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THE DEDUCTION DILEMMA IN COMPENSATING CONTROLLING STOCKHOLDERS

ALBERT W. KENNON*

THE deduction of compensation given to stockholders in closely-held corporations is a matter of practical difficulty by reason of the application of the law to varied and complex factual situations. A review of all the cases decided would require categorizing by some method of extrasensory perception with respect to what factual element was the deciding factor in each decision. If the client is already in tax trouble, the attorney can pick out the best case to suit his purposes. The object of this article is to clarify the application of the fundamental principles involved, and will conclude with a restatement of these elementary rules.

The closely-held corporation operating at a profit is not only subject to the tax problems of other corporations, but it is particularly subject to scrutiny with respect to compensating the officer stockholders. Many of these close corporations are concerned with this more difficult problem, due in large part to the fact that the net earnings of these companies vary substantially from year to year as do their working capital requirements; and due to the fact that they do not feel able to pay for adequate auditing services which will keep the management currently informed as to their true financial status. The net result of this situation is that, unless compensation is directly determined by some predesignated formula which may or may not be practical in operation, the determination of the compensation of the executives is subject to the dilemma of not being allowed as a deduction against the earnings for the year when the services produced the earnings, or being disallowed in the year, when actually paid. For example, an accrual-basis corporation must take very definite action prior to the end of its year, in order to secure the deduction. But if it does not, and charges the compensation against the next year’s earnings, the company may be in a lower tax bracket, and consequently receive less of a tax benefit. If the officers try to hedge by voting large salaries and then rescinding part of them after the profits are determined, various difficulties may exist. The officials of the corporation may be accused of siphoning off profits by way of compensation, rather than by payment of dividends. If the officers wait until after the net profits are determined, and then act *nunc pro tunc* the end of the previous year, questions of misrepresentation and evasion appear.

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1. We will skip over the problem of what constitutes reasonable compensation as an allowable deduction for income tax purposes by assuming that such a determination is largely a matter of horse trading between tax counsel and the revenue agents, or a “guesstimate” by the court. See Annot. 145 A.L.R. 834 (1943).
It seems appropriate, therefore, that the subject be re-examined from 
a factual approach, so that the legal principles which seem somewhat 
elementary can be applied with more certainty of tax results.

Compensation Paid or Incurred

The statutory coverage of the problem is found in two Internal Revenue 
Code sections: the first allows a corporate deduction for ordinary and 
necessary expenses "paid or incurred during the taxable year" including 
salaries "or" other compensation. The second disallows an otherwise 
incurred liability under certain conditions which relate to the time of 
payment and taxation of the recipient in closely-held corporations.

What constitutes payment by media other than by cash, such as by 
check, delivery of property or notes, has been amply discussed by others, 
so that this article can focus immediately on the problem at hand. In 
short, the word "paid" can be understood as the liquidation of a liability 
incurred in cash or its equivalent. If the item is paid by either a cash-basis or an 
accrual-basis corporation pursuant to a legal obligation, the statute is 
satisfied in this respect. Our concern, therefore, is with the question of the 
time at which an expense is incurred. This problem relates to an accrual-
basis taxpayer. The definition of the term "incurred" is simply stated 
as being the time at which all the events have occurred in the taxable 
year of the payor which are necessary to a determination that there is a 
definite liability in a definite amount. The application of this principle, 
however, is more difficult.

Definite Liability

For a liability to be incurred there must be a liability enforceable at 
law during the taxable year. For example, the owner of a corporation 
employed key personnel from time to time, and promised them that when 
the profits were adequate there would be a division of these riches among 
them. In 1941, when it was apparent that profits would be substantial, 
the owner directed his bookkeeper to ascertain whether such a division 
would be tax deductible. In February 1942, the bookkeeper was directed 
to credit the employees with a certain percentage of profits. These 
amounts were deducted on the corporate return for 1941. The court dis-
allowed the deductions on the ground that there was no enforceable agree-
tment between the corporation and the employees prior to 1942.

3. Id. § 267. The cases discussed in the first part of this analysis will disregard the 
disallowance provisions of § 267, which are considered pp. 667-78 infra.
5. P. G. Lake, Inc. v. Commissioner, 148 F.2d 893 (5th Cir.), cert. denied, 326 U.S. 
Where a corporation agrees with a union to pay employees vacation pay, the process is advanced one step further. A labor contract was effective from May 1, 1945, through April 30, 1946, and for the following year unless notice to terminate the contract was given 60 days prior to April 30, 1946. In 1945, the corporation deducted the 1945 vacation pay and two-thirds of the estimated vacation pay for the following year, covering May 1, 1946, through December 30, 1946. The corporation contended that, when the 1945 return was filed, the contract had been renewed, and hence the liability was definitely determinable. The court properly held, however, that the liability was not absolute, but contingent in 1945.\(^8\) The court said:

"The reasonable probability during the taxable year that a liability will accrue is not sufficient if, as a matter of fact, it does not actually come into existence during the taxable year. A liability does not accrue for tax purposes as long as it remains contingent, or if the events necessary to create the liability have not occurred. Brown v. Helvering, 291 U.S. 193. . . .\(^9\)"

