Sierracin Corp. v. Commissioner, 90 T. C. 341 (1988)

The completed-contract method of accounting is appropriate for manufacturing contracts involving custom-designed, unique items subject to unpredictable risks.

Summary

Sierracin Corp. sought to use the completed-contract method of accounting for its manufacturing divisions. The court held that this method was appropriate for the Sylmar and Transtech divisions, which produced custom-designed aircraft transparencies and security glazings, respectively, due to their unique nature and the unpredictable risks involved in their production. However, the method was not suitable for the Magnedyne division, as its products, though custom-designed, did not exhibit the same level of unpredictability in costs. The court also ruled that the contracts of Sylmar and Transtech need not be severed by delivery, as their pricing was not independent per shipment.

Facts

Sierracin Corp. operated several manufacturing divisions, including Sylmar, Transtech, and Magnedyne. Sylmar produced custom-designed aircraft transparencies, Transtech manufactured security glazings, and Magnedyne made electromagnetic devices. In 1979, Sierracin obtained permission from the IRS to switch to the completed-contract method of accounting for its long-term contracts. The IRS challenged this method, arguing that the products were not unique and that the contracts should be severed by delivery.

Procedural History

Sierracin Corp. filed a petition with the U. S. Tax Court after the IRS determined deficiencies in its corporate income tax for the years 1976, 1977, 1979, and 1980. The Tax Court reviewed the appropriateness of Sierracin's use of the completed-contract method and the IRS's proposal to sever contracts by delivery.

Issue(s)

1. Whether Sierracin Corp. was entitled to use the completed-contract method of accounting for its Sylmar, Transtech, and Magnedyne divisions.
2. Whether Sierracin's contracts with Sylmar and Transtech should be severed by delivery to clearly reflect income.

Holding

1. Yes, because the Sylmar and Transtech divisions produced unique items subject to unpredictable risks, making it difficult to estimate ultimate profit or loss on an interim basis. No, because the Magnedyne division's products did not exhibit the same level of unpredictability.

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2. No, because the contracts of Sylmar and Transtech were not independently priced by delivery, and severing them would not clearly reflect income.

Court’s Reasoning

The court defined “unique items” as those custom-designed for specific customers and not normally carried in finished goods inventory. It emphasized the unpredictability of risks in manufacturing as a key factor for using the completed-contract method. For Sylmar and Transtech, the court found that the custom design and the unpredictable nature of the manufacturing process justified the method. The court noted that “each transparency produced by Sylmar is limited in use to a specific opening in a particular model of aircraft,” and “each glazing produced by Transtech can only be installed in a specific opening in a specific building. ” In contrast, Magnedyne’s products were not subject to the same level of unpredictability. The court also reasoned that severing contracts by delivery was inappropriate because the pricing of Sylmar and Transtech contracts was not independent per shipment but based on the total quantity called for in a program.

Practical Implications

This decision clarifies when manufacturers can use the completed-contract method, focusing on the custom nature of products and the unpredictability of manufacturing risks. It informs legal practitioners and accountants that this method may be appropriate for contracts involving unique, custom-designed items where interim cost estimation is difficult. The ruling also emphasizes the importance of contract pricing in determining whether severance by delivery is justified. Subsequent cases, such as Spang Industries, Inc. v. United States, have cited this decision in analyzing the appropriateness of the completed-contract method for other manufacturing contracts.

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