20 T.C. 323 (1953)

Payments for services rendered under a contingent contract made prior to the rendering of services, in an arm's length transaction, are deductible as ordinary and necessary business expenses if the amounts are reasonable under the circumstances existing when the contract was made. Business gratuities are deductible if they have a direct relationship to the taxpayer's business and are reasonable in amount.

Summary

Olivia de Havilland Goodrich, a motion picture actress, deducted payments to her business manager and certain business gratuities. The Commissioner disallowed a portion of these deductions, arguing that the manager's compensation was excessive and the gratuities were personal expenses. The Tax Court held that the payments to the manager were reasonable because they were made under an arm's length contract entered into before the services were rendered and that the business gratuities were deductible as ordinary and necessary business expenses because they were directly related to her profession and were reasonable in amount. The court emphasized the importance of the circumstances existing when the contract was made, not when it was questioned, in determining the reasonableness of compensation.

Facts

Olivia de Havilland Goodrich, a motion picture actress, employed her stepfather, G.M. Fontaine, as her business manager in 1939, compensating him with 25% of her earnings. After the IRS challenged the reasonableness of this compensation in 1943, she agreed to reduce it to 15%. In 1945 and 1946, she paid Fontaine 15% of her salary under this revised agreement. She also gave gifts (gold necklace and silver tea set) to Edith Head and Phyllis Laughton, head designer and dialogue director respectively. In 1947, she gave an oil painting to her agent, Kurt Frings.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Goodrich's income tax for 1945, 1946, and 1947, disallowing portions of deductions claimed for payments to her business manager and business gratuities. Goodrich appealed to the Tax Court, contesting the Commissioner's determination.

Issue(s)

1. Whether Goodrich is entitled to deduct the full amounts paid to her business manager, G.M. Fontaine, in 1945 and 1946, or whether the deduction is limited to the amount deemed reasonable by the Commissioner.

2. Whether the business gratuities given by Goodrich in 1945 and 1947 constitute deductible ordinary and necessary business expenses.

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Holding

1. Yes, because the payments to Fontaine were made pursuant to a bona fide, arm's-length contract entered into before the services were rendered, and the compensation was reasonable under the circumstances existing when the contract was made.

2. Yes, because the business gratuities were directly related to Goodrich's profession as an actress and were reasonable in amount.

Court's Reasoning

The court reasoned that the payments to Fontaine were made under a valid contract established before the services were rendered. The court cited Regulations 111, Section 29.23(a)-6, which states that contingent compensation paid pursuant to a free bargain between the employer and individual, made before the services are rendered, should be allowed as a deduction even if it proves to be greater than the amount which would ordinarily be paid. The court emphasized that the circumstances existing at the time the contract was made should be considered, not those existing when the contract is questioned. The Court found there was no evidence to support the Commissioner's assertion that the payments were a form of support for Fontaine. Regarding the business gratuities, the court found a direct relationship between the gifts and Goodrich's profession, noting that they were given to individuals who contributed to her success as an actress. It distinguished the case from *Reginald Denny, 33 B.T.A. 738*, where the gift was so large that it could not be considered an ordinary and necessary business expense without a showing that the services were in some way commensurate with the outlay.

Practical Implications

This case provides guidance on the deductibility of compensation paid to employees or contractors and the deductibility of business gifts. It highlights the importance of having a written contract established prior to the rendering of services when compensating individuals on a contingent basis. It emphasizes that the reasonableness of compensation should be evaluated based on the circumstances existing when the contract was made, not with hindsight. The case also clarifies that business gratuities can be deductible if they are directly related to the taxpayer's trade or business and are reasonable in amount. This ruling has been cited in subsequent cases dealing with the reasonableness of compensation and the deductibility of business expenses in the entertainment industry and beyond.

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