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TAXATION—ACCOUNTING METHODS—FORFEITURE OF PRIVILEGE OF ELECTING INSTALLMENT BASIS—During 1953, petitioner sold her farm and agreed to receive payment in yearly installments. Her 1953 income tax return, in which she elected to report the sale on the installment basis,[1]

[1] Int. Rev. Code of 1939, ch. 1, § 44(b)(2), 53 Stat. 25 [now INT. REV. CODE OF 1954, § 453(b)(2)]. This provision states: "In the case . . . of a sale or other disposition of real property, if in either case the initial payments do not exceed 30 per centum of

was not filed until 1957. Respondent, the Commissioner of Internal Revenue, assessed a deficiency and included the entire gain from the transaction in petitioner's 1953 return. On the basis of previous Tax Court decisions, he contended that petitioner was not entitled to use the installment method because of her failure to file a timely return. Petitioner argued that neither the statute nor the regulations required a timely return as a prerequisite to electing. On petition to the Tax Court, *held,* for respondent, five judges dissenting. The privilege of electing the installment method for reporting gain from the disposition of property is forfeited unless an election is made in the year of the sale. *Marion C' de Baca,* 38 T.C. 609 (1962).

In 1938 the Supreme Court held that once the taxpayer has elected a particular method for reporting an installment sale he is bound by his election and may not later amend it.[2] This rule was not based on any express or implied directive in either the Code or the Treasury regulations.[3] Disallowance of amended elections was instead rested upon the proposition that Congress intended the use of the installment method—a scheme designed to reflect annual income more clearly—to be a mere elective right.[4] Since regarding it as involving only a right to elect, the courts have felt free to condition its use upon a proper election in a return filed in a timely fashion.[5]

the selling price . . . , the income may, under regulations prescribed by the Commissioner with the approval of the Secretary, be returned on the basis and in the manner above prescribed in this section." Int. Rev. Code of 1939, ch. 1, § 44(a), 53 Stat. 24, allows the taxpayer to return as income from an installment sale in any taxable year that proportion of the installment payments actually received in that year which the gross profit, realized or to be realized when payment is completed, bears to the total contract price.

2 Pacific Nat'l Co. v. Welch, 304 U.S. 191 (1938). *Accord,* Jacobs v. Commissioner, 224 F.2d 412 (9th Cir. 1955); Marks v. United States, 98 F.2d 564 (2d Cir. 1938); Erhart v. Gray, 192 F. Supp. 71 (W.D. Ky. 1961); Coffin v. United States, 120 F. Supp. 9 (S.D. Ala. 1954); Albert Vischia, 26 T.C. 1027 (1956); Max Viault, 36 B.T.A. 430 (1937).

3 There is no indication whether Congress intended the allowance of amended elections, since neither § 44 of the Internal Revenue Code of 1936 (§ 44 of the Internal Revenue Code of 1939) nor the pertinent regulation thereunder expressly requires an unequivocal election of the installment method. It is clear, however, that the taxpayer will receive considerable benefit even if the period of election is restricted to the year of the sale. See also Treas. Reg. § 1453-8 (1958) which, though declared to be non-retroactive, demands that gross profit be mentioned in the return for the year of the sale if the installment method is to be used. See also Rev. Rul. 93, 1953-1 CUM. BULL. 82, which requires that the return for the year of the sale be filed in a timely fashion.

4 For discussion of the congressional intention that the installment method should be a limited privilege, see generally Pacific Nat'l Co. v. Welch, 304 U.S. 191, 194 (1938); W. A. Ireland, 32 T.C. 994, 997 (1959); Lang, *Installment Sales in Their Relation to Business and Taxation,* 5 NAT'L TAX MAGAZINE 407 (1927) (now TAXES).

5 The following decisions, with factual situations similar to that in the *Welch* case, have refused the belated use of the installment method where an election had not been made in an otherwise timely return for the year of the sale. W. A. Ireland, *supra* note 4; Western Supply & Furnace Co., 28 P-H Tax Ct. Mem. 253 (1959); Paul Haimovitz, 25 P-H Tax Ct. Mem. 253 (1956); W. T. Thrift, Sr., 15 T.C. 366 (1950). In Sarah Briarly, 29 B.T.A. 256 (1933), the Commissioner reported for the taxpayer, due to her failure to file any return, and her claim that a sale should have been reported on the installment basis was denied. *Cf.* Johnson Realty Trust, 21 B.T.A. 1333 (1931).

Soon after the Supreme Court decision, however, courts began to recognize the harshness of a denial of the use of the installment basis in every case of belated election; consequently, a number of decisions have relaxed the strict election rule. Indeed, the dissent in the principal case emphasized these decisions in reasoning that petitioner had the right to use the installment basis.[6] The dissenting opinion failed to notice, however, the element of good faith which distinguished those decisions from the principal case. Illustratively, in *Scales v. Commissioner*[7] the petitioner erroneously reported the income from a sale of real property as rent. The court felt that, although there was no express election of the installment basis, he could nevertheless exercise his right belatedly. In overruling the Commissioner's deficiency assessment, the court reasoned that "failure to adopt ritualistic measures should not foreclose the allowance to all lawful benefits under the statute."[8] The good faith reporting of the transaction in a timely return appears to be the determining factor in that court's decision. Clearly, consideration of such a factor avoids prejudicing the integrity of the strict election rule. Furthermore, permission to shift from the reporting of the sale as rent to reporting it as an installment sale gave the petitioner no tax advantage.

