15 T.C. 943 (1950)

Gains from purchased accounts receivable are taxed when the collections are made, not at the time of purchase, regardless of whether the taxpayer uses the accrual method of accounting.

Summary

Carroll Furniture Co., which used the accrual method for excess profits tax purposes, purchased accounts receivable from another company. The Tax Court addressed whether the gains from collecting on these purchased accounts were taxable in the year of purchase or the year of collection, and whether insurance proceeds were includable in excess profits net income. The court held that the gains were taxable when the collections occurred, as no gain is realized until the disposition of the assets. The court also held the insurance proceeds were includable in excess profits net income.

Facts

Carroll Furniture Co. was a retail furniture business that regularly made installment sales. In 1940, the company received $14,091.34 from a use and occupancy insurance contract. In 1941, Carroll Furniture purchased accounts receivable from Matthews Furniture Co., an unrelated business that had ceased operations. The face value of these accounts was $229,373.66, and Carroll paid $178,765.76 for them. Carroll Furniture Co. did not include any collections on the purchased accounts in its excess profits net income for 1941 and 1943.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Carroll Furniture's excess profits tax for 1940, 1941, and 1943. The Commissioner added income from collections on purchased accounts receivable to the company's income. Carroll Furniture Co. petitioned the Tax Court for a redetermination of these deficiencies.

Issue(s)

1. Whether proceeds from a use and occupancy insurance contract are includible in excess profits net income.
2. Whether the gain realized from collections on purchased accounts receivable is taxable in the year of purchase or the year of collection when using the accrual method of accounting.
3. Whether the deduction for charitable contributions is limited to 5% of net income computed on the accrual basis for excess profits tax purposes.

Holding

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1. Yes, because the company did not demonstrate the income was abnormal and thus excludable.
2. No, because gain is recognized upon the sale or disposition of assets, which in this case, occurred when the accounts were collected.
3. Yes, because the court followed its prior ruling in *Leo Kahn Furniture Co.*

Court's Reasoning

The Tax Court reasoned that the insurance proceeds were includible in excess profits net income because Carroll Furniture Co. failed to demonstrate that this income was "abnormal income" under Section 721(a)(1) of the Code. Regarding the purchased accounts receivable, the court stated that gain is not taxable until "realized" on sales or exchanges of property. The court cited *Palmer v. Commissioner*, stating that "profits derived from the purchase of property, as distinguished from exchanges of property, are ascertained and taxed as of the date of its sale or other disposition by the purchaser." The court emphasized that a cash purchase does not trigger a realization of gain, but collections on those accounts do. On the final issue, the court followed its prior ruling in *Leo Kahn Furniture Co.*, holding that the contribution deduction is limited to 5% of net income computed on the accrual basis.

Practical Implications

The Carroll Furniture Co. case clarifies the tax treatment of purchased accounts receivable for businesses using the accrual method. It establishes that the gain from collecting on purchased accounts is taxed when the collections are made, reinforcing the principle that income is recognized when realized, not merely when the right to receive it is acquired. This ruling impacts how businesses account for and report income from purchased receivables, ensuring they recognize gains in the year of collection rather than the year of purchase. It also highlights the importance of properly pleading and proving claims of abnormal income to exclude items from excess profits net income, and reinforces that a taxpayer's election to use the accrual method for excess profits tax purposes impacts calculations of contribution deductions.

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