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Taxation -- Promissory Notes Held Not To Be Appropriate Form of "Payment" to Profit-Sharing Plan

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Taxation—Promissory Notes Held Not To Be Appropriate Form of "Payment" to Profit-Sharing Plan

Section 404(a) of the Internal Revenue Code[1] allows an employer to deduct on its tax return payments made to a qualified pension or profit-sharing plan, within limits as to the amount.[2] Under section 404(a)(6), this deduction is available if the liability is incurred within the taxable year and actual payment is made within the deadline for filing tax returns;[3] however, uncertainty has arisen as to what satisfies the "payment" requirement of this section of the Code. Recently the Seventh Circuit Court of Appeals, in *Don E. Williams Co. v. Commissioner*,[4] held that delivery of a secured, interest-bearing, demand promissory note within the period prescribed by statute to the trustees of a qualified employee profit-sharing plan established by a company did not entitle the company to a deduction for the contribution under the statute.[5]

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1. I.R.C. § 404(a) reads as follows:

> (a) **General Rule.**—If contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan, or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under section 162 (relating to trade or business expenses) or section 212 (relating to expenses for the production of income); but, if they satisfy the conditions of either of such sections, they shall be deductible under this section, subject, however, to . . . limitations as to the amounts deductible in any year.

2. The limits as to amount are set forth in I.R.C. § 404(a)(1) (pension trusts), § 404(a)(2) (employees' annuities) and § 404(a)(3) (stock bonus and profit-sharing trusts).

3. I.R.C. § 404(a)(6) provides as follows:

> (6) **Time when contributions deemed made.**—For purposes of paragraphs (1), (2), and (3), a taxpayer shall be deemed to have made a payment on the last day of the preceding taxable year if the payment is on account of such taxable year and is made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof).

Before 1974, I.R.C. § 404(a)(6) applied only to accrual basis taxpayers:

> (6) **Taxpayers on accrual basis.**—For purposes of paragraphs (1), (2), and (3), a taxpayer on the accrual basis shall be deemed to have made a payment on the last day of the year of accrual if the payment is on account of such taxable year and is made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof).

Int. Rev. Code of 1954, 68A Stat. 138, 141.

The change in the language of § 404(a)(6) was included in the Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. No. 93-406, 88 Stat. 829 (codified in scattered sections of 5, 18, 26, 29, 31, 42 U.S.C.). As a result, cash basis taxpayers are allowed the same grace period for making payment previously afforded only accrual basis taxpayers.

4. 527 F.2d 649 (7th Cir. 1975), *aff'd*, 45 U.S.L.W. 4160 (U.S. Feb. 22, 1977).

5. *Id.* at 653. *See generally* Brandis, *The Treatment Accorded Promissory Notes Under the Federal Income Tax*, 52 N.C.L. REV. 93 (1973).

For each of three taxable years[6] the Williams Company, an accrual basis taxpayer, had entered a liability on its books for contributions to the employee profit-sharing fund established by the company.[7] Instead of making payment in cash before expiration of the statutory grace period, the company in each of the three years delivered to the trustees a secured, interest-bearing demand note for the amount of the liability.[8] Collateral for the notes consisted of shares of stock in the company and interests of two of the shareholders of the plan.[9] The value of the collateral, it was stipulated, exceeded the face amount of the notes for each of the three taxable years;[10] nevertheless, the Seventh Circuit, affirming the Tax Court,[11] reasoned that the statute contemplates a form of "payment" more akin to cash than a promissory note and accordingly upheld the Commissioner's disallowance of the deduction.[12]

A primary source of authority utilized by the *Williams* court was a 1932 Supreme Court decision, *Eckert v. Burnet*,[13] which established conclusively that the issuance of a cash basis taxpayer's promissory note is not the equivalent of payment.[14] Thus, the issue presented to the court was whether, in light of *Eckert*, accrual basis taxpayers are to be distinguished from cash basis taxpayers with regard to promissory notes; the *Williams* court could find no such distinction. In arriving at this conclusion, the court cited a 1948 House Ways and Means Committee Report that stated, "[a]n employer on the accrual basis of accounting may under existing law deduct contributions *actually paid* within the first 60 days of the subsequent year."[15] The Committee's use of the phrase "actually paid" intimated a congressional intent to require a "liquid form of payment and not a promissory note . . . ."[16] On the basis of this legislative guidance, coupled with the absence of any language in the statute distinguishing cash and accrual basis taxpayers, *Williams* refused to follow the holdings of courts of

