one-half; held, in effect, that the deductible loss occurred when taxpayer gave his note); James T. Benn, 32 P-H Tax Ct. Mem. 802 (1963) (to extent purchase notes paid with money borrowed from another, payment could be accepted as basis); W.H. Harris, 11 T.C. 864 (1948) (bad debt); William D. Hutchings, 14 B.T.A. 421 (1928) (taxes); cf. Bramer v. United States, 259 F.2d 717 (3d Cir. 1958) (note given to one who, upon his payment to taxpayer's obligee, acquired by subrogation the latter's rights against taxpayer; held not a borrowing from Peter to pay Paul).

ratings, has control over the timing of his deduction.

As to the latter result, it is simply one example of the fact that, as a generality, the cash taxpayer has greater control over timing than an accrual taxpayer. It hardly differs fundamentally in that respect from the situation in which the cash taxpayer, with thousands in the bank, decides to pay his substantial property tax bill on January 1 instead of December 31, anticipating that the deduction will offset income in a higher bracket in the later year.

In its wider aspects, the rule is perhaps justified by practical considerations. In the simple example above the proceeds of the new note are readily traceable into the old note. However, there are millions of situations yearly in which a taxpayer pays a deductible item by a check drawn on a bank account containing a credit balance smaller than the taxpayer's indebtedness to the drawee bank. Thus the entire credit balance is derived from borrowed money. In effect, the taxpayer is paying Paul with money borrowed from Peter. The transaction may or may not reflect a situation in which the taxpayer's original purpose in borrowing from Peter was to pay Paul, but the effect is the same. A rule dependent upon tracing the proceeds of the loan from Peter into a specific payment to Paul would lead to countless factual hassles more troublesome to both taxpayers and the Commissioner than any overall financial benefit to the Treasury or any theoretical purism could justify.<sup>72</sup>

### C. *Related Taxpayer Transactions*

Though an item of expense or interest is otherwise deductible, deduction is barred if: (1) the taxpayer and the obligee are related taxpayers;<sup>73</sup> (2) within the taxable year or 2½ months thereafter the item is "not paid;" and (3) within the same period, the item is not includible in the obligee's gross income "unless paid."<sup>74</sup> Since, for a cash taxpayer,

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<sup>72</sup>When a new loan from the original creditor is involved, and its proceeds are commingled with other funds of the taxpayer, and the creditor is paid from the pot, tracing may be necessary and is not always a simple matter. See, e.g., *Jenkins v. Smith*, 21 F. Supp. 433 (D. Conn. 1937), *rev'd on other grounds*, 99 F.2d 827 (2d Cir. 1938); *Thomas Watson*, 8 T.C. 569 (1947); *Newton A. Burgess*, 8 T.C. 47 (1947), *supra* note 64; *O.L. Burnet*, 11 P-H Tax Ct. Mem. 1344 (1942).

When the original is a bank and the item is interest, there must be countless situations in which a taxpayer pays interest by check drawn on an account with the same bank which contains less money than the total of his indebtedness to the bank. As a practical matter it seems doubtful that any itemizing taxpayer in this situation will refrain from taking the deduction, or that the Commissioner will ordinarily object if he takes it.

<sup>73</sup>For identification of those within this category see INT. REV. CODE OF 1954, § 267(b), (c).

<sup>74</sup>INT. REV. CODE OF 1954, § 267(a)(2).

the item would not be "otherwise deductible" when not paid, the provision, in effect, applies only to accrual obligors; Furthermore since an accrual payee would ordinarily be required to include the item in gross income, at the latest, when payable, it is also reasonably accurate to say that the provision applies only when the payee uses the cash method of reporting.<sup>75</sup>

Under the plain language of the statute and the regulations thereunder,<sup>76</sup> if any one of these three elements is absent, the deduction is not barred, and this result is reflected in the cases.<sup>77</sup> Thus, if the obligee, within the taxable year or the grace period, either receives the amount in cash, or accepts the note "in payment," or has such constructive receipt as requires him to include it in his gross income, the section for that reason alone is inapplicable, and it is unnecessary to determine whether the obligor has "paid." That a note is given may be one circumstance, along with others, in determining whether the obligee has constructive receipt; however the giving of a note, even if it is payable on demand, is not, standing alone, conclusive proof of such receipt.<sup>78</sup>

If an accrual taxpayer gives a note to a related cash taxpayer who is not required to include the item within gross income within the specified time, the deduction is plainly barred unless the note may be said to be such payment as the statute requires. At least one of the reasons for enacting the statute was to bar deduction of an item that the obligee could defer reporting or, in some situations, never report at all.<sup>79</sup> For example, prior to the statute it was possible for an accrual corporation to deduct an item owing to its cash controlling stockholder, and for the latter thereafter to forgive the indebtedness, thus making a contribution to capital which increased the stockholder's basis on the stock but re-

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<sup>75</sup>See Treas. Reg. § 1.267(a)-1(b)(1)(ii) (1958).

