20 T.C. 15 (1953)

A taxpayer using the accrual method of accounting is not required to recognize income when the right to receive that income is subject to a substantial dispute or contingency.

Summary

Foster Wheeler Corp. involved a dispute over royalties owed to and by the petitioner, where payment was prohibited by a Navy order under the Royalty Adjustment Act of 1942. The Tax Court addressed the proper accounting treatment for these royalties. The court held that the petitioner was not required to accrue income from royalties when their right to receive payment was contested by the Navy. However, the petitioner could deduct accrued royalty expenses because its liability was fixed, even though the payee was initially undetermined. This case clarifies accrual accounting principles when government action affects income and expenses.

Facts

Foster Wheeler and Babcock & Wilcox Company had a cross-licensing agreement where each paid the other a 2% royalty on steam generators sold for marine use. During 1945 and 1946, both companies had Navy contracts for these generators. In June 1945, the Secretary of the Navy, under the Royalty Adjustment Act of 1942, directed both companies to cease royalty payments related to Navy contracts. Foster Wheeler requested a hearing with the Royalty Adjustment Board to contest this order. A settlement was reached in 1947, retroactively setting the royalty rate at 1%. Foster Wheeler accrued the royalties owed to them in 1945 and 1946, but did not report it as income until 1947. Foster Wheeler also accrued and deducted royalty expenses owed to Babcock in 1945.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Foster Wheeler's income and excess profits taxes for 1945 and 1946. Foster Wheeler contested this determination, claiming overpayment. The Commissioner claimed increased deficiencies for 1945. The Tax Court consolidated the cases to resolve the accounting treatment of the disputed royalties.

Issue(s)

1. Whether Foster Wheeler was required to accrue royalty income from Babcock in 1945 and 1946 when the Navy prohibited payment under the Royalty Adjustment Act?

2. Whether Foster Wheeler could deduct accrued royalty expenses owed to Babcock in 1945, even though payment was also subject to the Royalty Adjustment Act?

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Holding

1. No, because a genuine dispute existed regarding Foster Wheeler's right to receive the royalty income, making accrual inappropriate until the dispute was resolved in 1947.

2. Yes, because Foster Wheeler's obligation to pay the royalties was fixed and certain at the end of 1945, even though the ultimate recipient (Babcock or the government) was yet to be determined.

Court's Reasoning

The court reasoned that under accrual accounting, income is recognized when all events have occurred that fix the right to receive it, and the amount can be determined with reasonable accuracy. Because the Secretary of the Navy contested Foster Wheeler's right to royalties, a real dispute existed. Citing *Cold Metal Process Co.*, the court held that Foster Wheeler did not have to accrue the disputed royalties as income until the dispute was resolved in 1947. Regarding the deduction of royalty expenses, the court emphasized that the obligation was fixed, with only the ultimate recipient in question. The court quoted the Royalty Adjustment Act of 1942, noting that any reduction in royalties would benefit the government. Thus, Foster Wheeler's liability was established, justifying the deduction.

Practical Implications

Foster Wheeler clarifies the application of accrual accounting when a taxpayer's right to income is contingent or disputed, particularly when government regulations intervene. The case emphasizes that a mere expectation of receiving income is insufficient for accrual; a fixed and determinable right is required. For deductions, the focus is on whether the liability is fixed, even if the exact payee is uncertain. This case is frequently cited in tax law for its illustration of the "all events test" in the context of disputed income. Later cases distinguish *Foster Wheeler* by emphasizing the absence of a genuine dispute or contingency, requiring accrual even if payment is delayed. The case serves as a reminder that government actions affecting contractual rights can significantly impact tax accounting.

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