6. The taxable years involved were 1967, 1968 and 1969.
7. 527 F.2d at 650.
8. *Id.*
9. *Id.*
10. *Id.*
11. The Tax Court opinion is reported at 62 T.C. 166 (1974).
12. 527 F.2d at 651.
13. 283 U.S. 140 (1931).
14. *Id.* at 141.
15. 527 F.2d at 651 (quoting H.R. REP. No. 2087, 80th Cong., 2d Sess. 13 (1948)) (emphasis in original).
16. *Id.*

appeals of three other circuits and ruled instead that promissory notes are not an acceptable form of payment.[17]

The controversy concerning the use of promissory notes as an acceptable medium of payment to pension and profit-sharing plans first arose in 1949 under the statutory predecessor[18] to section 404(a)(6). In *Logan Engineering Co.*[19] the Tax Court found that the issuance and delivery of negotiable, interest-bearing notes was not a sufficient mode of payment.[20] Since *Logan*, three federal courts of appeals have addressed the issue and all three have overruled the Tax Court's position.[21] The first reversals came in 1953 in the companion cases of *Sachs v. Commissioner* and *Slaymaker v. Commissioner*,[22] two cases with essentially identical fact patterns in which the taxpayers delivered a "negotiable demand note made payable at a bank to the trustee of its exempt employees' pension trust."[23] The Third Circuit accepted the promissory note as payment in *Slaymaker* because of undisputed evidence of the company's solvency; the court remanded the *Sachs* case for a factual determination by the Tax Court of whether that corporation was solvent.[24] In *Sachs* the court found that on the basis of cases interpreting another section of the Code[25] in which promissory notes were deemed adequate forms of payment, " 'payment' or 'paid' does not invariably mean 'in cash.' "[26] The court reasoned that negotiable notes are, under contemporary commercial law, very similar to checks, which are undoubtedly an acceptable form of payment.[27]

Undaunted by these reversals, the Tax Court held firm to its

17. *Id.* at 653.

18. Int. Rev. Code of 1939, ch. 1, § 23(p)(1), 53 Stat. 15, *as amended by* Revenue Act of 1942, Pub. L. No. 77-753, 56 Stat. 865 (similar provisions now contained in I.R.C. § 404(a)).

19. 12 T.C. 860 (1949).

20. *Id.* at 868.

21. Wasatch Chem. Co. v. Commissioner, 313 F.2d 843 (10th Cir. 1963); Time Oil Co. v. Commissioner, 258 F.2d 237 (9th Cir. 1958); Sachs v. Commissioner, 208 F.2d 313 (3d Cir. 1953). Additionally, two federal district courts have reached similar conclusions: Advance Constr. Co. v. United States, 356 F. Supp. 1267 (N.D. Ill. 1972); Steele Wholesale Builders Supply Co. v. United States, 226 F. Supp. 82 (N.D. Tex. 1963).

22. The two cases were combined and the decision for both is reported at 208 F.2d 313 (3d Cir. 1953).

23. *Id.* at 314.

24. *Id.* at 316.

25. Int. Rev. Code of 1939, ch. 1, § 24(b)(1)(A), 53 Stat. 16 (similar provisions now contained in I.R.C. § 267).

26. 208 F.2d at 315.

