5 T.C. 431 (1945)

For excess profits tax calculations, a one-time payment to settle a contract dispute constitutes an 'abnormal deduction' if it deviates from the company's typical expenses and isn't simply a substitute for other, regular costs.

Summary

R.C. Harvey Co. sought to adjust its excess profits net income for the 1939 base period, claiming a $15,000 payment to a former employee, Gordon, for breach of contract was an 'abnormal deduction.' The Tax Court held that the payment, stemming from a contract dispute and threatened litigation, qualified as an abnormal deduction. This was because it was a one-time settlement, not a recurring business expense. Further, the court found that this abnormality wasn't just a disguised substitute for other regular expenses, like commissions, despite a subsequent decrease in commission expenses after Gordon's departure. The court sided with the company, allowing the adjustment for excess profits tax purposes.

Facts

R.C. Harvey Co. hired Jacob Gordon as a purchasing agent under a contract entitling him to commissions and a percentage of net earnings. After the death of a key executive, disputes arose between Harvey and Gordon regarding inventory and purchasing practices. Consequently, R.C. Harvey Co. terminated Gordon's contract, leading to threats of litigation by Gordon. To avoid a lawsuit, the company paid Gordon $15,000 as a settlement for breach of contract, in addition to $2,500 for earned commissions.

Procedural History

The Commissioner of Internal Revenue disallowed the $15,000 payment as an adjustment to the company's excess profits net income for the base period year 1939, arguing it wasn't a qualifying 'claim' under Section 711(b)(1)(H) of the Internal Revenue Code. The Tax Court reversed the Commissioner's determination, finding the payment was indeed an abnormal deduction properly attributable to a claim.

Issue(s)

Whether a payment made to a former employee in settlement of a threatened breach of contract lawsuit constitutes an 'abnormal deduction' under Section 711(b)(1)(H) of the Internal Revenue Code for the purpose of calculating excess profits tax.

Holding

Yes, because the payment arose from a specific contract dispute, resulting in a one-time settlement to avoid litigation, and because the abnormality was not a consequence of factors enumerated in Section 711 (b)(1)(K)(ii).

Court's Reasoning

The Tax Court reasoned that the $15,000 payment was directly attributable to Gordon's claim for damages resulting from the breach of contract. The court emphasized that the payment was a settlement to avoid litigation and secure a release from all claims. The court stated that the definition of 'abnormal' is that it deviates from the normal condition; not corresponding to the type; markedly or strangely irregular. The court dismissed the Commissioner's argument that the payment was merely anticipated commissions or a substitute for future compensation. The court also emphasized that it was up to the taxpayer to prove that abnormality was not a consequence of an increase in the gross income of the taxpayer in its base period or a decrease in the amount of some other deduction in its base period. Despite a subsequent decrease in commission expenses after Gordon's departure, the court found that the settlement payment was not a direct consequence of this decrease. The court also clarified that, in determining whether a deduction attributable to a claim against the taxpayer is 'abnormal for the taxpayer' they do not regard as material the factor as to whether the taxpayer was or was not benefited by the payment of the claim.

Practical Implications

The *R. C. Harvey Co.* case provides guidance on how to classify deductions as 'abnormal' for excess profits tax purposes. It clarifies that settlement payments arising from contract disputes can qualify as abnormal deductions if they represent a deviation from the company's regular business expenses. It also warns against attempts to recharacterize such payments as disguised forms of regular compensation or substitutes for other deductions. This case highlights the importance of documenting the specific circumstances surrounding a payment to demonstrate its unusual and non-recurring nature. It establishes that a deduction cannot be disallowed unless the taxpayer establishes that the abnormality or excess is not a consequence of an increase in the gross income of the taxpayer in its base period or a decrease in the amount of some other deduction in its base period, and is not a consequence of a change at any time in the type, manner of operation, size, or condition of the business engaged in by the taxpayer.

