T.C. Memo. 1949-253

The reasonable compensation for partners used in calculating excess profits tax credit should be based on the actual value of their services to the partnership, not solely on formulas used for earned income credit under normal tax provisions.

Summary

Post and Floto, Inc. challenged the Commissioner's calculation of excess profits tax credit, arguing that the reasonable compensation for the partners during the base period years should be limited to the "earned income" figures used for normal tax purposes. The Tax Court upheld the Commissioner's determination, finding that the "earned income credit" under Section 25 of the Revenue Act of 1936 was not the proper criterion for determining reasonable compensation for excess profits tax purposes. The court also found that the Commissioner's lump-sum determination of the partners' compensation did not invalidate the deficiency determination and the evidence supported the reasonableness of the compensation allowed.

Facts

A partnership, later incorporated as Post and Floto, Inc., sought to determine its excess profits tax credit for fiscal years 1941-1944. The partners had each drawn $5,200 annually before profit division. In their initial 1941 and 1942 excess profits tax returns, the corporation used $10,400 as the total reasonable compensation for both partners. After filing the 1943 return, amended returns for 1941 and 1942 were filed, using lower figures derived from "earned income" calculations under Section 25 of the Revenue Act of 1936, specifically $7,550.98 for 1937 and $6,000 for subsequent base period years. One partner, Manscoe, experienced declining health during the base period.

Procedural History

The Commissioner determined deficiencies based on the difference between the $10,400 figure and the lower figures used in the amended returns. The corporation petitioned the Tax Court, contesting the Commissioner's determination of reasonable compensation for the partners during the base period years.

Issue(s)

1. Whether the "earned income" figures used for normal tax purposes under Section 25 of the Revenue Act of 1936 are the proper figures to use for determining reasonable compensation of partners in computing excess profits tax credit.
2. Whether the Commissioner's determination of reasonable compensation in a lump sum, rather than individually for each partner, invalidates the deficiency determination.
3. Whether the Commissioner erred in determining that $10,400 per year was the reasonable compensation of the partners during the base period years.

Holding

1. No, because the “earned income credit” under Section 25 is a relief provision specific to normal tax computation and does not govern the determination of reasonable compensation for excess profits tax purposes.
2. No, because a lump-sum determination of reasonable compensation does not invalidate the Commissioner’s finding or relieve the petitioner of the burden of proof.
3. No, because the evidence supports the Commissioner’s determination that $10,400 per year was reasonable compensation for the partners, despite one partner’s declining health.

Court’s Reasoning

The court reasoned that Section 25 of the Revenue Act of 1936 explicitly states that the earned income credit applies only to the normal tax and not the surtax (which includes excess profits tax). The court stated, “In the light of such provisions we think we may not, for the purpose of another portion of the statute, involving excess profits tax, limit the range of inquiry as to what is a reasonable deduction for salary or compensation merely to a computation of earned income under section 25, where clearly the matter is one of an exemption in the form of a credit.” The court found no error in the lump-sum determination, citing *Miller Mfg. Co. v. Commissioner*, 149 F.2d 421, and holding that it does not invalidate the presumption of correctness afforded to the Commissioner’s determination. The court considered Manscoe’s declining health but noted the partnership’s continued profitability and the corporation’s initial assessment of $10,400 as reasonable compensation. The court noted the principle that a taxpayer cannot “blow hot and cold” to secure better tax results.

Practical Implications

This case clarifies that calculations used for one type of tax credit (earned income for normal tax) cannot be automatically applied to other tax contexts (excess profits tax credit). It emphasizes that “reasonable compensation” is a factual question, requiring consideration of the specific services rendered and the value of those services to the business. This highlights the importance of contemporaneous documentation supporting the value of partner or employee services. The case also serves as a reminder that the Tax Court gives weight to a taxpayer’s initial assessment of reasonable compensation, especially when it aligns with their economic interests at the time, and disfavors changing positions solely for tax benefits. It reinforces the Commissioner’s authority to make lump-sum determinations of reasonable compensation, placing the burden on the taxpayer to prove the determination is incorrect.