More recently, in *Hornberger v. Commissioner*[9] the Fifth Circuit broadened the exception to the general rule by allowing an untimely election though the transaction there was not even reported. The petitioners in that case had decided to report a sale on the installment basis, but, due to an error by their hired accountant, the sale was not disclosed in their return. A good faith attempt at a proper election was evidenced by the testimony at the trial: the taxpayers had not sought, in the first instance, to avoid the strict election rule.[10] Thus, allowance of a belated election did not undermine the spirit of the rule. The *Hornberger* decision has received the approval of one authoritative writer in the tax field,[11] and appears to be the leading case in an emerging trend of exceptions to the strict election rule.

Even the Tax Court has relaxed its narrow construction of the rule, although it is ostensibly unwilling to accept fully the *Scales* decision.[12] In some cases, the Tax Court has seemed to require a greater degree of good faith than is evidenced in the circuit court decisions. For example, in *John F. Bayley*[13] the taxpayer did not elect an accounting method when

[6] Principal case at 619-20.

[7] 211 F.2d 133 (6th Cir. 1954). *Accord*, United States v. Eversman, 133 F.2d 261 (6th Cir. 1943), where taxpayer mistakenly reported the sale as non-taxable income and was allowed to amend his return in order to elect the installment method.

[8] Scales v. Commissioner, 211 F.2d 133, 134 (6th Cir. 1954).

[9] 289 F.2d 602 (5th Cir. 1961).

[10] *Id.* at 604.

[11] 2 MERTENS, LAW OF FEDERAL INCOME TAXATION § 15.06 (Supp. 1962, at 95-96).

[12] See W. A. Ireland, 32 T.C. 994, 998 (1959). See also Jacobs v. Commissioner, 224 F.2d 412, 414 (9th Cir. 1955). The Ninth Circuit disagrees with the result in the *Scales* case.

[13] 35 T.C. 288 (1960).

he reported the sale of real estate. The omission was due to the fact that he was using the proceeds to purchase a new residence and he therefore intended the gain to be unrecognized. He did not reside in his new home within the alloted time, however, and therefore lost the benefit of the otherwise satisfied non-recognition provision.[14] The court alleviated his misfortune by allowing a belated election of the installment method.[15]

Permission to amend a previous election, or to elect in an untimely fashion in order to use the installment basis, results, in effect, in an extension of the filing period. The facts of the cases authorizing such practices are often difficult to distinguish from those in decisions denying belated elections. In the former group of cases, a close examination reveals that the courts based their decisions, in varying degrees, on the taxpayers' good faith in failing to disclose the sale or in erroneously reporting the transaction.[16] Approval of a late election in a factual situation like that of the principal case, however, would place a premium on the taxpayer's negligence[17] and thereby bring about a result which most certainly could not live harmoniously with the Supreme Court's binding election rule. The requirement of timely election forces the taxpayer who files a timely return to speculate in the year of the sale as to how much income he will acquire in the following years. Retrospective elections would permit taxpayers to replace this speculation with a decision based on positive knowledge as to what method of reporting would minimize his taxes. Thus, failure to file prompt returns would be encouraged and the careless taxpayer would have an advantage over the one who makes a timely election. This is especially true where installment sales are the taxpayer's principal source of income.

The allowance of belated or amended elections by taxpayers proving that they were not flagrantly negligent and that in the first instance they did not seek the advantage of a retrospective election indicates a wise relaxation of an otherwise harsh rule. By means of a careful consideration of the facts of each case, courts can determine whether the taxpayer acted in good faith or without negligence and can thereby avoid encouraging negligent late-filing. If permission were given to make an untimely election in the principal case, however, the rule denying amended elections would be hopelessly vitiated: the taxpayer here was incontestably negligent. An

14 See INT. REV. CODE OF 1954, § 1034(a), which provides, in certain cases, for non-recognition of gain on the sale of a principal residence.

15 See also Jack Farber, 36 T.C. 1142 (1961). Taxpayer did not receive any payment in the year of the sale and reported the transaction in his return for the following year, when he first received income. He was allowed to amend his initial return in order to elect the installment method properly. It is arguable that this case reveals a willingness on the part of the Tax Court to proceed at least as far as the circuit courts.

16 *But see* Nunn v. Gray, 196 F. Supp. 305 (W.D. Ky. 1961). In this case, the court recognized a late election of the installment method although the taxpayer had neither reported the sale in good faith nor evidenced a lack of negligence. This case appears to be an undue extension of the recent liberal interpretations.

17 Principal case at 615.

extension of the liberal trend to encompass this case would be to misinterpret the trend entirely. It would only be a short step from permitting an untimely election in the principal case to permitting an amended election where the original one had been deliberate but unwise.

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1 This plan was adopted for forty of the company's officers and executives. In the decedent's case, the maximum payable to his survivors was $100,000.

2 "The gross estate shall include the value of an annuity or other payment receivable by any beneficiary by reason of surviving the decedent under any form of contract or agreement . . . if, under such contract or agreement, an annuity or other payment was payable to the decedent, or the decedent possessed the right to receive such annuity or payment, either alone or in conjunction with another for his life or for any period not ascertainable without reference to his death or for any period which does not end before his death." INT. REV. CODE OF 1954, § 2039(a). The related regulations subsequently issued state that the decedent will be regarded as having possessed the right to receive an annuity or other payment if, immediately before his death, he had an enforceable right to receive payments at some time in the future. Treas. Reg. § 20.2039-1(b) (1958).