<sup>76</sup>Treas. Reg. § 1.267(a)-1(b) (1958).

<sup>77</sup>See, e.g., *Anthony P. Miller, Inc. v. Commissioner*, 164 F.2d 268 (3d Cir. 1947), *cert. denied*, 333 U.S. 861 (1948).

<sup>78</sup>See, e.g., *Anthony P. Miller Inc.*, 7 T.C. 729 (1946), *rev'd on other grounds*, 164 F.2d 268 (3d Cir. 1947) (demand note given, but constructive receipt not found, despite inclusion of the amount in gross income by the payee; indeed, the court held that the circumstances of the note transaction negated constructive receipt). On the other hand there may be constructive receipt though no note is given. See, e.g., *Geiger & Peters, Inc.*, 27 T.C. 911 (1957). Where controlling stockholders are concerned, it is the right and not the power to acquire cash which is significant. *Cosmopolitan Credit Corp.*, 41 P-H Tax Ct. Mem. 422 (1972), *aff'd per curiam*, 3 Am. Fed. Tax R.2d 73-945 (6th Cir. 1973); cf. *M.W. Turner*, 13 P-H Tax Ct. Mem. 1357 (1944).

<sup>79</sup>See the discussion of the relevant committee report in *Musselman Hub-Brake Co. v. Commissioner*, 139 F.2d 65, 66-67 (6th Cir. 1943).

sulted in no reportable income to either stockholder or corporation.<sup>80</sup>

To the extent that plugging such a loophole was a legislative purpose, it seems to this writer clear beyond cavil that the giving of the note should not be treated as payment by the maker. However, in the state of the authorities, making such an assertion proves only that the writer is sadly lacking in the perspicacity which would qualify him for the appellate bench. The members of the Board of Tax Appeals and the Tax Court were also originally devoid of such perspicacity,<sup>81</sup> but eventually acquired it after the enlightening indoctrination provided by the Courts of Appeal.<sup>82</sup>

First, negotiable demand notes were classified as payment.<sup>83</sup> Then, by the Tax Court, negotiable term notes were so classified;<sup>84</sup> and, in truth, there seems to be no practical difference between a note frankly payable in the future and a note, ostensibly payable on demand, when it is understood by payor and payee that no demand will be made within the critical line.

To treat the giving of the note as payment is, of course, inconsistent with the treatment accorded the cash taxpayer giving a note to his original obligee—he being regarded as having made no payment<sup>85</sup> and being allowed no deduction even if the obligee accepts the note as “payment.”<sup>86</sup> In this respect the courts have been sufficiently broad-minded to be untroubled by Emerson’s hobgoblin.<sup>87</sup> Furthermore, to their own

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<sup>80</sup>See *Commissioner v. Auto Strop Safety Razor Co.*, 74 F.2d 226 (2d Cir. 1934).

<sup>81</sup>Notes payable on demand or virtually so were routinely held not to constitute payment, e.g., *R. Fretwell & Sons, Inc.* 12 P-H Tax Ct. Mem. 502 (1943); *Wollner Mfg. Co.*, 12 P-H Tax Ct. Mem. 464 (1943); *Marria Transfer Co.*, 11 P-H B.T.A. & Tax Ct. Mem. 397 (1942); *Cosmo Cleaners & Dyers, Inc.*, 11 P-H B.T.A. & Tax Ct. Mem. 343 (1942). To some extent at least these decisions rested upon the cases denying a deduction to the cash maker of a note.

<sup>82</sup>*Anthony P. Miller, Inc. v. Commissioner*, 164 F.2d 268 (3d Cir. 1947); *Celina Mfg. Co. v. Commissioner*, 142 F.2d 449 (6th Cir. 1944), *rev'g per curiam* 47 B.T.A. 967 (1942); *Musselman Hub-Brake Co. v. Commissioner*, 139 F.2d 65 (6th Cir. 1943). These cases were followed as to demand notes in *Akron Welding & Spring Co.*, 10 T.C. 715 (1948).

<sup>83</sup>See cases cited note 82 *supra*.

<sup>84</sup>*Mid-State Products Co.*, 21 T.C. 696 (1954); *Heatbath Corp.*, 14 T.C. 332 (1950); *Mundet Cork Corp.*, 17 P-H Tax Ct. Mem. 341 (1948), *aff'd per curiam*, 173 F.2d 757 (2d Cir. 1949).

<sup>85</sup>See note 60 and accompanying text *supra*.

<sup>86</sup>See note 62 and accompanying text *supra*.

<sup>87</sup>“A foolish consistency is the hobgoblin of little minds, adored by little statesmen and philosophers and divines.” EMERSON, ESSAYS: FIRST SERIES. *Self Reliance* (1841).