Going on to a situation involving a closely-held corporation, the question arises as to whether formal action by the board of directors is necessary to create the liability. Take the case of three stockholders owning a corporation, who, prior to the end of the fiscal year, agreed that two of them should receive bonuses for that year. The books were immediately credited but payment was not made until several months later. The bonuses were not in proportion to stockholdings. There was no formal resolution or other written memorandum. The court held that the accrual-basis corporation could deduct the bonuses in the fiscal year when they were agreed upon.\(^10\)

Under corporate law the acts of all the stockholders who are also the directors are said to be valid without the formalities of a meeting.\(^11\) Other authority requires a meeting to constitute official action.\(^12\) While there are cases where formal action seems to have been dispensed with, the realities of the situation demand a formal meeting because of the difficult burden of proving that a meeting took place, that a definite agreement was reached, and what its terms were. With a formal resolution in written minutes, the proof that definite action was taken is facilitated. Relying on cases where informal action has been approved is hazardous, since the court may justifiably require some evidence corroborating the statements of the principles involved.

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9. Id. at 657.
Assuming then that there is valid corporate action by an accrual-basis corporation prior to the end of the year, other factual situations arise which need reviewing to determine just what constitutes a definite liability. In January 1918, a board of directors formally resolved that the sons of the majority stockholder would receive total compensation for that year in fixed amounts if the volume of sales was sufficiently increased through the efforts of the sons. Upon audit in January 1919, sales were found to have increased 56 per cent over the prior year. On January 31, 1919, therefore, the board adopted another resolution authorizing the credit on the books of the balance of the sons' salaries up to the amounts fixed by the January 1918 resolution. These salaries were deducted on the 1918 corporate income tax return but the Commissioner assessed a deficiency on the ground that no liability was incurred prior to January 31, 1919. The court held that the salaries were deductible in 1918. While this liability was not definite and unconditional at the time of the January 1918 resolution of the board, during the year the occurrence of events, i.e., increase in sales, made the liability definite. The court's opinion sets forth at length the reasoning behind this conclusion:

"... The fact that the books had to be closed to ascertain the increase of sales of 1918 over those of 1917, and the further fact that this could not be ascertained until after January 31st, when all records were in, does not prove that the liability was not one of 1918. Under the circumstances it could not be ascertained until all business of 1918 was closed.

"The resolution of January 31st did not give any new authorization of credit for salaries earned; it merely credited to each one the balance of salary fixed by the January 9th resolution. From the tenor of the Commissioner's letter, had the credit of December 31st given to each the full salary voted in the January 9th resolution he would have allowed it.

"The resolution passed on January 9, 1918, recited the salaries for 'the year'; therefore it was salaries for 1918 that were to depend on the sales for that year, and the further fact that the total amount of these sales were not ascertained until January 31, 1919, did not carry the claim over to the salary year, 1919.

"Particularly is this true because the total transactions of the year were ascertained and closed. As a fact it was shown that these salaries were put in the return made for the year 1918 which was made after the close of that year.

"The debt accrued when the conditions happened on which the debt depended, not when the evidence became available to prove these conditions."

Here the actual crediting on the books did not occur until after the end of the taxable year, but this is immaterial when the liability has been definite during the taxable year. A book credit will not, however, convert an otherwise indefinite liability into a proper incurred expense.

Another variation exists where the total bonus is authorized but the allocation among employees is not fixed in the taxable year. Thus, in one

14. Id. at 942.
case, employees were hired on the agreement that they would receive a bonus over and above their basic salaries. The board of directors, by resolution in the taxable year, set up a reserve in a fixed amount, to be allocated later. In the following year, a resolution was passed setting the date of the distribution and allocating the bonuses. The court held that the amount reserved was a proper accrual for the taxable year. It said that the liability was definite, because the employees as a class had an enforceable claim.

Another factual variation exists where formal action was taken by a board of directors in 1939. The resolution fixed the salary of the president of the corporation at $7,500 and that of the secretary at $1,800. Because of financial distress the president was paid only $2,500 and the secretary $600. The balance of the salaries was paid in 1941 and 1942. The court held that these additional sums could only be accrued in 1939 when the liability was definitely determined. The court emphasized that neither officer had waived his right to the full salary.

Suppose $18,000 per annum was authorized for each year and the president expressly waived $6,000 per year. Then in later years the directors authorized additional compensation to the extent of the amounts previously waived. Here the court permitted the accrual of these amounts in the later year on the theory that, because of the waiver, the original liability was modified and only the amounts paid in the former years were definite.

**Definite Amount**

We have seen that to constitute an incurred expense there must be definite liability. Under the definition there must also be a definite amount fixed. What facts constitute a fixed or definite amount are to be explored next.

