8 T.C. 47 (1947)

For a cash basis taxpayer, interest is considered 'paid' and thus deductible when the taxpayer parts with cash or its equivalent to the creditor, even if the funds are borrowed from the same creditor, provided the taxpayer has unrestricted control over the borrowed funds.

Summary

Newton A. Burgess, a cash basis taxpayer, borrowed money from Archer & Co. and sought to deduct interest payments. Burgess borrowed an additional $4,000 from Archer & Co., deposited the loan proceeds into his bank account (commingling it with other funds), and then issued a check to Archer & Co. covering interest on multiple loans, including the newly borrowed $4,000. The Tax Court considered whether this constituted a deductible 'payment' of interest. The court held that Burgess's actions constituted a valid cash payment of interest because he had unrestricted control over the borrowed funds in his bank account before making the interest payment, distinguishing it from situations where interest is merely added to the loan principal.

Facts

– In 1940 and 1941, Burgess took out loans from Archer & Co. totaling $203,988.90, secured by life insurance policies.
– Interest was due in advance at a 2% rate.
– On October 16, 1941, Archer & Co. billed Burgess for $4,136.44 in interest due on December 30, 1942, for renewal of the loans.
– On December 20, 1941, Burgess borrowed an additional $4,000 from Archer & Co., receiving a check dated December 22, 1941.
– Burgess deposited this $4,000 check into his bank account, commingling it with other funds.
– On December 26, 1941, Burgess wrote a check for $4,219.33 to Archer & Co., covering interest on the original loans and the new $4,000 loan.
– Prior to depositing the $4,000 loan, Burgess had $3,180.79 in his bank account.
– Burgess used his bank account for various expenses, not solely for interest payments.

Procedural History

The Commissioner of Internal Revenue disallowed $4,000 of the $4,219.33 interest deduction claimed by Burgess, arguing it was not a cash payment but merely an increase in debt. Burgess petitioned the Tax Court to contest this deficiency.

Issue(s)

1. Whether a cash basis taxpayer can deduct interest when they borrow funds from the same creditor, deposit those funds into their bank account,

commingle them with other funds, and then pay the interest with a check drawn from that account.
2. Whether the taxpayer adequately substantiated deductions for state gasoline taxes, federal admission taxes, and city sales taxes.

Holding

1. Yes, because Burgess received actual cash from the loan, deposited it into his bank account where it was commingled with other funds and under his control, and subsequently made a payment of interest. This constituted a cash payment of interest for a cash basis taxpayer.
2. Yes, in part. The court, applying the Cohan rule, allowed a reduced deduction of $80 for these taxes, finding the taxpayer had incurred such expenses but lacked precise documentation.

Court's Reasoning

The court reasoned that the crucial factor was whether Burgess made a 'cash payment' of interest. The court distinguished this case from situations where interest is merely discounted from the loan proceeds or added to the principal, citing *John C. Cleaver*. In *Cleaver*, the interest never passed through the borrower's hands. Here, however, Burgess received the $4,000 loan proceeds, deposited them, and commingled them with other funds. The court emphasized, "The cash received by the petitioner from the proceeds of his $ 4,000 loan was commingled with his other funds in the trust company. Its identity was lost and it could not be traced to the payment of the interest charge…The petitioner made a cash payment of interest as such. He did not give a note in payment…" Regarding the taxes, the court invoked the *Cohan v. Commissioner* rule, stating, "Absolute certainty in such matters is usually impossible and is not necessary; the Board should make as close an approximation as it can…to allow nothing at all appears to us inconsistent with saying that something was spent…" and allowed an estimated deduction.

Practical Implications

Burgess v. Commissioner clarifies the 'cash payment' rule for interest deductibility for cash basis taxpayers. It establishes that borrowing from the same creditor to pay interest does not automatically negate a cash payment, provided the borrower has unfettered control over the borrowed funds before payment. This case is important for tax practitioners advising cash basis clients on the timing and deductibility of interest expenses, especially in refinancing or loan renewal situations. It highlights the significance of the borrower having actual and unrestricted access to the borrowed funds, even if briefly, to constitute a valid cash payment. Later cases distinguish *Burgess* when the loan proceeds are immediately restricted or earmarked solely for interest payment, lacking the element of commingling and control present in *Burgess*.