The writer, though neither great nor little statesman, philosopher or divine, risks classification with the most minuscule in those categories by observing that, whatever germ of truth may be ensconced within the quotation, it is most often invoked by those either too stiff-necked to concede past error or else defending themselves against otherwise irrefutable charges of ignorance, oversight or irrationality.



satisfaction, they have found that the Congressional purpose is in no way frustrated by allowing the deduction,<sup>88</sup> though to the writer this has the same validity as perceiving no distinction between night and day.

In effect the Treasury has bowed to the judicial interpretation, though its regulation is so worded as not, on its face, precisely to reflect the case law. It speaks only of "notes or other instruments of similar effect received in payment."<sup>89</sup> Since, as already pointed out in several contexts, the ordinary cash taxpayer is required to report income when he receives a note "in payment," it follows that when he so receives it the related taxpayer provision is inapplicable for that reason alone. It is only when he does not so receive it, that there is any necessity for inquiring whether giving the note is payment by the obligor. However, the actual reporting of income by the payee is not enough to avoid such inquiry. He must be required to report it.<sup>90</sup>

The Treasury also states that the fair market value of the note "is includible in the gross income of the payee for the taxable year in which he receives the note."<sup>91</sup> If this is intended to insinuate that the cash payee

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<sup>88</sup>See, particularly, *Musselman Hub-Brake Co. v. Commissioner*, 139 F.2d 65 (6th Cir. 1943).

<sup>89</sup>Treas. Reg. § 1.267(a)-1(b)(3) (1958). The deduction authorized is for the fair market value of the note. Cf. *N.G. Basevi*, 15 P-H Tax Ct. Mem. 415 (1946) (Commissioner argued note had little or no market value, but court found that it was worth face amount).

The original ruling, finally acquiescing in the accumulating line of cases, said: "Accordingly, it is now the position of the Service that where a solvent taxpayer, on the accrual basis, issues its notes or other evidences of indebtedness in liquidation of expenses incurred . . . and such notes or other evidences of indebtedness have fair market value at the time when issued equal to their face values, then the face values . . . are deductible." Rev. Rul. 55-608, 1955-2 CUM. BULL. 546. Unless "liquidation" by the maker be equated with "received in payment" by the payee this is less restrictive on its face than the regulation. Neither ruling nor regulation attempts to draw any distinction between demand and term notes.

<sup>90</sup>*Eugene Ashe Electric Co. v. Commissioner*, 153 F.2d 295 (5th Cir. 1946) (fact that obligee included salary in his amended return did not entitle taxpayer employer to deduction; no note involved); *Geiger & Peters, Inc.*, 27 T.C. 911, 920 (1957) (same); *Akron Welding & Spring Co.*, 10 T.C. 715, 722 (1948) (accrued rent, not included in note, not deductible, though obligee reported it as income). The text statement is also implicitly supported by *Anthony P. Miller, Inc. v. Commissioner*, 164 F.2d 268 (3d Cir. 1947), where it was conceded that only payment by the accrual taxpayer was open to argument, though, as indicated in the Tax Court's report of the case, 7 T.C. 729 (1946), the payee had in fact included it in his return. See also *Industrial Equipment Co. v. United States*, 51 Am. Fed. Tax R. 1183 (N.D. Okla. 1954); *Celina Mfg. Co. v. Commissioner*, 47 B.T.A. 967 (1942).

A very practical reason for insisting on required reporting by the cash payee, as distinguished from voluntary, unrequired reporting, is that frequently the note is given during the grace period and the payee's return is filed a year later than that of the maker which reflects the deduction. Thus the payee may amend and demand a refund after the statute of limitations has run on the maker's return.

<sup>91</sup>Treas. Reg. § 1.267(a)-1(b)(3) (1958).

must include the note because it was treated as payment by the maker, as distinguished from acceptance as payment by the payee, this insinuation might, to the extent followed, ease the Treasury's pains, but it would reflect circular reasoning not supported by either statute or case law.<sup>92</sup>

If, as the writer believes, it is true that the deduction may now be taken by the payor merely upon giving the note, but the knowledgeable payee, by refraining from acceptance as "payment," may defer his reporting of income, there are present the same opportunities (including the opportunity for subsequent forgiveness of the indebtedness) as existed before the statute was enacted. The loophole has been plugged with a sieve, and any taxpayer who, having failed to give a note, is denied the deduction is being penalized for ignorance or inadvertence and not for violation of any rational or meaningful policy.<sup>93</sup>

When responsible judges produce a result so incongruous,<sup>94</sup> one is

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<sup>92</sup>See cases cited in notes 9, 10, 17, 24-30, *supra*.

