23 T.C. 208 (1954)

Payments made by a corporation to settle claims related to a former employee's alleged profit share, where no stock ownership exists, are considered ordinary income, not capital gains, for the employee and deductible business expenses for the corporation.

Summary

Frank Feagans, former president of Feagans Paint Company, received $19,500 from the company to settle his claims stemming from an alleged agreement to share in company profits and a dispute over stock ownership. The Tax Court determined that Feagans had no actual stock ownership and the payment was not for the sale of a capital asset. Instead, the court held the settlement represented ordinary income to Feagans, compensating him for his services and resolving his claims. Correspondingly, the court allowed Feagans Paint Company to deduct the settlement payment and related legal fees as ordinary and necessary business expenses. This case clarifies the tax treatment of settlement payments in disputes involving employee compensation versus capital asset sales.

Facts

Lafayette Dirksmeyer purchased Whittemore Paint Company and renamed it Feagans Paint Company. He employed Frank Feagans to manage the business, with an informal understanding to share profits if successful. Feagans Paint Company incorporated, with Dirksmeyer contributing all capital. Although stock certificates initially showed Feagans holding a majority stake (for Dirksmeyer's personal reasons), Feagans immediately endorsed and returned the certificate to Dirksmeyer, retaining no ownership. Later, a duplicate stock certificate was created and held by Feagans for deceptive purposes related to Dirksmeyer's divorce. When relations soured, Feagans claimed ownership based on the duplicate certificate and demanded a share of accumulated profits. Dirksmeyer sued Feagans to recover the duplicate certificate. To settle the lawsuit and Feagans' claims, Feagans Paint Company paid Feagans $19,500, and Feagans resigned.

Procedural History

The Commissioner of Internal Revenue assessed deficiencies against Frank Feagans and Esther Feagans, Lafayette A. Dirksmeyer, and Feagans Paint Company for the 1948 tax year. The cases were consolidated in the United States Tax Court. The Tax Court reviewed the facts and circumstances surrounding the $19,500 payment to Frank Feagans to determine its proper tax treatment for both Feagans and Feagans Paint Company.

Issue(s)

1. Whether the $19,500 payment received by Frank Feagans from Feagans Paint

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Company constituted ordinary income or capital gain?
2. Whether Feagans Paint Company could deduct the $19,500 settlement payment and related legal fees as ordinary and necessary business expenses?
3. Whether legal fees incurred by Frank Feagans in negotiating the settlement are deductible?

Holding

1. Yes, the $19,500 payment to Feagans was ordinary income because it was compensation for services and settlement of claims, not payment for a capital asset.
2. Yes, Feagans Paint Company could deduct the settlement payment and legal fees as ordinary and necessary business expenses because they were incurred to resolve business disputes and claims related to employee compensation.
3. Yes, Feagans' legal fees were deductible as expenses for the collection of income because they were directly related to securing the settlement payment, which was deemed ordinary income.

Court's Reasoning

The Tax Court reasoned that Feagans never actually owned stock in Feagans Paint Company and had no proprietary interest. The court emphasized that the initial stock certificate issued in Feagans' name was immediately endorsed back to Dirksmeyer, and the duplicate certificate was created for deception, not ownership. The court found the $19,500 payment was to settle Feagans' claims for a share of profits, stemming from an informal agreement, and to resolve the lawsuit. The court stated, "*We have found as a fact, and it is clear to us from the entire record, that Feagans never did in fact own any shares of stock in the corporation; had no proprietary interest in the business; and that in reality his claims were for additional compensation.*" Because the payment was not for the sale of a capital asset, it was deemed ordinary income. For the corporation, the court found the payment was a necessary business expense to resolve a dispute with a former employee and protect the business's goodwill, stating, "*We think that the sum so paid constitutes an ordinary and necessary expense of the corporation, deductible in the year in which the settlement was reached…*" The court also allowed Feagans to deduct his legal fees as expenses for collecting income, consistent with the determination that the settlement was ordinary income.

Practical Implications

Feagans v. Commissioner provides practical guidance on the tax treatment of settlement payments in business disputes, particularly those involving claims by former employees or officers who allege rights to profits or equity but lack formal ownership. For employees, it clarifies that settlements related to compensation or profit-sharing claims, even if arising from disputes resembling ownership claims, are likely to be taxed as ordinary income, not capital gains, unless actual stock

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ownership and transfer are clearly demonstrated. For businesses, the case confirms that payments made to settle such disputes, along with associated legal fees, can be deductible as ordinary and necessary business expenses, reducing taxable income. This ruling highlights the importance of properly characterizing the nature of settlement payments and ensuring documentation reflects the true substance of the agreement to achieve the desired tax consequences. Later cases have cited *Feagans* to distinguish between payments for capital assets versus compensation or settlement of other claims in determining tax treatment.

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