20 T.C. 733 (1953)

Income received from the collection of accounts receivable, after the sale of the business that generated them, is considered ordinary income rather than capital gain if the taxpayer uses the cash method of accounting.

Summary

In *Sherwood v. Commissioner*, the United States Tax Court addressed whether collections on accounts receivable, retained after the sale of a business, should be taxed as ordinary income or capital gains. The Sherwoods, using the cash method, sold their wallpaper and paint store but kept the accounts receivable. The court held that the collected amounts were ordinary income. The court reasoned that the receivables represented income from the business's ordinary operations. They were not sold or exchanged, as required for capital gains treatment. This decision reinforces that the nature of income is determined by its source and the method of accounting used, irrespective of when the income is received in relation to the sale of a business.

Facts

The petitioners, DeWitt M. Sherwood and Edith Sherwood, owned and operated a wallpaper and paint store, using the cash method of accounting. On March 5, 1949, they sold the stock, fixtures, and tools of the business, but retained the accounts receivable. In the remainder of 1949, they collected $4,998.21 from those accounts. On their 1949 tax return, they reported this amount as capital gain. The Commissioner of Internal Revenue determined a deficiency, classifying the collections as ordinary income.

Procedural History

The case was heard in the United States Tax Court following the Commissioner's determination of a tax deficiency. The facts were presented by a stipulation. The Tax Court ruled in favor of the Commissioner, determining that the income from collecting accounts receivable was ordinary income, not capital gains.

Issue(s)

1. Whether the amounts collected on accounts receivable after the sale of the business constitute ordinary income or capital gain.

Holding

1. Yes, because the income received from the collection of accounts receivable, which were created through sales of merchandise in a regular business and retained by the seller, constitutes ordinary income when the taxpayer uses the cash method of accounting.

Court’s Reasoning

The court relied on the principle that under the cash method of accounting, income is recognized when it is received. The accounts receivable were not sold or exchanged, which is a requirement for capital gains treatment. The amounts collected represented income from the ordinary course of the Sherwoods’ business. The court cited Internal Revenue Code Section 22(a), which defines gross income, and Section 42(a), concerning the period in which items of gross income should be included. Furthermore, the court pointed out that the sale of the business did not change the nature of the income. As the court stated, “Amounts due them from merchandise sold under their system represent ordinary income when received.” The court also referenced several prior cases to support its conclusion, including *Charles E. McCartney*, 12 T.C. 320.

Practical Implications

This case is crucial for business owners who sell their businesses and retain accounts receivable. It clarifies that the income from these receivables, under the cash method, will be taxed as ordinary income, even if the business assets were sold. Accountants and tax advisors must consider this when advising clients on the tax implications of business sales and should structure agreements to align with the desired tax outcome. The decision highlights the importance of the accounting method used by the taxpayer and the nature of the asset generating the income. Subsequent cases involving sales of business with retained receivables would likely follow the holding in *Sherwood*, unless there was a sale or exchange of the receivables themselves.