Three brothers controlled a corporation. They were directors along with three employees who held a few shares of stock. Early in 1918, a resolution was passed authorizing bonuses for officers and heads of departments who were instrumental in achieving successful operations during the year; the amount of the bonus and its division were left to the discretion of the president. Before the end of the year, the three brothers met informally and decided upon the men to whom the bonuses would be paid, and the amount to be paid each of them for that year. No memorandum was made with respect to these bonuses until the president of the

15. Willoughby Camera Stores Inc. v. Commissioner, 125 F.2d 607 (2d Cir. 1942).
17. Skinner Mfg. Co. v. United States, 80 Ct. Cl. 137, 8 F. Supp. 741 (1934). This case did not involve a close corporation or the question of constructive receipt by an officer. This phase will be discussed pp. 663-67 infra.
18. See note 6 supra.
corporation in March of the following year gave the bookkeeper a list of the bonuses. The book entries were then made as of 1918, before making the closing entries for that year. The court held that the bonuses were not determined in a sufficiently definite amount during the taxable year to permit their deduction. It assumed that the brothers had authority to bind the corporation, but had not committed themselves to the employees in any definite amount. It concluded:

"There was lacking that definiteness which under familiar principles of the law of contract fixed the legal liability of the corporation, at least in any such amount as was afterwards allowed."  

The importance of precise determination of the amount in the taxable year of the amount of compensation is illustrated by the case of *Fourth Avenue Amusement Co. v. Glenn.* In this case, the directors in 1923 passed a resolution providing that the president and secretary-treasurer should receive, in addition to fixed salaries, a bonus of 5 per cent of the net profits of the company for the year 1923 and each year following, "provided the earnings are sufficient to first take care of the regular dividend of 20%." The bonus was paid from 1923 through 1930. In 1931 through 1935 there were no net profits and no bonuses were paid. In 1936 the officers were re-elected for the following year at the same salary but without reference to the bonus. Later in the year a bond issue was authorized which provided that until the principal and interest were paid in full, no dividends should be declared, and that "the salaries of the officers shall not be increased over and above the amounts allowed to them as of April 15, 1936." In 1937 the officers were re-elected at the same salary "plus the regular bonus which bonus will not be paid however until after the bonds and accruing interest had been retired in full." The company made substantial profits during 1936, 1937 and 1938. It employed the accrual method of accounting, but no bonuses were paid nor any book entry made accruing the bonus. The bonds were paid off in 1939, but differences arose as to the computations of the bonus arrearages because of an unsettled tax deficiency and a damage suit arising in that year. Part payment on the arrearages was made in 1939 and then in 1940. After everything was settled, the directors definitely acknowledged the corporation's indebtedness, and authorized the payment of the bonus arrearages. The bonuses were then deducted in 1940. The court upheld the 1940 deduction on the grounds that: (1) accruing a legal liability for the bonuses before that year would be in violation of the bond provisions; (2) recognition of an indefinite amount after the bonds were paid would be inadequate; and (3) a definite liability was not incurred until the

20. Id. at 876.
21. 201 F.2d 600 (6th Cir. 1953).
amount was fixed in 1940. It is important to note in this case that the corporation accountant testified that the consistent practice of the directors was to wait until after the annual audit and then award the bonus in a specific amount. Then a book entry was made as of the year following the year in which the profit was earned. Since the amount of the bonus was not fixed in the taxable year, no credit on the books could later validate an accrual.

However, where formal action during the year authorizes a bonus of a percentage of net profits in excess of that earned for the previous year, the fact that the bonus was recomputed and additional amounts paid in a later year would not permit their deduction in the later year. The reason for this rule is that the amount of the obligation was capable of definite and accurate ascertainment during the years earned.22 The fact that errors were made in the calculations did not detract from this conclusion.

The Tax Court has reviewed some particular factual situations in this connection. In the case of E. B. & A. C. Whiting Co.23 the president, director and treasurer owned a majority of the stock. In May 1943, the directors voted their hard-working president a bonus “up to but not to exceed $50,000” to be paid “at such time as in the discretion of the Treasurer the finances of the corporation will permit.” The 1942 fiscal year ended on May 31, 1943, and the bonus was paid in September, November and December of 1943. No accrual entry was made on the books until payment was made. The court held that since no determination of the amount was made in the fiscal year 1942, and since the finances did not permit the determination in that year, the liability was contingent. If paid in the 1943 fiscal year, the court implied that it would have been deductible as an expense paid in that year.

In the case of Federal Mach. & Welder Co.24 it was agreed that bonuses would be fixed by the board after the audit at the close of the prior year. The court determined that the bonuses based on the 1940 profit, but paid in 1941, were deductible in 1941; and that bonuses based on 1941 profits, but paid in 1942, were deductible in 1942.

