12 T.C. 860 (1949)

A taxpayer on the accrual basis cannot deduct the face value of promissory notes contributed to an employee's trust in the year the notes are issued; the deduction is permissible only in the year the notes are actually paid.

Summary

Logan Engineering Co., an accrual-basis taxpayer, sought to deduct the value of promissory notes issued to its employee profit-sharing trust, which was tax-exempt under I.R.C. § 165, in the year of issuance. The Tax Court held that the company could only deduct the amounts in the year the notes were actually paid, not when they were issued. The court reasoned that I.R.C. § 23(p) specifically requires contributions to be "paid" to be deductible, and the issuance of a promissory note does not constitute payment until the note is satisfied. This decision emphasizes the strict interpretation of "paid" in the context of employee trust contributions.

Facts

Logan Engineering Co. established a profit-sharing trust for its employees, which qualified as tax-exempt under I.R.C. § 165(a). The trust agreement allowed the company to contribute cash or legally enforceable, interest-bearing promissory notes. The company's board authorized contributions to the trust in the form of negotiable promissory notes for the years 1942-1945. The company recorded these notes as current liabilities and charged them to operations, accruing them as "Notes Payable — Profit Sharing Trust." The trust, in turn, recorded the notes as assets. The company had sufficient cash assets at the end of each year to cover the notes. The promissory notes were paid in the year following their issuance.

Procedural History

The Commissioner of Internal Revenue disallowed the deductions claimed by Logan Engineering Co. in the years the promissory notes were issued, except for notes paid within 60 days after the close of the year, as permitted by statute. The Commissioner allowed deductions in the subsequent years when the notes were paid in cash. Logan Engineering Co. petitioned the Tax Court for a redetermination of the deficiencies assessed by the Commissioner.

Issue(s)

Whether an accrual-basis taxpayer can deduct contributions to an employee's trust under I.R.C. § 23(p) in the year negotiable promissory notes are issued and delivered to the trust, or only in the year the notes are actually paid in cash.

Holding

No, because I.R.C. § 23(p) requires that contributions be "paid" to be deductible,

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and the issuance of a promissory note does not constitute payment until the note is actually satisfied.

Court's Reasoning

The Tax Court emphasized that deductions are a matter of legislative grace and taxpayers must clearly meet the terms of the statute. The court noted that I.R.C. § 23(p) specifically uses the word "paid," which ordinarily means liquidating a liability in cash. Unlike other subsections of I.R.C. § 23 that use the phrases "paid or incurred" or "paid or accrued," subsection (p) uses only "paid," indicating a more restrictive intent. The court reasoned that Congress intended to put cash and accrual taxpayers on equal footing, requiring actual payment for a deduction, subject to the 60-day rule in I.R.C. § 23(p)(1)(E). The court distinguished the case from those interpreting I.R.C. § 24(c), which addressed situations where the "paid" requirement was met by the creditor constructively receiving income. Here, the issuance of a promissory note was considered a mere promise to pay, not actual payment. The court cited *Estate of Modie J. Spiegel*, distinguishing payment by check (conditional payment) from payment by promissory note (mere promise).

Practical Implications

This case clarifies that for contributions to employee trusts, the "paid" requirement in I.R.C. § 23(p) necessitates actual cash payment (or its equivalent within the 60-day rule) for accrual-basis taxpayers to claim a deduction. Issuing promissory notes, even if negotiable and interest-bearing, does not suffice. This decision has significant implications for tax planning: companies must ensure actual payment is made to the trust within the prescribed timeframe to claim the deduction in the intended tax year. It prevents companies from inflating deductions by issuing notes without immediate cash outlay. Subsequent cases and IRS guidance have reinforced this principle, emphasizing the need for tangible economic outlays to support deductions related to employee benefit plans.

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