<sup>93</sup>"So, if you're not in a good enough cash position to make an actual payment now, give your related taxpayer a note." 54 P-H FEDERAL TAXES BULLETIN No. 7, ¶ 60,082 at 60,117 (Jan. 25, 1973). Nothing could more succinctly illustrate the fact that the line now drawn results only in penalizing ignorance. The note becomes the equivalent of cash though given solely because cash is unavailable.

<sup>94</sup>The writer is perhaps open to the charge that the text has not dealt fully or fairly with the reasoning of the cases. It may be pointed out, for example, that in *Anthony P. Miller, Inc. v. Commission*, 164 F.2d 268 (3d Cir. 1947), after conceding that "The point is one which can be argued either way and have the arguments make sense," the court said:

When a debtor gives a creditor a negotiable instrument for a debt, legal relations between them are not the same as before by any means . . . .

[T]he creditor with the negotiable instrument in his hands is in a much better position than a creditor without one. He has a piece of paper which he can transfer to a holder in due course free of equities. He has an instrument on which he makes out a case against the debtor simply by its presentation the proof of execution . . . .

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 . . . . 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.

*Id.* at 269-70. To this it may be replied: (1) to the extent that this opinion emphasized the demand feature of the note, it is already obsolete; (2) even so, a demand note and a check are not identical; (3) in other contexts in which payment is required, a check is not payment unless eventually honored, and subsequent honoring of the check does not relate back to delivery when the drawer requested that presentment be delayed; (4) the observations about negotiable instruments, far from proving payment, deal only with the ease of enforcing payment, thus merely emphasizing that payment in any meaningful sense has not already been made. As was accurately and succinctly said by the Board of Tax Appeals, "The issuance of the notes simply changed the title of the liability." *Marria Transfer Co.*, 11 P-H B.T.A. & Tax Ct. Mem. 397, 399 (1942).

tempted to look for some unenunciated reason. In this situation the writer identifies, as a possible such reason, the "overkill" feature of the statute. Much more often than not, the delay in cash payment is not motivated by any plan to take undue advantage of the tax laws. The item is, in fact, ultimately paid in cash and must at that time, at the latest, be reported by the cash recipient. Yet, when the statute applies, its effect is not merely to postpone the obligor's deduction. Since it bars deduction at the only time when deduction is proper under accrual accounting, the deduction is gone forever.<sup>95</sup> It is difficult for this writer to believe that notes would have won such free judicial acceptance as payment by related accrual taxpayers—any more than they have won such acceptance as payment by cash taxpayers—had the effect of the statute been merely to postpone the deduction.

Be that as it may, it is no longer possible to lay the entire blame for the result on the courts. The case law is of such antiquity that Congress has had more than an adequate opportunity to amend the statute. It must be concluded that Congress is not unhappy about the evisceration of its handiwork—or at least that those relatively few committee members who are presumitively knowledgeable about such technical matters are not unhappy. *Sic transit* tax reforms.

#### *D. Notes as Payment of Contributions to Qualified Employee Benefit Plans*

Under the Code employer contributions to pension trusts, employees' annuity plans, and stock bonus and profit-sharing trusts are deductible "in the taxable year when paid,"<sup>96</sup> though, for accrual taxpayers, amounts properly accrued in a tax year are deductible in that year if "payment" is made within the time (including extensions) for filing the tax return for that year.<sup>97</sup>

For this purpose, as in the other contexts already discussed, there inevitably arose the question of whether notes given by the accrual employer constituted payment. As in the related taxpayer situation, the Tax Court originally said, "No,"<sup>98</sup> even though two courts of appeals had already classified notes as payment in related taxpayer cases.<sup>99</sup>

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<sup>95</sup>Treas. Reg. § 1.267(a)-1(b)(2) (1958).

<sup>96</sup>INT. REV. CODE OF 1954, § 404(a)(1), (2), (3).

<sup>97</sup>INT. REV. CODE OF 1954, § 404(a)(6).

<sup>98</sup>Freer Motor Transfer Co., 18 P-H Tax Ct. Mem. 440 (1949); Logan Engineering Co., 12 T.C. 860 (1949).

<sup>99</sup>See cases cited note 82 *supra*.

Those cases were distinguished on the ground that they involved restrictions on a deduction otherwise generally available, whereas the payment requirement for employee benefit contributions is a part of the basic provision allowing the deduction.

Again the courts of appeals have differed with the Tax Court. In two cases decided together at the appellate level, the giving of a negotiable demand note payable at a bank was classified as payment.<sup>100</sup> The court relied upon the related taxpayer cases<sup>101</sup> and, stressing the fact that the notes were payable at banks, said, "If a check is sufficient we see no reason why a negotiable demand note payable at a bank is not likewise sufficient."<sup>102</sup> Another court of appeals reached the same conclusion as to a demand note, without specifying whether it was payable at a bank.<sup>103</sup>

As in the related taxpayer cases, the next development was classifi-

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<sup>100</sup>*Sachs v. Commissioner*, 208 F.2d 313 (3d Cir. 1953). In *Slaymaker*, the Court believed that there was a sufficient showing that fair market value equalled face amount to allow the latter as a deduction. It remanded *Sachs* for a determination of value, with the amount determined to be allowed as a deduction. (Presumably if, on this principle, the initial deduction is less than the face amount, the difference is subsequently deductible when the note is paid in full.)

