5 T.C. 1355 (1945)

Payments received in settlement of a lawsuit arising from a contract for personal services are taxed as ordinary income, not as capital gains, even if the settlement includes property.

Summary

A.L. Parker sued his former employer, National Hotel Co., for breach of contract, seeking 25% of the profits from hotels he brought into the chain. The suit was settled with Parker receiving cash and a hotel property. The Tax Court held that the settlement proceeds constituted ordinary income, not capital gains, because the underlying claim stemmed from a personal services contract. The court also upheld the Commissioner's valuation of the property received and the determination of gain from the sale of stock in a related corporation.

Facts

Parker, experienced in the hotel business, contracted with National Hotel Co. to manage hotels and develop new hotel acquisitions. He was to receive a salary plus 25% of the net profits from hotels he brought into the organization. Parker successfully brought four hotels into the chain. However, National Hotel Co. later terminated Parker's contract and refused to pay him the agreed-upon share of profits. Parker sued for breach of contract, seeking an accounting and specific performance.

Procedural History

Parker filed suit in the District Court of the United States for the Northern District of Texas. The litigation was settled by agreement. The Commissioner of Internal Revenue determined a deficiency in Parker's income tax, asserting that the settlement income was ordinary income. Parker petitioned the Tax Court, contesting this determination.

Issue(s)

1. Whether the cash and fair market value of property received in settlement of the lawsuit constitutes ordinary income under Section 22 of the Internal Revenue Code or long-term capital gain under Section 117 of the Code?

2. Whether the Commissioner correctly valued the property received in the settlement?

3. Whether a short-term capital gain was realized from the sale or exchange of Parker's interest in the Cliff Towers Hotel Co.?

Holding

1. No, because the settlement was compensation for services rendered under an employment contract.

2. Yes, because Parker failed to provide sufficient evidence to prove the Commissioner's valuation was incorrect.

3. The Tax Court approved whatever determination was made by the Commissioner, because Parker failed to establish a cost basis for the stock.

Court's Reasoning

The Tax Court reasoned that the settlement arose from a contract for personal services. The court relied on *Albert C. Becken, Jr.*, which held that payments received in compromise settlement of employment contracts constitute ordinary income. The court stated, "the 'nature and basis of the action' which the petitioner here brought in the District Court of the United States was to recover from the defendants a 25 percent interest in the profits theretofore realized and thereafter as realized, of the four hotels under petitioner's contract of employment…" This showed the settlement consideration was ordinary income. The court distinguished cases cited by Parker, noting they involved assignments of already-earned income or joint ventures where the taxpayer contributed capital. The court found Parker's contract was an ordinary employment contract, not a joint venture, as Parker had no control over the hotels or shared in their operating risks. The court also found Parker had not presented sufficient evidence to show the Commissioner's valuation of the settlement property was incorrect. With respect to the stock, the court found Parker had not established a cost basis, so it approved the Commissioner's determination.

Practical Implications

This case illustrates that the character of income received in a settlement is determined by the nature of the underlying claim. Attorneys must carefully analyze the origin of the claim to advise clients on the tax implications of settlements. Specifically, if a settlement relates to compensation for services, it will likely be treated as ordinary income, even if the settlement includes property. This principle impacts litigation strategy and settlement negotiations, as the tax consequences can significantly affect the net benefit received by the client. Later cases applying this ruling would focus on whether the original claim stemmed from services rendered, or from something else like the sale of property.