17 T.C. 516 (1951)

Under cost-plus-fixed-fee contracts with the government, disputes over reimbursable costs and fees delay income accrual until the government acknowledges the taxpayer's entitlement; subsequent recoupment by the government requires retroactive income reduction under Section 3806 of the Internal Revenue Code, but later reimbursements of previously disallowed costs are taxable in the year received or accrued.

Summary

Cramp Shipbuilding Co. disputed with the Navy over reimbursable costs and fees under cost-plus-fixed-fee contracts. The Tax Court addressed the timing of income accrual for these disputed items. It held that income accrues when the government acknowledges entitlement. If the government later recoups previously reimbursed amounts, Section 3806 mandates a retroactive reduction of income in the year of original accrual. However, subsequent reimbursements for previously disallowed costs are taxable in the year they are received or accrued. Additionally, the court found that amounts borrowed by the company to fulfill government contracts constituted borrowed invested capital for excess profits tax purposes, despite assigning contract rights to banks as security.

Facts

Cramp Shipbuilding Co. engaged in shipbuilding and facility construction for the U.S. Navy under several cost-plus-fixed-fee contracts from 1941 to 1945. Disputes arose concerning the reimbursability of certain costs, including Pennsylvania corporate net income tax and miscellaneous expenses. The Navy initially disallowed some reimbursements, later reversed its position on the Pennsylvania tax, and the General Accounting Office (GAO) subsequently disallowed some of the Navy's reimbursements. These disputes were eventually settled, and the company received reimbursements in later years. Cramp also borrowed funds to finance its operations, assigning its rights to contract payments as collateral.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Cramp's income and excess profits taxes for 1942-1945. The cases were consolidated. The Commissioner later amended his answer to raise an affirmative issue claiming additional deficiencies in excess profits taxes. The Tax Court addressed multiple issues, including the timing of income accrual under government contracts and whether certain indebtedness constituted borrowed invested capital. A separate hearing was held regarding deductions for amortization of emergency facilities.

Issue(s)

1. When should an accrual-basis taxpayer recognize income under cost-plus-fixed-fee

contracts when disputes exist with the government over reimbursable costs and fees?

2. Does Section 3806 of the Internal Revenue Code require relating back income to the year costs were initially incurred when the Government later recoups previously reimbursed amounts?

3. Do amounts borrowed by the taxpayer to execute Government contracts constitute borrowed invested capital for excess profits tax purposes when the taxpayer assigns its right to receive contract payments to the lending banks?

Holding

1. Income is recognized when the government agrees that the taxpayer is entitled to reimbursement of costs and payment of fees.

2. Yes, because Section 3806(a)(2) mandates reducing the amount of reimbursement for the taxable year in which the reimbursement was received or accrued by the amount disallowed, while Section 3806(a)(1) requires similar reduction in accrued fees.

3. Yes, because amounts borrowed to finance government contracts constitute borrowed invested capital, even if the taxpayer assigns its right to receive payments under the contracts to the lending banks.

Court's Reasoning

The court reasoned that general tax principles dictate income is not reportable until its receipt is reasonably assured. For accrual-basis taxpayers, income is realized when events fix the right to receive it. The court found that the Navy's initial stance against reimbursing the Pennsylvania tax created sufficient uncertainty, delaying accrual until 1945 when the Navy reversed its position.

However, the court emphasized that Section 3806 provides specific rules for cost-plus-fixed-fee contracts, requiring a reduction in prior-year income when reimbursements are later disallowed and recouped. This provision overrides general accrual principles to that extent. However, the court found that Section 3806 does not require relating back to prior years any later reimbursements of items earlier disallowed.

Regarding borrowed capital, the court followed *Brann & Stuart Co.*, holding that the loans were bona fide indebtedness of Cramp, evidenced by notes, and used for business purposes. The assignments to the banks were merely security measures and did not shift the debt obligation to the government.

Practical Implications

This case clarifies the timing of income recognition under cost-plus-fixed-fee government contracts, emphasizing the importance of government acknowledgment of entitlement. Attorneys advising clients on government contracts should be aware of Section 3806 and its implications for adjusting prior-year income. The case also confirms that assigning contract proceeds as collateral does not necessarily disqualify debt as borrowed capital for tax purposes. This is important for companies seeking to maximize their excess profits tax credit. Later cases must distinguish between the treatment of disallowances and repayments (which relate back) versus later reimbursements of previously disallowed costs (which do not).

