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Taxation - Federal Income Tax - Contract Right Income to Cash Method Taxpayer Who Refused Cash Offer

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TAXATION—FEDERAL INCOME TAX—CONTRACT RIGHT INCOME TO CASH METHOD TAXPAYER WHO REFUSED CASH OFFER—During 1951 petitioner, a cash method taxpayer, executed a mineral lease. As part of the consideration petitioner was to receive an unconditional bonus or advance royalty of fixed amount. The lessee was ready, able and willing to pay the entire amount on execution, but at petitioner's request the contract provided for a small payment on execution with one-half the balance due on January 5th of each of the next two years. About one month before each due date the contract rights were discounted at a bank of which petitioner was a director. The lessee remained ready, able and willing to make full payment of the unpaid portion at all times after execution. Respondent Commissioner assessed a deficiency because petitioner had not included the discounted value of the future payments in his gross income for 1951. In a Tax Court proceeding, *held,* for respondent, two judges dissenting. Where a cash offer is refused, if the unconditional contract right actually received is readily and immediately convertible to cash, its face amount is taxable income to a cash method taxpayer in the year of execution. *Frank Cowden, Sr.,* 32 T.C. No. 73 (1959).

The outstanding advantage of the cash receipts and disbursements method of accounting is its simplicity, but income so computed may vary materially from that calculated under the accrual method. Property and cash actually received are income under either method. Rights to receive future payments are normally income under the accrual method, but are income under the cash method only when they have a fair market value and thus are the "equivalent of cash."[1] If a contract right is not the equivalent of cash when created, courts may still find "constructive receipt"[2] at some time prior to actual payment and hold that the cash method taxpayer has realized income even though he has received neither cash, property, nor contractual rights with fair market value. The two doctrines emphasize different factors.[3] Cash equivalent deals with one aspect of the general problem of *what* non-cash benefits constitute income. Contract rights with fair market value are treated like property and taxed when received. Constructive receipt is a fiction which determines *when* certain income is realized[4] and is applicable only to cash method taxpayers.[5] In essence, the doctrine of constructive receipt regards income which is unqualifiedly available to a cash method taxpayer as though it had been received at the time it became available.[6] The time of actual receipt is irrelevant. The doctrine does not appear in the code and for many years it was strictly limited[7] to situations where there was unfettered command[8] but not actual possession, or where

1 See, generally, 2 MERTENS, LAW OF FEDERAL INCOME TAXATION, c. 11 (1955). There is an established market for negotiable instruments and they normally qualify as the equivalent of cash.

2 See, generally, 2 MERTENS, LAW OF FEDERAL INCOME TAXATION, c. 10 (1955); comment, 45 ILL. L. REV. 77 (1950); Zarky, "Problems in Constructive Receipt and Deferral of Income," PROC. N.Y.U. 13TH ANNUAL INSTITUTE ON FEDERAL TAXATION 53 (1955).

3 But both serve to limit the extent to which the cash method results in postponing the realization of income. "The doctrine of constructive receipt was, no doubt, conceived by the Treasury in order to prevent a taxpayer from choosing the year in which to return income merely by choosing the year in which to reduce it to possession." Justice Frankfurter in Ross v. Commissioner, (1st Cir. 1948) 169 F. (2d) 483 at 491.

4 I.R.C., §451 (a) gives the general rule as the year in which received, unless the taxpayer's accounting method requires another period. But see Automobile Club of Michigan v. Commissioner, 353 U.S. 180 (1957). Note that a decision not to apply the doctrine may determine whether certain income will ever be realized, as when a contract right later becomes partially uncollectible.

5 Harbor Plywood Corp. v. Commissioner, 14 T.C. 158 (1950), affd. (9th Cir. 1951) 187 F. (2d) 734.

6 Ross v. Commissioner, note 3 supra, at 490. See George W. Drysdale, 32 T.C. 378 (1959). Cf. Treas. Reg. §1.451-2.

7 See, e.g., Alice H. Moran, 26 B.T.A. 1154 (1932), affd. (1st Cir. 1933) 67 F. (2d) 601. The doctrine was substantially broadened in 1948 when it was held to be a rule of law and thus available to the taxpayer as a defense in the year of actual payment, even though the statute of limitations prevents taxation in the year the income was constructively received. Ross v. Commissioner, note 3 supra.

