DEFERRAL OF INCOME UNDER THE COMPLETED CONTRACT METHOD OF TAX ACCOUNTING*

THE Internal Revenue Code permits the taxpayer to compute his taxable income in accordance with the method regularly employed in keeping his books unless that method does not clearly reflect income.[1] Ordinarily, only those transactions which occur during the taxable year are taken into account.[2] However, the taxpayer who derives income from long-term construction contracts is authorized by regulation to use the completed contract method of accounting.[3] He may then report the profit or loss from the entire contract in the year in which it is "finally completed and accepted."[4] This exception to the general requirement that there be an annual accounting of income is based on the fact that the uncertainties involved in many long-term building contracts

*E.E. Black, Ltd. v. Alsup, 211 F.2d 879 (9th Cir. 1954).

1. INT. REV. CODE OF 1954, §§ 446(a), (b).

2. North American Oil Consolidated v. Burnet, 286 U.S. 417 (1932); Burnet v. Sanford and Brooks Co., 282 U.S. 359 (1931); Healey v. Commissioner, 345 U.S. 278 (1953).

3. "Income from long-term contracts is taxable for the period in which the income is determined, such determination depending on the nature and terms of the particular contract. As used in this section the term "long-term contracts" means building, installation or construction contracts covering a period in excess of one year from the date of execution to the date on which the contract is finally completed and accepted. Persons whose income is derived in whole or in part from such contracts may, as to such income, prepare their returns upon either of the following bases:

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"Gross income may be reported for the taxable year in which the contract is *finally completed and accepted* if the taxpayer elects as a consistent practice so to treat such income, *provided such method clearly reflects the net income.* If this method be adopted there should be deducted from gross income all expenditures during the life of the contract which are properly allocated thereto . . . ." U.S. Treas. Reg. 118, § 39.42-4 (1953) (emphasis added). The other accounting method permitted by the regulation is the percentage of completion method.

There seems no reason to doubt that § 39.42-4 will continue in force under the 1954 Code. The Treasury has provided that until new regulations are issued, those enacted under the previous Code will continue in effect insofar as they are not inconsistent with the new Code. T.D. 6091, 1954 INT. REV. BULL. No. 35, at 13. Section 39.42-4 was authorized under §§ 41 and 42 of the previous Code; § 446(a) of the 1954 Code is substantively identical with §§ 41 and 42. Moreover, the Senate Report states that all methods of accounting recognized under prior law will continue to be recognized, and specifically refers to the "long-term contract method" in one of its illustrations. S. REP. No. 1622, 83d Cong., 2d Sess. 300 (1954).

4. The contractor carries his entries of receipts and expenditures in a separate account for each contract. Any debit balance in the account represents his investment (expenditures) in the contract and any credit balance represents unearned income (receipts). Upon final completion and acceptance, the credit or debit balance is carried over respectively into the profit or loss account. Fort Pitt Bridge Works, 24 B.T.A. 626, 641 (1931), *rev'd on other grounds*, 92 F.2d 825 (3d Cir. 1937).

make it difficult to estimate the true profit-loss result of each undertaking until its completion.[5]

In the recent case of *E.E. Black, Ltd. v. Alsup*,[6] the Ninth Circuit construed the phrase "finally completed and accepted" in direct opposition to the approach of previous cases.[7] In July 1944 Black contracted with the Federal Public Housing Authority to construct a housing project for approximately $725,000. The dwelling units were completed in April 1945,[8] at which time the taxpayer requested the final payment of $44,533. On November 5, 1945 the Authority allowed him that amount less $533, a disallowance of less than 8/100 of one per cent of the contract price. This balance was retained because sixteen thermostat heads for the fire alarm system in the project's community building had not been installed. A subcontractor installed the heads in March 1946, and the $533 was released three months later.[9] Black reported the income from the entire contract in 1946, but the Commissioner assessed a deficiency for 1945 on the ground that under the applicable regulation the contract had been

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A contract need not last over a year in order to be treated as a long-term contract under the regulation if it overlaps an accounting period. *Ibid.*; L.A. Wells Constr. Co., 46 B.T.A. 302, 307 (1942).

