24 T.C. 722 (1955)

Under the completed contract method of accounting, income from a contract is recognized in the year of completion, but only to the extent that the income is reasonably certain and not contingent.

Summary

The U.S. Tax Court addressed whether a partnership, using the completed contract method, properly accrued income in 1938 related to a government construction contract completed that year. The partnership accrued both the remaining contract balance and an estimated amount for delay damages. The court held that the remaining contract balance was properly accrued because it was certain, but the estimated damages were not, as the amount was uncertain and unliquidated until the court's judgment in 1946. Consequently, the partnership had to include the damage award, less the contract balance, in its 1946 income. The court also disallowed a claimed bad debt deduction for the difference between the accrued amount and the ultimate judgment.

Facts

Irwin and Leighton, a partnership, contracted with the U.S. government to build a library, using the completed contract method of accounting. The contract was substantially completed in 1938, with the government taking possession. The partnership accrued as income the remaining balance due on the contract, which was $2,500, and an estimated $25,700 for damages due to government-caused delays. The government paid all but the $2,500 contract balance. The partnership sued the government in 1940 for the delay damages and the unpaid balance, eventually receiving a judgment in 1946. The judgment included the $2,500 and additional amounts for delay damages, less certain disputed bills. The partnership did not report the 1946 recovery as income but instead claimed a bad debt deduction. The Commissioner of Internal Revenue disallowed the bad debt deduction and included the recovery in the partnership's 1946 income.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the income tax of the petitioners for the year 1946, disallowing the bad debt deduction and including the recovery in income. The Tax Court consolidated the cases for hearing. The Tax Court sided with the Commissioner, which resulted in this appeal.

Issue(s)

1. Whether the Commissioner erred in including in partnership income for the year 1946 a recovery in the Court of Claims in the amount of $12,915.66.

2. Whether the Commissioner erred in denying the deduction of the difference

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between a $28,200 accrual made in 1938 and the $12,915.66 judgment which represented the net recovery on the items accrued.

Holding

1. Yes, because the $2,500 portion of the judgment, representing the balance due on the contract, should have been accrued as income in 1938. The delay damages were not properly accrued in 1938 because the amount was contingent and uncertain.

2. No, because the bad debt deduction was based on the improper accrual of the delay damages in 1938, which was correctly included in the 1946 income, as determined by the Commissioner.

Court’s Reasoning

The court focused on whether the partnership’s accruals in 1938 were proper under the completed contract method. The court stated, “The only exception to the rule requiring the accrual of outstanding items in the year of completion is made in the case of outstanding items which are ‘contingent and uncertain.’

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