5 T.C. 498 (1945)

Settlement proceeds received in lieu of stock promised under an employment contract, including a non-compete clause, are taxed as ordinary income, not capital gains; and businesses using the accrual method can deduct definitively accrued volume discounts and reasonable bad debt reserves.

Summary

Albert Becken sued for specific performance of a contract where he was promised stock in a new company and a cash bonus in exchange for employment and a non-compete agreement. He settled the suit for $17,000. The Tax Court determined the settlement was ordinary income, not capital gains, because it arose from an employment contract. Furthermore, the Tax Court addressed whether Becken, operating a wholesale jewelry business, could deduct a reserve account. It held that definitively accrued volume discounts and a reasonable bad debt reserve were deductible, but contingent cash discounts were not.

Facts

Becken, previously the president of a bankrupt jewelry firm, entered into a contract with Clark in 1932. Clark agreed to employ Becken as vice president of a new company formed to acquire the assets of the bankrupt firm. The agreement stipulated a salary, a cash bonus, and $40,000 in capital stock. Becken was also subject to a five-year non-compete clause. Clark acquired the assets and formed A.C. Becken Co. Becken worked for the new company but never received the stock. He later sued Clark’s estate for specific performance. He settled the suit for $17,000.

In 1941, Becken started his own wholesale jewelry business and used the accrual method of accounting. He set up a reserve account for discounts and bad debts at the end of the year. This included cash discounts, a volume discount for a specific customer, and an allocation for bad debts.

Procedural History

Becken initially sued Clark’s estate in Illinois state court for specific performance and lost at the trial level. He appealed. While the appeal was pending, the parties settled. Becken reported the settlement as a capital gain on his 1941 federal income tax return. The Commissioner determined the settlement was ordinary income, resulting in a deficiency. Becken then petitioned the Tax Court contesting the deficiency.

Issue(s)

1. Whether the $17,000 received by Becken in settlement of his suit for specific performance was taxable as a long-term capital gain or as ordinary income?

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2. Whether Becken was entitled to deduct the full amount of the reserve account established for volume discounts, cash discounts, and bad debts?

Holding

1. No, because the right to the stock stemmed from an employment contract that included a non-compete agreement, and settlements related to such contracts are considered ordinary income.

2. No, but a deduction for the definitively accrued volume discount and a reasonable reserve for bad debts is permissible because he used the accrual method of accounting and met the criteria for a bad debt reserve.

Court's Reasoning

The Tax Court reasoned that Becken's right to the stock was an integral part of his employment contract, not a separate capital asset. The court stated, "The agreement to issue the stock forms an integral part of the entire contract. It is no more severable from petitioner's obligations…not 'in anywise for the period of five (5) years…directly or indirectly [to] engage in any competing business…'" Because the agreement included both employment and a non-compete clause, the settlement was akin to compensation for services or for the agreement not to compete, both of which constitute ordinary income. The court distinguished this case from *Lyeth v. Hoey, 305 U.S. 188*, and *Margery K. Megargel, 3 T.C. 238*, noting Becken never

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