4 T.C. 750 (1945)

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Payments deferred due to unusual circumstances imposed by a lender as a condition of a loan can qualify as “back pay” for favorable tax treatment under Section 107(d) of the Internal Revenue Code, but only if the circumstances are similar to bankruptcy or receivership.

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Summary

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Norbert Kenny, president of National Meter Co., received a payment in 1941 representing deferred salary from 1938-1940. The deferral was required by the Reconstruction Finance Corporation (R.F.C.) as a condition for granting a loan to National. The Tax Court addressed whether this payment qualified as “back pay” under Section 107(d) of the Internal Revenue Code, allowing for taxes to be calculated as if the income had been received in the prior years. The court held that the portion of the payment representing deferred salary qualified as back pay, but a separate portion representing a share of profits did not.

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Facts

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National Meter Co. received loans from the R.F.C. in 1935 and 1937. As a condition of the 1937 loan, the R.F.C. required National to adjust the compensation of certain officers, including Norbert Kenny, its president. Kenny’s annual salary was set at $12,000, but $4,200 was to be withheld and credited on National’s books, payable only with the R.F.C.’s consent or upon full repayment of the loan. From 1938 to 1940, Kenny received only $7,800 annually, with the remaining $4,200 credited to his account each year. In 1940, an additional $1,957.63 was credited to his account based on a profit-sharing agreement. In 1941, Pittsburgh Equitable Meter Co. acquired National, paid off the R.F.C. loan, and paid Kenny $9,704.96, representing the balance of his credited salary and profit share after Kenny agreed to cancel one-third of his claim. Kenny reported his income on a cash basis.

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Procedural History

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Kenny initially did not report the credited amounts as income in 1938, 1939, and 1940. He later filed amended returns, increasing his reported income for those years. The Commissioner of Internal Revenue included the $9,704.96 in Kenny's 1941 income and determined overassessments for the prior years, stating that the excess amounts credited were contingent and not constructively received until 1941. Kenny then petitioned the Tax Court, arguing the 1941 payment constituted "back pay" eligible for special tax treatment.

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Issue(s)

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Whether the $9,704.96 received by Kenny in 1941, representing deferred salary and a share of profits from prior years, qualifies as "back pay" under Section 107(d) of the Internal Revenue Code, thus entitling him to have the tax liability calculated as if the income were received in the prior years.

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Holding

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1. Yes, $8,400 of the $9,704.96 received by Kenny in 1941, representing deferred salary, constitutes "back pay" because the deferral was due to unusual circumstances similar to those of a company under receivership, as the R.F.C. imposed restrictions on National's operations.
2. No, the remaining $1,304.96, representing a share of profits, does not constitute "back pay" because profit-sharing is not similar to wages or salaries, and the profit-sharing agreement was made without the R.F.C.'s consent.

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Court's Reasoning

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The court relied on Section 107(d)(2) of the Internal Revenue Code, which defines

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“back pay” as remuneration that would have been paid in prior years but for certain events, including bankruptcy or receivership, or “any other event determined to be similar in nature under regulations prescribed by the Commissioner.” The court considered Treasury Regulation 111, Section 29.107-3, which specifies that a similar event must be unusual and of the type specified in the statute. The court reasoned that the R.F.C.’s restrictions on National’s salary payments resembled the restrictions placed on businesses under receivership, as the R.F.C. effectively controlled National’s financial operations. As the court stated, “The situation was not usual, and National was restricted under its agreement with R. F. C. in making payments from earnings in ways which resemble the restrictions placed upon business operations conducted under receivership.” However, the court distinguished the profit-sharing agreement, noting it was not a typical form of compensation like wages or salaries and was not part of the R.F.C.’s restrictions.

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Practical Implications

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This case illustrates the importance of carefully analyzing the reasons for deferred payments to determine whether they qualify as “back pay” for tax purposes. The key takeaway is that the circumstances causing the deferral must be unusual and similar in nature to bankruptcy or receivership, involving external constraints on the employer’s ability to make payments. The case highlights that agreements to defer compensation must arise from external constraints such as those imposed by a lender with significant control over a company’s finances. Taxpayers seeking to claim “back pay” treatment should ensure that the deferral arises from conditions similar to those enumerated in Section 107(d)(2) and be prepared to demonstrate the unusual and restrictive nature of the circumstances that prevented timely payment. This case is often cited when determining whether specific situations meet the criteria for back pay, especially regarding unusual circumstances affecting payment of compensation.

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