20 T.C. 900 (1953)

Taxpayers must make a timely and affirmative election in their income tax return to utilize the installment method for reporting capital gains from the sale of real estate, and consistent past practices do not excuse this requirement.

Summary

The United States Tax Court considered whether a taxpayer could report capital gains from real estate sales under the installment method when they had failed to make a timely election in their tax return. The taxpayers, who had previously reported sales in the year the final installment was paid, argued for the same treatment for 1948 sales, or alternatively, to apply the installment method. The court held that because the taxpayers did not elect the installment method in their 1948 return, they were not entitled to its benefits, and the capital gains were taxable in that year. The court emphasized the necessity of a timely and affirmative election to use the installment method, even if the taxpayer had erroneously reported income in previous years.

Facts

John W. Commons and his wife filed a joint income tax return for 1948. Commons sold real estate on installment contracts, with small down payments and monthly payments. He and his wife had consistently reported the entire gain from real estate sales in the year the final installment was paid. In their 1948 return, they reported the gain from sales of vacant lots made in 1942, 1945, and 1946 when the last payment was received in 1948. In 1948, they sold additional real estate, receiving down payments of less than 30% of the selling price, but did not report any profit from these sales in their 1948 return. The Commissioner of Internal Revenue determined a deficiency, arguing that the gains from the 1948 sales should be included in income for that year, and that the installment method was not properly elected.

Procedural History

The Commissioner determined a tax deficiency for the 1948 tax year. The taxpayers contested the determination, leading to the case being heard by the United States Tax Court.

Issue(s)

1. Whether the taxpayers could report income from real estate installment sales in the year of the final payment, consistent with their prior practice.

2. Whether the taxpayers were entitled to report income from the 1948 sales using the installment method under Section 44 of the Internal Revenue Code, despite not making a timely election in their 1948 tax return.

Holding

1. No, because the method was not authorized by the Internal Revenue Code and was inconsistent with annual tax accounting.

2. No, because the taxpayers failed to make a timely election in their 1948 return to use the installment method of accounting.

Court's Reasoning

The court held that reporting income from real estate sales in the year the final installment was paid was incorrect as it was neither a permissible accounting method nor permitted by consistent past practice. The court cited the Second Circuit's definition of when a sale is considered closed for tax purposes, namely when the seller has an absolute right to receive the consideration. It also found that since taxpayers stipulated they had a capital gain in 1948, it should be included in that year unless the installment method applied. The court relied on Section 44 of the Internal Revenue Code which permits installment method reporting under certain conditions, including the requirement that the initial payments do not exceed 30% of the selling price. The court determined that a timely election to use the installment method was required. As the taxpayers did not elect to use the installment method in their 1948 return and had not shown that the sales qualified, the gains were taxable in 1948.

Practical Implications

This case underscores the importance of making a proper and timely election of accounting methods for tax purposes. Taxpayers must adhere to specific statutory requirements, such as making a timely election to use the installment method. Consistent past practices or erroneous filings do not excuse the taxpayer from complying with the current tax law. Attorneys should advise clients to follow the explicit procedures of the Internal Revenue Code and regulations, particularly when dealing with the sale of property and the election of reporting methods. Failing to do so can result in adverse tax consequences, as seen in this case, where the entire gain from the 1948 sales was taxable in that year.

