Henry v. Commissioner, 62 T. C. 605 (1974)

Settlement proceeds from a lawsuit for breach of an employment contract are taxable as ordinary income when they are compensatory for lost commissions.

Summary

In Henry v. Commissioner, the U. S. Tax Court ruled that $32,461. 38 received by William F. Henry as settlement for a lawsuit against his former employer for breach of an employment contract was taxable as ordinary income. The settlement was considered compensatory for lost commissions, which would have been taxable had they been earned as income. The court granted the Commissioner's motion for partial summary judgment, finding no genuine issue of material fact and affirming that such settlements are taxed as ordinary income based on the nature of the claim settled.

Facts

William F. Henry filed a lawsuit against his former employer seeking damages for breach of an employment contract, specifically for lost commissions. He alleged that he earned $57,772. 38 in commissions in 1967 under the contract. In December 1969, Henry received a settlement of $32,461. 38. He reported this amount on his 1969 tax return, noting it as nontaxable income. The IRS determined this sum to be taxable as additional income for 1969.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Henry's federal income taxes for 1968 and 1969, including the settlement amount as income for 1969. Henry filed a timely petition with the U. S. Tax Court challenging these determinations. The Commissioner filed a motion for partial summary judgment regarding the taxability of the settlement proceeds. The Tax Court granted the motion, finding the settlement proceeds taxable as ordinary income.

Issue(s)

1. Whether the $32,461. 38 received by Henry in settlement of his lawsuit for breach of an employment contract is taxable as ordinary income.

Holding

1. Yes, because the settlement proceeds were compensatory for lost commissions, which would have been taxable as ordinary income if earned under the employment contract.

Court's Reasoning

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The Tax Court, adopting the opinion of Commissioner Randolph F. Caldwell, Jr. , reasoned that the nature and basis of the action determine the character of the settlement proceeds. Since Henry's lawsuit sought to recover lost commissions, the settlement proceeds were deemed compensatory in nature and thus taxable as ordinary income. The court cited *Margery K. Megargel*, 3 T. C. 238 (1944), where it was held that the nature of the action shows the character of the compromise consideration, and *Lyeth v. Hoey*, 305 U. S. 188 (1938), reinforcing that principle. The court found no genuine issue of material fact, affirming that the settlement was fully taxable as ordinary income under existing tax law and precedent.

Practical Implications

This decision clarifies that settlement proceeds from lawsuits that compensate for lost income, such as commissions under an employment contract, are taxable as ordinary income. Legal practitioners should advise clients that settlements for lost wages or commissions are subject to taxation in the same manner as if those amounts had been earned through employment. This ruling impacts how attorneys structure settlement agreements and informs tax planning for clients involved in employment-related litigation. Subsequent cases like *F. W. Jessop*, 16 T. C. 491 (1951), and *Victor H. Heyn*, 39 T. C. 719 (1963), have followed this principle, reinforcing the taxability of similar settlement proceeds.

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