27. *Id.*

position when the issue next arose in 1956 in *Time Oil Co.*[28] Once again the Tax Court was reversed—this time by the Ninth Circuit Court of Appeals.[29] When the issue was presented again in 1962 in *Wasatch Chemical Co.*[30] the Tax Court attempted to distinguish *Slaymaker* and *Time Oil Co.* from the facts in *Wasatch* on the ground that the notes given in the two earlier cases were demand notes, whereas the notes given in *Wasatch* were five year term notes.[31] Consequently, the court held that the term notes did not possess sufficient similarity to a check as did the demand notes in *Slaymaker*.[32] This distinction did not persuade the Tenth Circuit Court of Appeals—the Tax Court was again reversed upon appeal.[33] In spite of these reversals, the Tax Court in *Williams* reaffirmed the rationale that it first enunciated in *Logan*.[34] Finally, in *Williams* the Tax Court and the Commissioner reaped the fruits of their perseverence—an affirmance by the Seventh Circuit Court of Appeals.[35]

Other than the 1948 House Ways and Means Committee Report cited by *Williams*,[36] there is no congressional guidance on the issue of what constitutes payment for the purposes of section 404(a)(6). As a result courts have been forced to choose between strict statutory construction on the one hand, exemplified by the *Eckert* court's interpretation of "payment,"[37] and a more lenient result brought about through liberal construction on the other hand, as was done in the Third, Ninth and Tenth Circuits.[38] The *Williams* court opted for a strict statutory construction of the "payment" requirement, finding no basis in the statute to distinguish between cash and accrual method taxpayers regarding the use of promissory notes as an acceptable form of payment.[39] *Eckert v. Burnet* had established the notion that, with regard to cash method taxpayers,[40] promissory notes are not an appropriate mode of "payment" in the context of a deduction for a bad debt: "[a] dededuction may be permissible in the taxable year in which the *peti-*

28. 26 T.C. 1061 (1956).
29. Time Oil Co. v. Commissioner, 258 F.2d 237 (9th Cir. 1958).
30. 37 T.C. 817 (1962).
31. *Id.* at 819-20.
32. *Id.*
33. Wasatch Chem. Co. v. Commissioner, 313 F.2d 843, 847 (10th Cir. 1963).
34. 62 T.C. at 168.
35. *See* text accompanying notes 4, 5, 10-12 *supra.*
36. 527 F.2d at 651 (quoting H.R. REP. No. 2087, 80th Cong., 2d Sess. 13 (1948)).
37. Eckert v. Burnet, 283 U.S. 140, 141-42 (1931).
38. *See* text accompanying notes 21-35 *supra.*
39. 527 F.2d at 650-51.
40. 283 U.S. 140 (1931), discussed in text accompanying notes 13 & 14 *supra.*

tioner pays cash."[41] Thus, according to the Seventh Circuit in *Williams,* if accrual method taxpayers are to be treated like cash method taxpayers, and if promissory notes are not a proper form of payment for cash method taxpayers, it logically follows that the use of promissory notes is also forbidden for accrual method taxpayers.[42]

The notion of similarity of treatment between cash and accrual method taxpayers under section 404(a)(6), as presented by the *Williams* court, is bolstered by the fact that in other sections of the Code in which a distinction between the two types of taxpayers is intended the language "paid or accrued" or "paid or incurred" is normally employed.[43] By contrast, in section 404(a)(6) this language is missing; the statute merely uses the term "paid." The *Williams* court's distinction based on contrasting terminology is by no means perfect, however. In at least one other section of the Code in which the term "paid" is used,[44] the courts have allowed promissory notes to satisfy the payment requirement.[45] The Tax Court has attempted to distinguish between the two situations in that the sections allowing promissory notes as "payment" merely limit a deduction already granted, whereas section 404(a)(6) is an affirmative grant of a deduction and as such is to be more strictly construed[46]—further indication that something more resembling cash than a promissory note must be offered as payment.[47]

Unfortunately the court's reliance on this definition of "paid" or "payment" does not withstand close examination; even the Tax Court has admitted that the definition of payment that requires liquidation of a liability in cash does not foreclose the use of checks as an acceptable method of payment.[48] No one would seriously argue that a check is anything other than a substitute form of cash, and contemporary commercial law reflects this assumption. The inconsistency of the Tax Court's position, which rejects promissory notes as payment while accepting other forms of noncash substitutes as payment, is illustrated

41. 283 U.S. at 141-42 (emphasis added).

42. *See* 527 F.2d at 651.