The question arises as to whether ratification of compensation subsequent to the taxable year is effective to form the basis of a deduction by the corporate taxpayer. The case of Helvering v. J. L. Brandeis and Sons25 is generally considered as authority for this procedure. In that case the president owned one-fifth of the stock; the vice-president four-fifths. In 1922, a resolution of the board of directors provided for a regular

22. American Snuff Co. v. Commissioner, 93 F.2d 201 (6th Cir. 1937).
23. 10 T.C. 102 (1948).
24. 11 T.C. 952 (1948), aff'd per curiam, 184 F.2d 843 (6th Cir. 1950).
25. 75 F.2d 487 (8th Cir. 1935).
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salary for the president of $60,000 per year for the years 1923 to 1927 inclusive. A sum of $200,000 in the nature of a bonus to the president for the same period, to be paid at the end of the fiscal year ending January 31, 1927, was also voted in that resolution. The salary was paid but the bonus was not. The managing officers of the corporation ordered credit and payment to the president of $80,000 in additional salary for the fiscal year ending January 31, 1928. The credit was entered in the books for that fiscal year and the amount was paid. The corporation listed the $80,000 as a deduction on its return for the tax year ending January 31, 1928.

On June 18, 1928—after the close of the fiscal year in which the $80,000 had been entered on the books and paid—the board of directors resolved, with the consent of the president, that the $200,000 bonus voted in the 1922 resolution would be formally discharged and cancelled. It was further resolved that the act of the officers in crediting and paying the $80,000 during the fiscal year ending January 31, 1928, was expressly approved and ratified.

The Commissioner disallowed the deduction on the ground that it represented an adjustment and reduction of the $200,000 bonus voted but unpaid for the years 1923 through 1927. The $80,000, therefore, was not properly an expense accrued in fiscal year 1928 but a payment of an expense accrued from 1923 through 1927. The Commissioner argued that it should have been pro-rated over that five-year period so that the maximum deduction in the tax year in question should have been only $16,000.

The court rejected the contention of the Commissioner. It considered the agreement to pay the $200,000 as cancelled in its entirety by the resolution of June 18, 1928. The only question remaining, therefore, was whether the $80,000 entry and payment, having been made by the officers without authority, could properly be considered an expense incurred and paid by the corporation during the fiscal year ending January 31, 1928. The court held that it could be so considered since the ratification of that act by the resolution of June 18, 1928 related back so as to make the act authorized as of the time it was performed. The result was that the $80,000 was an expense incurred and paid by the corporation during the tax year for which the deduction was claimed, and the deduction should have been allowed.

Receipt, Actual or Constructive

The question of constructive receipt of compensation by a stockholder-officer and its relation to the deduction by the corporation needs re-

26. Id. at 488-89.
examination from the point of view of varying factual situations prevalent in close corporations. But first a word about the doctrine itself.

In the first place, the doctrine is not properly applied to an officer-stockholder on an accrual basis, since income is accrued when the right thereto is fixed and determinable. But where the officer is on a cash basis, the principle is generally stated that sums constitute income when they are unqualifiedly available and subject to the demand of the taxpayer. A cash-basis taxpayer ordinarily reports income when actually received, but the principle of constructive receipt is invoked to require inclusion when the money is readily available. The application of the principle would seem easy except that the old Treasury Regulations approved by court decisions have engrafted other requirements. These old Regulations not only require availability and control, but they also indicate that something more is required:

"To constitute receipt in such a case the income must be credited or set apart to the taxpayer without any substantial limitation or restriction as to time or manner of payment or condition upon which payment is to be made, and must be made available to him so that it may be drawn at any time, and its receipt brought within his own control and disposition."27

Under this Regulation the facts in the leading case of Eckhard v. Commissioner28 must be analyzed carefully. This case is said to uphold the principle that even though a taxpayer's salary has been authorized by a corporation controlled by him, and even though he could have caused the corporation to pay the salary at any time, the income is not constructively received in the absence of any credits established on the corporation's books.29 An examination of the facts of this case, however, reveals that the deficiency assessed against the individual officer was for income taxes for the year 1943, when, upon dissolution in that year, he was paid a sum of money as compensation for prior years. When the taxpayer had entered the business in 1941, he was given a contract whereby he was to purchase 50 of the 147 shares of the corporation immediately, and the remaining 97 shares later. The contract also provided for payment of a basic salary and 100 per cent of the profits, after deduction of dividends and other reserves. The taxpayer did not draw his extra remuneration. He did not purchase the remaining stock and become a controlling stockholder until January 1943. One month later the additional compensation was paid to him and the corporation dissolved. The Tax Court decided that, since prior to 1943 no book credit was made which permitted pay-

28. 182 F.2d 547 (10th Cir. 1950), affirming on this point 12 T.C. 384 (1949).
ment without restriction, the taxpayer could not have constructively received it prior to its receipt in 1943. The Tax Court held that the doctrine of constructive receipt was to be applied sparingly; that a book credit had to be present before the doctrine could be applied. Despite the fact that a contract had been entered into (thus incurring the compensation liability), and despite the fact that the corporation had net profits and an ample surplus during the intervening years, still there was no constructive receipt by the taxpayer, because there was no book credit. The court of appeals while reversing on other grounds agreed that the law of the case was as follows:

"Salaries authorized by a corporation, to be paid to its officers and credited on its books or unqualifiedly set apart to the account of such officers, constitutes payment by the corporation and constructive receipt by the officer within the meaning of the Regulations. Ross v. Commissioner, . . . 169 F.2d 433. See also Weil v. Commissioner, . . . 173 F.2d 805. But mere authorization of the amount of salary or compensation to be drawn by an officer of the corporation does not constitute payment or constructive receipt, even though the officer may, at all times, have the power to effect the payment of such salary or compensation in virtue of his control of the corporation. Hyland v. Commissioner, . . . 175 F.2d 422."

