23 T.C. 462 (1954)

To qualify as "back pay" under section 107 of the Internal Revenue Code, remuneration must have been deferred due to events similar in nature to bankruptcy or receivership, and there must have been an agreement or legal obligation to pay the amount during the prior period.

Summary

The Estate of Alfred B. Thoreson contested a tax deficiency determined by the Commissioner of Internal Revenue. Thoreson had received $4,800 from the A.O. Jostad Company, which he designated as "back pay" for the years 1932-1935, attempting to allocate this income to those earlier years for tax purposes. The Tax Court held that this payment did not qualify as "back pay" under Section 107 of the Internal Revenue Code of 1939 because there was no existing agreement or legal obligation to pay the sum during the period in question, and the company's financial situation was not analogous to bankruptcy or receivership. Consequently, the court ruled in favor of the Commissioner, disallowing the allocation and affirming the tax deficiency.

Facts

Alfred B. Thoreson received $4,800 from the A.O. Jostad Company in 1946, representing deferred compensation. He attributed this sum to back pay for the years 1932-1935, claiming the benefits of section 107 of the Internal Revenue Code. The A.O. Jostad Company was a small, local general merchandising store. While the company experienced financial difficulties, it was never in bankruptcy or receivership. Thoreson was a shareholder and officer of the company, but had no written employment contract. The company's financial statements showed it was not insolvent, and that it possessed a surplus of approximately $14,000 or more. Corporate minutes from 1932-1946 made no mention of officer salaries until April 25, 1946, when the payment was authorized.

Procedural History

The Commissioner of Internal Revenue determined a tax deficiency, disallowing Thoreson's allocation of the $4,800 as back pay. The Estate of Thoreson petitioned the United States Tax Court to challenge the deficiency.

Issue(s)

1. Whether the $4,800 received by Alfred B. Thoreson in 1946 constituted "back pay" within the meaning of section 107(d)(2)(A)(iv) of the Internal Revenue Code of 1939?

Holding

1. No, because the financial circumstances of the A.O. Jostad Company during 1932-1935 did not constitute an event similar to bankruptcy or receivership, and there was no agreement or legal obligation for the payment of the $4,800 during that time.

Court's Reasoning

The court analyzed whether the conditions for "back pay" treatment under the tax code were met. The court stated that the company's financial condition was not similar to bankruptcy or receivership. It noted that the company always had current assets in excess of current liabilities, had no funded debt or mortgage, and maintained a substantial surplus. Low cash balance or slow-moving assets, in the court's view, did not, by themselves, constitute events similar to bankruptcy or receivership. The court emphasized that the taxpayer had to demonstrate that the payment would have been made but for an event akin to bankruptcy or receivership. The court found that no agreement or legal obligation to pay the salary existed during the prior years. The court cited *Sedlack v. Commissioner* and other cases to support its view that the lack of a pre-existing agreement or legal obligation was fatal to the taxpayer's claim. "To come within the scope of this section and the regulations … there must have been during the years to which the taxpayer seeks to allocate the compensation an agreement or legal obligation to pay the amount received."

Practical Implications

This case clarifies the definition of "back pay" under the Internal Revenue Code, specifically requiring evidence of a prior agreement or legal obligation and an event analogous to bankruptcy or receivership to justify allocation to prior tax years. Lawyers advising clients on deferred compensation issues must carefully examine whether the conditions for favorable tax treatment of back pay are met, including documenting any pre-existing agreements or legal obligations. This case is a reminder that merely labeling payments as "back pay" does not automatically entitle a taxpayer to favorable tax treatment; the underlying circumstances must meet the strict requirements established by the tax code and supporting regulations. The court's emphasis on the absence of an existing legal obligation is particularly significant.

