T.C. Memo. 1944-247

For tax purposes, a construction contract is considered "completed" when the building is substantially finished, even if minor defects remain, allowing income to be recognized despite pending minor adjustments.

Summary

Day & Zimmermann, Inc. contested the Commissioner's determination of income tax liability for 1938, arguing that income from two construction contracts (Fredericks store/office building and North End Hotel) shouldn't be included because they weren't "completed and accepted" until 1939. The Tax Court held that both contracts were substantially completed and accepted in 1938, despite minor unresolved issues. It emphasized that "completed" doesn't require absolute perfection and that consistent accounting practices must be followed. The court also addressed the reasonableness of salary deductions for the company's officers, adjusting the amounts allowed by the Commissioner.

Facts

Day & Zimmermann, Inc. used the completed contract method of accounting. In 1938, they had two significant construction projects: the Fredericks store and office building and the North End Hotel. The Fredericks building had minor defects at the end of 1938, leading to a withheld payment. The North End Hotel was occupied and operating as a hotel from July 1938, but formal acceptance was argued to have occurred later. The company also claimed deductions for officer salaries, which the Commissioner deemed excessive.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Day & Zimmermann's income tax for 1938. Day & Zimmermann contested this determination in the Tax Court, specifically challenging the inclusion of income from the construction contracts and the disallowed portion of officer salary deductions.

Issue(s)

1. Whether the income from the Fredericks construction contract was properly included in Day & Zimmermann's 1938 income, considering alleged incomplete status and lack of acceptance until 1939.
2. Whether the income from the North End Hotel construction contract was properly included in Day & Zimmermann's 1938 income, given the claim that formal acceptance occurred in 1939.
3. Whether the Commissioner erred in disallowing a portion of the deductions claimed for officer salaries for Ehret and Day.

Holding

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1. Yes, because the Fredericks contract was substantially completed in 1938, despite minor defects, and was deemed accepted in 1938 based on the architect's certificate.
2. Yes, because the North End Hotel was completed, occupied, and mostly paid for in 1938, constituting acceptance despite a later formal inspection.
3. Yes, in part. The Commissioner's allowance for Day's salary was deemed inadequate, and the full claimed deduction was allowed. The allowance for Ehret's salary was also deemed inadequate, and increased based on the evidence presented.

Court's Reasoning

The court interpreted Treasury Regulations allowing income recognition upon contract completion and acceptance. It defined "completed" practically, noting that substantial completion suffices despite minor defects. Quoting from 17 C.J.S., the court noted that literal and strict performance isn't required and that if the builder, acting in good faith and intending and attempting to perform his contract, does so, he may recover the contract price, notwithstanding slight and trivial defects or deviations in performance, for which compensation may be made, in all its material and substantial particulars, by an allowance to the owner. The architect's certificate and the client's occupancy indicated acceptance in 1938. Regarding officer salaries, the court weighed the specific services rendered, time devoted, and experience to determine reasonable compensation, referencing *Cohan v. Commissioner*, 39 F.2d 540, for the principle of approximating deductions when exact figures are unavailable.

Practical Implications

This case clarifies the meaning of "completed" for tax purposes, offering guidance on when to recognize income from long-term construction projects. It emphasizes that minor remaining work doesn't necessarily delay income recognition. Attorneys can use this case to argue for income recognition in the year of substantial completion, even if acceptance occurs later. It also highlights the importance of consistent accounting practices and the need for evidence to support deductions, particularly for officer compensation. This case has been cited in subsequent tax cases involving similar disputes over the timing of income recognition in construction contracts and the determination of reasonable compensation.

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