McMaster v. Commissioner, 69 T. C. 952 (1978)

Legal fees incurred in negotiating and drafting long-term contracts must be deducted in the year the contracts are completed under the completed contract method of accounting.

Summary

McMaster v. Commissioner addresses the timing of deductions for legal fees related to long-term contracts under the completed contract method of accounting. The petitioners, shareholders of Glasstech, Inc. , a subchapter S corporation, sought to deduct legal fees incurred during preliminary contract negotiations in the fiscal year they were paid. The Tax Court held that these fees must be deferred until the contracts are completed, as they are incident and necessary to the performance of specific long-term contracts. This decision emphasizes the importance of matching income and expenses in long-term contract accounting, impacting how businesses account for legal costs in similar situations.

Facts

Glasstech, Inc. , a subchapter S corporation, engaged in designing, manufacturing, and selling glass-tempering furnaces under individual long-term contracts. For the fiscal year ending June 30, 1973, Glasstech attempted to deduct $13,875 in legal fees incurred during preliminary negotiations and contract drafting with furnace purchasers. These contracts were not completed by the end of the fiscal year, and Glasstech reported income using the completed contract method of accounting.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the petitioners' income taxes for 1973 due to the disallowed legal fee deductions. The case was submitted to the United States Tax Court, which ruled in favor of the Commissioner, holding that the legal fees must be deferred until the contracts are completed.

Issue(s)

1. Whether legal fees incurred by Glasstech, Inc. during preliminary contract negotiations and drafting must be currently deducted or deferred until the contracts are completed under the completed contract method of accounting?

Holding

1. No, because the legal fees were incident and necessary to the performance of specific long-term contracts and must be deferred until the contracts are completed.

Court's Reasoning

The Tax Court reasoned that under the completed contract method, all costs incident and necessary to the performance of a long-term contract must be deferred until the contract is completed. The court distinguished between costs that benefit individual contracts and those that benefit the business as a whole. The legal fees in question were specifically related to negotiating and drafting individual contracts, thus falling under the former category. The court rejected the petitioners' argument that these fees should be currently deductible because they were incurred before the contracts were formally executed, emphasizing that the key distinction is the degree to which the costs relate to and benefit individual contracts. The court also cited cases like Woodward v. Commissioner and Collins v. Commissioner to support the principle of deferring legal costs until the income-producing event is realized.

Practical Implications

This decision clarifies that legal fees related to negotiating and drafting specific long-term contracts must be deferred until the contracts are completed under the completed contract method of accounting. For businesses using this method, it means careful tracking and allocation of legal costs to specific contracts. This ruling impacts how legal expenses are accounted for in long-term contract scenarios, emphasizing the importance of matching income and expenses. It also influences tax planning strategies, as businesses must consider the timing of legal fee deductions in relation to contract completion. Subsequent cases have followed this principle, reinforcing the need for businesses to align legal costs with the revenue they help generate.

