14 T.C. 420 (1950)

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Payments received in settlement of a breach of contract suit are not considered "back pay" eligible for special tax treatment under Section 107(d) of the Internal Revenue Code unless they represent remuneration for services actually performed prior to the taxable year.

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Summary

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Lester Stearns sued his former employer for breach of contract after his employment was terminated. The case was settled, and Stearns received $15,000, of which he paid $5,000 in attorney fees. The Tax Court addressed whether the $10,000 net Stearns received qualified as "back pay" under Section 107(d) of the Internal Revenue Code, which would have allowed him to spread the tax burden over previous years. The court held that the settlement did not constitute back pay because it was compensation for the breach of contract, not for services previously rendered.

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Facts

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Lester Stearns was employed as a sales manager for Columbia Radiator Co. under a written contract for an indefinite term. In March 1943, Columbia's board of directors adopted a resolution terminating Stearns's employment, effective May 31, 1943. Stearns claimed the termination was unauthorized and sued Columbia for breach of contract and damages. He argued that because Columbia did not provide six months' notice prior to October 31, 1941, as required by the contract, the termination was invalid. Stearns started a tool supply business in September 1943. The suit was settled on December 21, 1945, with Columbia paying Stearns $15,000.

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Procedural History

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Stearns filed suit against Columbia Radiator Co. in the Court of Common Pleas of Allegheny County, Pennsylvania. The suit was settled out of court. The Commissioner of Internal Revenue determined a deficiency in Stearns's income tax for 1945, disallowing his claim that the settlement was "back pay" under Section 107 of the Internal Revenue Code. Stearns petitioned the Tax Court for review.

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Issue(s)

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Whether the $10,000 net amount received by Stearns in 1945 in settlement of his suit for breach of an employment contract and all claims arising under said contract constituted "back pay" within the meaning of Section 107(d) of the Internal Revenue Code.

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Holding

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No, because the settlement was compensation for the breach of contract, not remuneration for services previously performed for his employer.

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Court's Reasoning

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The court focused on the definition of "back pay" under Section 107(d)(2) of the Internal Revenue Code, which requires that the remuneration be for "services performed prior to the taxable year for his employer." The court noted that the release Stearns signed characterized the $15,000 payment as "full payment and satisfaction of any and all damages suffered by me on account of the breach…of a certain contract of employment." The court reasoned that the payment was not "remuneration…the payment of which has been deferred by reason of the unusual circumstances of the type specified in the definition." Referencing *Norbert J. Kenny, 4 T.C. 750*, the court reiterated that "[t]he term [back pay] refers only to remuneration, the payment of which has been deferred by reason of the unusual

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circumstances of the type specified in the definition." The court concluded that the $10,000 Stearns received did not fall within the definition of "back pay" as defined by Congress. Judges Disney and Opper dissented, arguing that the settlement was an equivalent payment for services and should be considered "back pay."

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Practical Implications

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This case clarifies the scope of "back pay" under Section 107(d) of the Internal Revenue Code. It establishes that a settlement for breach of contract is not automatically considered back pay; the payment must be directly linked to services performed. Legal practitioners must carefully analyze the nature of settlement agreements to determine whether the payments qualify as remuneration for past services or compensation for other damages. This case underscores that merely receiving a payment related to a prior employment relationship does not automatically qualify it for the tax benefits associated with "back pay." Later cases would need to distinguish between payments for actual services rendered versus payments for the wrongful termination of the opportunity to render those services.

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