Guy F. Atkinson Company of California and Subsidiaries v. Commissioner of Internal Revenue, 82 T. C. 275 (1984)

Under the completed contract method, construction losses cannot be deducted until the contract is completed or substantially completed, even if performance has been terminated.

Summary

Guy F. Atkinson Co. and its subsidiaries sought to deduct losses from a water tunnel project under the completed contract method of accounting. The Tax Court held that 1975, the year the contractor ceased work, was not the year of contract completion because less than 60% of the work was finished. The court also ruled that a subsidiary qualified as a Western Hemisphere Trade Corporation (WHTC) for 1975 because its gross income from constructing a dam equated to gross receipts, not net of costs, allowing for a WHTC deduction.

Facts

Water Tunnel Contractors (WTC), in which Atkinson's subsidiary Walsh had a 30% interest, was engaged in constructing a water tunnel for New York City. WTC elected the completed contract method of accounting. Due to significant delays and cost overruns, WTC ceased work in 1975 after completing less than 60% of the project. The city declared WTC in default and took possession of the site and assets. WTC and the city later settled in 1979 with the city paying WTC $23. 5 million and rescinding the default declaration. Another Atkinson subsidiary, AIDR, was constructing a dam in the Dominican Republic and reported its income using the percentage of completion method.

Procedural History

The IRS issued a notice of deficiency to Atkinson for tax years 1972-1975. Atkinson petitioned the Tax Court, contesting the disallowance of deductions for the water tunnel project losses in 1975 and seeking a WHTC deduction for AIDR in 1975. The Tax Court ruled against Atkinson on the water tunnel deduction but in favor of AIDR's WHTC status.

Issue(s)

1. Whether 1975 was the proper year for deducting losses from the water tunnel project under the completed contract method of accounting.
2. Whether Atkinson's subsidiary AIDR qualified as a Western Hemisphere Trade Corporation in 1975.

Holding

1. No, because the water tunnel contract was not completed or substantially

completed in 1975, as less than 60% of the work was finished and the contract was not mutually terminated.
2. Yes, because AIDR's gross income from constructing the dam was equivalent to its gross receipts, meeting the WHTC requirements.

Court's Reasoning

The court applied the completed contract method regulations, which require final completion and acceptance for income and expenses to be reported. Since WTC had completed less than 60% of the contract and the city had not consented to termination, the contract was not completed in 1975. The court also noted that WTC's claims against the city and the city's counterclaims made it impossible to determine the net outcome of the contract in 1975. For the WHTC issue, the court found that AIDR's activity was primarily a service rather than manufacturing, merchandising, or mining, and thus its gross income equaled gross receipts. The court rejected the IRS's argument that gross income should be reduced by the cost of operations.

Practical Implications

This decision clarifies that under the completed contract method, losses cannot be deducted until the contract is completed or substantially completed, even if work has ceased. This has significant implications for contractors using this method, as they must wait until the contract's completion to realize tax benefits from losses, even if they have ceased work and incurred substantial losses. The ruling on WHTC status expands the definition of gross income to include gross receipts for service-based contracts, potentially allowing more companies to qualify for WHTC deductions. Subsequent cases have applied this ruling to similar situations involving the timing of deductions under different accounting methods and the classification of income for WHTC purposes.