<sup>101</sup>*Id.* at 315. It was the same court which decided *Anthony P. Miller, Inc. v. Commissioner*, 164 F.2d 268 (3d Cir. 1947), *cert. denied*, 333 U.S. 861 (1948), discussed in note 78 *supra*.

<sup>102</sup>*Sachs v. Commissioner*, 208 F.2d 313, 315 (3d Cir. 1953), *supra* note 100. As pointed out by the court, the governing Pennsylvania Negotiable Instruments statute provided: "Where the instrument is made payable at a bank, it is equivalent to an order to the bank to pay the same for the account of the principal debtor thereon." Act of May 16, 1901, No. 162 § 87, [1901] Laws of Pennsylvania 194 (now PA. STAT. ANN.: tit. 12A, §§ 3-204, 8-308 (1970)). To any extent that this is not rendered completely obsolete by subsequent cases, it does not reflect the current rule in some states and was not nationwide law at the time the case was decided. See the Official Comment to N.C. GEN. STAT. § 25-3-121 (1965) (a part of the Uniform Commercial Code, which in this respect is not "Uniform"). That section provides: "A note or acceptance which states that it is payable at a bank is not of itself an order or authorization to the bank to pay it."

<sup>103</sup>*Time Oil Co. v. Commissioner*, 258 F.2d 237 (9th Cir. 1958). The court said that the *Sachs-Slaymaker* decision (*supra* note 100) "[i]s a reasonable, but not required, extension" of the *Miller* case (*supra* note 77) and that "it seems unnecessary to set up a conflict between circuits." 258 F.2d at 240.

The same case was again before the court in 294 F.2d 667 (9th Cir. 1961), in which the earlier decision was confirmed and the panel held, two to one, to the prejudice of the taxpayer, that when the note is given during the grace period the deduction must be taken for the prior year, the taxpayer having no option to deduct in the year in which the grace period falls. There were three opinions on this second issue, and in that of Judge Chambers it is parenthetically said of the earlier decision that "obviously our holding as made would require that such a note would be payment for a cash-basis taxpayer, too." *Id.* at 670. This is, indeed, a logical observation, but not one supported by prior or subsequent authority.

In *Wasatch Chemical Co. v. Commissioner*, 313 F.2d 843, 846 (10th Cir. 1963), the court said, referring to the *Time Oil* case, discussed *supra* note 103, "it further appears that the notes were not payable at a bank."

cation of term notes (due in five years, with interest at six percent) as payment.<sup>104</sup> The court, after finding no help in legislative history and after reviewing prior cases, said:

The authorities on demand notes seem to be clear, and as mentioned, these represent situations where it had been agreed that a demand would not be made until some time from delivery had elapsed. The cases already decided have taken us far down the road on promissory notes as payment, and we feel so far indeed that there is now no return and also no basis to distinguish notes with a stated maturity from demand notes. There can be no real difference in principle, for the purposes here involved, between a demand note to be held for a time and a note having a stated maturity. If either is delivered and accepted, there is brought about significant changes in the legal relationship of the parties. These changes are of such a character that they constitute "payment" in the case at bar.<sup>105</sup>

The Commissioner, after adequate time for cogitation, announced his intention to refuse to follow this decision, though in terms implying that he will not refuse to classify demand notes as payment.<sup>106</sup> Thus if, miraculously, in some future round of cases, the Commissioner's dissent should be vindicated, the measure of his earth shaking victory would be that a taxpayer would need to know not merely that a note should be given, but also that it should be nominally payable on demand. The most recent judicial pronouncement does not vindicate the Commissioner's dissent.<sup>107</sup>

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<sup>104</sup>*Wasatch Chemical Co. v. Commissioner*, 313 F.2d 843 (10th Cir. 1963).

<sup>105</sup>*Id.* at 847. The *Wasatch* case was followed in *Steele Wholesale Builders Supply Co. v. United States*, 226 F. Supp. 82 (N.D. Tex. 1963).

<sup>106</sup>"The delivery of a taxpayer's own term promissory note to an employees' trust does not constitute payment for purposes of section 404(a)." Rev. Rul. 71-95, 1971-1 CUM. BULL. 130, *citing* Rev. Rul. 55-608, 1955-2 CUM. BULL. 546. The latter, in effect acquiescing in the related taxpayer decisions, stated that they were inapplicable to employee trust contributions, *citing* *Freer Motor Transfer Co.*, 18 P-H Tax Ct. Mem. 440 (1949), and *Logan Engineering Co. v. Commissioner*, 12 T.C. 860 (1949), the current precedential weight of which seems to range somewhere between infinitesimal and non-existent.