The taxpayer who derives income from long term contracts need not report on the basis of completed contracts or percentage of completion. He can use his regular method of accounting—cash or accrual. G.C.M. 22682, 1941-1 CUM. BULL. 307; Robert M. Robinson, 10 P-H 1941 BTA MEM. DEC. ¶ 41,406 (1941).

5. G.C.M. 7998, IX-2 CUM. BULL. 206, 208 (1930); Harrison v. Heiner, 28 F.2d 985, 989 (W.D. Pa. 1928) (dictum); Alfred E. Badgley, 21 B.T.A. 1055, 1059 (1931) (same). See also Ahern, *Getting the Best Effective Use Out of Accounting Methods and Accounting Periods*, N.Y.U. 6TH INST. FED. TAX. 479, 502 (1947); Rolnik, *Tax Problems of Construction Contractors*, N.Y.U. 9TH INST. FED. TAX. 925 (1951).

However, the completed contract method has the disadvantage of exposing income to graduated tax rates which may impose a greater burden on the bunched income than would be imposed on the same income divided over the number of years it took to complete the contract. Ahern, *supra* at 502; Rolnik, *supra* at 932.

6. 211 F.2d 879 (9th Cir. 1954). The Solicitor General decided not to file any petition for certiorari. 4 P-H 1954 FED. TAX. SERV. ¶ 71,102 (1954).

7. The Ninth Circuit specifically disapproved of the nonliteral construction given the phrase in Ehret-Day Co., 2 T.C. 25 (1943). Ehret-Day had contracted to construct two buildings. By December 1938, one was finished except for some cracked floors and other minor defects, for which the owner withheld 3/5 of 1% of the contract price. The other was completed in every detail in 1938, but was not formally accepted until 1939. The Tax Court held that for purposes of the regulation, both projects were "finally completed and accepted" in 1938. This construction was approved and recently applied in Ben C. Gerwick, Inc., P-H 1954 TC MEM. DEC. ¶ 54,100 (1954) (naval construction contract held "finally completed and accepted" in 1945, although 3/10 of 1% of work not finished until 1946). See also Standard Paving Co., 13 T.C. 425, 438 (1949); Mesta Machine Co., 12 B.T.A. 523 (1928). Compare the approach of the courts in Rice, Barton & Fales Inc. v. Commissioner, 41 F.2d 339 (1st Cir. 1930); National Contracting Co., 25 B.T.A. 407 (1932), *aff'd*, 69 F.2d 252 (8th Cir. 1934); C.F. Martin, 34 B.T.A. 111, 114 (1936).

8. Transcript of Record, pp. 26, 34, E.E. Black, Ltd. v. Alsup, 211 F.2d 879 (9th Cir. 1954).

9. *Id.* at 11-13, 19, 22, 25-36.

"finally completed and accepted" in that year. If the Commissioner had permitted Black to report the contract profit in 1946 rather than in 1945, the expiration of the wartime excess profits tax would have lowered his tax liability by approximately $130,000.[10] Yet the Ninth Circuit reversed a district court judgment in favor of the Commissioner and held that the contract was not "finally completed and accepted" until 1946.[11]

The standard imposed in *Black* is a strictly literal one.[12] All payments on the contract must have been received. No work, not even that of a minor character, must remain undone. The ultimate formal acceptance, even if not obtained for a number of months after all the work has been completed, is essential.[13] The astute contractor will not fail to put such a standard to profitable use. By merely postponing an insignificant part of the job for a few months he may be able to reduce his tax liability considerably by shifting income from profitable contracts to a year in which he has sustained losses or made little profit, or to one for which rates have been lowered or certain taxes repealed.[14] The builder's desire to avoid the contractual liability which may result from

10. *Id.* at 5. Black was suing for a refund of $129,740 in excess profits tax plus $30,395 in interest on that sum. *Id.* at 6. The wartime excess profits tax was repealed with respect to taxable years beginning after December 31, 1945, 59 STAT. 568, and Black's taxable year for 1946 began January 1, 1946.

The statement in the text assumes that Black had no offsetting losses in 1945 that he did not have in 1946 and that the marginal rate on the contract income in 1946 was not greater than in 1945. If Black had such losses or the marginal rate was higher, his saving would be somewhat less.

