*10 T.C. 1158 (1948)*

Contingent compensation arrangements, established through free bargaining before services are rendered, are deductible as reasonable compensation even if they prove greater than amounts ordinarily paid, provided the total compensation is reasonable under all circumstances.

**Summary**

California Vegetable Concentrates, Inc. contested deficiencies in declared value excess profits tax and excess profits tax for 1942 and 1943. The Tax Court addressed whether deductions for compensation paid to officers under contingent contracts were reasonable, whether excess profits tax deferment should be reflected in the deficiencies, and whether the petitioner was entitled to certain credits. The court held that the compensation was reasonable, the deferment should be considered, and denied one credit for lack of proof, finding the other outside its jurisdiction for deficiency determination.

**Facts**

California Vegetable Concentrates, Inc. (CVC), a Nevada corporation, manufactured and sold vegetable powders. In 1936, L.P. Sims began experimenting with vegetable dehydration. In 1937, J.B. Pardieck was hired to manage procurement and production. CVC compensated Sims and Pardieck through a base salary plus a percentage of net profits. The Commissioner disallowed portions of the compensation paid to Sims and Pardieck in 1942 and 1943, deeming it excessive.

**Procedural History**

CVC filed income, declared value excess profits, and excess profits tax returns for 1942 and 1943. The Commissioner determined deficiencies, disallowing parts of the compensation deductions. CVC petitioned the Tax Court, contesting the Commissioner’s determination regarding officer compensation, excess profits tax deferment, and entitlement to certain credits.

**Issue(s)**

1. Whether the amounts paid to Sims and Pardieck in 1942 and 1943 constituted reasonable compensation for services actually rendered, deductible under Section 23(a)(1)(A) of the Internal Revenue Code.

2. Whether the deferment of excess profits tax provided for in Section 710(a)(5) of the Internal Revenue Code should be reflected in the determined deficiencies.

3. Whether petitioner is entitled to a credit under Sections 780 and 781 for post-war refunds and for debt retirement under Section 783.

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## Holding

1. No, because the contingent compensation arrangements were the result of a free bargain, the policy was based on sound business principles, and the amounts were reasonable considering the services rendered.

2. Yes, because Section 710(a)(5) provides for deferment until the determination of the claim under Section 722, and the deficiencies should not include the amount of the reduction provided under Section 710(a)(5).

3. No for the debt retirement credit, because the taxpayer provided insufficient evidence. The court held that the post-war refund credit was outside the jurisdiction of the Tax Court in determining deficiencies.

## Court's Reasoning

The court reasoned that the regulations approve the method used by the petitioner to fix compensation, stating that "if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid." The court emphasized the importance of the facts and circumstances at the time the compensation agreements were made. The court also found that the success of the company was primarily due to the efforts of Sims and Pardieck, justifying the compensation paid. Regarding the excess profits tax deferment, the court determined that including the deferred amount in the deficiency was incorrect, as Section 710(a)(5) provides for deferment until the Section 722 claim is resolved.

## Practical Implications

This case provides guidance on determining the reasonableness of compensation, particularly when contingent arrangements are involved. It emphasizes that contingent compensation agreements, if the product of free bargaining, are not inherently unreasonable simply because they result in high pay. Courts must consider the circumstances at the time the agreement was made, the services rendered, and the overall financial performance of the company. It also clarifies the proper handling of excess profits tax deferments under Section 710(a)(5) in relation to Section 722 claims, dictating that deficiencies should not include deferred amounts until the Section 722 claim is resolved. This ensures taxpayers receive the intended benefit of deferment pending the outcome of their relief claim. House Joint Resolution 385 amended Section 710(a)(5) retroactively, allowing assessment of any excess deferred tax within one year of the final Section 722 determination, mitigating concerns about revenue loss.

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