43. *E.g.*, I.R.C. §§ 163(a), 164(a), 174(a)(1), 175(a), 212, 216(a).

44. Int. Rev. Code of 1939, ch. 1, § 24(c)(1), 53 Stat. 17 (now I.R.C. § 267).

45. *See, e.g.*, Anthony P. Miller, Inc. v. Commissioner, 164 F.2d 268 (3d Cir. 1947) (promissory note given by a corporation to one of its officers as salary constituted payment of the salary).

46. The Tax Court first enunciated this position in Logan Eng'r Co., 12 T.C. 860, 868-69 (1949).

47. *See* 527 F.2d at 651.

48. *E.g.*, in Wasatch Chem. Co., 37 T.C. 817 (1962), the Tax Court stated that "[t]he act of payment for tax purposes, and generally, may be accomplished by the transfer of funds directly or by check." *Id.* at 819.

further in a decision rendered by the Tax Court in 1958,[49] nine years after its first promissory note decision[50] under section 404(a)(6)'s predecessor. In *Colorado National Bank*[51] the taxpayer transferred a piece of real property to a qualified pension plan in order to satisfy its obligation for the taxable year in question.[52] The Commissioner relied on the Tax Court's earlier decisions involving promissory notes to argue that the transfer of land was not a payment in cash or its equivalent as arguably required by the statute, and accordingly disallowed the deduction.[53] Rejecting the Commissioner's argument, the Tax Court found that the taxpayer transferred an income-producing asset with an ascertainable value to the pension trust and that this payment was "within the words and intent of the applicable statutory provisions."[54] The Seventh Circuit made no mention of *Colorado National Bank* in the *Williams* decision.

Colorado National Bank points out in the context of a transfer of land what the three circuit courts[55] that had ruled on the promissory note issue prior to *Williams* had emphasized: in certain situations, promissory notes, like a piece of land or cash or a check, do indeed have a "value" that can be ascertained.[56] Moreover, promissory notes also have income-producing capabilities; in two of these cases the notes paid interest until they were satisfied.[57] Indeed in situations involving negotiable demand notes, there is probably a closer "cash equivalency" than with a parcel of land.

As suggested in *Colorado National Bank* and by the Third, Ninth and Tenth Circuits, the most logical approach to the problem is not to emphasize the form of payment, but rather to inquire whether anything of value has been transferred; such a determination presents no insurmountable problems. In *Slaymaker*, for example, the circuit court found that the notes were worth their face amount.[58] This finding was based on the fact that the corporation was solvent and the notes were adequately secured.[59] Additionally, the same court remanded the

49. Colorado Nat'l Bank v. Commissioner, 30 T.C. 933 (1958).
50. *See* note 46 and accompanying text *supra*.
51. 30 T.C. 933 (1958).
52. *Id.* at 934.
53. *Id.* at 934-35.
54. *Id.* at 936.
55. *See* note 21 and accompanying text *supra*.
56. 30 T.C. at 935-36.
57. Wasatch Chem. Co. v. Commissioner, 313 F.2d 843, 844 (10th Cir. 1963); Sachs v. Commissioner, 208 F.2d 313, 314 (3d Cir. 1953).
58. 208 F.2d at 314.
59. *Id.*

Sachs case because no finding was made below on the "value" question.[60] The *Slaymaker-Sachs* court was not willing to allow promissory notes per se to satisfy the "value" requirement; instead there was an inquiry into the underlying worth of the notes.

This "value" approach, first taken by the Third Circuit Court of Appeals in *Sachs* and *Slaymaker,* followed by the Ninth and Tenth Circuits, and subsequently rejected in *Williams* is an eminently workable and sensible approach. As was suggested by the circuit court in *Sachs,* findings of fact could easily be made to determine if the notes had any value. This approach allows the best of both worlds. When a solvent corporation is temporarily caught in a cash-flow squeeze, contributions could still be made in the form of notes; the pension plans would not have to be slighted in that year and the corporation could take a deduction for its contribution. On the other hand, when the notes are of no value or worth less than their face value, the deduction would properly be disallowed or reduced. Certainly such an approach does not require an overly strained interpretation of the statute, and the legislative history on this issue is so scanty as to be meaningless.