11. The Ninth Circuit also rejected the Commissioner's alternative argument that the completed contract method in this situation was inappropriate because it did not clearly reflect income. E.E. Black, Ltd. v. Alsup, 211 F.2d 879, 880 (9th Cir. 1954).

12. "[W]e are of the opinion that the Regulation should be taken as meaning what it plainly says. . . ." *Ibid.*

13. The court relied upon Rice, Barton & Fales v. Commissioner, 41 F.2d 339 (1st Cir. 1930), but this case is distinguishable on its facts and does not enunciate a literal standard. In 1920, Rice, an American manufacturer, received an order from a Japanese firm for two specially designed papermaking machines. The machines were so large that it was not practical to assemble them in the United States or to test them as to their suitability for the purpose for which they were ordered and guaranteed. They were manufactured and shipped in units which did not arrive in Japan until the spring of 1922 and which were not fully assembled for testing until the late summer of that year. However, the last of the parts were shipped in September 1921 and final payment was made at that time. The taxpayer reported his profit on the entire contract in 1922 and was sustained in his action by the First Circuit. The court relied heavily on (a) the fact that the taxpayer could not know whether the machines had been finally accepted until the buyer made an inspection in 1922 and (b) the need of adjustments after completion and delivery for proper mechanical operation, sometimes at considerable expense. Nothing in the opinion suggests that the court was approving a strictly literal construction of the Regulation. Furthermore, if such had been the court's conclusion, there would have been no need to discuss the peculiar nature of the Rice contract.

14. Thus Black was able to save approximately $130,000 in his tax bill. See note 10 *supra*. The construction given to "finally completed and accepted" becomes crucial when-

delaying the performance of minute details of his contract will often be overcome by the desire to effect large tax savings.[15]

The Ninth Circuit seems to have been influenced strongly by the taxpayer's argument that unless the court gave a literal construction to "finally completed and accepted" it would be supporting a standard undesirable because of its uncertainty.[16] The *Black* rule does give the contractor certainty, but in so doing it enables him arbitrarily to select the year in which he will report income already earned.[17] Rules which foster such tax manipulation have not, in the past, been deemed appropriate despite the certainty they might have afforded. Thus, in deciding when a cash basis taxpayer is to report income, courts refuse to be bound by the Code's provision that income items be included in the year in which they are "received by the taxpayer."[18] Rather,

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ever the general tax burden is lightened. Since the excess profits tax was not extended beyond December 31, 1953, 3-A P-H FED. TAX. SERV. ¶ 45,015 (1953), it is probable that a number of cases in which the date of final completion and acceptance is contested will soon arise.

15. The *Black* standard will generally enable the contractor to save taxes without subjecting himself to the risk of any penalty aside from being deprived of the use of a minor fraction of the contract price, an amount which corresponds to the value of the unfinished or defective work. The contractor would not have to cause any real damage to the owner in order to take advantage of the *Black* standard. He need only delay in placing the finishing touches on a project, a delay which will not prevent the owner from using the project. Delays are so common and so often unavoidable in building construction that time is rarely held to be of the essence unless this is specified in the document. See, *e.g.*, Central Contracting Co. v. Grignon, 255 Fed. 952, 954 (8th Cir. 1919); 3 CORBIN, CONTRACTS § 720 (1951). And if the contractor is unlucky enough to invoke the owner's wrath, so that the owner withholds more than a minor part of the contract price, the doctrine of substantial performance protects the contractor and enables him to recover the contract price less *compensatory* damages. 3 *id.* § 701. The ordinary damages for delay consist of rental value for the period the project cannot be used. 5 *id.* § 1092. A liquidated damages provision will seldom be invoked for the sort of breach that will delay the date of final completion for tax purposes under the *Black* standard since courts will not enforce such a provision if there is no significant damage. Massman Constr. Co. v. City Council, 145 F.2d 925 (5th Cir. 1945); 3 CORBIN, CONTRACTS § 1061 (1951). Furthermore, the contract itself may make substantial completion of the project a bar to the operation of the liquidated damages provision. See the standard building contract form published by the American Institute of Architects, Art. 2, in 2 NICHOLS, LEGAL FORMS § 1071 (1936). Of course the contractor may be limited in his ability to delay by a desire to maintain a good business reputation.