<sup>107</sup>*In Advance Construction Co. v. United States*, 31 Am. Fed. Tax R.2d 695 (N.D. Ill. 1972), deduction was allowed for a secured term note given to a profit sharing plan. Since the Government stipulated that its fair market value equalled the face amount, the deduction was allowable in that amount. The court said:

The epitome of the intangible is a mere promise to pay a sum certain at a future date absent any physical evidence of that promise that in itself has a current cash value. A bare promise to pay a contribution to a profit sharing fund at a future date creates no decrease in the company's assets, no increase in the fund's assets, fails to provide the recipient with physical evidence of current cash value and consequently merely

Since the initial result of disallowing the deduction under the employee benefit statute is merely to postpone it until the contribution is paid, this Code provision does not embody the "overkill" feature of the related taxpayer provision.<sup>108</sup> It is perhaps not guaranteeable that the full deduction would be available upon later payment, as there are limitations upon the total deduction allowable in any one year,<sup>109</sup> and, dependent upon the amounts involved, this could be of consequence if contributions for two years were otherwise deductible in the same taxable year. However, these limitations in turn, are subject to a carry-over provision,<sup>110</sup> so that, if a deduction were not allowed upon giving a note, the ultimate tax consequence would be problematical. In any event, disallowance upon giving a note does not inevitably mean that no deduction on account of the contribution could ever be taken. Thus the reason suggested by the writer as a possible underlying but unenunciated reason for the related taxpayer decisions is here either absent altogether or present only to a generally indeterminable extent.

Nevertheless, the employee benefit decisions rely heavily upon the related taxpayer decisions. Having treated notes as payment in the latter, the courts, though not always with enthusiasm, have felt compelled

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transforms one degree of intangibility, the *obligation* to pay, to another form of intangibility, a *promise* to pay.

A promise to pay can however be converted to tangibility where that promise is evidenced by an instrument such as a promissory note. In an instance such as this it is not the words of the promise that are primary but rather the physical evidence of those words. It is this reflection of the promise that takes on a self-contained, extrinsic current cash value. The degree of that current value is a function of many factors such as the duration of the note, the solvency of the obligor and the security underlying the obligation. The delivery of such a note therefore constitutes a physical transfer of something of value.

This, of course, emphasizes the delectable results flowing from observance of the proper ritual. However: (1) The note no more decreases the obligor's assets than does the original obligation to pay. They equally increase the obligor's liabilities and, in consequence, have an identical effect on net worth. (2) The court's statement to the contrary notwithstanding, by any ordinary accounting principles the original, legally enforceable, obligation to pay increases the fund's assets. (3) Maturity date, presence or absence of security, the nature of the security, and solvency of the obligor need not vary as between the original obligation and a note. They obviously affect the value of either, because they bear upon the relative certainty of future payment, but this merely emphasizes the fact that payment has not as yet been made. (4) The court's concentration on the attributes of a note is at the expense of recognition that in many situations—indeed, perhaps more often than not—the original obligation to pay is worth face amount or, at least, that amount adjusted for absence of an interest-bearing feature.

<sup>108</sup>See text accompanying note 90 *supra*.

<sup>109</sup>INT. REV. CODE OF 1954, § 404(a)(1)(A), (a)(2), (a)(3)(A), (a)(7).

<sup>110</sup>INT. REV. CODE OF 1954, § 404(a)(7).

to adopt a consistent construction of the same statutory word, "paid." Thus, to any extent that the "overkill" feature of the statute may have sired the related taxpayer decisions, that feature has also sired in the employee benefit cases a progeny of even more questionable legitimacy. Also, for whatever reason, there has been created a second area in which only the ignorant will be penalized. Since concededly in this second area the imported rationale was rested upon no identifiable legislative history, Congress cannot realistically be said to have intended what the courts have wrought. Again, however, Congress may be saddled with some ultimate responsibility, if it indeed had some other intention, because of its failure to amend the statute.

### *E. Notes Given as Charitable Contributions*

Like the related taxpayer and employee benefit provisions, the Code provisions governing the deduction for charitable contributions limit it to the year of payment with a grace period allowed corporate accrual taxpayers.<sup>111</sup> There is also an optional grace period for estates and trusts.<sup>112</sup> The regulation speaks of contributions "actually paid during the taxable year."<sup>113</sup>

As in the case of employee benefit contributions, there are limitations on the total amount of charitable contributions deductible within a single year, complicated by carry-over provisions,<sup>114</sup> and the effect of requiring the deduction to be postponed is indeterminate, though it would only very rarely result in the ultimate complete loss of the deduction.

