74-SBE-026

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
KING NUTRONICS CORPORATION)

Appearances:

For Appellant: Dennis A. Page
Attorney at Law

For Respondent: Karl F. Munz
Counsel

OPINION

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of King Nutronics Corporation against a proposed assessment of additional franchise tax in the amount of $3,923.00 for the income year ended June 30, 1969.

Appellant is a California corporation engaged in the manufacture and sale of electronic components and hardware.

Most of its business consists of government contracts, one of which forms the basis for this appeal. The contract was awarded to appellant by the United States Air Force on October 30, 1963. The contract called for the manufacture and delivery of eighteen hydraulic test stands at a final delivery price of $13,227.00 per unit, plus the production of technical and engineering data at additional cost which resulted in a total contract price for the job of $249,861.00. The test stands were to be used in connection with the ground-testing of flight instrumentation. The specifications called for the government to furnish an engine and certain components for each test stand to be manufactured by appellant.

Soon after appellant commenced work under the contract it discovered that the engines shipped by the government were incomplete. The engines lacked critical parts, 'and departed from the standard configuration called for by the relevant specifications. Consequently, appellant was required to fabricate and purchase the necessary components to overcome the defects in the government-furnished equipment. The work required in correcting the defective equipment resulted in a substantially increased cost per unit, and set back the production schedule so that not all of the units could be delivered prior to the close of appellant's income year ended June 30, 1965.

Because of the. increased unit cost and the anticipated delay caused by the defective government -supplied equipment, appellant's vice president wrote the contracting officer on January 25, 1965, requesting an equitable price adjustment in the amount of $112,342.50. Apparently, this request was denied or no action was taken. In any event, on June 21, 1967, appellant made another request to the contracting officer for an equitable adjustment in the amount of $170,522.00. On September 6, 1967, this request was denied in its entirety.

Notwithstanding the difficulties which arose during performance, appellant completed- the contract. All eighteen test stands were delivered to, and accepted by, the government: ten units during the income year ended June 30, 1965; four units during the income year ended June, 30, 1966; and four units during the income year ended June 30, 1967.

On September 25, 1967, after completion of the contract, appellant appealed the adverse decision of the contracting officer to the Armed Services Board of Contract Appeals (ASBCA). After a hearing the ASBCA determined, on November 27, 1968, that the equipment furnished by the government had, in fact, been' incomplete, thereby causing appellant to incur substantially increased costs and delaying the completion of the contract. The ASBCA then remanded the matter to the contracting officer for the negotiation of a financial settlement with appellant. Thereafter, in December 1968, the parties agreed to a settlement in the amount of $66,730.00. 'This amount was received by appellant during its income year ended June 30, 1969.

Appellant reported the net amount of the award, $56,040.00,[1] as income in its federal corporation income tax return for the income year ended June 30, 1969. However, no part of the award was reported in appellant's California franchise tax return for that year. Instead, appellant noted that the award should have been accrued as income during the fiscal year ended June 30, 1965. In support of this action appellant maintains that during the course of performance it became obvious that the cost of performing the contract would substantially exceed the contract price. Thus, by the end of the income year ended June 30, 1965, appellant had already recorded costs in its inventory far in excess of the contract price, resulting in a substantial. overinflation of the inventory account on the books of the corporation; Accordingly, appellant wrote down its work-in-process inventory for the job to the lower of cost or market and absorbed the entire loss from the contract in that income year. In its franchise tax return for the income year ended June 30, 1965, appellant reported a loss of $166,556.00. Although appellant had submitted its claim for an equitable price adjustment during this year, no provision was made for any price adjustment and no income was accrued on account of the claim.

1/ The amount reported reflected a reduction of the gross amount of the award received by $10,690.00 expended in attorney's fees.

