17 T.C. 465 (1951)

A cash basis taxpayer selling property and receiving a contractual obligation for future payments does not realize income until those payments are received, unless the contractual obligation is the equivalent of cash.

Summary

Nina Ennis, a cash basis taxpayer, sold business property in 1945, receiving a cash down payment and a contractual obligation for the balance, payable in installments. The Tax Court addressed whether the entire profit from the sale was taxable in 1945. It held that because Ennis was a cash basis taxpayer, she only realized income to the extent of the cash received in 1945, as the contractual obligation was not the equivalent of cash. This case clarifies the tax treatment of deferred payment sales for cash basis taxpayers.

Facts

Nina Ennis and her husband jointly owned a business, the Deer Head Inn. On August 1, 1945, they sold the business for $70,000, receiving $8,000 down. The contract stipulated monthly payments, with a percentage of annual net profits to be paid annually. The buyers took immediate possession and assumed all responsibilities of ownership. The balance due at the end of 1945 was $57,446.41. The adjusted basis of the property was $26,514.69, resulting in a profit of $43,485.31. Ennis did not report the sale on her 1945 tax return.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Ennis’s 1945 income tax, arguing that she should have reported the entire profit from the sale in that year. Ennis contested this determination, arguing that as a cash basis taxpayer, she only recognized income when she received cash. The Tax Court heard the case to determine whether the contractual obligation was equivalent to cash.

Issue(s)

Whether a cash basis taxpayer who sells property in exchange for a cash down payment and a contractual obligation to receive future payments must recognize the entire profit from the sale in the year of the sale, even if the contractual obligation is not the equivalent of cash.

Holding

No, because a cash basis taxpayer recognizes income only when cash or its equivalent is received. The contractual obligation in this case was not the equivalent of cash; therefore, Ennis only realized income to the extent of the cash she received in 1945.

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Court’s Reasoning

The court reasoned that under Section 111(a) of the Internal Revenue Code, gain from the sale of property is the excess of the amount realized over the adjusted basis. Section 111(b) defines “amount realized” as “any money received plus the fair market value of the property (other than money) received.” The court emphasized that for a cash basis taxpayer, only cash or its equivalent constitutes income. It stated, “* * * in the case of one reporting income on the receipts and disbursements basis only cash or its equivalent constitutes income.”

The court distinguished the contractual obligation from instruments like notes or mortgages that are freely and easily negotiable, stating that the promise to pay was “merely contractual; it was not embodied in a note or other evidence of indebtedness possessing the element of negotiability and freely transferable.” Because the obligation was not the equivalent of cash, it was not included in the “amount realized” in 1945.

The dissenting opinion argued that land contracts are economically similar to mortgages and should be treated similarly for tax purposes. The dissent also distinguished Harold W. Johnston, supra, because there the selling price had not even been and could not be fixed and determined in 1942, the taxable year.

Practical Implications

This case provides a clear rule for cash basis taxpayers selling property for deferred payments: they only recognize income when they receive cash or its equivalent. This ruling is particularly important when the buyer’s obligation is not easily transferable or negotiable. Legal practitioners should advise clients to structure sales carefully, considering whether the form of the buyer’s obligation will trigger immediate tax consequences. Later cases applying this ruling focus on whether the debt instrument received is readily tradeable. The case highlights the importance of considering the taxpayer’s accounting method when structuring a sale and determining when income is recognized.

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