Shepherd Construction Co. , Inc. v. Commissioner, 51 T. C. 890 (1969)

An accrual method taxpayer cannot deduct retainage withheld from subcontractors until all events fix the liability and the amount can be determined with reasonable accuracy.

Summary

Shepherd Construction Co. , using an accrual method of accounting, withheld retainage from subcontractors on highway construction projects, deducting these amounts as expenses in the year withheld. The IRS disallowed these deductions, arguing that the liability was not fixed until final acceptance of the project. The Tax Court agreed, holding that the retainage was not deductible until all events determining the liability occurred. The court also allowed an adjustment under Section 481 for amounts deducted in prior years, resulting in a significant tax increase for the year of the change.

Facts

Shepherd Construction Co. , Inc. , a highway contractor, entered into prime contracts with the Georgia Highway Department, which allowed partial payments based on monthly estimates of work completed, less a 10% retainage. Shepherd subcontracted portions of the work, withholding the same percentage of retainage from subcontractor payments. Shepherd accrued this retainage as an expense in the year withheld, despite not receiving the corresponding retainage from the Highway Department until final project acceptance. The IRS audited Shepherd's tax returns for fiscal years ending March 31, 1961, and 1962, disallowing the retainage deductions and adjusting income under Section 481.

Procedural History

The IRS issued a notice of deficiency for the fiscal years ending March 31, 1961, and 1962, disallowing deductions for subcontractor retainage and adjusting income under Section 481. Shepherd Construction Co. petitioned the U. S. Tax Court for review. The Tax Court upheld the IRS's position, disallowing the deductions and affirming the Section 481 adjustment.

Issue(s)

1. Whether Shepherd Construction Co. , using an accrual method of accounting, could deduct amounts withheld as retainage from subcontractors in the year withheld, despite not receiving corresponding retainage from the Highway Department until final project acceptance.
2. Whether the IRS's adjustment of Shepherd's taxable income under Section 481 for the year ended March 31, 1961, was proper.

Holding

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1. No, because all events fixing the liability to pay subcontractors the retainage had not occurred until final project acceptance, and the amount could not be determined with reasonable accuracy until then.
2. Yes, because the IRS initiated a change in Shepherd's method of accounting by disallowing the retainage deductions, necessitating an adjustment under Section 481 to prevent omission of income.

Court's Reasoning

The court applied the "all events" test from United States v. Anderson (1926), requiring that all events fixing the liability and determining the amount with reasonable accuracy must occur before an expense can be accrued. The court found that Shepherd's liability to pay subcontractors the retainage was contingent on final project acceptance, mirroring the Highway Department's obligation to Shepherd. The court rejected Shepherd's argument that monthly estimates fixed the liability, as the retainage could still be used to remedy defective work. The court also upheld the Section 481 adjustment, finding that the IRS's disallowance of the deductions constituted a change in Shepherd's method of accounting for a material item. The adjustment was necessary to prevent omission of income from prior years when the retainage was improperly deducted. Judge Bruce dissented on the Section 481 issue, arguing that the disallowance of the deduction was not a change in accounting method and that the adjustment was not necessary to prevent omission or duplication of income.

Practical Implications

This decision clarifies that contractors using the accrual method cannot deduct retainage withheld from subcontractors until all events fix the liability, typically at final project acceptance. This may require contractors to adjust their accounting practices and cash flow projections, as they cannot claim deductions for retainage until the project is complete. The case also demonstrates the IRS's ability to make Section 481 adjustments for prior years when changing a taxpayer's method of accounting, potentially resulting in significant tax increases in the year of change. Contractors should carefully review their accounting practices to ensure compliance with the "all events" test and be aware of the potential tax consequences of IRS-initiated accounting method changes.

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