9 T.C. 15 (1947)

When a taxpayer's method of reporting income is changed from the installment sales method to the accrual method, previously unreported profit pertaining to payments due on installment sales contracts as of the close of the year preceding the change must be included in the income for the year the change takes effect.

Summary

Gus Blass Co. was required by the Commissioner to change its method of reporting income from installment sales to the accrual method. The company argued that unrealized profit on installment accounts receivable at the close of the fiscal year preceding the change should be included in income for the year the method was changed. The Tax Court agreed with Gus Blass Co., holding that the adjustment was required to accurately reflect income. The court also addressed whether the company was avoiding surtax on shareholders (finding it was not), executive compensation (finding some deductions excessive), and other tax issues.

Facts

Gus Blass Co., an Arkansas department store, used the accrual basis for accounting, except for installment sales. It deferred 50% of the profit on installment accounts receivable. The Commissioner later required the company to switch to the accrual method for all income. A key issue was the treatment of $99,681.30, representing profit not previously reported under the installment method.

Procedural History

The Commissioner determined deficiencies in income tax, declared value excess profits tax, and excess profits tax. Gus Blass Co. petitioned the Tax Court for redetermination. The Commissioner amended his answer, claiming increases in the deficiencies. The Tax Court addressed multiple issues, including the accounting method change and its impact on taxable income.

Issue(s)

1. Whether the amount of $99,681.30, representing unrealized profit on installment accounts receivable at the close of the fiscal year preceding the mandated change to the accrual method, should be included in the taxpayer's income for the fiscal year in which the accounting method changed.

2. Whether the company was availed of in the fiscal year ended January 31, 1941, for the purpose of preventing the imposition of surtax on its shareholders within the meaning of section 102, Internal Revenue Code;

3. Whether the petitioner is entitled to deductions for the fiscal year ended January 31, 1942, for compensation paid to its president and two of its vice presidents in

excess of the amounts allowed by the respondent;

4. Whether in computing the petitioner’s excess profits tax for the fiscal years ended January 31, 1941 and 1942, the petitioner should be granted relief under section 722 of the Internal Revenue Code by restoring to earnings of the base period fiscal year ended January 31, 1939, a loss incurred in that year from the sale of its shoe department in the amount of $ 7,037.59;

5. Whether the petitioner is entitled to a deduction in the fiscal year ended January 31, 1942, of $ 41,854.17, which amount it had set aside under an employee’s profit-sharing pension plan for payment of bonuses to employees during the fiscal year ended January 31, 1943; and

6. Whether excess profits net income for the fiscal year ended January 31, 1941, should be increased to the extent of $ 5,568.75 by computing the amount of petitioner’s deduction for contributions at 5 per cent of its excess profits net income before deduction of contributions, rather than at 5 per cent of its normal tax net income before deduction of contributions.

Holding

1. Yes, because when the method of reporting income is changed it is necessary in certain cases to make some adjustment to protect the taxpayer and the revenue.

2. No, the petitioner was not availed of during the fiscal year ended January 31, 1941, for the purpose of preventing the imposition of surtax on its shareholders.

3. No, the amount of $ 42,000 constitutes reasonable compensation for the services rendered by Noland Blass, $10,000 for Jesse Heiman, and $10,000 for Hugo Heiman.

4. No, the petitioner failed to show its average base period net income is an inadequate standard of normal earnings.

5. Yes, the fund in the hands of the trustees was effectively placed beyond the control of the petitioner and the liability of petitioner became fixed and definite at the time when the agreement was made.

6. No, the computation proposed by the respondent in his amended answer is contrary to the plain and unambiguous terms of the statute.

Court’s Reasoning

The Tax Court reasoned that when the Commissioner directs a change in accounting methods, taxpayers must include previously untaxed profits in the year the change takes effect. It emphasized that regulations require this inclusion to avoid distorting income. Regarding the accumulated earnings tax, the court found that the company’s dividend policy and the lack of tax avoidance intent among shareholders negated the imposition of the surtax. On executive compensation, the court scrutinized the reasonableness of the deductions, comparing them to similar companies. Finally, regarding relief under section 722, the Court determined the petitioner failed to provide supporting evidence. The Court stated,

“Where the change is made from the installment to the straight accrual method, the regulation provides that the taxpayer “will be required” to return as additional income for the taxable year in which the change is made all the profit not theretofore returned as income pertaining to payments due on installment sales contracts as of the close of the preceding year. This part of the regulation is mandatory in terms, and the necessity of returning such profit is present whether the change be made at the direction of the Commissioner or upon the application of the taxpayer.”

Practical Implications

This case provides guidance on accounting method changes, particularly the transition from installment to accrual. It reinforces that the Commissioner’s adjustments must accurately reflect income. It highlights the importance of contemporaneous documentation in justifying executive compensation and demonstrates that a company must provide supporting evidence for relief under Section 722. The case is also a reminder that changes in accounting methods can have significant tax consequences. Later cases cite this decision regarding reasonable compensation, Section 102 issues and accounting changes.

