19 T.C. 1 (1952)

A contingent compensation plan, established in good faith, can result in deductible compensation even if it appears high in profitable years; however, an erroneous deduction taken in a prior year generally cannot be treated as income in a later year unless the tax benefit rule or estoppel applies.

Summary

Streckfus Steamers, Inc. contested the IRS's disallowance of a portion of compensation paid to its officers and the inclusion of a previously deducted but unpaid state sales tax in its income. The Tax Court held that the compensation was reasonable under a bona fide contingent compensation plan. It also ruled that the previously deducted sales tax, which the company successfully contested, should not be included in income in the later year because the initial deduction, though erroneous, was not subject to the tax benefit rule in this case, nor was there a basis for estoppel.

Facts

Streckfus Steamers, Inc. operated excursion boats on the Mississippi River. The company had a long-standing contingent compensation plan for its four officer-shareholders, based on a percentage of profits. The IRS challenged the deductibility of portions of the compensation paid to these officers in 1942, 1943, 1944, and 1946, arguing it was excessive. In 1940, the company had accrued and deducted Illinois sales tax but later successfully contested its liability for the tax in Illinois state court in 1943. The IRS then included the amount of the unpaid tax as income for 1943.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Streckfus Steamers' income, declared value excess-profits, and excess profits taxes for 1942-1944 and 1946-1947. Streckfus Steamers petitioned the Tax Court for redetermination. The cases were consolidated, and the Tax Court addressed two primary issues: the reasonableness of the officer compensation and the inclusion of the previously deducted sales tax in income.

Issue(s)

1. Whether the respondent erred in disallowing in part compensation paid by petitioner to its four officers in the taxable years 1942, 1943, 1944 and 1946 as excessive.
2. Whether the respondent erred in including the amount of $2,867.98 in petitioner's income for 1943, representing Illinois sales tax accrued and deducted in 1940, but which petitioner never paid.

Holding

1. No, because the compensation was paid pursuant to a bona fide contingent compensation plan adopted in 1931 and consistently followed, and the amounts constituted reasonable compensation for the services rendered by the officers.
2. Yes, because an erroneous deduction taken in a prior year generally cannot be treated as income in a later year when the prior year is closed, unless the tax benefit rule or estoppel applies, and neither applied here.

Court's Reasoning

Regarding compensation, the court emphasized the importance of a "free bargain uninfluenced by any consideration other than securing on fair and advantageous terms the services of the individual." The court found the contingent compensation plan was bona fide, noting its long-standing existence, shareholder approval, and the fact that officer compensation was tied to profits, reflecting both good and lean years. The court considered the officers' skills, dedication, and the company's success under their leadership. Citing Mayson Manufacturing Co. v. Commissioner, 178 F. 2d 115; Regulations 111, sec. 29.23 (a)-6 (2) and (3).

Regarding the sales tax, the court acknowledged that the original deduction was improper, citing Dixie Pine Products Co. v. Commissioner, <span normalizedcite="320 U.S. 516“>320 U.S. 516, and Security Flour Mills Co. v. Commissioner, <span normalizedcite="321 U.S. 281“>321 U.S. 281, which held that a controverted obligation is not accruable until the dispute is settled. However, the court stated, "An erroneous deduction taken in a prior year may not be treated as income of a later year," citing Commissioner v. Schuyler, 196 F. 2d 85. The court found neither the tax benefit rule nor the doctrine of estoppel applied because the IRS did not plead estoppel, nor was any evidence presented showing any basis for an estoppel.

Practical Implications

This case underscores that a well-designed and consistently applied contingent compensation plan is likely to be upheld, even if it results in high compensation in profitable years. It also highlights the limits of the tax benefit rule. While the rule generally requires the inclusion of an item in income if a prior deduction provided a tax benefit, this case makes clear that an erroneous deduction, if the year is closed, does not automatically trigger income inclusion in a later year, absent the application of estoppel or a properly claimed and allowed deduction as described under section 22 (b) (12) of the Internal Revenue Code. Tax advisors should carefully document the rationale behind compensation plans and thoroughly analyze whether the tax benefit rule or estoppel applies before including previously deducted amounts in income.