16. Brief for Appellant, pp. 11, 12, E.E. Black, Ltd. v. Alsup, 211 F.2d 879 (9th Cir. 1954). In rejecting Ehret-Day Co., 2 T.C. 25 (1943), the ninth circuit said, "The . . . doctrine there applied tends merely to import into the tax law an unwarranted and undesirable uncertainty." E.E. Black, Ltd. v. Alsup, *supra* at 880. The court gave no other reason for preferring a literal standard.

17. See text at note 14 *supra*. The *Black* rule may be disadvantageous to the taxpayer, for an insignificant delay or nonperformance may place income in a less favorable tax year. Furthermore, the ability of the owner to shift the contractor's income to the later year by intentionally protracting the job or delaying acceptance may give the owner an unfair bargaining advantage over the contractor as to matters involved in their contract.

18. INT. REV. CODE OF 1954, § 451.

they apply the judicially created doctrine of constructive receipt.[19] Whether or not a cash basis taxpayer has received money in hand, he must report income as soon as he has the unqualified right to receive it.[20] The desire to assure an equitable distribution of the tax load among all taxpayers has thus led the courts to prohibit manipulation of the year of income realization and to conclude that it is sufficient if the law gives the taxpayer a reasonably certain guide for determining when to report.[21]

The *Black* standard is also in conflict with the general principle that taxation of income earned during the taxable year can not be deferred to a later year if the existence and amount of such income can be ascertained with reasonable accuracy.[22] The reporting of income may not be delayed because of contingent possibilities that part or all of it may not be retained.[23] And if the right to

19. "Not recognizing constructive receipt of income as income realized would open the door to fraud by leaving it within the power of the taxpayer to reduce income to possession at such time as would best suit his taxation purposes. Such a right of selection does not rest with the taxpayer nor does it find approval in the cases." Loose v. United States, 74 F.2d 147, 150 (8th Cir. 1934).

20. Hedrick v. Commissioner, 154 F.2d 90 (2d Cir. 1946); Loose v. United States, 74 F.2d 147 (8th Cir. 1934); Hooker Electrochemical Co., 8 T.C. 1120 (1947). *Cf.* Corliss v. Bowers, 281 U.S. 376, 378 (1930). For a comprehensive discussion of the doctrine of constructive receipt, see 2 MERTENS, FEDERAL INCOME TAXATION §§ 10.01-.17 (1942).

21. Whenever a taxpayer is allowed to defer his income tax, he may not only be able to effect a saving by shifting the income to a more favorable year, see text at note 14 *supra*, but in effect he often forces the Government to make a capital investment in his business for the period of deferral since he gets an interest free loan from the Treasury of funds he would otherwise have had to disburse in payment of taxes. This twofold advantage is obtained at the expense of other less favored taxpayers, whose relative share of the tax burden is thereby increased.

22. Although rarely stated explicitly, this principle underlies most of the decisions which involve the question of when income should be reported. The courts more often justify their decisions by the doctrines of "claim of right," "annualization," or "constructive receipt." An analysis of the facts in the cases outlined in the following two footnotes indicates that these doctrines are really applications of the general principle that deferral of income is improper whenever income is reasonably ascertainable.

For reasons of administrative convenience this principle is not fully applicable to the cash basis taxpayer. He has the right to defer income to the year of actual or constructive receipt, even if income is reasonably ascertainable prior to that time, unless such a deferral does not clearly reflect income. INT. REV. CODE OF 1954, §§ 446(a), (b), (c). But even the cash basis taxpayer is limited in his right to defer by this pervasive principle. The constructive receipt doctrine prevents the cash basis taxpayer from deferring beyond the point when he receives the unqualified right to receive payment. See cases cited note 20 *supra*, and accompanying text. And the claim of right doctrine prohibits deferral for reason of future contingencies. Healey v. Commissioner, 345 U.S. 278 (1953); North American Oil Consolidated v. Burnet, 286 U.S. 417 (1932); Saunders v. Commissioner, 101 F.2d 407 (10th Cir. 1939).