Aside from the strict statutory construction applied by the *Williams* court, an obvious underlying concern throughout these cases is the protection of the pension and profit-sharing plans from employer contributions of worthless promissory notes. Yet the fact remains that under the law, trustees of pension and profit-sharing plans are perfectly free to invest in the stocks and securities of the employer corporation.[61] Apparently, such investments are a common practice in many of the large pension plans.[62] Hence, the value of the plan in such situations depends ultimately upon the solvency of the corporation. If the corporation's promissory notes are of little or no value, then surely its securities are not very valuable, and the plan remains in jeopardy. Allowing trustees to hold securities but not promissory notes makes

60. *Id.* at 316.

61. Rules concerning investments in employer securities by pension and profit-sharing trusts were tightened considerably with the passage of ERISA, cited note 3 *supra.* Nevertheless, pension and profit-sharing plans may still invest in employer securities, within the percentage limitations set forth in § 407(a)(2) of ERISA, 29 U.S.C. § 1107 (a)(2) (Supp. V 1975), if the security is an "employer security" as defined in ERISA § 407(a)(1)(D)(5), 29 U.S.C. § 1107(a)(1)(D)(5) (Supp. V 1975). *See* Sollee & Shapiro, *(ERISA) Profit-sharing Plans—Qualification,* 310 TAX MANAGEMENT A-40 (1975); Sollee & Shapiro, *(ERISA) Pension Plans—Qualification,* 309 TAX MANAGEMENT A-44 (1975).

62. *See* D. MCLAUGHLIN, THE EXECUTIVE MONEY MAP 11 (1975).

little sense if the ultimate goal is to protect these plans and ensure their survival.

The issue in the *Williams* case is a close one and perhaps should receive specific congressional attention; in the absence of more illuminating congressional guidance, however, encouragement of pension and profit-sharing plans and the preservation of their integrity demand a judicial definition of "payment" that includes promissory notes within its ambit—a broader definition than that adhered to for almost thirty years by the Tax Court and, more recently, by the Seventh Circuit. Admittedly this result would have to be achieved at the expense of a strict statutory construction; however, this broader definition of "payment" would be tempered by an inquiry into the underlying worth of the notes as suggested by the *Slaymaker-Sachs* approach. This result would encourage more corporations to adopt or retain pension plans, which is, after all, the basic purpose of section 404(a).

ALLEN W. WOOD III

Zoning — Adjudication by Labels: Referendum Rezoning and Due Process

In recent years, the use of procedural devices providing for direct citizen participation[1] in land use planning decisions has proliferated.[2] The use of these devices to regulate change in land use patterns previously established by zoning ordinances[3] has given rise to due process

1. Popular participation is facilitated by the availability of two devices: the initiative and the referendum. The initiative permits citizens to legislate directly by having a proposed measure placed on the ballot and submitted to a popular vote. The referendum permits citizens to have measures already approved by a legislative body submitted to voter review. The operation of these devices is usually conditioned on the receipt of appropriate petitions requesting the particular initiative or referendum. Comment, *The Initiative and Referendum's Use in Zoning*, 64 CALIF. L. REV. 74, 74 nn.1 & 2 (1976).

2. *See, e.g.*, City of Scottsdale v. Superior Court, 103 Ariz. 204, 439 P.2d 290 (1968); San Diego Bldg. Contractors Ass'n v. City Council, 13 Cal. 3d 205, 529 P.2d 570, 118 Cal. Rptr. 146 (1974), *appeal dismissed*, 96 S. Ct. 3184 (1976); Associated Home Builders v. City of Livermore, 41 Cal. App. 3d 677, 116 Cal. Rptr. 326 (Ct. App. 1974); West v. City of Portage, 392 Mich. 458, 221 N.W.2d 303 (1974); Bird v. Sorenson, 16 Utah 2d 1, 394 P.2d 808 (1964).

3. Land use restrictions imposed by a local zoning ordinance can be altered by the use of three procedures. When the application of zoning restrictions to a particular