The last sentence quoted was pure dicta. It is not authority where the stockholder-officer has voting control, because the taxpayer had no such control prior to 1943.

The case cited by the court, Hyland v. Commissioner, had a different background. Here there was a controlling stockholder of a personal service corporation. On December 23, 1942, the board of directors voted to pay him $40,000 for his services for the fiscal year ending January 31, 1943. No time was set for such payment. After the end of the fiscal year, closing entries were made including the credit accrual of $40,000. The sum was paid on March 6, 1943. The taxpayer did not include the bonus in his 1942 return. There was insufficient cash on hand in December 1942 to pay the bonus although there were ample current assets to accomplish payment without financial embarrassment to the corporation. The court upheld the assessment of a deficiency on the individual income tax return for 1943, and rejected the taxpayer's contention that he had constructively received the compensation in 1942 because of his control over the corporation. The court upheld the principle that the doctrine of constructive receipt could be used for the taxpayer, as well as against him. Significantly, the court also said that, but for the factor of the taxpayer's control of the corporation, there would be no question about the income being taxable in 1943, when it was actually received. In discussing the doctrine of constructive receipt the court stated that it was a creature
of the Treasury Regulations. Citing the Regulation, the court noted that a book entry indicates an absolute transfer from one account to another. But if such entry merely represents a contingent action by the corporation so that no right in the employee to draw on the sum is in fact created, the doctrine of constructive receipt will not apply. The court said:

"The mere authorization of the amount of salary does not satisfy the requirement that income be credited or set apart or made available to the taxpayer so that it may be drawn at any time. Cf. Avery v. Commissioner, 292 U.S. 210, 215. . . .

". . . . The argument that the rule of constructive receipt becomes applicable with the mere possession of such power, without any indication of an intent to exercise it, proves too much. It would mean that in every close corporation the corporate earnings are immediately constructively received by the controlling stockholder provided their withdrawal would not make the corporation insolvent. But the law ordinarily treats a corporation and its controlling stockholder as separate juristic persons, and they are separately taxable. Whether the Treasury—in the absence of evidence that the corporate form was adopted to avoid taxes could successfully invoke the constructive receipt doctrine against the sole stockholder of a one-man corporation we are not called upon to say. However that may be, we think that where, as here, the controlling stockholder treats himself as a creditor and the corporation as his debtor, he must, if he invokes the doctrine of constructive receipt, prove that the requirements of the Regulations have been satisfied."

A converse example is found in the situation where dividends were declared, and dividend checks written out to two stockholders. One of the checks was cashed but the other was not. There was no corporate restriction, but the petitioning taxpayer demanded that his check be mailed to him and thus be reported in the following year. The Tax Court held he had constructively received the income in the year that it was made available to him by corporate action. His own act alone prevented its receipt.

Now let us take a case where corporate action specifies the date when the bonus is payable, but there are no book entries until after the end of the year. This is the case of Cooney v. Commissioner. The petitioners in this case were brothers who owned an equal amount of stock in the corporation and were two of the three directors. In January 1947, the directors voted the petitioners a bonus of 10 per cent of the net profits for that year. In December 1947, a directors' resolution recited that the net profits could not be exactly determined until after the close of the year, but they resolved that during the month of December each of the petitioners should be paid $10,000 on account of their bonuses and that the balance should be paid after audit. The petitioners alone were authorized to sign checks and the corporation had ample funds to pay the

32. Id. at 423-24.
33. Kunze v. Commissioner, 19 T.C. 29 (1952), aff'd per curiam, 203 F.2d 957 (2d Cir. 1953).
34. 18 T.C. 883 (1952).
bonuses of $10,000 each during December 1947. These sums were paid on January 9, 1948. The exact amount of bonuses was determined February 25, 1948, when it was accrued on the books. The balance of the bonuses was paid periodically during 1948. The court here disregarded the failure to make a book entry within the taxable year since the board of directors had vested in petitioners the unrestricted right to the bonuses of $10,000 during 1947. The court said:

"This is not a situation where, as petitioners argue, their constructive receipt of the funds depended upon book entries showing the amounts set aside or credited to them in the corporation's books. The December 2 resolution was in itself sufficient to vest in petitioners a complete and unqualified right to the present use and enjoyment of the funds. Its very purpose was to make $10,000 of their bonuses available to them in 1947, before the final determination of the exact amount of the corporation's profits for that year. It stands to reason that if any further corporate action had been deemed necessary to carry out that purpose it would have been taken."

