8 T.C. 569 (1947)

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A cash-basis taxpayer can deduct a bad debt in the year they sustain actual cash detriment by payment of notes representing advances to a corporation, even if the taxpayer is also an endorser of those notes.

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Summary

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Thomas Watson, a cash-basis taxpayer, advanced funds to his corporation, receiving notes he then discounted at a bank. When the corporation dissolved without paying the notes, Watson renewed them, endorsing each renewal. In 1940, he paid off the renewed notes with a personal check, simultaneously borrowing the same amount from the bank on his individual note. In 1941, he repaid this personal note with a check and borrowed a smaller amount. The Tax Court addressed the deductibility of these advances as bad debts, the basis for a loss on the sale of municipal bonds acquired through exchanges, and the deductibility of a cash advance to a bankrupt business associate. The court held that the bad debt deduction was proper in 1941, when the taxpayer actually sustained a cash detriment.

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Facts

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Thomas Watson, an attorney, was the principal shareholder of Green Road Stone & Supply Co. He frequently advanced money to Green Road, duly credited in an open ledger account. Green Road gave Watson notes for these advances, which he discounted at a bank. As the notes matured, he paid interest, reduced the principal, and issued new notes for the remaining balance. Green Road dissolved in 1934, insolvent. Its assets were transferred, and Watson accepted notes from the purchasing company as payment for his claims against Green Road. These notes were used to pay off the debts, including Watson's discounted notes at the bank. Watson continued renewing these notes, endorsing them each time.

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Procedural History

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The Commissioner of Internal Revenue determined deficiencies in Watson’s income tax for 1940 and 1941. Watson challenged the disallowance of a bad debt deduction claimed in 1940, or alternatively in 1941, related to his payment of notes for advances to Green Road. He also contested the disallowance of a loss on the sale of municipal bonds and a bad debt deduction for a cash advance to a business associate. The Tax Court addressed these issues, ultimately ruling in Watson’s favor on the bad debt deduction for 1941 and the business associate advance, but against him on the bond sale.

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Issue(s)

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1. Whether the taxpayer can deduct as a bad debt the amount of the advances to the corporation represented by the discounted notes, and if so, in which year?

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2. What is the taxpayer’s basis in municipal bonds acquired through successive exchanges, for purposes of calculating gain or loss on their sale?

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3. Whether the taxpayer can deduct as a bad debt a cash advance to a business associate who subsequently declared bankruptcy?

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Holding

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1. Yes, because the taxpayer sustained actual cash detriment when he made payments on the notes, and the deduction is proper in the year of payment, here 1941. However, the settlement of notes and simultaneous borrowing of the same amount does not constitute “payment.”

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2. The taxpayer’s basis is the fair market value of the old bonds at the time of the

exchange.

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3. Yes, because an indebtedness resulted from the advance, and the business associate’s bankruptcy reasonably supports the ascertainment of worthlessness in 1941.

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Court’s Reasoning

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The Tax Court reasoned that the advances to Green Road were loans, not capital contributions. The right to deduct the bad debt was postponed until Watson sustained a cash detriment, which occurred when he paid the notes. The court distinguished between a mere substitution of notes and an actual cash payment. Borrowing money to immediately pay off a debt does not constitute payment for tax purposes. However, when the taxpayer paid off his individual note in 1941 using funds not directly traceable to a new loan, a deduction was allowed. Regarding the municipal bonds, the court found that the exchanges were not tax-free, thus the basis was the fair market value of the bonds at the time of the exchange. Finally, the court allowed the deduction for the advance to the business associate, finding that the bankruptcy established worthlessness and that the debt was not worthless prior to 1941. The court noted, “It is not enough that such detriment is reasonably certain at some future time.”