16 T.C. 1114 (1951)

When a company transfers unclaimed customer deposits on returnable containers to its income account after the containers are fully depreciated, the transferred amount constitutes ordinary income, not capital gain, and is subject to taxation.

Summary

Nehi Beverage Co. transferred $17,271.42 from its deposit liability account (representing deposits received on containers) to its miscellaneous income account after the containers had been fully depreciated. The IRS determined this amount was ordinary income, leading to a tax deficiency. Nehi argued it was a capital gain from an involuntary conversion that should not be immediately recognized under Section 112(f) of the Internal Revenue Code or, alternatively, that it qualified for capital gains treatment under Section 117(j). The Tax Court held that the transfer constituted ordinary income because the company did not reinvest the funds as required by Section 112(f), and the transfer did not arise from a sale, exchange, or involuntary conversion necessary for Section 117(j) treatment.

Facts

Nehi Beverage Company used a deposit system for its bottles and cases, retaining ownership marked on the containers. Deposits were collected from retail vendors and refunded upon return of the containers. Nehi depreciated the containers over a four-year period. After a survey in 1945, the board of directors authorized the transfer of $17,271.42 from the "container deposits returnable" liability account to a "miscellaneous non-operating income" account, deeming this amount unlikely to be claimed. The transferred funds were not earmarked for container replacement but were commingled with general corporate funds.

Procedural History

The Commissioner of Internal Revenue determined income tax deficiencies against Nehi Beverage Co. for the taxable years ending February 29, 1944, and February 28, 1946. The Commissioner denied Nehi's claim for a refund of part of its 1944 taxes, which was based upon the Commissioner's alleged erroneous treatment of a 1946 income item. Nehi petitioned the Tax Court for a redetermination. The Tax Court ruled against Nehi, finding the transfer constituted ordinary income.

Issue(s)

1. Whether the transfer of funds from Nehi's deposit liability account to its income account qualifies for non-recognition of gain under Section 112(f) of the Internal Revenue Code as an involuntary conversion.

2. Whether the gain realized from the transfer of funds should be treated as capital gain under Section 117(j) of the Internal Revenue Code.

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Holding

1. No, because Nehi did not "forthwith in good faith" expend the money in the acquisition of similar property as required by Section 112(f). The funds were commingled with general corporate funds and not earmarked for container replacement.

2. No, because the transfer did not result from a sale, exchange, or involuntary conversion of property as required by Section 117(j). The court found no sale occurred, no reciprocal transfer occurred which would constitute an exchange, and that nothing involuntary occurred which would constitute an involuntary conversion.

Court's Reasoning

The court reasoned that Section 112(f) requires taxpayers to trace the proceeds from an involuntary conversion to the acquisition of similar property to qualify for non-recognition of gain. Nehi failed to do this because the funds were not placed in a special account or earmarked for a specific purpose but were commingled with other funds. The court cited *Vim Securities Corp. v. Commissioner*, 130 F.2d 106 (2d Cir. 1942), emphasizing the need for strict compliance with the statutory requirements.

Regarding Section 117(j), the court determined that the transfer did not arise from a sale, exchange, or involuntary conversion. The court stated that a sale requires a contract, a buyer, a seller, and a meeting of the minds. An "exchange" as used in Section 117(j) means reciprocal transfers of capital assets (citing *Helvering v. Flaccus Oak Leather Co.*, 313 U.S. 247 (1941)). An involuntary conversion did not occur under Section 117(j) because there was no destruction, theft, seizure, or condemnation. The court relied on *Wichita Coca Cola Bottling Co. v. United States*, 152 F.2d 6 (5th Cir. 1945), to emphasize that closing out a deposit liability account and transferring the money to free surplus funds is a "financial act" that creates income in the year it is done.

Practical Implications

This case clarifies that companies using deposit systems for returnable containers must properly account for unclaimed deposits. Transferring these unclaimed deposits to income after the containers are fully depreciated results in ordinary income, taxable in the year of the transfer. The case highlights the importance of tracing funds when claiming non-recognition of gain under Section 112(f) and confirms that a mere bookkeeping entry can have significant tax consequences. It also serves as a reminder that to obtain capital gains treatment under Section 117(j), there must be a sale, exchange, or involuntary conversion, and the burden is on the taxpayer to demonstrate that the relevant transaction falls within one of those categories. The case also distinguishes the treatment of assets that are sold, rather than written off after depreciation.

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