Some of the criteria to be applied in determining whether the stockholder has constructively received the income are set forth as follows:

"... an employee on the cash receipts basis has sufficiently realized income if he has acquired an unconditional right to be paid for his services, if the employer is solvent when this right is acquired, if payment would have been made in the absence of an anticipatory arrangement which deferred payment, and if the employer did not require the deferment because of some genuine business purpose."

The conclusion to be drawn from this discussion is that compensation is constructively received by a cash-basis taxpayer when corporate authority unconditionally authorizes a determinable amount to be paid at a particular time, irrespective of book credits required by the Regulations. However, if authorization is had, setting the same apart can be had by a book credit if no set time for payment was fixed. Lacking either a fixed time for payment or a book credit, the doctrine of constructive receipt would not apply; only actual payment and receipt would give rise to taxation of the recipient.

**INTERDEPENDENCY OF DEDUCTION AND TAXATION OF RECIPIENT**

The question of the interdependency of the deduction and the taxation of the recipient is primarily controlled by Internal Revenue Code section 267.37

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35. Id. at 885-86.
37. Int. Rev. Code of 1954, § 267 provides:

"(a) Deductions Disallowed.—No deduction shall be allowed—"

"... . . ."

"(2) Unpaid Expenses and Interest.—In respect of expenses, otherwise deductible under section 162 or 212, or of interest, otherwise deductible under section 163,—"

"(A) If within the period consisting of the taxable year of the taxpayer and 2½ months
Constructive Ownership

Under the conditions prescribed by this Code section, the deduction is allowed unless the payor and the payee are persons having a relationship after the close thereof (i) such expenses or interest are not paid, and (ii) the amount thereof is not includible in the gross income of the person to whom the payment is to be made; and

"(B) If, by reason of the method of accounting of the person to whom the payment is to be made, the amount thereof is not, unless paid, includible in the gross income of such person for the taxable year in which or with which the taxable year of the taxpayer ends; and

"(C) If, at the close of the taxable year of the taxpayer or at any time within 2½ months thereafter, both the taxpayer and the person to whom the payment is to be made are persons specified within any one of the paragraphs of subsection (b).

"(b) RELATIONSHIPS.—The persons referred to in subsection (a) are:

"(1) Members of a family, as defined in subsection (c) (4);

"(2) An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;

"(3) Two corporations more than 50 percent in value of the outstanding stock of each of which is owned, directly or indirectly, by or for the same individual, if either one of such corporations, with respect to the taxable year of the corporation preceding the date of the sale or exchange was, under the law applicable to such taxable year, a personal holding company or a foreign personal holding company;

"(4) A grantor and a fiduciary of any trust;

"(5) A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;

"(6) A fiduciary of a trust and a beneficiary of such trust;

"(7) A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;

"(8) A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is grantor of the trust; or

"(9) A person and an organization to which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual.

"(c) CONSTRUCTIVE OWNERSHIP OF STOCK.—For purposes of determining, in applying subsection (b), the ownership of stock—

"(1) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners or beneficiaries;

"(2) An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family;

"(3) An individual owning (otherwise than by the application of paragraph (2)) any stock in a corporation shall be considered as owning the stock owned, directly or indirectly, by or for his partner;

"(4) The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants; and

"(5) Stock constructively owned by a person by reason of the application of paragraph (1) shall for the purpose of applying paragraph (1), (2), or (3), be treated as actually owned by such person, but stock constructively owned by an individual by reason of the application of paragraph (2) or (3) shall not be treated as owned by him for the purpose of again applying either of such paragraphs in order to make another the constructive owner of such stock."
specified in section 267(b). This Code section applies, for example, to any corporation and a stockholder where he and his family own more than 50 per cent in value of the outstanding stock. It does not apply to two or more persons who are unrelated but none of whom own over 50 per cent in value of the stock either actually or by virtue of constructive ownership of stock held by related parties. By virtue of section 267(c)(5), however, there cannot be a tacking on in applying the constructive ownership test. Thus if all the stock of corporation X is owned 5 per cent by A, 20 per cent by B his brother, 50 per cent by W his wife, and 25 per cent by P an unrelated person, both A and W would be considered as owning more than 50 per cent. A would constructively own the stock of W and B in addition to his own, or 75 per cent. Actually W owns 50 per cent but the rule will not tack on the stock of B already considered constructively owned by A, but will include the 5 per cent of A which he actually owned. In this example B could not be considered as constructive owner of any stock other than the 5 per cent of A.39

The purpose of this statute was to prevent manipulation by closely-held corporations with respect to deductions by the corporation that should be current income to the stockholders. The Joint Committee on Tax Evasion and Avoidance of the 75th Congress found that corporations on an accrual basis would accrue such expenses as compensation payable to its controlling stockholder. The stockholder, being on a cash basis, would not receive the compensation until a later year when he had losses to offset the tax; or the compensation would never be paid and hence no income tax.39

Time of Payment Under the Old Code

The difficulty arises where payment is not in fact made within the taxable year or within the two and one-half months after its close. The Treasury Department will take the position that the expense was accruable in one year as an incurred liability but disallowed as not paid until a later year; and not deductible in the later year as properly accrued in the former year.40

So far as our immediate question is concerned, the changes made by the Revenue Act of 1954 affected only constructive ownership of stock between trusts and exempt organizations in which an individual has an interest. See H.R. Rep. No. 1337, 83d Cong., 2d Sess. 32 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 35 (1954).


