11 T.C. 672 (1948)

A taxpayer on a cash basis is not taxable in a given year on compensation received in a prior year but repaid to the corporation in the given year, if the agreement to repay and the execution of a promissory note occurred before the close of the taxable year in question, effectively negating the 'claim of right' to that portion of the income in the repayment year.

Summary

Willis W. Clark, president of Dingle-Clark Co., received compensation in 1941 and 1942. After the IRS challenged the deductibility of a portion of his 1941 compensation for the company, Clark agreed with the company to repay any disallowed amount. Before the end of 1942, he executed a promissory note for $28,208.14, representing the excess compensation. The Tax Court held that Clark was not taxable in 1942 on the amount covered by the promissory note because his obligation to repay was established within the 1942 tax year, thus negating his 'claim of right' to that portion of the income in 1942. The court distinguished this situation from cases where repayment arrangements occur after the close of the taxable year.

Facts

Willis W. Clark was president and a major shareholder of Dingle-Clark Co.

Clark had an employment contract specifying a base salary plus a bonus based on company profits.

In 1941, Clark received $24,000 salary and bonuses totaling $94,208.14 ($60,000 initially paid in 1941 and $34,208.14 paid on March 5, 1942).

Dingle-Clark Co. deducted $118,204.14 as Clark's 1941 compensation on its corporate tax return.

The IRS audited Dingle-Clark Co.'s 1941 return and proposed disallowing a portion of the compensation paid to Clark and another officer.

In 1942, Clark agreed with the other officers and directors to refund any compensation for 1941 that the IRS disallowed as a deduction to the company. This agreement was made before the end of 1942.

The IRS and Dingle-Clark Co. agreed that reasonable compensation for Clark in 1941 was $90,000.

On or about December 31, 1942, Clark gave Dingle-Clark Co. a promissory note for $28,208.14, representing the difference between the compensation already paid and the agreed-upon $90,000.

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Clark was financially capable of paying the note, and both Clark and the company considered the note a binding obligation.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Clark's income and victory tax for 1943, impacting the year 1942 due to the Current Tax Payment Act of 1943 forgiveness provisions.

Clark petitioned the Tax Court to contest the deficiency determination.

The Tax Court reviewed the Commissioner's determination regarding the taxability of the compensation repaid by promissory note in 1942.

Issue(s)

1. Whether Clark was taxable in 1942 on the portion of the 1941 compensation ($28,208.14) that he agreed to repay and for which he gave a promissory note to Dingle-Clark Co. in 1942, prior to the close of the taxable year.

Holding

1. No. The Tax Court held that Clark was not taxable in 1942 on the $28,208.14 covered by the promissory note because the agreement to repay and the execution of the note occurred within the 1942 tax year, effectively adjusting his compensation for 1941 and negating a 'claim of right' to that amount in 1942.

Court's Reasoning

The court relied on the principle that a cash basis taxpayer is generally taxed on income received under a claim of right without restriction as to use, citing *North American Oil Consolidated v. Burnet*, 286 U.S. 417 (1933).

However, the court distinguished this general rule by noting an exception: when an adjustment to compensation and repayment occur within the taxable year, the tax liability is based on the adjusted amount. The court cited *Albert W. Russell*, 35 B.T.A. 602, as precedent, where a salary reduction and repayment within the same tax year resulted in taxability only on the reduced salary.

The court found the facts in Clark's case analogous to *Russell*, emphasizing that the agreement to repay and the promissory note were executed before the end of 1942. The court stated, "Even if the note may not be regarded as actual repayment, we think that there was a definite obligation on petitioner's part at the close of the taxable year to return the $28,208.14 to the company. In effect, he had overdrawn his authorized compensation by that amount."

The court also cited *Commissioner v. Wilcox*, 327 U.S. 404 (1946), highlighting the

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Supreme Court's view that taxable gain requires both a 'claim of right' and the 'absence of a definite, unconditional obligation to repay'. The court reasoned that Clark's situation lacked the 'claim of right' for the repaid amount in 1942 due to his obligation to return it.

Dissenting Opinion (Turner, J.)

Judge Turner dissented, arguing that the majority misapplied precedent. The dissent emphasized that the compensation was fully earned and paid in prior years, and Clark's agreement to repay was a voluntary act after the services were rendered and compensation received under a claim of right. The dissent argued that a subsequent voluntary repayment cannot retroactively alter the income's character in the year of receipt. Turner stated, "…his subsequent voluntary return after completion of all acts with respect thereto between the parties can in no way serve to convert the amounts involved into something other than income."

Practical Implications

Clark v. Commissioner provides a practical example of how agreements to adjust compensation, when executed within the tax year of potential repayment, can impact taxability under the claim of right doctrine for cash basis taxpayers.

This case highlights the importance of timing in compensation adjustments. For cash basis taxpayers, if an agreement to reduce or repay salary is reached and acted upon (e.g., promissory note executed) before year-end, it can effectively reduce taxable income in that year, even if the original compensation was received in a prior year.

Legal practitioners should advise clients to formalize and execute any compensation repayment agreements within the tax year in question to leverage the principles of *Clark*. Using a promissory note, as in *Clark*, can be a valid method to establish a repayment obligation for tax purposes, provided it is a bona fide obligation.

Later cases may distinguish *Clark* if the repayment agreement or obligation is not firmly established within the same taxable year as the adjustment is sought, or if the repayment is deemed not to be a genuine obligation.

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