12 T.C. 324 (1949)

To qualify for income averaging under Section 107 of the Internal Revenue Code (as amended in 1942), a taxpayer must demonstrate that the compensation was for services rendered over a period of at least 36 months and that at least 80% of the total compensation was received in one taxable year.

Summary

Lucilla de V. Whitman, president and treasurer of Countess Mara, Inc., sought to allocate a $20,000 salary received in 1943 over five prior years under Section 107 of the Internal Revenue Code. The Tax Court denied Whitman's claim, holding that the $20,000 was compensation for services rendered in 1943 alone, not for prior years. The court also ruled against Whitman's attempt to deduct New York state income tax in computing her victory tax net income. This case clarifies the strict requirements for income averaging and demonstrates the importance of contemporaneous documentation to support claims of deferred compensation.

Facts

Whitman founded Countess Mara, Inc., in 1938 and served as its president and treasurer. The corporation experienced losses in its early years, paying Whitman minimal or no salary from 1938-1942. In November 1943, the board of directors (essentially controlled by Whitman) authorized a $20,000 payment to Whitman for her services over the past five years. Whitman reported the $20,000 as salary on her 1943 tax return and attempted to allocate it over the prior five years under Section 107. The corporation later applied to the Salary Stabilization Unit for approval of the 1943 and 1944 salaries, representing that Whitman's salary rate for 1943 was $20,000 per year.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Whitman's income and victory taxes for 1943, disallowing the application of Section 107 and the deduction of state income tax. Whitman petitioned the Tax Court for a redetermination of the deficiency. The Tax Court upheld the Commissioner's determination.

Issue(s)

1. Whether the $20,000 salary received by Whitman in 1943 qualifies for income averaging under Section 107 of the Internal Revenue Code, as amended.

2. Whether Whitman was entitled to deduct the amount of New York State income tax she paid in 1943 in computing her victory tax net income for 1943.

Holding

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1. No, because the $20,000 salary was compensation for services rendered in 1943 only, and even if it were for services over five years, less than 80% of the total compensation was received in one taxable year.

2. No, because payment of a state income tax does not come within the language of Section 451(a)(3) of the code so as to be deductible in computing her victory tax net income.

Court’s Reasoning

The Tax Court emphasized that Section 107 is an exemption statute, and Whitman bears the burden of proving she meets its requirements. The court found that the $20,000 salary was compensation for services rendered in 1943 alone, based on several factors: (1) The corporation’s application to the Salary Stabilization Unit represented the $20,000 as Whitman’s annual salary for 1943; (2) The corporation agreed that a portion of Whitman’s 1943 salary was excessive, which is inconsistent with the notion that it was intended to compensate her for prior years; (3) There was no evidence of a prior agreement to compensate Whitman for her early services; and (4) Whitman, as a substantial owner, likely worked for minimal pay initially to ensure the corporation’s success. Even assuming the salary covered services from 1938-1943, Whitman failed to meet the requirement that at least 80% of the total compensation be received in one taxable year. The court found that she received salary payments in 1938, 1939, and 1941, making the $20,000 less than 80% of her total compensation for the period. Regarding the victory tax deduction, the court cited its prior decision in *Anna Harris*, holding that state income taxes are not deductible for victory tax purposes.

Practical Implications

This case illustrates the stringent requirements for income averaging under Section 107 (and similar provisions in later tax codes). Taxpayers seeking to allocate income over multiple years must maintain thorough documentation establishing that the compensation relates to services performed over the required period and that the statutory percentage thresholds are met. The case also highlights the importance of consistent treatment of payments on corporate books and tax returns. Contradictory statements and actions can undermine a taxpayer’s claim, especially when the taxpayer is in control of the paying entity. It serves as a reminder that self-serving resolutions are subject to close scrutiny and must be corroborated by actual circumstances. Later cases cite *Whitman* for the principle that taxpayers must strictly comply with the requirements of exemption statutes. The case also demonstrates the enduring relevance of contemporaneous documentation when tax authorities or courts assess the nature of payments made years earlier.

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