23. "If a taxpayer receives earnings under a claim of right and without restriction as to its disposition he has received income which he is required to return even *though it may still be claimed that he is not entitled to retain the money and even though he may still be adjudged liable to restore its equivalent.*" North American Oil Consolidated v. Burnet, 286 U.S. 417, 424 (1932) (emphasis added). There, in 1916, taxpayer operated

an item becomes fixed during the taxable year, the impossibility of making more than a reasonable approximation of its amount until some time after the taxable year does not permit taxpayer to defer the report of such income until the exact amount can be calculated.[24] It is because the existence and amount

certain oil lands under lease from the United States. The Government claimed it was entitled to the profits from the 1916 operation and had the profits impounded. In 1917, the profits were released to the company under a decree of the district court which did not become absolute until the Government's appeal to the Supreme Court was dismissed in 1922. In the tax case, the Supreme Court held that the profits were taxable to the company in 1917 rather than in 1922 whether the taxpayer was on a cash or accrual basis.

See also Brown v. Helvering, 291 U.S. 193 (1954), where an insurance broker on a cash basis received income in the form of commissions on premiums paid to the insurance company. The Supreme Court held that he could not deduct from his commission receipts the estimated amount he would have to return to the insurance company because of cancellations. And see Healey v. Commissioner, 345 U.S. 278 (1953). In that case, executives of a closely held corporation reported their full salaries as income in the year of receipt. Parts of these salaries were later declared to be unreasonable. The executives sought to deduct the unreasonable parts from the income reports of the year of receipt on the ground that, when the salary was paid, the employees had a liability in law to return the unreasonable excess to the corporation. The Court rejected their contention on the ground that such a potential or dormant restriction on use was not enough to bar recognition of the entire salary as income in the year of receipt. Further supporting cases: Clifton Mfg. Co. v. Commissioner, 137 F.2d 290 (4th Cir. 1943) (debt, collectibility of which became established with reasonable probability in 1936, was taxable in 1936 rather than in 1937, the year of receipt); Frost Lumber Ind. v. Commissioner, 128 F.2d 693 (5th Cir. 1942) (In 1935 the Secretary of Agriculture exercised his option to purchase land from taxpayer, a corporation on accrual basis. The deed was recorded in 1935, but the full purchase price was not paid, and formal acceptance of title was not given until 1936. The court held that the profit from the sale was taxable as income in 1935); Saunders v. Commissioner, 101 F.2d 407 (10th Cir. 1939) (money received by corporate officers from sale of capital stock held taxable in year of receipt although it was possible that the payments were illegal and the officers under advice of counsel later voluntarily returned the amounts to the corporation); Fawsett v. Commissioner, 63 F.2d 445 (7th Cir. 1933), *cert. denied*, 290 U.S. 641 (1935) (income from sale of realty not deferrable because of vendor's contingent liability on one of the outstanding mortgages of the realty); Barker v. Magruder, 95 F.2d 122 (D.C. Cir. 1938) (usurious interest charges levied by loan company against customers held taxable in year they accrued because borrowers had not yet challenged their invalidity); Highland Milk Condensing Co. v. Phillips, 34 F.2d 777 (3d Cir. 1929) (tax on profits from sales could not be deferred although seller had guaranteed purchasers against any decline in market price); W.J. Scholl Co., 30 B.T.A. 993 (1934) (a taxpayer on the completed contract basis had derived income from a long-term contract. Against the contention that an accurate estimate of costs was impossible until the end of the guarantee period, the Board held this income taxable in the year the principal work was finished). See Magill, *When is Income Realized?*, 46 HARV. L. REV. 933, 947 (1933), for a similar statement of the rule in the text, but restricted to the accrual basis taxpayer. See also Comment, *Taxing Unsettled Income*, 58 YALE L.J. 955, 964 (1949). *But cf.* Lucas v. North Texas Lumber Co., 281 U.S. 11 (1930).

