***Charles G. Smith and Margaret M. Smith, Petitioners v. Commissioner of Internal Revenue, Respondent, 66 T. C. 213 (1976)***

Under the completed contract method of accounting, a subcontractor's income is taxable in the year the subcontract work is completed and accepted by the prime contractor, even if the entire project is not yet finished.

**Summary**

Charles G. Smith, a subcontractor, completed work on a construction project in 1968 but disputed $18,000 of the contract price with the prime contractor, Laguna. The Tax Court held that, under the completed contract method of accounting, Smith's income from the subcontract was taxable in 1968, the year his work was completed and accepted by Laguna, despite ongoing disputes and the fact that the entire project was not completed until 1969. The court reasoned that acceptance by the prime contractor, not the project owner, was sufficient for tax purposes, and the disputed amount did not prevent determination of a profit.

**Facts**

In 1967, Charles G. Smith entered into a subcontract with Laguna Construction Co. to perform foundation and pile-driving work for the Almonaster-Florida Avenues overpass project in New Orleans. Smith completed his work in early 1968 and submitted his final bill in March. Laguna paid $209,896. 17 of the $227,896. 17 owed but withheld $18,000 due to a dispute over materials. The entire project was formally accepted by the City in June 1969. Smith sued Laguna in 1970 for the disputed amount, and the litigation settled in 1972 with Laguna paying Smith $5,000.

**Procedural History**

The Commissioner determined a deficiency in Smith's 1968 federal income tax, asserting that the profit from the subcontract should have been reported in that year. Smith petitioned the U. S. Tax Court, arguing that the income was not taxable until the dispute over the $18,000 was resolved. The Tax Court upheld the Commissioner's determination, ruling that the income was taxable in 1968 under the completed contract method.

**Issue(s)**

1. Whether Smith's work under the subcontract was accepted in 1968 for purposes of the completed contract method of accounting?
2. Whether the dispute over $18,000 and subsequent counterclaim prevented the determination of profit in 1968?

**Holding**

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1. Yes, because Laguna accepted Smith's work in 1968, as evidenced by progress payments and authorization of subsequent construction, triggering income recognition under the completed contract method.
2. No, because the dispute over $18,000 did not affect the determination of profit in 1968; the remaining profit of $23,647. 33 was taxable in that year.

**Court's Reasoning**

The court applied IRS regulations governing the completed contract method, which state that a subcontractor's work is considered completed and accepted when the prime contractor accepts it. The court found that Laguna's acceptance of Smith's work in 1968, as shown by progress payments and allowing subsequent construction, met this standard. The court rejected Smith's argument that acceptance by the project owner (the City) was necessary, citing prior cases like *Hooper Construction Co. v. Renegotiation Board* that held acceptance by the prime contractor was sufficient. Regarding the dispute over $18,000, the court applied regulations stating that if a profit is assured despite the dispute, the profit less the disputed amount is taxable in the year of completion. The court determined that Smith's profit was assured in 1968, so the $23,647. 33 profit (excluding the $18,000 in dispute) was taxable that year.

**Practical Implications**

This decision clarifies that subcontractors using the completed contract method must report income in the year their work is accepted by the prime contractor, not when the entire project is completed. This can accelerate tax liability for subcontractors compared to waiting for project completion. The ruling emphasizes the importance of documenting acceptance by the prime contractor for tax purposes. It also illustrates that disputes over part of the contract price do not necessarily delay income recognition if a profit is still assured. This case has been cited in subsequent Tax Court decisions involving the completed contract method, reinforcing its application to subcontractors.

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