8 "The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his own income whether he sees fit to enjoy it or not." Justice Holmes in Corliss v. Bowers, 281 U.S. 376 at 378 (1930). Although this case was decided under what is now §676, this language is often referred to in constructive receipt cases. E.g., Loose v. United States, (8th Cir. 1934) 74 F. (2d) 147.

the taxpayer turned his back[9] on income to which he had a present legal right. A frequently-cited example where the court found "an unrestricted right to demand payment" involved a taxpayer who failed to clip and cash matured interest coupons.[10] Constructive receipt was not applied in cases like the instant one, where the taxpayer did not have an existing right to the money when the cash offer was made.[11] Apparently this is recognized by the majority in the principal case, since they do not mention constructive receipt. The court does find that ". . . here the bonus payments were not only readily but immediately convertible to and were the equivalent of cash and for that reason had a fair market value in their face amounts." The court thus assumes that they have a fair market value because they are readily convertible to cash. But the fact that a promise to pay in the future can be converted into cash "by seeking out a purchaser and higgling with him on the basis of the particular transaction"[12] has not previously been grounds for holding that contractual rights have a fair market value. It was stipulated in the principal case that while the discounting bank had, over several years, acquired a number of such obligations in like manner, such transactions were not considered commonplace. And even if there were a commercial market for such rights in this area of Texas, these non-interest-bearing obligations would not be worth their face amount at execution. But the court ignores the discounted value determined by respondent and taxes their face amount. The chief emphasis of the court seems to be on the fact that taxpayer refused to enter into a contract calling for immediate cash payment. The cash offer may bear on the solvency of the promisor and thus on the value of the rights, but it is not relevant to the question whether there is a commercial market for such rights. If the court really wants to tax these rights under the doctrine of cash equivalent, the best rationalization would be to hold that the existence of a commercial market is unnecessary if the promisor provides a "one-buyer market" by remaining willing and able to pay cash after execution of the deferred payment contract.[13] However, if the crucial fact is that Mr. Cowden "turned his back" on a cash offer, the court is really extending[14] the doctrine of

[9] Hamilton Nat. Bank of Chattanooga, 29 B.T.A. 63 at 67 (1933) (holder of promissory note refused to accept early payment when maker had right to pay before due date).

[10] Loose v. United States, note 8 supra.

[11] Richards' Estate v. Commissioner, (2d Cir. 1945) 150 F. (2d) 837 (no constructive receipt when offer in compromise of a judgment was accepted only on condition that a portion not be paid until a subsequent year). See J. D. Amend, 13 T.C. 178 (1949).

[12] Judge Learned Hand in Bedell v. Commissioner, (2d Cir. 1929) 30 F. (2d) 622 at 624.

[13] This "one-buyer market" would serve to effectuate the administrative purpose of minimizing disputes as to value and the practical consideration of insuring the taxpayer a method of obtaining cash to pay the tax for the year in which the contract rights are received.

[14] A bonus arrangement like that of the principal case was made five years earlier with other Cowdens residing in the same Texas town and there was no attempt to tax the contract right in the year of execution under either theory. R. B. Cowden, P-H T.C. Mem. Dec. ¶50,304 (1950), remanded for decision in accordance with agreement of parties (5th Cir. 1953) 202 F. (2d) 748.

constructive receipt rather than cash equivalent. This is the view taken by the dissent which concludes that ". . . this is a far reaching and dangerous extension of the doctrine of constructive receipt." That such extension is not unintentional is confirmed by another recent Tax Court decision in a case involving a Michigan taxpayer's attempt to defer compensation. In *George W. Drysdale*[15] the employment contract provided that the salary was to be paid directly to a trustee (who was a party to the contract) and to be unavailable to the cash method employee until he became 65 or retired. Before entering into this contract the employee refused an offer of direct payment with no apparent motive other than tax avoidance.[16] The court found constructive receipt,[17] emphasizing that the right was nonforfeitable and treating the trustee as an agent of the employee. The *result* in *Drysdale* is in accord with previous compensation cases involving a trust arrangement, but there was no precedent for finding constructive receipt where the taxpayer did not have unfettered control over the money and could not legally obtain it if he wanted to.[18]

