10 T.C. 715 (1948)

A corporation on the accrual basis can deduct accrued salary expenses paid to controlling stockholder-officers with promissory notes, provided the officers report the notes as income in the year received, but unpaid rent intended as a capital contribution is not deductible.

Summary

Akron Welding & Spring Co. sought to deduct accrued salary and rent expenses owed to its controlling stockholder-officers. The Tax Court addressed whether promissory notes issued to the officers for unpaid salaries constituted payment for deduction purposes and whether unpaid rent, later converted to stock, was deductible. The court held that the salary expenses covered by notes were deductible because the notes represented payment and were included in the officers' income. However, the unpaid rent was deemed a capital contribution and thus non-deductible.

Facts

Akron Welding & Spring Company, an accrual basis taxpayer, accrued salary and rent expenses to its controlling stockholder-officers, George I. Stuver and George W. Stuver. The company issued demand, non-interest-bearing promissory notes to the Stuvers for portions of their unpaid salaries. The Stuvers reported the full amount of their salaries, including the amounts represented by the notes, on their cash basis tax returns. The company also accrued rent expense to George I. Stuver, but this amount was later satisfied by issuing company stock to him.

Procedural History

The Commissioner of Internal Revenue disallowed deductions for the unpaid portions of salaries and the unpaid rent, citing section 24(c) of the Internal Revenue Code. Akron Welding & Spring Co. petitioned the Tax Court for review of the Commissioner's determination.

Issue(s)

1. Whether the issuance of promissory notes to controlling stockholder-officers for accrued salary expenses constitutes payment, allowing the corporation to deduct these expenses.

2. Whether unpaid rent owed to a controlling stockholder, which was subsequently converted into company stock, is deductible as a business expense.

Holding

1. Yes, because the issuance of demand promissory notes constituted payment when

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the officers included the value of the notes in their individual income tax returns.

2. No, because the unpaid rent was intended as a capital contribution by the stockholder and was ultimately converted into stock ownership.

Court's Reasoning

Regarding the salary expenses, the court relied on *Musselman Hub-Brake Co. v. Commissioner*, which held that demand notes with cash value given to controlling stockholders constitute payment if the stockholders report the notes as income. The court emphasized the importance of the notes being treated as payment on the company's books and the officers reporting the note amounts as income. The court found no evidence of tax evasion. The court noted the subsequent payment of the notes in 1942 supported their face value at issuance.

Regarding the rent expense, the court found that the facts demonstrated the parties intended the unpaid rent to be a capital contribution. George I. Stuver's testimony indicated his intent to increase his investment in the company. The issuance of stock to cover the rent obligation further solidified this intent. Because it was a capital contribution, the rent expense was not deductible as an ordinary and necessary business expense.

The court also addressed the Commissioner's reliance on *Anthony P. Miller, Inc.*, noting that the Third Circuit Court of Appeals reversed that decision, holding that notes given in that case constituted payment of salary.

Practical Implications

This case clarifies when a corporation's promissory notes can be considered payment for accrued expenses owed to related parties, specifically under I.R.C. Section 267 (formerly Section 24(c)). For accrual-basis taxpayers, issuing notes can allow for a deduction if the related party includes the note's value in their income. However, the intent of the parties matters, and if the transaction is effectively a capital contribution, no deduction is allowed. This decision underscores the importance of documenting the intent behind transactions with related parties. Later cases distinguish *Akron Welding* by focusing on whether there was a genuine intent to pay with the notes versus using them as a mere accounting formality. The case illustrates the principle that substance prevails over form in tax law.

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