James R. Harkness v. Commissioner of Internal Revenue, T.C. Memo. 1958-4 (1958)

Amounts designated as reimbursements to an employee but deducted directly from their commission income are not considered true reimbursements for the purpose of calculating adjusted gross income under Section 22(n)(3) of the 1939 Internal Revenue Code.

Summary

James Harkness, a salesman, reported only the net commission income after deducting expenses. The IRS argued his gross income was the full commission amount, allowing expense deductions separately. The Tax Court agreed with the IRS, holding that Harkness's contract, which deducted expenses from commissions, did not constitute a reimbursement arrangement for adjusted gross income calculation. The court clarified that while travel, meals, and lodging away from home are deductible from gross income to reach adjusted gross income, other business expenses are deductible from adjusted gross income to reach net income, impacting the availability of the standard deduction. The court also addressed the substantiation of expenses, partially disallowing some claimed amounts due to insufficient evidence.

Facts

1. James Harkness was employed as a salesman and paid on commission.
2. His employment contract stipulated that he would be reimbursed for approved business expenses, but these reimbursements would be deducted from his earned commissions.
3. Harkness submitted monthly expense accounts to his employer, who primarily checked for mathematical accuracy and did not audit for substantive correctness.
4. The employer withheld a portion of commissions for prior year deficits and a $2,000 reserve as per the employment agreement.
5. Harkness claimed deductions for various business expenses, including transportation, meals, lodging, entertainment, supplies, and salary for an assistant.
6. Harkness reported only the net commission income (commissions minus expenses) on his tax returns.
7. The IRS determined that the gross commission income should be reported, with expenses deducted separately.

Procedural History

This case originated in the Tax Court of the United States. The Commissioner of Internal Revenue determined deficiencies in Harkness's income tax for the years 1949, 1950, and 1951. Harkness contested this determination in Tax Court.

Issue(s)

1. Whether the full amount of commissions earned by Harkness, before deduction of expenses, constitutes gross income.
2. Whether the expense arrangement with Harkness's employer qualifies as a "reimbursement or other expense allowance arrangement" under Section 22(n)(3) of the Internal Revenue Code of 1939, allowing deduction of expenses from gross income to arrive at adjusted gross income.
3. Whether Harkness adequately substantiated the amounts and deductibility of his claimed business expenses.

Holding

1. Yes, because the employment contract clearly stated commissions were paid as a percentage of sales, and under cash accounting, all received income is gross income.
2. No, because the contractual arrangement where expenses were deducted from commissions does not constitute a true reimbursement arrangement under Section 22(n)(3). The court reasoned that the substance of the agreement was that Harkness was paid commissions from which he was expected to pay his own expenses.
3. Partially. The court accepted the expense account figures as evidence of expenditure but found substantiation lacking for the reasonableness of the mileage rate for transportation and for the business necessity of expenses related to Harkness's wife accompanying him on trips. Some expenses were disallowed or reduced due to insufficient evidence of their nature and business purpose.

Court's Reasoning

The court reasoned that the contract language, stating expenses would be "deducted from the commissions," indicated that Harkness was essentially paying his expenses out of his commission income, not receiving a separate reimbursement. The court distinguished this from a true reimbursement arrangement where the employee is made whole for expenses incurred on behalf of the employer, in addition to their compensation. The court stated, "The substance of the employment contract was that he was to receive his commissions and pay whatever expenses he found it necessary to incur in earning his commissions. The amount which he would receive was determinable without reference to the amount of expenses which he might incur. Thus, although the contract states that the petitioner will be reimbursed for his expenses, the claimed effect thereof as a reimbursement arrangement within the meaning of the statute is destroyed by the further provision that 'we will deduct the same from the commissions.'"

Regarding substantiation, the court noted Harkness's lack of detailed records and failure to provide evidence supporting the claimed mileage rate or the business necessity of his wife's travel expenses. Referencing *Old Mission Portland Cement Co. v. Commissioner*, 293 U.S. 289, the court emphasized the taxpayer's burden to prove the deductibility of expenses beyond simply showing they were spent.

Practical Implications

Harkness clarifies the distinction between true reimbursements and expense allowances that are effectively reductions of commission income for employees. It highlights that for expenses to be deductible from gross income to reach adjusted gross income under Section 22(n)(3) (and later iterations of similar provisions in subsequent tax codes), there must be a genuine reimbursement arrangement, separate from the employee's compensation structure. This case underscores the importance of contract language in defining the nature of payments and expense arrangements between employers and employees for tax purposes. It also serves as a reminder of the taxpayer's burden to adequately substantiate all deductions claimed, not just the fact of expenditure but also their business nature and reasonableness. This case is relevant for understanding the nuances of employee business expense deductions and the calculation of adjusted gross income, particularly in commission-based employment scenarios.

