Schultz v. Commissioner, 59 T. C. 559 (1973)

Income must be reported in the year it is received under the claim-of-right doctrine, even if it may have to be returned in a subsequent year.

Summary

In Schultz v. Commissioner, the U. S. Tax Court ruled that Mortimer Schultz realized a taxable long-term capital gain of $213,000 in 1962 from selling stock to Office Buildings of America, Inc. (OBA), despite later being ordered to repay part of the proceeds due to OBA's bankruptcy. The court upheld the annual accounting principle, stating that income received without an obligation to repay at the time of receipt must be reported in that year. Additionally, the court found $18,575 received by Schultz from OBA in May 1962 to be taxable income, as it was not reported on the Schultzes' tax return. This case underscores the importance of the claim-of-right doctrine in determining the timing of income recognition for tax purposes.

Facts

On December 31, 1962, Mortimer Schultz sold his stock in First Jersey Securities Corp. (FJS) and his proprietorship interest in First Jersey Servicing Co. to Office Buildings of America, Inc. (OBA), where he was president. The total consideration of $270,500 was received in cash and notes on that date. OBA's check was cleared immediately, and the transaction was intended to reduce Schultz's debt to OBA. Several months later, OBA filed for bankruptcy, and Schultz was ordered to repay $270,500 less a credit of $50,945. 48. Additionally, in May 1962, Schultz received two checks from OBA totaling $18,575, which he used for personal business or investment purposes but did not report on his 1962 tax return.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Schultz's 1962 income tax return, leading to a petition in the U. S. Tax Court. The court consolidated cases involving Schultz and his family, who were nominees for the stock sale. The court ruled in favor of the Commissioner, determining that the capital gain and the $18,575 received were taxable in 1962.

Issue(s)

1. Whether a capital gain of $213,000 realized from the sale of stock on December 31, 1962, is taxable in that year, despite a subsequent order to repay part of the proceeds due to the buyer's bankruptcy.
2. Whether two checks received in May 1962 totaling $18,575 represent taxable income not reported in the 1962 return.

Holding

1. Yes, because under the claim-of-right doctrine and annual accounting principle, income received without a repayment obligation at the time must be reported in the year of receipt, even if it may need to be repaid later.
2. Yes, because the checks were received and used for personal business or investment purposes, and the taxpayers failed to report them on their 1962 return.

Court's Reasoning

The Tax Court applied the claim-of-right doctrine, citing cases like *Healy v. Commissioner* and *James v. United States*, which establish that income received without an obligation to repay must be reported in the year of receipt. The court emphasized the annual accounting principle, stating that subsequent events, such as OBA's bankruptcy and the repayment order, do not affect the tax liability for the year the income was received. The court rejected Schultz's argument that the sale was not completed due to OBA's insufficient funds, as no evidence supported this claim. The court also found that the $18,575 received in May 1962 was taxable income, as it was not reported on the Schultzes' tax return and was used for personal purposes.

Practical Implications

This decision reinforces the importance of the claim-of-right doctrine for tax practitioners, requiring income to be reported in the year it is received, even if it may later need to be returned. It impacts how capital gains and other income should be reported, particularly in transactions involving potential future liabilities. Taxpayers must carefully consider the timing of income recognition and cannot defer reporting based on potential future events. This ruling may influence business practices by emphasizing the need for clear documentation and understanding of tax implications in transactions. Subsequent cases, such as *Wilbur Buff*, have distinguished this ruling, highlighting the need for a repayment obligation within the same tax year to avoid income recognition.