Federated Department Stores, Inc. v. Commissioner, 51 T. C. 500 (1968)

Deferred service charges must be recognized as income when accounts receivable are sold, even if the charges were not previously recognized.

Summary

Federated Department Stores sold its installment accounts receivable to a bank, which included unrecognized service charges. The court held that these charges must be recognized as income at the time of sale, despite the bank retaining a contingency reserve. The court distinguished this transaction from previous ones, ruling it was not a change in accounting method. Additionally, payments received from a land developer to induce store construction were deemed contributions to capital, excludable from income.

Facts

Federated Department Stores, Inc. , a retail chain, sold its installment accounts receivable to First National Bank of Chicago (FNB) on February 1, 1964, for $155,295,052. These accounts included service charges that Federated had not recognized as income. FNB paid 88% in cash and retained 10% as a contingency reserve. Federated had previously engaged in similar transactions with other banks but treated them differently for accounting purposes. Additionally, Federated received land and cash from Sharpstown Realty Co. to build a store in their shopping center.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Federated's income tax for the fiscal years ending February 2, 1963, and February 1, 1964. Federated petitioned the United States Tax Court, which held that the deferred service charges must be recognized as income at the time of sale to FNB. The court also ruled that the payments from Sharpstown were contributions to capital, not taxable income.

Issue(s)

1. Whether Federated must recognize previously unrecognized service charges as income at the time it sold its accounts receivable to FNB.
2. Whether the recognition of these charges upon sale constitutes a change of accounting method under section 481, I. R. C. 1954.
3. Whether payments received from Sharpstown Realty Co. qualify as contributions to capital under section 118, I. R. C. 1954.

Holding

1. Yes, because the sale of the accounts receivable to FNB constituted a realization

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event for the service charges, requiring their recognition as income.
2. No, because the transaction with FNB was materially different from previous transactions with other banks, thus not constituting a change in accounting method under section 481.
3. Yes, because the payments from Sharpstown were intended to induce Federated to build a store, qualifying as contributions to capital under section 118.

Court's Reasoning

The court applied the rule from General Gas Corp. and Hansen, holding that deferred service charges must be recognized as income upon the sale of accounts receivable. The court rejected Federated's argument that the contingency reserve held by FNB should prevent recognition, citing cases like Arthur V. Morgan and Wiley v. Commissioner. Regarding the change in accounting method, the court found the FNB transaction substantially different from previous bank transactions, based on Federated's intent and the terms of the agreements. For the Sharpstown payments, the court followed precedents like Brown Shoe Co. and Edwards v. Cuba Railroad, determining that the payments were contributions to capital under section 118, as they were made to induce the construction of a store with only indirect benefits to Sharpstown.

Practical Implications

This decision clarifies that deferred service charges must be recognized as income upon the sale of accounts receivable, impacting how companies account for such transactions. It also distinguishes between sales and financing arrangements, affecting how similar transactions are analyzed for tax purposes. The ruling on contributions to capital provides guidance on when payments to induce business activity are excludable from income, influencing future agreements between developers and businesses. Later cases like United Grocers, Ltd. v. United States have cited this decision in distinguishing between payments for services and contributions to capital.

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