24. "Where income tax returns are made by the taxpayer on an accrual basis, there need not be certainty, but only reasonable accuracy, in calculating the amount to be received, in order to bring that amount within taxable income .... Whether a taxpayer is entitled to or bound to accrue an item of income in a certain year depends on whether there was justification for a reasonable expectation that the payment of the item would be made

of income from a construction contract whose length overlaps the taxable year is often not reasonably ascertainable at the end of the taxable year that the regulations allow the builder to defer his income report beyond that point.[25] But the requirement of reasonable ascertainability does not necessitate deferral of the report until the contract is one hundred per cent complete and formally accepted.

The standard for determining when the contractor must report should enable him to estimate his income on the contract with reasonable accuracy and should afford him a guide which is reasonably certain, yet not susceptible to manipulative use. The Ninth Circuit was therefore correct in rejecting the contract doctrine of substantial performance as a basis for the tax standard of "finally completed."[26] The contract standard is too indefinite for tax purposes. Not only between states [27] but also within a single state,[28] the contract cases

in due course." Franklin County Distilling Co. v. Commissioner, 125 F.2d 800, 803-04 (6th Cir. 1942). There, an accrual taxpayer sold whiskey to buyers in 1935 under an agreement that the production tax would be repaid to seller over the next 5 years as each of the buyers withdrew his whiskey from the warehouse. The court held that taxpayer had to report the amount of the production tax he was later to collect as part of income receipts for 1935. See also Continental Tie and Lumber Co. v. United States, 286 U.S. 290 (1932), where taxpayer operated a short line railroad from 1918 to 1920. By virtue of the Transportation Act of 1920 it became entitled to a Government award compensating it for loss of profits because of the Government's operation of the main lines. The amount was to be calculated from figures on the railroad's books in 1920, but the ICC did not compute the amount and pay the award until 1923. The Supreme Court held the award was taxable income for 1920 because the right to the award was fixed in that year by passage of the Transportation Act; despite certain difficulties, the Court felt that it would have been possible for the carrier to ascertain the amount of the award with reasonable accuracy in 1920. *Accord*, Helvering v. St. Louis Southwestern Ry., 66 F.2d 633 (8th Cir. 1933); Commissioner v. Midland Valley R.R., 57 F.2d 1042 (10th Cir. 1932); Commissioner v. Old Dominion S.S. Co., 47 F.2d 148 (2d Cir. 1931).

25. See note 5 *supra*.

26. The substantial performance doctrine enables a builder who has substantially but not completely performed his contract to recover the contract price less damages equal to the value of the defects or unfinished work. 3 CORBIN, CONTRACTS §§ 700-12 (1951); 3 WILLISTON, CONTRACTS § 842 (rev. ed. 1936).

27. *Compare* Shimel, *Substantial Performance of Building Contracts in Illinois*, 20 CHI-KENT REV. 142, 163 (1941), *with* Note, *Substantial Performance of Building Contracts in New York*, 31 COL. L. REV. 307, 311 (1931). See cases cited in 3 CORBIN, CONTRACTS § 705 n.15 (1951).

28. It is probable that the stronger the equities are in favor of the builder, the less performance the courts will require. *Compare* Bowen v. Kimbell, 203 Mass. 364, 89 N.E. 542 (1909) (contractor's performance held not substantial because of an intentional departure from the specifications, which reduced the value of the building constructed by 6/10 of 1%, *with* Bergfors v. Caron, 190 Mass. 168, 76 N.E. 655 (1906) (contract held substantially performed although value of defects was 12½% of the contract price; the trial court had found that the plaintiff had attempted in good faith to perform his contract). And *compare* Hollister v. Mott, 132 N.Y. 18, 29 N.E. 1103 (1892) (court refused to find substantial performances where value of unfinished work constituted 6% of the contract price, the builder having failed to put in sewer connection because of disagreement with owner), *with* Woodward v. Fuller, 80 N.Y. 312 (1880) (performance

vary greatly on how much work constitutes substantial performance. Moreover, the situation contemplated by the tax regulation is completely different from that to which the substantial performance doctrine has been applied. The contract doctrine was developed in order to protect a builder, who in good faith had substantially but not fully performed, from forfeiting all his labor and materials to the owner under the older common law doctrine of strict performance.[29] The tax regulation was designed to apply to a proceeding between the treasury and the contractor, a proceeding to which the owner is not a party and to which the equitable principle of relief from forfeiture is irrelevant.[30]

