Gertz v. Commissioner, 64 T. C. 598 (1975)

A bad debt deduction for unpaid wages cannot be claimed unless the income was previously included in the taxpayer's gross income.

Summary

In Gertz v. Commissioner, the Tax Court denied Robert Gertz's claim for a bad debt deduction under IRC section 166 for $8,917 in unpaid wages from his former employer, Edward E. Gurian & Co. , Inc. , which had gone bankrupt. Gertz had not included these wages in his income for any prior tax year. The court held that under the relevant regulations and case law, a bad debt deduction for unpaid wages is only allowable if the income was previously reported. Additionally, the court rejected Gertz's alternative argument for a tax credit for withholding on the unpaid wages, as no actual or constructive payment had been made by the employer.

Facts

Robert Gertz entered into an oral two-year employment agreement with Edward E. Gurian & Co. , Inc. in July 1963, where he worked as an engineer until the company ceased operations on August 16, 1964. At the time of termination, Gertz was owed $8,918 in wages, which he claimed in Gurian's bankruptcy proceeding. The bankruptcy court allowed a $600 priority claim (paid in full) and an $8,318 unsecured claim (not satisfied). In 1969, Gertz claimed a bad debt deduction for the full $8,917 on his tax return, despite never having included this amount in his income.

Procedural History

The Commissioner of Internal Revenue disallowed the bad debt deduction, leading Gertz to petition the U. S. Tax Court. The Tax Court upheld the Commissioner's decision, disallowing the deduction and rejecting Gertz's alternative claim for a withholding tax credit.

Issue(s)

1. Whether a taxpayer can claim a bad debt deduction for unpaid wages under IRC section 166 without having previously included those wages in income.
2. Whether the taxpayer is entitled to a tax credit for withholding on unpaid wages when no actual or constructive payment was made by the employer.

Holding

1. No, because under IRC section 166 and the applicable regulations, a bad debt deduction for unpaid wages is not allowed unless the income was included in the taxpayer's return for the year the deduction is claimed or a prior year.
2. No, because no actual or constructive payment of the wages occurred, thus no

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withholding tax was required to be deducted, and no tax credit is available under IRC section 31(a).

Court’s Reasoning

The Tax Court applied IRC section 166 and the corresponding regulation, section 1. 166-1(e), which states that a bad debt deduction for unpaid wages, salaries, fees, rents, and similar items is only allowed if the income was previously included in the taxpayer’s income. The court cited long-standing case law (e. g. , Charles A. Collin, 1 B. T. A. 305 (1925)) to support this principle. The court did not need to determine the validity of Gertz’s debt, as the lack of prior income inclusion was dispositive. Regarding the tax credit, the court explained that IRC section 3402 requires withholding only when wages are actually or constructively paid, which did not occur in this case. The court rejected Gertz’s argument that the bankruptcy court’s allowance of his claim constituted constructive payment, as it merely allowed him to participate in the distribution of the bankrupt’s assets.

Practical Implications

This decision clarifies that taxpayers cannot claim bad debt deductions for unpaid wages without first reporting those wages as income. Legal practitioners must advise clients to include all earned income in their tax returns, even if payment is uncertain, to preserve the option of claiming a bad debt deduction if the income becomes uncollectible. The ruling also underscores that withholding tax obligations and corresponding tax credits do not arise unless wages are actually or constructively paid. This case has been cited in subsequent decisions, such as Estate of Mann v. Commissioner, 73 T. C. 768 (1980), to reinforce these principles. Businesses and taxpayers should be aware of these requirements when dealing with unpaid wages in bankruptcy or other insolvency situations.

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