18 T.C. 418 (1952)

Payments received as compensation are not considered “back pay” for tax purposes if the right to receive that compensation was contingent upon a future event and not merely deferred by circumstances similar to bankruptcy or receivership.

Summary

Bavis, Bell, and Giangiulio sought to treat stock received in 1946 as “back pay” under Section 107(d) of the Internal Revenue Code, arguing its payment was deferred due to the company’s financial difficulties. The Tax Court disagreed, holding that the stock distribution wasn’t back pay because the petitioners’ right to it was contingent on them remaining with the company until creditors were paid, a condition not met until 1946. Therefore, the income was taxable in the year it was received, not allocated to prior years.

Facts

Bavis, Bell, and Giangiulio were key employees of Chichester Chemical Company. In 1928, the company entered an agreement with its creditors, and the employees agreed to continue working at their existing salaries plus a percentage of gross sales. Critically, they were also promised an interest in the business, to be received as stock in a newly organized corporation, contingent on them remaining with the company until all creditors were paid. The creditors were fully paid in 1946, at which point the employees received their stock.

Procedural History

The Commissioner of Internal Revenue determined that the fair market value of the stock received in 1946 was taxable as ordinary income in that year. Bavis, Bell, and Giangiulio petitioned the Tax Court, arguing that the stock should be treated as “back pay” and taxed according to the years in which the services were performed. The Tax Court upheld the Commissioner’s determination.

Issue(s)

Whether the shares of stock received in 1946 qualify as “back pay” under Section 107(d) of the Internal Revenue Code, allowing the petitioners to allocate the income to prior years, or whether the full value is taxable as income in the year received.

Holding

No, because the payment of the stock was not merely deferred, but contingent upon the employees remaining with the company until all creditors were paid, which was a condition not satisfied until 1946. Therefore, the distribution does not meet the statutory definition of “back pay”.

Court’s Reasoning

The court emphasized that for compensation to qualify as “back pay,” it must have been earned in prior years but payment was deferred due to specific events, such as bankruptcy or similar circumstances. The court cited Regulations 111, section 29.107-3, which clarifies that the event must be unusual and operate to defer payment. In this case, the court found that the creditor’s agreement didn’t defer payment; it established a contingency. The employees weren’t entitled to the stock until all creditors were paid and they remained employed. The court distinguished this case from *Langer’s Estate v. Commissioner*, 183 F.2d 758, where salaries were actually due in prior years but couldn’t be paid due to insolvency. The court stated, “An event will be considered similar in nature to those events specified in section 107 (d) (2) (A) (i), (ii), and (iii) only if the circumstances are unusual, if they are of the type specified therein, if they operate to defer payment of the remuneration for the services performed, and if payment, except for such circumstances, would have been made prior to the taxable year in which received or accrued.”

Practical Implications

This case clarifies the narrow definition of “back pay” for tax purposes, emphasizing that a mere delay in payment isn’t sufficient. The right to the compensation must have existed in prior years, and payment must have been prevented by specific, unusual circumstances akin to bankruptcy or receivership. It serves as a reminder to carefully examine the conditions under which compensation is earned to determine if it truly constitutes back pay. Contingent compensation arrangements, where the right to payment depends on future events, will likely be taxed in the year the contingency is satisfied, not allocated to prior years. Later cases have cited *Bavis* to differentiate between deferred compensation and compensation contingent on future performance, impacting tax planning for businesses and executives.