Watertown Realty Co. v. Commissioner, 16 T.C. 1312 (1951)

A taxpayer cannot attribute income to other years for excess profits tax purposes if doing so would alter its established method of accounting without the Commissioner's consent.

Summary

Watertown Realty Co., which reported income on a cash basis using the 'recovered cost' method for land sales contracts, sought to attribute abnormal income received in 1942 and 1943 to earlier years to reduce excess profits tax. The Tax Court ruled against the company, holding that it could not retroactively alter its accounting method to shift income for tax advantages. The court emphasized that the taxpayer consistently used the cash method and never sought permission to change it, precluding the requested attribution of income.

Facts

Watertown Realty Co. subdivided its land and sold lots under a "nothing down" periodic payment plan, with payments commencing three years post-contract and continuing for ten years. Prior to 1942, many vendees defaulted. However, in 1942 and 1943, most vendees made current payments, paid arrearages, and made accelerated payments. The company used a "recovered cost" method, recognizing income only after payments exceeded the land's cost basis.

Procedural History

The Commissioner determined deficiencies in Watertown Realty Co.'s excess profits tax for 1942 and 1943, adjusting both excess profits net income and credits. The company then claimed a refund, arguing it could attribute some income to other years, which the Commissioner denied. The Tax Court reviewed the Commissioner's determination.

Issue(s)

1. Whether Watertown Realty Co. could attribute net abnormal income received in 1942 and 1943 to other years under Section 721(b) of the Internal Revenue Code to reduce excess profits tax, considering its established cash basis accounting method.
2. Whether the income resulting from overdue payments constitutes income "arising out of a claim, award, judgment, or decree" under Section 721(a)(2).

Holding

1. No, because the company was attempting to alter its established cash basis accounting method without the Commissioner's consent to gain a tax advantage.

2. No, because the company never undertook to enforce its contract rights or make demands for payments and allowed vendees to pay as they were able.

Court’s Reasoning

The court reasoned that allowing Watertown Realty Co. to attribute income would effectively permit it to change its accounting method retroactively. The company had consistently used the “recovered cost” method, a cash method, and had not sought permission to change it. The court cited precedent (E. T. Slider, Inc., Geyer, Cornell & Newell, Inc., R. H. Bogle Co.) establishing that taxpayers cannot attribute income in a manner inconsistent with their established accounting method. The court stated, “However, a taxpayer cannot elect to use one method of accounting in one year in order to secure a tax advantage and then change to another method for the purpose of obtaining a further tax advantage.” It also found that the arrearage payments did not constitute income from a “claim” because the company did not actively pursue or enforce its contractual rights.

Practical Implications

This case reinforces the principle that taxpayers must adhere to their chosen accounting methods unless they obtain the Commissioner’s approval for a change. It limits the ability of taxpayers on the cash method to retroactively shift income to reduce tax liabilities, particularly in situations involving fluctuating income streams. It highlights the importance of consistently applying an accounting method and seeking approval for changes to avoid challenges from the IRS. It also clarifies that a mere right to receive payment does not constitute a “claim” for purposes of abnormal income attribution.

