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Year Income Taxable-Restricted Savings Accounts Received as Part Payment

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YEAR INCOME TAXABLE—RESTRICTED SAVINGS ACCOUNTS RECEIVED AS PART PAYMENT

The facts in three consolidated cases were substantially the same.[1] The petitioners, two accrual basis corporate taxpayers and a man and wife filing joint, cash basis tax returns, were engaged in the business of selling houses. The purchasers of these houses were often unwilling or unable to pay the difference between the selling price and the amount of money a mortgagee was legally allowed to loan (80 per cent of the lower of the selling price or the appraised value of the house). To effect a sale under these conditions the mortgagee, a savings and loan association, took a note and a mortgage from the purchaser equal to the difference between the amount of money paid as down payment by the purchaser and the selling price of the house. The mortgagee, however, lent to the purchaser only the amount of money legally allowable, with the purchaser, in turn, paying this amount to the petitioners. At the same time, the mortgagee delivered to the petitioners a savings account, or savings and loan shares representing such an account,[2] equal to the difference between the face of the note and the cash loaned to the mortgagor-purchaser.

The petitioners, in the same transaction, assigned back the savings account or shares to the mortgagee as additional security for the purchaser's note. The terms of the assignment required that funds be released to the petitioners at the rate of $100 for each $200 paid by the purchaser on the principal of his note. The court found the savings account or shares to be restricted rather than unrestricted at the time of sale.[3] While the mortgage was not in default, the savings and loan association paid interest to the petitioners on the account or shares at the same rate as was paid on unrestricted accounts or shares. On default the petitioners could assume the purchaser's obligation on the note and take over the property or could allow the balance of the account or shares standing as security for the purchaser's note to be forfeited and applied against the loan principal, in which case the petitioners were not further liable. A savings account, or shares established for a loan, secured the payment of only the one loan with respect to which the account or shares were created, and could not be applied against a balance owing on another loan.

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1. There is substantial precedent for consolidation of similar cases, especially where two parties are represented by the same attorney. *See, Commerce Clearing House*, WHEN YOU GO TO THE TAX COURT—PROCEDURE AND PRACTICE 117 (1967).

2. The parties stipulated that there was no difference in procedure or substance between the receipt of a savings account and shares representing such an account.

3. Since it was admitted that the savings and loan association gave unrestricted accounts or shares to the petitioners, who immediately assigned them back in the same transaction, the court, by finding that petitioners received restricted accounts or shares, recognized that the transaction would not be consummated without a previous understanding that the reassignment would occur; thus the accounts or shares were restricted *eo instanti*.

Each of the petitioners reported the restricted accounts or shares on their tax returns as deferred income, not includible in gross income in the year of sale, but includible only as accounts were released by payments on the principal by the purchaser. The petitioners did not maintain bad debt reserves and took no bad debt deduction if an account or shares were forfeited. The court found that the savings accounts and shares were neither easily negotiable nor freely bought and sold in commerce.[4] *Held,* an accrual basis taxpayer is required to include in gross income the face amounts of savings accounts or shares when received, but a cash basis taxpayer is not. *Western Oaks Building Corporation v. Commissioner*, 49 T.C. 365 (January 22, 1968).[5]

Prior to 1959, The Courts of Appeals were sharply divided on the issue of whether reserve accounts which were not accessible to an accrual basis taxpayer and which had an element of uncertainty as to the amount ultimately to be received were includible in income before such accounts were actually released to the taxpayer.[6] Most of the decisions which had held that the withheld reserve was not includible in income did so on the theory that the transaction was a single, "three-cornered" one whereby a dealer agreed to sell property and a purchaser agreed to borrow the purchase price from a finance company directing its payment to the dealer, but with the proviso that the finance company could retain a portion of the loan as security.[7]

> So viewing the transaction, those courts held that the dealer acquired merely a contingent right to receive the amounts withheld by the finance company and that such amounts were not taxable to the dealer until they were received.[8]

Additional rationale for exclusion from income was based on the proposition that the right to an amount is not accruable until the right to receive an amount certain is fixed. "Otherwise, [a taxpayer] would be required to pay a tax on income which he might never have a right to receive."[9]

4. Testimony by an officer of the savings and loan association to the effect that "[y]ou might go for months and not hear anything about a savings account being sold, and then maybe in the next week * * * you will hear about two or three sales," appears to have satisfied the court of the restricted exchangeability of the accounts or shares. Western Oaks Bldg. Corp., 49 T.C. 365, 377 (1968).