Although the contract doctrine of substantial performance is inappropriate for tax purposes, courts are not compelled to adopt a literal standard.[31] Prior to *Black*, the Tax Court had already developed a set of criteria which satisfied the requisites of reasonable ascertainability of income and reasonable certainty of rule without fostering tax manipulation. The essential requirement for "final completion" is that the project be capable of the use for which the contract was undertaken.[32] Such a condition may exist even if minor work of repair, cleanup, or rearrangement remains to be done.[33] For similar reasons,

held substantial where value of nonperformance was 15% of contract price, the contractor having attempted in good faith to perform properly). See CORBIN, CONTRACTS § 708 (1951).

29. 3 WILLISTON, CONTRACTS § 805 (rev. ed. 1936).

30. The amount of work courts have required to be finished before finding a contract "finally completed" is thus significantly greater than that which some courts have required for a finding of substantial performance. In the following tax cases the contracts were found to be "finally completed" despite unfinished work: Ehret-Day Co., 2 T.C. 25 (1943) (unfinished and defective work 6/10 of 1% of total contract price); Ben C. Gerwick, Inc., P-H 1954 TC MEM. DEC. ¶ 54,100 (1954) (unfinished work 3/10 of 1%); Mesta Machine Co., 12 B.T.A. 523 (1928) (evidence doesn't indicate exact percentage of unfinished work, but apparently not more than 3%). In National Contracting Co., 25 B.T.A. 407 (1932), *aff'd*, 69 F.2d 252 (8th Cir. 1934), the contract was not held "finally completed" because the unfinished work amounted to 10% of the contract. *Cf.* the following contract cases in which courts found substantial performance: Jones and Hotchkiss v. Davenport, 74 Conn. 418, 50 Atl. 1028 (1910) (defective work 23% of contract price); Stoeppelman v. Carter, 111 S.W.2d 774 (Tex. Civ. App. 1937) (defective work 15%).

31. The following tax cases applied a non-literal construction of the regulation without relying on the contract doctrine of substantial performance: Ben C. Gerwick, Inc., P-H 1954 TC MEM. DEC. ¶ 54,100 (1954); Mesta Machine Co., 12 B.T.A. 523 (1928); C. F. Martin, 34 B.T.A. 111, 114 (1936) (before it ruled that the contract was not "finally completed and accepted" the Board found it necessary to hold that the unfinished work was substantial rather than merely the usual gathering up of loose ends). Ehret-Day Co., 2 T.C. 25 (1945), did refer to the substantial performance doctrine by name but the same result could have been reached without use of the contract doctrine.

32. See cases cited note 31 *supra*. See also Standard Paving Co., 13 T.C. 425, 438 (1949) (dictum). That the owner is using the project, Vang v. Lewellyn, 35 F.2d 283 (3d Cir. 1929); Mesta Machine Co., *supra* note 31; Ben C. Gerwick, Inc., *supra* note 31; or that his architect has approved practically all the work, Mesta Machine Co., *supra* note 31; Ehret-Day Co., *supra* note 31, Ben C. Gerwick, Inc., *supra* note 31, is persuasive that the contract is finally completed for tax purposes.

33. Ehret-Day Co., 2 T.C. 25 (1943) (repair); Mesta Machine Co., 12 B.T.A. 523 (1928) (rearrangement). See also C.F. Martin, 34 B.T.A. 111, 114 (1936). Even when

unimportant defects in performance which can easily be remedied by action of the contractor himself or by compensation exacted by retention of a small portion of the contract price do not postpone the date of completion.[34] And contracts providing for guaranty periods are considered finally completed when the principal work is finished, although substantial expenditures on account of the guaranty may later be necessary.[35]

