Samuel Hebrew v. Commissioner, 12 T.C. 523 (1949)

A taxpayer cannot deduct unpaid expenses, such as salary, owed to a related party if the expenses are not paid within the taxable year or two and a half months after, and are not includible in the related party's gross income for that year due to the related party's accounting method.

Summary

Samuel Hebrew sought to deduct additional compensation payable to his sons. The Tax Court disallowed the deductions under Section 24(c) of the Internal Revenue Code. The court found that all three conditions of Section 24(c) were met: the expenses were unpaid within the required timeframe, the sons (cash basis taxpayers) did not constructively receive the income within the tax year, and the taxpayer and his sons were related parties. The court reasoned that the sons' right to the additional salaries was not established until after the close of the tax year, precluding constructive receipt.

Facts

Samuel Hebrew employed his two sons. He sought to deduct additional compensation payable to them. The sons were on the cash basis method of accounting. The additional salary due to each son was computed annually, after allowances for the petitioner's percentage of annual profit plus the petitioner's income tax. The sons were not entitled to the additional salaries until the end of their respective calendar years. The salaries were computed and placed on the books between January 15 and 20 of each subsequent year.

Procedural History

The Commissioner disallowed the deductions claimed by Samuel Hebrew for additional compensation payable to his sons. Hebrew petitioned the Tax Court for review. The Tax Court upheld the Commissioner's disallowance.

Issue(s)

1. Whether the additional compensation was paid within the taxable year or within two and one-half months after the close thereof, as required by Section 24(c)(1) of the Internal Revenue Code.

2. Whether, by reason of the sons' cash method of accounting, the additional compensation was includible in their gross income for the taxable year in which or with which the taxpayer's taxable year ended, as required by Section 24(c)(2) of the Internal Revenue Code.

Holding

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1. Yes, the salaries were not paid as required by Section 24(c)(1) because constructive payment does not constitute actual payment under this section.

2. No, the additional compensation was not includible in the sons' gross income for the relevant taxable year because the amount was not fixed and available to them until after the close of the tax year; therefore, the doctrine of constructive receipt did not apply.

Court's Reasoning

The court emphasized that all three conditions of Section 24(c) must be met to disallow the deduction. The court found that the relationship between the father and sons satisfied condition 24(c)(3). Regarding 24(c)(1), the court determined that constructive payment is insufficient. Citing *P.G. Lake, Inc. v. Commissioner*, the court held that the salaries were not paid in cash, notes, or any other form within the specified timeframe.

Regarding 24(c)(2), the court addressed the constructive receipt doctrine. The court stated that sums are includible in gross income under 24(c)(2) if constructive receipt applies. The court relied on *McDuff Turner*, finding that the additional salaries were not accrued on the petitioner's books during the taxable years. The court emphasized that the sons were not entitled to the salaries until the end of the year, and the amounts were computed and recorded later. The court stated: "Section 24 (c) (2) provides expressly that to allow the salary deduction, the salaries must be includible in the sons' incomes 'for the taxable year in which or with which the taxable year of the taxpayer ends.'" Therefore, because the income was not constructively received within the tax year, condition 24(c)(2) was satisfied, and the deduction was disallowed.

Practical Implications

This case highlights the importance of adhering to the strict requirements of Section 24(c) when deducting expenses owed to related parties. Taxpayers must ensure that payments are actually made within the taxable year or the prescribed grace period. Furthermore, the case clarifies that mere bookkeeping entries are not sufficient to establish constructive receipt; the related party must have an unrestricted right to demand and receive the funds within the taxable year. This case continues to be relevant in situations involving closely held businesses and family-owned enterprises where scrutiny of related-party transactions is common. Later cases cite this for the proposition that all three conditions of Section 267 (formerly 24(c)) must be met to disallow the deduction.

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