5. Neither the taxpayers nor the Commissioner appealed this decision. However, the Commissioner entered a non-acquiescence to the extent of the decision relative to the cash basis taxpayers. 1968 INT. REV. BULL. No. 35, at 6 (August 26, 1968).

6. Decisions that the amounts in reserve must be included in income were: Baird v. Comm'r, 256 F.2d 918 (7th Cir. 1958); and Schaeffer v. Comm'r, 258 F.2d 861 (6th Cir. 1958). Decisions that the amounts in reserve were not taxable until released were: Glover v. Comm'r, 253 F.2d 735 (8th Cir. 1958); Hansen v. Comm'r, 258 F.2d 585 (9th Cir. 1958); Johnson v. Comm'r, 233 F.2d 952 (4th Cir. 1956); and Texas Trailercoach, Inc. v. Comm'r, 251 F.2d 395 (5th Cir. 1958). In addition, the Tax Court had consistently held that the reserve amounts were includible. *Cf.* Shoemaker-Nash, Inc., 41 B.T.A. 417 (1940).

7. Texas Trailercoach, Inc. v. Comm'r, 251 F.2d 395 (5th Cir. 1958).

8. Western Oaks Building Corp., 49 T.C. 365, 374 (1968).

9. Johnson v. Comm'r, 233 F.2d 952, 956 (4th Cir. 1956).

Those decisions holding that the reserve was includible in income did so by relying on the often-quoted definition of accrual basis tax accounting:

> Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive becomes fixed, the right accrues.[10]

Furthermore, in at least one instance the Tax Court did not consider material the question of whether the transaction was to be regarded as a single transaction (three-cornered) or as two separate transactions.[11]

Ultimately, the United States Supreme Court decided the issue.[12] In so doing, the Court heard three cases involving dealer sales and concurrent discounts with finance companies of notes made payable by purchasers to the dealers, in which the finance companies "held back" a percentage as security for the notes. The taxpayers in those cases argued that the substance of the transaction was that of a three-cornered deal, and that therefore there was only a future right to an undeterminable amount rather than a fixed, ascertainable claim to the reserve at the time of the sale or holdback. (It is generally agreed that a taxpayer is under no obligation to pay a tax on income he might never receive.[13]) The Court held that the transaction had to be viewed in two steps, *viz.*, a sale of the property followed by a sale of the note. The facts were clear that the taxpayers had acquired the notes from the purchasers and, in turn, discounted them with the finance companies.[14]

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10. Spring City Foundry Co. v. Comm'r, 292 U.S. 182, 184 (1934).

11. Key Homes, Inc., 30 T.C. 109 (1958), *aff'd*, 271 F.2d 280 (6th Cir. 1959).

12. Commissioner v. Hansen, 360 U.S. 446 (1959).

13. North American Oil Consolidated v. Comm'r, 286 U.S. 417 (1932). (But the "fact that there is always the possibility that a purchaser or debtor may default in his obligation is not sufficient to defer the accruing of income that has been earned." First Sav. & Loan Ass'n, 40 T.C. 474, 487 (1963)).

14. In Texas Trailercoach, Inc. v. Comm'r, 251 F.2d 395, 404 (5th Cir. 1958), the taxpayer was actually engaged in a three-cornered transaction since the note was made payable to the finance company. The court said:

> It may well be, in another case, that a dealer's sale of a trailer to an individual purchaser may be a complete and separate transaction; that, thereafter, the dealer may discount the purchaser's note or sell the purchase contract to a bank or finance company in a distinct and separate transaction; and, that, because of no intervening conditions or few restrictions on the dealer's reserve, amounts in a dealer's reserve account may be accruable to the dealer when withheld. Here, however, the financing agreement between Texas Trailercoach, Inc. and Minnehoma made the trailer sale and its financing one transaction. Minnehoma played a vital part in the transaction from the incipiency of each trailer sale. Minnehoma controlled each sale, passed on the credit risk, furnished the printed form, dictated the terms of each trailer sale, and was specifically designated as the party to receive the unpaid balance. As far as the trailer purchaser knew or cared about the transaction, his dealings were with Minnehoma from the moment the sale was executed. In a real sense Minnehoma extended its credit to the trailer purchasers, and purchased the trailer contracts *for the trailer purchasers,* at least to the same extent that Bancredit Corporation "merely discounted notes for applicators" in Keasbey & Mattison v. Commissioner.

In the later case of *Key Homes, Inc. v. Commissioner*,[15] an accrual basis taxpayer was engaged in the business of building and selling houses. In connection with the sale of homes which required financing, the taxpayer agreed to deposit a certain amount in a savings account to be held as additional security for loans made to the taxpayer's customers. The savings accounts thus created earned interest, but were restricted until such time as the mortgages they secured were satisfied. It was held, on the basis of *Hansen v. Commissioner*,[16] that the mere contingency of ultimate receipt was not sufficient to cause deferral of income to an accrual basis taxpayer.

In the instant case, the accrual basis petitioners maintained that the decision in *Key Homes, Inc.* was affirmed by misplacing reliance on the *Hansen* decision in that the transactions involved in *Key Homes, Inc.* (and in the instant case) were more nearly analogous to the three-cornered transaction of *Texas Trailercoach, Inc. v. Commissioner*.[17] But it would appear that in *Key Homes, Inc.*, by the wording of the agreement between the financing institution and the taxpayer,[18] the savings accounts were created by the taxpayer's deposit after receipt of the total loan proceeds, much as would be the case in a separate-step transaction similar to the *Hansen* case. Furthermore, as the court pointed out, the *Hansen* decision was not based on the question of whether the transaction was a single, three-cornered transaction or two separate transactions, but on whether the amounts retained by the finance company would ultimately be either received by the dealer or used to satisfy the obligations of the dealer.[19] It was held that they would be so used and, therefore, the dealer's right to receive was fixed. It was immaterial that because of future contingen-

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> The practical effect of Minnehoma being a party to the transaction from the beginning, is that the taxpayer did *not* receive the full sales price or its equivalent from the purchaser.

However, the court appeared, in large part, to base its decision of non-includibility of the reserve on the fact that the finance company could charge the taxpayer's reserve with items unrelated to the sale of trailers, thus making ultimate collection and present value all the more speculative.

15. 271 F.2d 280 (6th Cir. 1959), *aff'g*, 30 T.C. 109 (1958).

16. 360 U.S. 446 (1959).

17. 251 F.2d 395 (5th Cir. 1958). The Tax Court had clearly indicated in *Key Homes, Inc.* that it was immaterial whether the transaction was a three-cornered one or two separate transactions. However, the Tax Court case on appeal ante-dated the decision in Commissioner v. Hansen, 360 U.S. 446 (1959), and the difference between the two methods was of significance in guiding the decisions of the courts of appeals at that time. It so happens that the Sixth Circuit was sympathetic with the Commissioner's view of taxability of withheld reserve funds prior to its affirmation of *Key Homes, Inc. See* Schaeffer v. Comm'r, 258 F.2d 861 (1958). The Court, therefore, would probably have affirmed even without the *Hansen* decision.

18. 30 T.C. 109, 110 (1958).

19. *See*, Guarantee Title and Trust Co. v. Comm'r, 313 F.2d 225 (6th Cir. 1963) and Etheridge and Vanneman, Inc., 40 T.C. 461 (1963), which distinguished *Hansen* by holding that amounts credited to reserve accounts of the accrual basis taxpayers were not includible in income since the right to receive the income was contingent upon the happening of a future event, which event would *not* alter any of the taxpayers' legal obligations.

cies the dealer might never receive the amount of the reserve in cash, since it would otherwise be applied in discharge of the dealer's legal obligations.[20] The rationale of *Key Homes, Inc.* has been widely accepted.[21]