The acceptance required by the regulations has not been held to mean ultimate formal acceptance.[36] Such a requirement would delay the reporting of income until months, sometimes years after the principal work had been discharged and the taxpayer had received final payment or all payment save a small amount retained to cover minor imperfections.[37] The acceptance required is that which would entitle the contractor to all payment except this retained amount.[38] Thus, ordinarily, if a contract has been "finally completed" for tax purposes, the requirement of acceptance has been met.[39]

The propriety of these standards becomes evident when applied to the facts in *Black*. They are clear enough to have given Black fair notice that its income from the project should have been reported on its 1945 return. Well before the end of 1945, the housing development was in actual use and was capable of use for all purposes envisioned by the contract even though the fire alarm system was not in perfect working order.[40] Furthermore, in April 1945, the

a substantial amount of work remains, one decision suggests that if the builder makes no reasonable effort to finish on time, the undertaking will, nevertheless, be deemed "finally completed." Mesta Machine Co., *supra*.

34. Ben C. Gerwick, Inc., P-H 1954 TC MEM. DEC. ¶ 54,100 (1954); Ehret-Day Co., 2 T.C. 25 (1943).

35. Vang v. Lewellyn, 35 F.2d 283 (3d Cir. 1929); Thomas Cronin Co. v. Lewellyn, 9 F.2d 974 (W.D. Pa. 1925); W.J. Scholl Co., 30 B.T.A. 993 (1934).

36. Ben C. Gerwick, Inc., P-H 1954 TC MEM. DEC. ¶ 54,100 (1954) (everything accepted but some minor work on power plant); Mesta Machine Co., 12 B.T.A. 523 (1928) (owner had right to make audit within two years); Ehret-Day Co., 2 T.C. 25 (1943) (everything accepted by architect except defective parts of job amounting to 6/10 of 1%).

37. In addition to the usual delay in obtaining formal acceptance, a longer wait may be necessary because of "red tape" when the construction has been done for a governmental body. If the contract has a guarantee period, the ultimate acceptance may not be obtained until its expiration. See W.J. Scholl Co., 30 B.T.A. 993 (1934); Harrison v. Heiner, 28 F.2d 985 (W.D. Pa. 1928).

38. Ehret-Day Co., 2 T.C. 25, 34-35 (1943); Ben C. Gerwick, Inc., P-H 1954 TC MEM. DEC. ¶ 54,100 (1954); Mesta Machine Co., 12 B.T.A. 523 (1928).

39. *But cf.* Rice, Barton & Fales, Inc. v. Commissioner, 41 F.2d 339 (1st Cir. 1930) (contract held not "finally completed and accepted" until a year after completion; see analysis of *Rice*, *supra* note 13); Stirton-Oman, 11 P-H BTA MEM. DEC. ¶ 42,121 (1942) (income from highway contract did not have to be reported until one year after completion, when final estimate was made, because without final estimate there was no way of estimating the amount of loss or gain on contract). The result in both cases can be explained by the general principle discussed in the text at notes 22-24 *supra*. Because of the peculiar circumstances in each case, income was not reasonably ascertainable until a year after completion.

40. Transcript of Record, pp. 27, 34, E.E. Black, Ltd. v. Alsup, 211 F.2d 879 (9th Cir. 1954).

contractor thought the project was complete enough to ask for final payment, and by November 1945 the authority had paid him 99.93 per cent of the contract price.[41] A reasonably accurate, indeed an almost absolutely accurate estimate of his profit on the contract could have been made by November 1945. Any conceivable uncertainty of costs involved in the installation of the thermostat heads (less than 8/100 of one per cent of the job) could not have significantly affected this estimate. It is difficult to see what hardship would be imposed on Black by applying these well established criteria. The refusal of the Ninth Circuit to do so has apparently enabled the corporation to reduce its tax liability by the kind of manipulation which courts have in the past denied to other taxpayers.[42]

41. *Id.* at 12, 26.

42. See, *e.g.*, V.T.H. Bien, 20 T.C. 49, 55 (1953); Julia C. Nast, 7 T.C. 432, 434 (1946); Mesta Machine Co., 12 B.T.A. 523, 537-38 (1928); Wright v. Commissioner, 50 F.2d 727, 729-30 (4th Cir. 1931); Loose v. United States, 74 F.2d 147, 150 (8th Cir. 1934).