20 T.C. 294 (1953)

For an accrual basis taxpayer, a deduction for contested excess profits taxes accrues in the year the contest is settled and the taxes are paid, not the year the taxes were initially levied.

Summary

Robert Reis & Co., an accrual basis taxpayer, contested excess profits taxes for 1943 and 1944. The dispute was settled in 1949, and the taxes were paid that year. The Tax Court addressed whether the taxpayer could deduct these excess profits taxes in 1949 under Section 122(d)(6) of the Internal Revenue Code for purposes of calculating a net operating loss carry-back. The court held that the deduction was proper in 1949 because, as an accrual basis taxpayer, the liability became fixed and determinable in that year upon settlement of the contested tax liability. This decision clarifies the timing of deductions for contested liabilities under the accrual method of accounting.

Facts

Robert Reis & Co. (the "Petitioner"), used the accrual method of accounting. The IRS proposed adjustments to the Petitioner's 1943 and 1944 income and excess profits taxes. The Petitioner contested the proposed deficiencies, primarily due to a disagreement over an excess profits credit carry-over from 1942 linked to a loss from a subsidiary's stock. The Petitioner contested the taxes until March 22, 1949, when a settlement was reached, and the Petitioner consented to the assessment of deficiencies. The Petitioner paid the agreed-upon amount of $60,012.74 on June 27, 1949. The Petitioner sustained a net operating loss in 1949 and sought to carry it back to 1947, including the excess profits tax payment as a deduction.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the Petitioner's income tax for 1946 and 1947. The case was brought before the Tax Court concerning the propriety of the Commissioner's failure to increase the Petitioner's net operating loss sustained in 1949 by the amount of excess profits taxes for 1943 and 1944, which were contested until settled and paid in 1949.

Issue(s)

Whether an accrual basis taxpayer can deduct contested excess profits taxes in the year the contest is settled and the taxes are paid, for the purposes of calculating a net operating loss under Section 122(d)(6) of the Internal Revenue Code.

Holding

Yes, because for an accrual basis taxpayer, a contested liability becomes deductible

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when the contest is resolved, and the amount is fixed and determinable.

Court's Reasoning

The court reasoned that Section 122(d)(6) allows a deduction for excess profits taxes "paid or accrued within the taxable year." Relying on *Dixie Pine Products Co. v. Commissioner, 320 U.S. 516*, and *Security Flour Mills Co. v. Commissioner, 321 U.S. 281*, the court emphasized that an accrual basis taxpayer cannot deduct a contested tax liability until the contest is resolved. Until settlement, the liability is not fixed and determinable. The court distinguished its prior decision in *Stern Brothers & Co., 16 T.C. 295*, noting that the issue there concerned the accrual of federal income and excess profits taxes as called for by section 35.718-2 (a) of Regulations 112 relating to accumulated earnings and profits. The court stated, "We are here dealing with an item specifically denominated 'a deduction' in the statute, and are of the opinion that *Stern Brothers* is not pertinent." The court rejected the Commissioner's argument that allowing the deduction in 1949 would distort the Petitioner's excess profits picture, stating that the statute plainly provides for the deduction claimed by the Petitioner in 1949.

Practical Implications

This case provides clarity on the timing of deductions for contested liabilities for accrual basis taxpayers. It confirms that a deduction for contested taxes cannot be taken until the year the contest is settled, and the amount of the liability is definitively determined. This rule prevents taxpayers from prematurely claiming deductions for uncertain liabilities and ensures that deductions are matched with the period in which the liability becomes fixed. Tax practitioners must advise accrual basis clients to defer deductions for contested tax liabilities until the dispute is resolved through settlement, judgment, or other means. Subsequent cases have reinforced this principle, emphasizing the importance of a fixed and determinable liability for accrual.

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