The question persists in cases similar to the one under discussion: how will a taxpayer know how much tax to pay, if his tax is computed on income which he has not yet actually reduced to possession? The plain fact is that such a dilemma is a normal result of the accrual basis of accounting. The alternative would be to permit accrual basis taxpayers to escape taxation in a particular year by permitting portions of their sales to be retained by buyers or agents. To maintain the necessary order in income taxation, accrual basis taxpayers must, under ordinary circumstances, be accountable for taxes computed on their income as determined at the moment of sale, *i.e.*, when the right to the income arises.[22]

The intent of Congress, as embodied in the Internal Revenue Code of 1954, is to assess a tax based upon taxable income computed in accordance with acceptable methods of tax accounting. The concept is basically simple: income must be taxed at the proper time. Recognizing that different business conditions require different accounting techniques, some latitude is provided by allowing the adoption of different methods of accounting.[23] At the same time, great discretion has been accorded the Commissioner of Internal Revenue in requiring a method of accounting which clearly reflects income.[24] It is obvious that if it is held that only accrual basis reporting is appropriate in the case of transactions where reserves for collateral are retained by third parties, the marginal operator will be unable to operate a business which requires such holdbacks. Thus, while a taxpayer has the right to elect the accrual method of accounting and should pay taxes on accrued income regardless of whether or not it is received, he should also be given the opportunity to reduce his taxable income to an amount which is more in line with what could reasonably be expected to be a fair measure of accrued income, by taking as a deduction a reasonable addition to a reserve for bad debts which may arise out of

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20. Payment of the legal obligation of a taxpayer constitutes taxable income. Old Colony Trust Co. v. Comm'r, 279 U.S. 716 (1929).

21. Bolling v. Comm'r, 357 F.2d 3 (8th Cir. 1966); United States v. Wood, 352 F.2d 522 (5th Cir. 1965); Lewis Building & Supplies, Inc., 25 CCH Tax Ct. Mem. 244 (1966); Warren G. Morris, 22 CCH Tax Ct. Mem. 660 (1963); Carl B. Holland, 22 CCH Tax Ct. Mem. 504 (1963). *See also* Gallagher Realty Co., 4 B.T.A. 219, 222-23 (1926) where it is said that

> [t]he fact that a portion of the purchase price . . . was assigned *or left in the hands* of the building association to insure mortgage payments by the purchaser and that the actual payment to the taxpayer was deferred does not . . . justify the taxpayer in excluding these amounts from income when it kept its books on the accrual basis. [Emphasis added.]

22. TREAS. REG. § 1.451-1(a) provides that "[u]nder an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy."

23. INT. REV. CODE of 1954, § 446(c).

24. *Id.*, § 446(b).

his liability as guarantor, endorser, or indemnitor of debt obligations arising from sale by him of property.[25]

Shortly after the decision in *Hansen* was handed down, the Courts of Appeals (but not the Tax Court) began recognizing the taxpayers' need for measuring income in a manner which would also result in availability of funds with which to pay income taxes.[26] This was done by allowing bad debt reserve additions equal to the amount of the holdback reserves. The reasonableness of this addition was justified theoretically by reference to the large dollar volume of outstanding loans being guaranteed. Because of the controversy between the Tax Court and the Courts of Appeals in this area, the Internal Revenue Code was amended in 1966 to provide that a reasonable reserve addition for guaranteed debts could be taken as a deduction by a dealer in property.[27]

But instead of proving reasonable additions to a reserve for bad debts, should a dealer be allowed to adopt the cash basis of reporting income and thereby avoid tax on holdback reserves? Interestingly enough, the decision in *Western Oaks Building Corp.*, to the effect that cash basis taxpayers did not have to include the unreceived holdback reserves in income, did not turn on whether such taxpayers employed a proper method of accounting, but upon the nature of the document evidencing their interest in the holdback reserves. Cases where the Commissioner has invoked his broad powers under Section 446(b) of the Internal Revenue Code are legion,[28] but there is little case law directly related to this issue with respect to a dealer's reserves. In one case, the Commissioner forced the dealer to use the accrual basis method although, according to the court's findings, he had consistently used a cash method. The court held that the forced accrual of income by the Commissioner was improper, erroneous, and illegal.[29]

25. *Id.*, § 166(c).

