2 T.C. 62 (1943)

A corporation using the accrual method of accounting must recognize income when earned, even if it dissolves before receiving payment, if no further expenses are required to earn that income.

Summary

Pershell Engineering Co., using accrual accounting, dissolved shortly before completing a lucrative contract for an oil refinery in Roumania. The Tax Court held that Pershell was liable for income tax on the profits from the completed contract, despite its dissolution. The court reasoned that because Pershell had substantially completed the contract and no further expenses were required to earn the income, the income was properly accruable to Pershell for that tax year. This case illustrates the importance of the accrual method in reflecting income and preventing corporations from avoiding taxes by dissolving before formal receipt of income.

Facts

Pershell Engineering Co., a Kansas corporation, provided engineering services for constructing petroleum processing plants. It used the accrual basis and the completed-contract method for long-term contracts. Pershell had a contract related to the design and construction of an oil refinery in Ploesti, Roumania. On August 9, 1938, Pershell's stockholders resolved to dissolve the company, just days before the refinery project was completed and accepted. The resolution stated that the corporation had no outstanding debts. The dissolution resolution was filed on August 11, 1938. Shortly thereafter, payment for the refinery project was received by trustees for the stockholders and distributed to them.

Procedural History

The Commissioner of Internal Revenue assessed deficiencies in income and excess profits taxes against Pershell for 1938. The Commissioner then sought to hold the former stockholders liable as transferees for these deficiencies. The stockholders, as transferees, petitioned the Tax Court for review, arguing that the income was not taxable to Pershell because the corporation had dissolved before the income was received.

Issue(s)

Whether a corporation using the accrual method of accounting is liable for income tax on profits from a contract completed shortly after its dissolution, where the corporation had substantially performed the contract and no further expenses were necessary to earn the income.

Holding

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Yes, because the corporation had substantially completed the contract and no further expenses were required to earn the income, the income was properly accruable to the corporation for that tax year, even though it dissolved before actual payment.

Court's Reasoning

The Tax Court emphasized that Pershell used the accrual method of accounting. Under this method, income is recognized when earned, not necessarily when received. The court found that Pershell had substantially completed the Roumanian refinery project, and no further expenses were required to earn the income. The court cited Section 41 of the Revenue Act of 1938, which dictates that income should be computed based on the taxpayer's accounting method, provided that method clearly reflects income. The court distinguished the case from situations where a corporation's existence is continued for the purpose of liquidation, referencing Article 22(a)-21 of Regulations 101. Since Pershell was ostensibly dissolved, that regulation was deemed not directly applicable. However, the underlying principle of accurately reflecting income for the tax year was paramount. The court cited *United States v. Anderson*, stating that the accrual system aims "to enable taxpayers to keep their books and make their returns according to scientific accounting principles."

Practical Implications

This case highlights the importance of the accrual method of accounting in determining when income is taxable. It prevents corporations from strategically dissolving to avoid taxes on income that has already been earned. The decision clarifies that dissolution does not automatically extinguish tax liabilities on accrued income. Legal practitioners should analyze contracts and accounting methods closely when advising corporations considering dissolution, especially if substantial income-generating activities are nearing completion. Later cases have applied this principle to various scenarios involving accrued income and corporate liquidations, underscoring the need for careful tax planning to avoid unexpected tax liabilities.

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