The difficulty with this code section is due to its negative wording. Prior to the Technical Changes Act of 1953, it read:

"Unpaid Expenses and Interest. In computing net income no deduction shall be allowed under section 23(a) relating to expenses incurred or under section 23(b) relating to interest accrued—

"(1) If such expenses or interest are not paid within the taxable year or within two and one-half months after the close thereof. . . .

"(2) If, by reason of the method of accounting of the person to whom the payment is to be made, the amount thereof is not, unless paid, includible in the gross income of such person for the taxable year in which or with which the taxable year of the taxpayer ends. . . ."41

The Act of 1953 changed sub-paragraph (1) to read:

"(1) If within the period consisting of the taxable year of the taxpayer and two and one-half months after the close thereof (A) such expenses or interest are not paid, and (B) the amount thereof is not includible in the gross income of the person to whom the payment is to be made. . . ."42

The professed reason for the addition to subparagraph (1) was that the 1939 Code disallowed the deduction if there was no actual payment within the taxable year or the two and one-half month period following it, irrespective of the fact that the stockholder was considered as having constructively received the income.43

Under the Code, disallowance of deductions is limited to cases where all the prescribed conditions exist.44 In the Platt case, decided under the Code as it existed prior to the 1953 amendment the corporation and stockholder had calendar years as their taxable years. The former reported its income on the accrual basis; the latter on the cash basis. The salaries were voted and accrued on the books during the calendar year. Part of the salaries was paid during the calendar year and a negotiable note for the balance given the following year. Each of the officer stockholders reported the full salary in his return for the calendar year in which the salaries were accrued. There was no question that the appro-

44. Anthony P. Miller, Inc. v. Commissioner, 164 F.2d 268 (3d Cir. 1947), cert. denied, 333 U.S. 861 (1948); Musselman Hub-Brake Co. v. Commissioner, 139 F.2d 65 (6th Cir. 1943); Platt Trailer Co., 23 T.C. 1065 (1955).
45. Platt Trailer Co., supra note 44.
appropriate relationship was present, so that this condition was fulfilled. There was no evidence to show that the notes had been delivered within the first two and one half months of the following year. Since payment had not been made, condition (1) for disallowance was present. The court found that the salaries had been unconditionally credited in the current calendar year and were, therefore, includible in the gross incomes of the taxpayer-recipients and taxable as constructively received. Thus condition (2) of the old Code was not present. Since one of the conditions was not present, the court held that the deduction was allowed.

**Time of Payment Under the Present Code**

The 1953 amendment prescribed another condition so that if the compensation is constructive income within the two and one-half month period then the deduction is allowable. Under the Code since 1953 a deduction is denied only where all of the following requirements are met in addition to the requisite relationship: (a) compensation is neither paid nor taxable income to the recipient during the period comprising the corporate year and two and one-half months after the close thereof; (b) the amount is not taxable to the recipient actually or constructively during the taxable year of the recipient in which or with which the corporate tax year ends. Take, for example, an accrual-basis corporation with a calendar year as its taxable year. A controlling stockholder is on the cash basis and also has a calendar year as his tax year. Before the end of the calendar year the board of directors votes additional compensation for the year payable in January. In January, salaries payable are credited by the auditors, but the controlling stockholder fails to sign a check and gets his money until April. Condition (a) above is not present, because, although not paid, the income was constructively received in January. Condition (b) is present, since the income was not constructively received until payment was unrestricted. Because condition (a) is not present the deduction would be allowed. If, however, the resolution of the board of directors had provided for immediate payment and the book entry had been made in the calendar year, condition (b) would not be fulfilled, since the compensation was constructively received in the calendar year. If the resolution had provided that the compensation was to be paid out of earnings for the current year but not until April of the following year, it can be said that a fixed determinable liability was incurred, and therefore there was a deductible expense. However, all of the conditions are present to disallow the deduction under section 267.

The case of *Lincoln Storage Warehouses v. Commissioner* adds another factor for consideration. A New Jersey corporation was on the accrual basis and its taxable year was the calendar year. Its sole stock-
holder was on a cash and calendar year basis. A running account of rent, interest, and compensation due the stockholder built up over several years and was credited each year on the corporate books. No payments were made on these accounts. In 1943 and 1944 the books were again credited for current liabilities to the stockholder. At this time payments were made, but the company credited the payments first to the latest liabilities, that is, to the debts owed the stockholder for 1943 and 1944, and then to prior debts. The actual payments were in excess of the liability accrued before 1943.

The court, applying New Jersey law, held that the payments should properly be credited first to the earliest debts and then to the liability of 1943 and 1944. This being so, all the debts accrued in the last two years were not actually paid in each taxable year or within two and one half months following. Only the excess over credits for prior years was paid within the statutory period. Therefore the court held that the facts brought the case squarely within section 24 of the 1939 Code and the deduction must be disallowed except as to the excess.

