Putchat v. Commissioner, 52 T. C. 470 (1969)

Amounts received for the release of employment contract rights, including stock options, are taxable as ordinary income.

Summary

Nathan Putchat received $75,000 in settlement of a lawsuit against his employer, Associated General Builders, Inc. , for the release of his rights under an employment contract. These rights included employment as a project manager, a share of profits, and a stock option. The U. S. Tax Court held that the $58,433. 36 net amount received after legal fees was ordinary income, not capital gain, as the rights released were compensatory in nature. The decision emphasizes that the nature of the underlying claim determines the tax treatment, not the method of collection, and that the release of employment-related rights, including stock options, results in ordinary income.

Facts

Nathan Putchat entered into an employment agreement with Associated General Builders, Inc. , to work on an atomic energy project, with compensation including a weekly salary, 20% of net profits, and an option to purchase 40 shares of Builders stock at a fixed price. Due to a dispute with his employer, Putchat filed a lawsuit seeking enforcement of his contract rights. After being terminated, he settled the lawsuit for $75,000, releasing all his rights under the contract. Putchat reported the settlement as capital gain, but the IRS treated it as ordinary income.

Procedural History

Putchat and his wife filed a petition with the U. S. Tax Court challenging the IRS’s determination of a deficiency in their 1959 and 1960 federal income taxes. The Tax Court found for the Commissioner, ruling that the settlement amount was ordinary income.

Issue(s)

1. Whether the $58,433. 36 received by Nathan Putchat in settlement of his lawsuit constitutes ordinary income or capital gain?

Holding

1. Yes, because the amount received was in exchange for the release of employment-related rights, including a stock option granted as compensation for services, which are taxable as ordinary income under the applicable tax regulations.

Court’s Reasoning

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The court determined that the stock option was granted as compensation for Putchat's services, not as a return of capital. The court relied on the factors that the option was tied to his employment, nontransferable, and would expire upon his death or termination of employment. The court applied the principle that the nature of the underlying claim governs the tax treatment, citing *Spangler v. Commissioner*. The court also referenced *Commissioner v. Smith* and *Commissioner v. LoBue*, which established that compensation, including stock options at bargain prices, is taxable as ordinary income. The court concluded that the release of these employment-related rights resulted in ordinary income under the applicable tax regulations, specifically section 1. 421-6(d)(3) of the Income Tax Regulations.

Practical Implications

This decision clarifies that settlements for the release of employment contract rights, including stock options, are treated as ordinary income for tax purposes. Attorneys should advise clients that the tax treatment of such settlements depends on the nature of the underlying rights, not the method of collection. This ruling impacts how employment disputes are settled and reported for tax purposes, emphasizing the importance of distinguishing between compensatory and capital elements in settlement agreements. Subsequent cases have followed this precedent, reinforcing the principle that the release of employment-related rights results in ordinary income.

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