T.C. Memo. 1949-254

Payments received for personal services, even if connected to a sale of property, are taxed as ordinary income, not as capital gains, when the services are a prerequisite for receiving the payments.

Summary

Whitman sold his company stock and entered into a 5-year employment contract that included a salary plus a percentage of magnet sales. Later, he received a lump sum for cancellation of the contract and a non-compete agreement. The court addressed whether the payments received under the employment contract and for its cancellation were taxable as capital gains from the stock sale or as ordinary income. The court held that the payments were compensation for services, taxable as ordinary income, because the services were a prerequisite for receiving the payments, and the employment contract was separate from the stock sale agreement.

Facts

Whitman sold his shares of Ohio Electric stock to M.B. Hott for $10 per share. As part of the deal, Ohio Electric (a separate entity) entered into a 5-year employment contract with Whitman, providing a stated salary plus a percentage of magnet sales. Later, Whitman received $13,500 for releasing Ohio Electric from the employment contract and agreeing not to compete in the magnet business for three years. Whitman conceded that a portion of payments received were compensation, but argued the remainder was connected to the sale of his stock.

Procedural History

The Commissioner of Internal Revenue determined that the payments Whitman received under the employment contract and for its cancellation constituted ordinary income. Whitman challenged this determination in the Tax Court.

Issue(s)

Whether payments received by Whitman pursuant to his employment contract with Ohio Electric (including the payment for cancellation of said contract) constituted compensation taxable as ordinary income, or long-term capital gains realized on the sale of his Ohio Electric stock.

Holding

No, because the payments were compensation for personal services, which had to be rendered as a prerequisite before any payments became due.

Court’s Reasoning

© 2025 SCOTUSreports.com. All rights reserved.

The court emphasized that the option agreement for the stock sale and the employment contract were two separate undertakings. The stock was sold for a set price per share. The employment contract was explicitly for personal services, stating, “This contract is for personal services, and no part of the same is assignable on the part of the Employee.” The court found that Whitman’s services were “prerequisite to the obligation of Ohio Electric to pay him compensation.” The court cited *Commissioner v. Smith*, 324 U.S. 177 (1945) for the principle that “the form and character of the compensation are immaterial.” The court further reasoned that the $13,500 payment was for the cancellation of Whitman’s right to receive future compensation and for his agreement not to compete. This, the court held, also constituted ordinary income, citing *Hort v. Commissioner*, 313 U.S. 28 (1941).

Practical Implications

This case highlights the importance of carefully structuring transactions to achieve desired tax outcomes. Even if an employment agreement is linked to the sale of a business, payments under the employment agreement will be treated as ordinary income if they are contingent on the performance of services. The case emphasizes that courts will look to the substance of the transaction, not just its form, in determining the character of income. Attorneys structuring business sales need to clearly delineate between the consideration paid for assets (potentially capital gains) and compensation for ongoing services (ordinary income). This ruling informs how similar cases should be analyzed by emphasizing the requirement of services rendered to receive the payment as the deciding factor.

© 2025 SCOTUSreports.com. All rights reserved.