Payments must be made in strict accordance with the Code. In the case of Eugene Ashe Elec. Co. v. Commissioner, a salary of $15,000 was voted by the directors in March 1940 for the current year; $2,600 paid during the year, the balance credited on the books. The stockholder had the sole authority to draw checks, but no payment was made within the two and one-half months. The court disallowed the deduction under the old statute. Apparently there was no credit on the books during the taxable year so as to constitute constructive receipt under the second condition of the old Code. The court held that the taxpayer must bring itself within the strict terms of the statute, and constructive payment would not suffice.

The 1953 amendment was intended to allow this deduction where credit is made during the two and one-half month period, because, although not in fact paid within the time allowed, it would be constructively received if credited. Hence the 1953 addition to the first condition would not be present. With one of the conditions not present the deduction would be allowed. In the case of L. R. McKee, the book entry was made after the end of the year but within the two and one-half month period. It was held not deductible under the Code prior to the 1953 amendment. But after that amendment it would be includible in the gross income of the payee during the two and one-half month period after the close of the taxable year of the corporation and within the terms of the 1953 amendment. Since the first condition under the 1953 amendment would not be present, the deduction would be allowed.

47. 153 F.2d 295 (5th Cir. 1946).
48. 18 T.C. 512 (1952).
It is interesting to note that the second condition requires inclusion in income during the year of the individual in which or with which the corporate year ends. Thus this condition would be present where both the corporation and individual were on a calendar year basis and no credit is made during the corporate year. However, if the corporation had been on a fiscal year basis ending September 30th or earlier and the individual on a calendar year basis, and credit was made within two and one-half months after the end of such year, it would constitute income during that calendar year. Neither the first or second condition would be present and the deduction would, therefore, be allowed. No practical problem should arise regardless of the time when the corporate year ends under the 1953 amendment, so long as there is constructive receipt of income in the corporate year or two and one-half months thereafter. If the addition to the first condition added by the 1953 act is not present, the deduction is allowed irrespective of the second condition.

Finally, it should be noted that when faced with a disallowance under section 267 the corporation counsel will re-examine the facts relating to the question whether the liability was in fact incurred during that year under the principles set forth in the first part of this article. It may still be deductible in the year when paid even if it distorts net income over the years involved. Of course, the return for the prior year indicates that the liability was incurred for that year but on the basis of the facts that may be a mistake of law. Care should be had, therefore, to assemble, properly appraise and effectively present the facts.

CONCLUSION

In the closely-held corporation the Treasury audit will not only scrutinize the reasonableness of compensation paid to stockholders but will examine the checks paid by the corporation and their cancellation to see whether payment was made when it was purported to be. What transpired at a directors' meeting, if any, according to records or otherwise is also of material concern. And it is important that the factual transactions are completely in accord with the principles permitting the deduction.

To be deductible under section 162(a), whether the compensation was paid or incurred, there must be an obligation upon the corporate taxpayer which is legally binding. For such a liability to exist the liability must be definitely determinable by events transpiring before the end of the taxable year. That does not mean that the exact compensation be determined, but only that events have occurred which fix the fact of liability and the means for ascertaining a fixed amount. A corporate resolution or contract

duly entered into will generally be essential. The corporate action must not be subject to conditions subsequent which may destroy the liability. Next, the amount must be a fixed and a definite amount determinable by events transpiring before the end of the taxable year. A bonus formula established during the year will qualify if the amount is fixed by the profits or other base during the year, although computation would be required after the end of the year. Any action taken which makes uncertain or contingent the amount payable will destroy the fixed liability. Fixing the amount after the end of the year will not relate back to incur a legal obligation during the year.

By the doctrine of constructive receipt, a cash-basis taxpayer is held to have taxable income prior to actual receipt when it is unqualifiedly available and subject to his demand. Whether a book credit is required, or whether it is sufficient that other circumstances, such as control of the corporation, will bring the doctrine into play, is questionable. Of course, the taxpayer cannot defer to a later year what was readily available in a prior year.

Having determined that the compensation has been incurred and having fixed the time at which it is taxable income to the recipient, the disallowance provisions of section 267 come into play. If all the conditions are present the deduction will be denied. Conversely, if any one of the conditions is not present, the deduction will be allowed. If the 50 per cent stock ownership condition is not present by virtue of actual or constructive ownership, it is not necessary to examine the other conditions. The condition requiring the inclusion of the compensation in the income of the individual for the taxable year in which or with which the corporate year ends will generally come into play only where constructive receipt exists. In the absence of such receipt, therefore, that requirement will not be present. The final condition will generally be present only where neither payment nor constructive receipt exists during the corporate year or the two and one-half months following the close of the corporate year.

Perhaps managers of close corporations will see to it that actual events transpire to prevent the disallowance of deductions which are lost forever when untimely payment is made on account of a liability in fact incurred in a prior year.