Thus far rights to future payments arising under a land contract unaccompanied by a promissory note have seldom been taxed. Where such rights have been taxed, there has been a commercial market for them and the cash equivalent doctrine has been used.[19] Assuming the principal case is an extension of constructive receipt rather than cash equivalent, it is precedent for finding constructive receipt if a land vendor desiring periodic payments is unfortunate enough to be offered cash.[20] But making tax liability depend solely on whether taxpayer had the foresight to warn the promisor not to mention cash is a tenuous distinction which seems unlikely to endure. If, as in the principal case, the court continues to talk the language of cash equivalent where there is no established market, emphasizing that a cash deal was refused, then all contract rights should be held includible in income to the same extent as under the accrual method. The nature of the right received is exactly the same regardless of whether a cash offer

[15] 32 T.C. 378 (1959), now on appeal by taxpayer to the Court of Appeals for the Sixth Circuit.

[16] Cf. James F. Oates, 18 T.C. 570 (1952), affd. (7th Cir. 1953) 207 F. (2d) 711 (no constructive receipt on similar facts but without a trust arrangement; distinguished in Drysdale on presence of business motive).

[17] The court relied solely on Williams v. United States, (5th Cir. 1955) 219 F. (2d) 523, but the reported facts in that case are unclear as to whether the seller of timber became entitled to proceeds *before* he arranged escrow.

[18] The court mentioned but did not rely on E. T. Sproull, 16 T.C. 244 (1951), affd. (6th Cir. 1952) 194 F. (2d) 541 (on similar facts court found constructive receipt inapplicable, but taxed the amount paid into trust as an "economic or financial benefit conferred on the employee as compensation in the taxable year").

[19] Paul Haimovitz, P-H T.C. Mem. Dec. ¶56,015 (1956) ("these contracts for deeds had a fair market value and did readily pass from hand to hand in commercial dealings"). See also Clarence W. Ennis, 23 T.C. 799 (1955).

[20] If constructive receipt occurs when the cash offer is refused or at the moment of execution, the promisor's subsequent willingness to pay in advance should be irrelevant. However, a court could avoid taxing the land vendor on the contract right by emphasizing the presence of a business motive (interest) in deferring payment.

was first made and refused. On the other hand, if the court really means to expand constructive receipt (as *expressed* by *Drysdale*), then the offer is the crucial fact and it can be argued that a subsequent sale is not even essential to taxing the appreciation revealed by the cash offer.[21] Such extension of either doctrine is extremely unlikely, but is suggested to illustrate the logical difficulties engendered by the present distinction. Some inroads on the cash method were necessary to prevent undue tax avoidance, but a systematic attempt to eliminate any use of the method for this purpose will eventually result in equating cash receipts with accrued receipts. This would penalize those who use the method for its simplicity.[22] The extent to which mere contract rights should constitute income under the cash method would seem to be an appropriate area for congressional action. The present position of the Tax Court may well conflict with existing legislation, since Congress has expressly authorized the cash method[23] and the recognition of income when received.[24]

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[21] Regardless of subsequent actions, the offeree has "turned his back" on an opportunity to receive cash for the existing unrealized appreciation. However, such extension would be complicated by the requirement that direct taxes be apportioned, unless the unrealized appreciation is "income" as used in the Sixteenth Amendment.

[22] Their gross income might exceed but would seldom be less than under the accrual method, without the corresponding advantage of being able to deduct accrued expenses. "Constructive payments" are almost never allowed as deductions under the cash method. E.g., Vander Poel, Francis & Co. v. Commissioner, 8 T.C. 407 (1947) (cash method corporation not allowed to deduct salaries authorized but not actually paid, even though employees were required to report them as constructively received).

[23] I.R.C., §446 (c) (1). But see I.R.C., §446 (b) (if the method used does not clearly reflect income, a method which does may be required); Caldwell v. Commissioner, (2d Cir. 1953) 202 F. (2d) 112 ("clearly reflect" means with as much accuracy as standard accounting methods permit); Boynton v. Pedrick, (S.D. N.Y. 1954) 136 F. Supp. 888, affd. per curiam on other grounds (2d Cir. 1955) 228 F. (2d) 745 (where there is only one standard accounting practice, which overwhelmingly surpasses the cash method in accuracy, its use is required as a matter of law).

[24] See note 4 supra.