***T.C. Memo. 1949-48***

A cash basis taxpayer does not realize taxable gain from the sale of property until the amount realized in cash or its equivalent exceeds the taxpayer's basis in the property, even if a contract for sale exists in a prior year.

## Summary

Harold W. Johnston, a cash basis taxpayer, sold stock in 1942 under a contract where the proceeds were placed in escrow and not fully distributed until 1943. The Commissioner determined that the gain was taxable in 1943, while Johnston argued it was taxable in 1942. The Tax Court held that Johnston did not realize the gain until 1943, when he actually received cash exceeding his basis in the stock. The court emphasized that a cash basis taxpayer recognizes income when cash or its equivalent is received, and a mere contract for future payment is not the equivalent of cash.

## Facts

Johnston owned stock in Traung Investment Co. On December 28, 1942, Traung and its stockholders entered into a contract to sell all outstanding shares to Seagram & Sons and Carstairs Bros. Distilling Co. The contract stipulated that the buyers would deposit 50% of the estimated purchase price with the Bank of America. The exact purchase price was to be determined later based on the balance sheets. The stockholders delivered their stock on December 28, 1942, and the initial payment was made to the bank. An escrow agreement was established in January 1943. Johnston's share of the initial deposit was less than his basis in the stock, and he received his total proceeds in 1943.

## Procedural History

The Commissioner determined a deficiency in Johnston's 1943 income tax, asserting that the gain from the stock sale was taxable in that year. Johnston contested this determination, arguing that the gain was realized in 1942. The case was brought before the Tax Court.

## Issue(s)

Whether a cash basis taxpayer realizes a taxable gain from the sale of stock in the year the contract for sale is executed and initial payment is deposited into escrow, or in the year the taxpayer actually receives cash exceeding their basis in the stock.

## Holding

No, because a cash basis taxpayer recognizes income when they actually or constructively receive cash or its equivalent. A contract for future payment, without notes or other readily transferable evidence of indebtedness, is not the equivalent of

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cash.

### Court’s Reasoning

The Tax Court reasoned that Johnston, as a cash basis taxpayer, only realizes gain when the amount realized (cash or its equivalent) exceeds his basis in the stock. The deposit into the escrow account in 1942 did not constitute actual or constructive receipt because the funds were not unqualifiedly subject to Johnston’s demand. The court emphasized the distinction between the cash and accrual methods of accounting, noting that a simple contract for future payment only creates accounts payable/receivable, which are relevant for accrual basis taxpayers but not for cash basis taxpayers. The court stated, “That kind of a simple contract creates accounts payable by the purchasers and accounts receivable by the sellers which those two taxpayers would accrue if they were using an accrual method of accounting in reporting their income. But such an agreement to pay the balance of the purchase price in the future has no tax significance to either purchaser or seller if he is using a cash system.” The court also noted that even an accrual basis taxpayer might have difficulty accruing the profit in 1942 because the final purchase price was not yet ascertainable. The court explicitly declined to follow earlier cases that suggested a different outcome.

### Practical Implications

This case reinforces the fundamental principle that cash basis taxpayers recognize income when they actually receive cash or its equivalent. It clarifies that a mere contractual right to future payment, without readily transferable instruments, does not trigger taxable income. Attorneys advising clients on the timing of income recognition should carefully consider the client’s accounting method. This case highlights that structuring a sale with escrow accounts and deferred payments can effectively defer income recognition for cash basis sellers until the funds are actually received. Later cases distinguish *Johnston* when the taxpayer receives notes or other negotiable instruments as part of the sale, which are treated as the equivalent of cash.

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