26. Bolling v. Comm'r, 357 F.2d 3 (8th Cir. 1966); Foster Frosty Foods, Inc. v. Comm'r, 332 F.2d 230 (10th Cir. 1964); Wilkens Pontiac v. Comm'r, 298 F.2d 893 (9th Cir. 1961).

27. INT. REV. CODE of 1954, § 166(g). Although this may solve the problem for the great majority of accrual basis taxpayers, it should be emphasized that the provision is applicable only to *dealers in property*. Thus a loan broker who guarantees debts for a fee and who thus allows holdback reserves to stand as security may not use the reserve method of providing for bad debts. Budget Credits, Inc., 50 T.C. No. 8 (April 15, 1968). Although this decision is currently on appeal by the taxpayer, it does not seem likely to be reversed in view of the clear statutory language and intent evidenced by S. REP. No. 1710, 89th Cong., 2d Sess. (1966). Furthermore, although no reference is made to a case involving a non-dealer, the dissenting opinion to the effect that *all* prior litigation which gave rise to the controversy over bad debt reserve additions in this area dealt with dealers is not completely accurate. Family Budget Service, Inc. v. United States, 64-1 U.S. Tax Cas. ¶ 9151 (S.D. Miss. Nov. 20, 1963).

28. *E.g.*, American Auto. Ass'n v. United States, 367 U.S. 687 (1961); Automobile Club of Mich. v. Comm'r, 353 U.S. 180 (1957); Schlude v. Comm'r, 372 U.S. 128 (1963); United States v. Catto, 344 F.2d 227 (1965); Hagen Advertising Displays, Inc., 47 T.C. 139 (1966).

29. Dalton & Ely Motor Co. v. United States, 61-2 U.S. Tax Cas. ¶ 9589 (E.D. Ky. July 10, 1961), *rev'd, by stipulation of the parties*, 62-2 U.S. Tax. Cas. ¶ 9650 (6th Cir. June 29, 1962).

On the other hand, it is well established that where inventories are a material factor in computing income, the accrual basis of accounting must be used with respect to purchases and sales of such inventory. As was stated in *Johnson v. Commissioner*,[30]

> But inventories were an essential part of taxpayer's accounting, and for that reason if for no other, his reporting would necessarily have to be on an accrual basis. (Treas. Regs. § 1.446-1(c)(2)); *Herberger v. Commissioner*, 195 F.2d 293, 295, *cert. denied*, 344 U.S. 820. Moreover, under [Sec. 446(b)] of the Internal Revenue Code of [1954], . . . the Commissioner was justified in revising and restating taxpayer's accounts in order clearly to reflect his income.

If it can be assumed that inventories are a material factor in determining a dealer's income, then it follows that the dealer should probably use the accrual basis and would have to rely on a bad debt reserve addition to ease his tax burden. But if it is assumed that inventories are *not* a material factor in determining income (and such an assumption does not appear to be totally unreasonable), or if the issue involves a broker or other type of non-dealer who has funds withheld in connection with his business transactions, the question then becomes whether such withheld funds will be subjected to taxation notwithstanding their inaccessibility to the taxpayer.

Clearly, even a cash basis taxpayer is entitled to use the reserve method of accounting for bad debts if he is a dealer in property and has recognized income with respect to an account.[31] Again, if this were the case, he could mitigate his tax problems by means of reasonable bad debt reserve additions. But assuming, *arguendo*, that no such reserve method is available to a dealer, and considering especially the non-dealer where no reserve method is permitted, it is submitted that the taxpayer should not be taxed on funds over which he has no command.

The Commissioner has consistently maintained that any evidence of indebtedness received by a cash basis taxpayer is taxable as the receipt of cash. In asserting taxability, the Commissioner will usually rely on the concepts of either constructive receipt,[32] equivalence of cash,[33] or economic benefit,[34] in addition to the requirement of clearly reflecting income.

30. 233 F.2d 952, 956 (4th Cir. 1956).

