10 T.C. 672 (1948)

Contingent compensation, such as incentive pay measured by a percentage of departmental sales, can qualify as "back pay" for tax purposes under Section 107(d)(2) of the Internal Revenue Code, even if dependent on company profits, when its payment is retroactively approved by a government agency and relates to prior-year services.

Summary

James Dean received $13,045.32 in 1944 from his employer, ERCO, representing incentive pay earned in 1943 but withheld due to initial Salary Stabilization Unit restrictions. The Tax Court addressed whether this payment qualified as "back pay" under Section 107(d)(2) of the Internal Revenue Code, allowing favorable tax treatment. The court held that the payment did constitute "back pay" because it was compensation for prior-year services, its payment was initially restricted by a government agency ruling, and the agency retroactively approved the payment. This decision allowed Dean to apply more favorable tax rates to the income.

Facts

James Dean was employed by Engineering and Research Corporation (ERCO) in 1943 and 1944. In 1942, Dean and ERCO entered into a contract providing incentive compensation based on a percentage of net sales from specific departments. ERCO's board authorized incentive payments in 1943, but payment was withheld due to a ruling from the Salary Stabilization Unit (SSU) limiting additional compensation to 1942 levels. In April 1944, the SSU reversed its ruling, and ERCO paid Dean $13,045.32, representing the previously authorized 1943 incentive pay.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Dean's 1944 income tax, arguing that the $13,045.32 payment did not qualify as "back pay" under Section 107(d)(2) of the Internal Revenue Code. Dean petitioned the Tax Court for a redetermination of the deficiency.

Issue(s)

Whether the $13,045.32 payment received by Dean in 1944 from ERCO, representing incentive pay earned in 1943 but initially withheld due to salary stabilization restrictions, constitutes "back pay" within the meaning of Section 107(d)(2) of the Internal Revenue Code.

Holding

Yes, because the payment represented compensation for services performed in a prior year, its payment was initially restricted by a ruling from a federal agency, and that agency subsequently approved the retroactive payment.

Court's Reasoning

The court reasoned that Section 107(d)(2)(B) of the Internal Revenue Code defines "back pay" as wages or salaries received during the taxable year for services performed prior to the taxable year, constituting retroactive wage or salary increases approved by a federal agency and made retroactive to a prior period. The court emphasized that the Salary Stabilization Unit's initial restriction and subsequent approval of the payment satisfied this condition. The court distinguished this case from *Norbert J. Kenny, 4 T.C. 750*, noting that in *Kenny*, the taxpayer failed to prove that a share of profits was compensation similar to salaries. Here, the incentive pay was directly tied to Dean's services and retroactively approved. The court stated, "Even though the petitioner's compensation of $ 13,045.32 was measured by a percentage of sales of certain departments of ERCO, and was contingent upon the realization of profits by that corporation, it is nevertheless 'back pay' within the meaning of that term as defined in section 107 (d) (2) (B)."

Practical Implications

This case clarifies the scope of "back pay" under Section 107(d)(2), particularly regarding contingent compensation arrangements. It establishes that compensation measured by a percentage of sales or profits can qualify as "back pay" if its payment is deferred due to government regulations and later retroactively approved. This ruling benefits taxpayers receiving such payments, allowing them to mitigate the tax burden by allocating the income to the years in which it was earned. Attorneys should analyze similar cases by focusing on whether the payment relates to prior services, whether a government agency initially restricted payment, and whether the agency later approved retroactive payment. It highlights the importance of documenting the reasons for delayed payment and any government agency involvement.