It is appellant's position that, although it maintains its books of original account on the accrual basis as opposed to the cash basis, it computes its income, or loss, from long-term contracts by the "completed contract" or "completed unit" method. Appellant asserts that, as such a taxpayer, the proceeds from the award should have been accrued as income during the income year ended June 30, 1965. If the award had been accrued as income in that year, it would have been entirely absorbed by the $166,556.00 loss reported in that year and no tax would have been attributable to the receipt of the award. Since no tax would have been incurred had the award been so reported, appellant concludes that it would be improper and inequitable to tax the income from the award in the year of receipt, the income year ended June 30, 1969. As an alternative argument appellant contends that the award should be assigned rateably to the income years ended June 30, 1965, 1966 and-1967, respectively, in the same ratio as the number of units completed in those years.

On the other hand, respondent asserts that appellant computed its income from long-term contracts strictly on the accrual basis, not by the completed contract method. Therefore, the income was reportable in the fiscal year ended June 30, 1969, the year in which the award was received. Respondent argues that the award did not accrue in an earlier year because the right to receive it was not fixed and the amount was not reasonably determinable in any earlier year.

Thus, the question for resolution in this appeal is whether the income awarded to appellant should have been reported in the year of receipt as respondent maintains, or whether the income should have been accrued during the income year ended June 30, 1965 or, alternatively, assigned rateably to the income years ended June 30, 1965, 1966 and 1967, respectively, as contended by appellant.

A substantial portion of the argument in this matter, both orally and on brief, centered around the question whether appellant computed its income from long-term contracts on the accrual basis or by the completed contract method. However, we do not find that a resolution of this question is critical to our determination. In either event, appellant cannot prevail.

It is well settled, and we do not understand appellant to argue otherwise, that before an item of income may be accrued by an accrual basis taxpayer, there must be a fixed, determined and enforceable right to receive a reasonably ascertainable amount. (See, e. g., Breeze Corporations v. United States, 117 F. Supp. 404 and the cases cited therein; see also Appeal of American President Lines, Ltd., Cal. St. Bd. of Equal., Jan. 5, 1961.) In the instant matter, it is readily apparent that appellant did not possess a fixed, determined and enforceable right to any monetary award from the federal government prior to the final ASBCA determination on November 27, 1968. Prior to that time, the government steadfastly denied any additional liability on the contract. Even at the time the ASBCA rendered its decision the amount of the award was not reasonably ascertainable since the matter was remanded to the contracting officer for the negotiation of a financial settlement with appellant. That the amount was not readily ascertainable prior to the negotiated settlement is further evidenced by the fact that the final settlement award was only slightly more than one-third of the amount originally claimed.

A similar approach has been adopted where the taxpayer reports income by either the percentage of completion or completed contract method, the two approved long-term contract methods of reporting income. (United States v. Rexach, 482 F. 2d 10, 21-24, cert. denied, 414 U. S. [38 L. Ed. 2d 330]; H. W. Nelson Co. v. United States, 308 F.2d 950, 955-956; C. H. Leavell & Co., 53 T. C. 426, 437; A. D. Irwin, 24 T.C. 722, aff'd, 238 F.2d 874; National Contracting Co., 37 B.T.A. 689, 700-702, aff'd, 105 F.2d 488.)

The rule was stated in National Contracting Co., 37 B. T. A.. 689, 701-702, as follows:

> Under the completed contracts method of accounting the ordinary rule in the case of items outstanding when a contract is "completed" is that "it is the right to receive and not the actual receipt that determines the inclusion* * *." Unless this accrual of outstanding items is made in the year of completion, the purpose of the completed contracts method, namely, to account for the entire results of a contract at one time, is defeated. However, as a general principle, when out - standing items are "contingent and uncertain", such as disputed claims in litigation, accrual is not proper,

> (Citations omitted.) While no case has apparently purported to determine this question under the long term contracts method, no reason appears why the rule should be less applicable to that type of accrual. And that this procedure may leave the exact profit or loss open for future adjustment is not fatal. (Citation and footnotes omitted.)