31. First Nat'l Bank of Omaha, 17 B.T.A. 1358 (1929).

32. United States v. Britt, 335 F.2d 907 (5th Cir. 1964); George W. Drysdale, 32 T.C. 378 (1959), *rev'd*, 277 F.2d 413 (6th Cir. 1960); Williams v. United States, 219 F.2d 523 (5th Cir. 1955); Ottilie B. Kuehner, 20 T.C. 875 (1953), *aff'd*, 214 F.2d 437 (1954).

33. Rhodes v. United States, 243 F. Supp. 894 (W.D.S.C. 1965); Drysdale v. Comm'r, 277 F.2d 413 (6th Cir. 1960), *rev'g* 32 T.C. 378 (1959); E.T. Sproull, 16 T.C. 244 (1951), *aff'd*, 194 F.2d 541 (1952); REV. RUL. 60-31, 1960-1 CUM. BULL. 174, 177-78; REV. RUL. 62-74, 1962-1 CUM. BULL. 68; REV. RUL. 67-203, 1967-1 CUM. BULL. 105.

34. J.D. Amend, 13 T.C. 178 (1949) (can also be read as a constructive receipt case); Dudley T. Humphrey, 32 B.T.A. 280 (1935), Estate of Clarence W. Ennis, 23 T.C. 799 (1955); Nina J. Ennis, 17 T.C. 465 (1951); Sam F. McIntosh, CCH Tax Ct. Mem. 1967-230 (1967).

In this regard, the taxpayer has frequently suffered under the economic benefit allegation where a sum certain receivable in the future is ascertained.

In the final analysis, however, despite the Commissioner's persistence, most courts do not tax the cash basis taxpayer unless he has received cash or a freely negotiable instrument, or has freely turned away from acceptance of cash or its equivalent, *e.g.*, a readily negotiable instrument which could be converted to cash in order to pay the related income taxes.

A long line of "escrow cases," called such because they involve the use of escrowed or restricted funds which are not certain as to ultimate amount or time of receipt, has reflected the courts' reluctance to tax cash basis taxpayers who, in concurrent or related transactions, place the cash out of their reach for bona fide business purposes.[35]

In summary, it is not contended that an accrual basis taxpayer should not report income on withheld reserves, since his method of accounting requires recognition of such income. On the other hand, recognizing business exigencies, the courts and the Commissioner should be agreeable to the admission of bad debt reserve additions of reasonable amounts by dealers in property. And, certainly, where the cash basis method of accounting is permitted because the use of inventories does not require some other method, the Commissioner should surrender his losing battle of trying to tax inaccessible cash. His attempts to do so are neither reconcilable with business transaction requirements nor consistent with proper revenue-raising methods.

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35. William O. Anderson, 20 CCH Tax Ct. Mem. 697 (1961); Marion H. McArdle, 11 T.C. 961 (1948); Preston R. Bassett, 33 B.T.A. 182 (1935), *aff'd per curiam*, 90 F.2d 1004 (2d Cir. 1937); Margaret L. Carpenter, 34 T.C. 408 (1960); Julian Robertson, 6 T.C. 1060 (1946); C. E. Gullett, 31 B.T.A. 1067 (1935). An indication of the courts' attitude in taxing withheld reserves of cash basis taxpayers is found in a well-reasoned escrow case. In Charles M. Kilborn, 29 T.C. 102 (1957), *aff'd sub nom.* United States v. Hine Pontiac, 360 U.S. 715 (1959), it was held that a taxpayer using inventories must compute his income on the accrual basis. Accordingly, the court said,

> [it is] unnecessary to consider and decide whether the amounts credited to a collateral reserve account, in circumstances such as we have here, would or would not constitute realized income to a cash basis taxpayer. See however, Luther Bonham, 33 B.T.A. 1100, *aff'd* 89 F.2d 725. *Id.* at 109, 110.

In the *Bonham* case, which the court implies it will follow if confronted with a cash basis holdback reserve situation, the court held that the amount in escrow was taxable to the cash basis taxpayer only because there was no condition on the ultimate receipt of the full amount, and that if there had been contingencies no tax would be assessed until cash was received or the contingencies expired.