Key Homes, Inc. v. Commissioner, T.C. Memo. 1958-116

Under accrual basis accounting, proceeds from a sale are taxable in the year of sale, even if a portion is placed in a restricted savings account as security, provided the taxpayer has a present right to receive the funds subject only to routine business contingencies.

Summary

Key Homes, Inc., an accrual basis taxpayer, sold houses and, to facilitate financing for buyers through South Side Federal Savings & Loan, deposited a portion of the sale price into savings accounts as security for the mortgages. These accounts, in Key Homes' name and earning interest for them, would be released as the mortgage principal decreased. The Tax Court held that these amounts were includible in Key Homes' income in the year of sale. The court reasoned that under accrual accounting, income is recognized when earned and the right to receive it is fixed, which was the case here despite the temporary restriction on the savings accounts.

Facts

Key Homes, Inc. (Petitioner) was an Ohio corporation engaged in building and selling residential real estate, reporting income on an accrual basis.
In fiscal year 1953, Petitioner sold five houses with financing from South Side Federal Savings & Loan Association (South Side).
South Side required Petitioner to deposit sums into savings accounts as additional security for mortgages it issued to purchasers of Petitioner's homes.
These savings accounts were in Petitioner's name, earned interest credited to Petitioner, and were assigned to South Side as collateral.
The agreement stipulated that in case of mortgage default, South Side could use the savings account to cover losses.
Once the mortgage principal was reduced to a specified amount, the savings account would be released to Petitioner.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Petitioner's federal income tax for fiscal year 1953, arguing that the amounts deposited in savings accounts were includible in gross income.
Key Homes, Inc. challenged this determination in the Tax Court of the United States.

Issue(s)

1. Whether, for an accrual basis taxpayer, portions of real estate sale proceeds, deposited in restricted savings accounts as security for purchaser mortgages, are includible in the taxpayer's gross income in the year of sale.

Holding

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1. Yes. The Tax Court held that the amounts placed in savings accounts were includible in Petitioner's gross income in the fiscal year 1953 because, under accrual accounting, the income was earned and the right to receive it was sufficiently fixed in that year.

Court's Reasoning

The court relied on precedent, particularly *E.J. Gallagher Realty Co., 4 B.T.A. 219*, which involved a similar financing arrangement and held that withheld deposits were includible in income. The court emphasized that the sale, mortgage, and assignment of the savings account were simultaneous transactions, indicating the income was earned at the time of sale.

The court also cited cases involving dealer reserve accounts, where amounts withheld by financing institutions were deemed income to the dealer in the year of the sale. The court noted distinguishing features making this case even stronger for income inclusion than dealer reserve cases: Petitioner received interest, each account was tied to a specific transaction, and Petitioner regained full control upon mortgage reduction.

The court distinguished *Commissioner v. Cleveland Trinidad Paving Co., 62 F. 2d 85*, where income accrual was deferred due to contingencies related to maintenance guarantees. In *Key Homes*, the court found no such contingencies affecting the earning of the sale price in the year of sale. The court stated, "[T]here is always the possibility that a purchaser or a debtor will default in his obligation but that contingency is not sufficient to defer the accruing of income that has been earned."

Ultimately, the court concluded that the Petitioner had a present right to the funds, subject only to the routine contingency of mortgage repayment, which is insufficient to defer income recognition under accrual accounting. Future non-receipt could be addressed through bad debt or loss provisions.

Practical Implications

This case reinforces the principle that accrual basis taxpayers must recognize income when it is earned and the right to receive it becomes fixed, even if actual receipt is temporarily restricted or contingent on routine business events like mortgage paydowns.

For businesses using accrual accounting in real estate sales or similar transactions involving security deposits or reserves, this case clarifies that such amounts are generally taxable in the year of sale, not when the restrictions are lifted.

Legal practitioners should advise clients on accrual accounting to recognize income when the sale is complete, focusing on whether the right to receive payment is fixed, rather than on temporary restrictions designed to secure financing or performance.

This decision highlights that the Tax Court prioritizes consistent application of accrual accounting principles and is wary of deferring income recognition based on typical business contingencies.

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