Among the three situations discussed herein, where special "paid" requirements have been legislatively imposed on accrual taxpayers, this is the Commissioner's last bastion upon which, rather surprisingly, no major assault seems yet to have been mounted. Whatever else may here

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<sup>111</sup>"There shall be allowed as a deduction any charitable contribution . . . payment of which is made within the taxable year." INT. REV. CODE OF 1954, § 170(a)(1). Under section 170(a)(2), the corporate accrual taxpayer may elect to deduct the contribution in the taxable year preceding payment if it was duly authorized by the directors in that year and "payment" is made on or before the 15th day of the third month following that year.

These are among the relatively few simple and straightforward provisions in a section which, as supplemented by interminable Regulations, now merits a high position in any ranking of witches' brews produced when the cauldron is loaded with equal parts of overintricate policy and overexpert draftsmanship.

<sup>112</sup>INT. REV. CODE OF 1954, § 642(c)(1).

<sup>113</sup>Treas. Reg. § 1.170-1(a)(1) (1958).

<sup>114</sup>INT. REV. CODE OF 1954, § 170(b), (d).

account for taxpayer nonbelligerence, it could hardly be any justified fear of encountering an adamantly unfavorable bias in the courts of appeals.

Where the taxpayer gave a fifteen thousand dollar interest-bearing demand note to a charity on the last day of his taxable year, the Tax Court denied a deduction for that year.<sup>115</sup> While the parties argued the question of whether this was "payment," the Court did not reach that issue, holding that, in the absence of any proof of consideration or of the occurrence of any event making the note enforceable, there was no "contribution or gift" within the meaning of the Code.

Where a solvent, accrual corporation delivered to a charity in 1965 its own registered six percent debenture bond, redeemable in 1968, which was freely transferrable without approval of the taxpayer, the Service ruled that no deduction could be taken in 1965, because during that year it continued to be held by the charity and under local law was not enforceable.<sup>116</sup> The same ruling denied a 1965 deduction to a cash taxpayer who in that year gave to a charity his interest bearing note, payable in 1966 and 1967, even though, before the end of 1965, the charity discounted the note to a holder in due course, and it thereupon became enforceable.<sup>117</sup>

As long as a promise to pay a charity, by whatever form evidenced, remains unenforceable, the Commissioner should certainly be sustained in disallowing a deduction as, in such a situation, not only does a cash taxpayer have no case, but there is no ground upon which an accrual

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<sup>115</sup>Norman Petty, 40 T.C. 521 (1963). The evidence demonstrated that at the time the note was given, the taxpayer had \$19,803.89 in his bank account and a net worth of \$76,054.82 (a commendably precise calculation); that in the ensuing January he had \$14,605.52 in the bank; and that the note was paid in the ensuing April.

Earlier the Tax Court allowed the deduction to relate back to the time the taxpayer delivered a check, though the check was not presented and paid until the following tax year and, meanwhile, the taxpayer had died. Estate of Modie J. Spiegel, 12 T.C. 524 (1949). *Inter alia*, the court, speaking of the status of a check under the Uniform Negotiable Instruments Law, said, "It was necessarily placed in a different category from a mere promise to pay; or even from such a promise reduced to formal terms and issued in the form of a negotiable promissory note." *Id.* at 526. Despite this indication that the Tax Court distinguished between notes and checks, this case has been cited as partial justification for the treatment of a note as "payment" in employee trust situations. See *Sachs v. Commissioner*, 208 F.2d 313, 315 (3d Cir. 1953), *supra* note 100.

<sup>116</sup>Rev. Rul. 68-174, 1968-1 CUM. BULL. 81, citing Lewis C. Christensen, 40 T.C. 563 (1963) (ledger account credits to charity not deductible until paid); H.R. REP. No. 1860, 75th Cong., 3d Sess. (1938) (reprinted in 1939-1 (Part 2) CUM. BULL. 728, 741).

<sup>117</sup>Rev. Rul. 68-174, 1968-1 CUM. BULL. 81, also said that interest actually paid to the charity by the accrual corporation was deductible only as a charitable contribution, but the cash taxpayer could deduct as interest the interest he paid after his note became enforceable.



taxpayer may accrue, since events fixing the amount and fact of liability have not occurred.<sup>118</sup>

The question remains as to whether the giving of an *enforceable* note is "payment" by an accrual taxpayer. The Commissioner's general position is that, for charitable contribution purposes, there is no difference between cash and accrual taxpayers,<sup>119</sup> and in this position he is supported by legislative history.<sup>120</sup> Perhaps when the question is presented, the courts of appeals will find in legislative history or otherwise a reason for distinguishing charitable contributions from related taxpayer and employee benefit situations. However, given the fact that, at least in the related taxpayer cases, those courts have clearly frustrated an initial congressional purpose, plus the fact that Congress has not acted to express its disapproval of those cases, the odds seem at least fair that, when the enforceable note question is presented, "payment" will receive the same interpretation as in the related taxpayer and employee benefit cases.