If we apply this rule to the facts set out above, we must conclude that the award received by appellant during its income year ended June 30, 1969, was "contingent" prior to the final decision of the ASBCA on November 27, 1968. Furthermore, it was "uncertain" in amount until the quantum of recovery was determined by negotiation between the parties, These negotiations were not concluded until sometime in December 1968. Therefore, the award was properly reportable as income in appellant's income year ended June 30, 1969, as maintained by respondent, and not accruable in any earlier year as urged by appellant.

Appellant places great reliance on the case of South Coast Co. v. Franchise Tax Board, 250 Cal. App. 2d 822 [58 Cal. Rptr. 747]. &ever, we find that case distinguishable. In South Coast, the taxpayer, who kept its books of original account on the accrual basis, determined its income from long-term contracts upon the percentage of completion method. In 1957, South Coast entered into a contract with the government under which it agreed to construct six minesweepers to be delivered, one each month, commencing in July 1953. Among other provisions, the contract contained a labor escalation clause whereby South Coast was allowed to request an upward adjustment in its contract price if it was required to pay an hourly wage rate in excess of a stated amount with the proviso that no adjustment would be allowed should it increase South Coast's profit above that specified in the contract. In 1953, wage increases in the shipbuilding industry raised the wage scale above that specified in the contract. South Coast paid the increased wage rate and deducted the increased labor expense of $137,284.21 in its 1953 California franchise tax return. On the same return it reported an estimated gross profit which included the estimated earned labor escalation income of $137,284.21.

After the contract was completed in 1955, South Coast filed two claims with the government, The first claim in the amount

of $195,791.55 included the total increased labor charges incurred during the life of the contract. The second claim, $581,867.42, was for losses occasioned by the government's delay in furnishing certain materials. In 1956, South Coast settled both claims for $211,000.00.

Thereafter, South Coast filed a claim' for refund for the amount it paid in taxes in 1953 on the estimated earned labor escalation income. In support of its position South Coast argued that where a taxpayer maintains records on an accrual basis, it is incorrect for him to reflect any sum as accrued income for tax purposes unless the right to receive it is a fixed, determined and enforceable right, not subject to contingencies'or conditions. (South Coast Co., supra, at 824 -325.) The court denied the claim for refund holding that South Coast did have a fixed, definite and certain right to be reimbursed for increased labor costs in 1953 and it properly treated the labor increase as income accrued in 1953.

In reaching its decision the court stated:

> Even if we are to assume that South Coast's right to the labor increase could be and was ultimately cut off, South Coast was nonetheless, at the end of 1953, entitled to a compensating income increment measured by at least that amount because the termination of its right to receive the $137,284.21 could come about only if that sum were paid under some clause other than the labor escalation clause. Ultimately, and no matter how the income might be designated, South Coast held an enforceable right to receive reimbursement of at least $137,284.21 accrued in 1953 and this right was then taxable. (250 Cal. App. 2d at 828.) (Citation omitted and emphasis added.)

In the instant matter, as we have illustrated, appellant did not- have an enforceable right to receive any amount until the ASBCA handed down its decision during appellant's income year ended June 30, 1969. Prior to that time appellant's claim, which had previously been denied in its entirety, was contingent and uncertain . Even after the ASBCA's decision the monetary amount of the award was uncertain since the decision left the actual amount

open for negotiation between the parties. Since South Coast Co. v. Franchise Tax Board, supra, concerned a fixed, definite and certain right to reimbursement, rather than a contingent and uncertain right such as we are presently concerned with, it is distinguishable from. the instant matter and does not support appellant's position.

Appellant has also advanced additional arguments which we have considered and found without merit.

In view of the facts and the law set forth above and the conclusions derived therefrom, it is our determination that the income received by appellant in settlement of its dispute with the government should properly have been included in the year of receipt, appellant's income year ended June 30, 1969. Accordingly, respondent's action in this matter must be sustained.

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

Appeal of King Nutronics Corporation

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of King Nutronics Corporation against a proposed assessment of additional franchise tax in the amount of $3,923.00, for the income year ended June 30, 1969, be and the same is hereby sustained.

Done at Sacramento, California, this 1st day of August, 1974, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____ Member

_____ Member

ATTEST: _____ Secretary