15 T.C. 961 (1950)

A taxpayer cannot deduct accrued salary expenses to a controlling shareholder if the payment is not actually or constructively made within the taxable year or within two and a half months after the close thereof, and a mere bookkeeping entry does not constitute constructive payment when the funds are not available.

Summary

H & H Drilling Co. sought to deduct salary accrued to its majority stockholder, Fred Ptak. The company issued a check to Ptak, who endorsed it back to the company for deposit into its account. The Tax Court disallowed the deduction, finding that this was not actual or constructive payment because the company did not have sufficient funds to cover the check, and the transaction was merely a bookkeeping maneuver. Therefore, the court held that the company failed to meet the requirements for deducting accrued expenses under Section 24(c) of the Internal Revenue Code.

Facts

H & H Drilling Co. was formed in 1941. Fred Ptak owned 50.4% of the company's stock but was not an officer or director. On December 30, 1941, the company's directors resolved to pay Ptak $10,000 for services rendered. On May 13, 1942, the company issued a check to Ptak for $9,970 (salary less social security tax). Ptak endorsed the check back to the company on the same day, and the company deposited it into its own bank account. The company's books showed a charge and then a credit to Ptak's account for the check amount. The company lacked sufficient funds in its account to cover the check when it was issued and deposited.

Procedural History

H & H Drilling Co. deducted the accrued salary expense on its tax return. The Commissioner of Internal Revenue disallowed the deduction, citing Section 24(c) of the Internal Revenue Code. H & H Drilling Co. then petitioned the Tax Court for review of the Commissioner's determination.

Issue(s)

Whether H & H Drilling Co. is entitled to a deduction for salary accrued to its majority stockholder when a check was issued but immediately endorsed back to the company and deposited into its own account, and when the company lacked sufficient funds to cover the check.

Holding

No, because H & H Drilling Co. did not demonstrate that actual or constructive payment was made to Ptak within the taxable year or within two and a half months after its close, as required by Section 24(c) of the Internal Revenue Code. The

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endorsement and redeposit of the check, combined with the lack of funds, constituted a mere bookkeeping entry rather than a true transfer of funds.

Court’s Reasoning

The Tax Court emphasized that the taxpayer bears the burden of proving the inapplicability of Section 24(c) of the Internal Revenue Code, which disallows deductions for unpaid expenses and interest under certain conditions. Specifically, the court focused on the requirement that the expenses be “paid within the taxable year or within two and one half months after the close thereof.” The court found that the issuance of the check, followed by its immediate endorsement back to the company, did not constitute actual or constructive payment. The court stated, “Endorsement of the check by Ptak, and delivery thereof to petitioner for deposit to its credit, was not payment, actual or constructive. Petitioner was in the same financial condition, as respects Ptak, after the completion of the transaction as it was before the issuance of the check and Ptak received nothing. The formality was nothing more than a bookkeeping or paper transaction.” The court distinguished the case from others where notes were issued and accepted as actual payment or where demand notes with a cash value were issued. Since H & H Drilling Co. did not prove that Ptak constructively received the salary or that the company constructively paid it, the deduction was properly disallowed.

Practical Implications

This case serves as a cautionary tale for closely held businesses. It highlights the importance of ensuring that payments to related parties are bona fide and not merely accounting maneuvers designed to create tax deductions. The case reinforces the principle that constructive payment requires the unqualified availability of funds to the payee. It clarifies that merely issuing a check that is immediately returned to the issuer does not constitute payment for tax purposes, especially when the issuer lacks sufficient funds to honor the check. Attorneys and tax advisors should counsel clients to avoid such “sham” transactions and to ensure that actual transfers of value occur when claiming deductions for accrued expenses, especially when dealing with controlling shareholders or related parties. Later cases cite this one to disallow deductions taken without actual transfer of funds.

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