In one respect the Commissioner may have gone too far, even by the standards of this writer. He has ruled that when a taxpayer makes his charitable contribution by means of a charge to a bank credit card, he has his deduction only when he pays the bank.<sup>121</sup> This seems contrary to all the authority recognizing that a cash taxpayer may deduct an item when he pays it to Paul, even if he borrowed the money from Peter.<sup>122</sup> As soon as the bank pays the charity, the taxpayer should have his deduction, since there is no difference between use of the credit card for this purpose and giving the bank a note to obtain funds with which to make the contribution.

#### IV. CONCLUSIONS<sup>123</sup>

A. While, in general, the treatment of cash makers of notes seems

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<sup>118</sup>See *Dixie Pine Products v. Commissioner*, 320 U.S. 516 (1944).

<sup>119</sup>Rev. Rul. 68-174, 1968-1 CUM. BULL. 81. The emphasis on unenforceability in the example involving the accrual taxpayer, standing alone, might imply a concession that an enforceable note would give such a taxpayer a deduction. But the simultaneous denial of a cash deduction to a taxpayer for an enforceable note, when coupled with the assertion that no distinction is to be made on the basis of accounting methods, serves to negate such an implication.

<sup>120</sup>H.R. REP. No. 1860, 75th Cong., 3d Sess. (1938) (reprinted in 1939-1 (Part 2) CUM. BULL. 728), states that the proposed bill designates "the taxable year in which the contribution is actually paid regardless of whether the taxpayer is reporting income on the cash or the accrual basis." This and other parts of the report are quoted in *Estate of Modie J. Spiegel*, 12 T.C. 524, 531 n.6.

<sup>121</sup>Rev. Rul. 71-216, 1971-1 CUM. BULL. 96.

<sup>122</sup>See notes 70-72, *supra*, particularly *E. Gordon Perry*, 28 B.T.A. 497 (1933).

<sup>123</sup>The reader is of course entitled to draw his own. The first he might legitimately draw is

proper, on the cash payee's side we should scrap the rule that acceptance of a note "in payment" is enough, of itself, to require income to be reported. The constructive receipt doctrine is more rational and realistic and is sufficient to prevent genuinely unwarranted delay in reporting. The Commissioner or the courts could abandon the "in payment" doctrine, but neither has shown any inclination to do so. Therefore, Congress should act.

B. In any event the related taxpayer provision should be amended—a step within the power of Congress alone—to eliminate the "overkill" feature and require only postponement of the deduction. This would not cause the Treasury a very substantial loss of money which it ought not to lose, since any revenue produced by the existing provision through permanent loss of the deduction comes from the pockets of the ignorant, as distinguished from those who concentrate intelligently on the joys of tax avoidance. Furthermore, no principle of justice, equity, or common fairness prescribes that a taxpayer should be denied the right to deduct at some time a legitimate actual expenditure.

Even if the "overkill" feature be eliminated, it is too late to expect the courts to revise their notions of notes as payment under those parts of the present statute which would remain. Congress, therefore, should specifically provide that the giving of a note of any description should not, of itself, be regarded as payment. This would not negate application of the constructive receipt doctrine, and if that doctrine required the payee to report income at or before the time of receiving the note, the accrual maker would not be required to postpone the deduction.

The combination of these amendments would produce a rational, enforceable policy. If Congress no longer regards any restrictive policy to be necessary—and there is none presently existing for the knowledgeable—then the expense and interest portion of the related taxpayer provision should be repealed.<sup>124</sup> Of the two alternatives—amendment or repeal—the writer prefers the former.

C. If Congress still believes that it is sound policy to require "payment" as a prerequisite to a deduction for employee benefit contributions and for charitable contributions, it should amend the governing Code provisions to specify that the giving of a note does not constitute

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that the writer has attempted to deal with too much too simply.

<sup>124</sup>INT. REV. CODE OF 1954, § 267 also bars deduction of losses on sales and exchanges between related taxpayers, subject to the modifications contained in subsection (d). The considerations involved in the loss provision are quite different from those involved in the interest and expense provision. At any rate, the loss provision is not within the purview of this article.

the requisite payment. If Congress had that in mind originally, its intention has been judicially frustrated in the employee benefit cases and may eventually be to some extent frustrated as to charitable contributions. If Congress never had such an intention—or no longer has it—it would seem wiser to eliminate the payment requirement. So far as this writer is concerned, there is no valid reason for drawing a line between one promise to pay and another, as distinguished from drawing it between cash on the one hand and all promises to pay on the other.

Again as between the two alternatives—amendment or repeal—the writer prefers the former. However, even the latter would leave in force the clearly correct existing rule that giving an unenforceable note gives rise to no charitable deduction.