Flower v. Commissioner, 61 T. C. 140 (1973)

Payments received for terminating a contract to perform personal services are taxable as ordinary income, not capital gains.

Summary

Harry M. Flower received payments from Rowell Laboratories, Inc. , following the termination of his sales franchise agreement. The U. S. Tax Court held that these payments, intended as compensation for future commissions he would have earned, were taxable as ordinary income. The court rejected Flower's claim that the payments represented capital gains from the sale of a franchise or goodwill. Additionally, the court disallowed deductions for business expenses Flower incurred under a separate agreement, as these were subject to reimbursement.

Facts

Harry M. Flower worked as a sales representative for Rowell Laboratories, Inc. , promoting their pharmaceutical products on a commission basis. In 1961, Flower and Rowell terminated their contract, with Rowell agreeing to pay Flower $216,000 over time. Flower reported these payments as capital gains, asserting they were for the sale of his franchise and goodwill. Flower also entered into a 1965 agreement with Rowell to represent their products in a new territory, under which Rowell agreed to reimburse Flower's business expenses over a 10-year period. Flower claimed deductions for these expenses on his tax returns.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Flower's income tax for the years 1965, 1966, and 1967, treating the payments from Rowell as ordinary income and disallowing the deductions for reimbursable expenses. Flower petitioned the U. S. Tax Court to challenge these determinations.

Issue(s)

1. Whether payments received by Flower under the 1961 termination agreement with Rowell are taxable as ordinary income or capital gains.
2. Whether Flower is entitled to deduct business expenses incurred under the 1965 agreement with Rowell, given the reimbursement provision.

Holding

1. No, because the payments were a substitute for ordinary income Flower would have received had the contract continued, and he did not transfer any capital assets such as goodwill.
2. No, because expenses subject to reimbursement are not deductible as they are considered advances or loans.

Court's Reasoning

The court found that the $216,000 payment Flower received was the maximum amount Rowell would have paid under the original contract's termination provisions, representing a substitute for future commissions. The court emphasized that Flower's role was to build goodwill for Rowell's products, which remained with Rowell upon termination. Therefore, the payment was for the relinquishment of Flower's right to future commissions, not the sale of a capital asset. The court also noted that Flower's sales organization was not transferred as part of the termination, further supporting the treatment as ordinary income. Regarding the second issue, the court followed established precedent that expenses subject to reimbursement are not deductible, as they are akin to advances or loans, not business expenses. The court rejected Flower's arguments that the reimbursement was not a true right to repayment due to its deferred and non-interest-bearing nature, affirming that such expenses are not deductible under the tax code.

Practical Implications

This decision underscores that payments for terminating personal service contracts are generally treated as ordinary income, impacting how such agreements should be structured and reported for tax purposes. It also clarifies that expenses subject to reimbursement agreements are not immediately deductible, affecting financial planning and tax strategies for individuals and businesses in similar arrangements. The ruling has been influential in subsequent cases involving the taxation of termination payments and the deductibility of reimbursable expenses, reinforcing the importance of clear contractual terms and understanding tax implications in personal service agreements.

