BEFORE TEE STATE BOARD OF **EQUALIZATION**

OF TEE STATE OF CALIFORNIA

In the Hatter of the Appeal of)
) **No. 83A-550-GO**
MAECON, INC.)

Appearances:

For Appellant: R. James Church
Certified Public Accountant

For Respondent: Grace Lawson
Counsel

O P I N I O N :

This appeal is made pursuant to section 25666[1] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Haecon, Inc., against proposed assessments of additional franchise tax in the amounts of $13,647 and $109,759[2] for the income years 1976 and 1977.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the years in issue.

2/ As a result of the resolution of certain issues, respondent now concedes that the additional tax for 1976 should be cancelled and the tax for 1977 should be reduced to $70,081. (Resp. Bt. at 1.)

The four issues for resolution in this appeal are as follows:

(1) Whether certain expenses relating to Job 3139 had accrued in 1977.

(2) Whether Job 3145 was completed for accounting purposes in 1977 rather than in 1978.

(3) Whether certain advances to shareholders during the years at issue were constructive dividends or bona fide loans.

(4) Whether respondent properly computed gain in 1977 upon the exchange and subsequent sale of property by appellant.

Appellant, a general contractor on the accrual basis of accounting, which reports its income by the completed-contract method, builds sewage and waste disposal projects and other buildings at military and utility facilities located in California, Nevada, Oregon, Washington, and Tennessee. Upon audit of the years at issue, respondent made several adjustments to appellant's income. Although additional issues were raised by the parties, two of those issues were settled resulting in respondent's concession noted in footnote 2, and two other issues involved years not here on appeal. The four remaining issues will be discussed separately below.

(1) Job 3139

Appellant performed Job 3139 for the United States Navy. When the job was closed out in 1977, there was a dispute regarding whether the Navy would pay the cost of certain changes it ordered during construction. Most of these costs had been incurred by appellant's subcontractors who asserted that, in any case, appellant was liable for their expenses. In light of the fact that the Navy contested its liability to appellant, appellant did not pay its subcontractors. Accordingly, these subcontractors filed lawsuits against appellant for the balances owed. (Resp. Reply Br., Exs. D & E.) Appellant, in turn, filed an administrative appeal with the Navy to resolve the underlying dispute. In 1977, appellant accrued, and deducted on its tax return, $678,967 which represented its liability to the subcontractors over Job 3139. However, the administrative appeal to the Navy board was not resolved until 1979 when it was determined that appellant should be allowed $497,410. This

amount, plus interest, was then paid to the subcontractors to settle their lawsuits against appellant.

Upon audit, respondent determined that appellant was not entitled to deduct the $678,967 in 1977 because at that time the liability was contingent and unknown since there was a legal dispute with the subcontractors. (Resp. Br. at 17.) Appellant answers that the subcontractors' complaints were not lawsuits, "but the equivalent of a 'Mechanics Lien' against the performance and payment bond. A lawsuit was never filed nor was the claim against the bond perfected." (App. Br. at 2.)

Under the "accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy." (Treas. Reg. § 1.461-1, subd. (a)(2).)

> It has long been held that, in order truly to reflect the income of a given year, all the events must occur in that year which fix the amount and the fact of the taxpayer's liability for items of indebtedness deducted though not paid: and this cannot be the case where the liability is contingent and is contested by the taxpayer. [Footnotes omitted.]

(Dixie Pine Products Co. v. Commissioner, 320 U.S. 516, 519 [88 L.Ed. 270] (1944); see also, Lutz v. Commissioner, 396 F.2d 412, 414 (9th Cir. 1968).)

It is recognized that where the taxpayer is judicially contesting the question of liability or the amount of the liability, the liability is contingent. (See Gillis v. United States, 402 F.2d 501 (5th Cir. 1968).) We do not understand appellant to contest this principle, but to argue that no-lawsuit was ever filed. However, the evidence presented by respondent clearly contradicts this contention. As indicated above, lawsuits were, in fact, filed by the subcontractors against appellant for the amounts due them. (Resp. Reply Br., Exs. D & E.) Moreover, in 1977, appellant sought resolution of the underlying dispute before a Navy board. Neither the appeal to the Navy board nor the lawsuits were resolved until 1979. Accordingly, we must find that in 1977 appellant's liability to its subcontractors

arising out of Job 3139 was contingent, and, therefore that such liability did not properly accrue in 1977. Respondent's determination with respect to this issue must be sustained.

(2) Job 3145

Since appellant reports its income by the completed-contract method, all profit or loss from a particular job is reported in the year the job is completed. Appellant contends that Job 3145 was completed in 1978 and so reported the profit from it in that year. Respondent contends that the job was actually completed in 1977 and that the only work done on it in 1978 was minor warranty work.

The term "completed" is defined in section 1.451-3(b)(2) of the Treasury Regulations as follows: "[A] long-term contract will not be considered 'completed' until final completion and acceptance have occurred." (See also Smith v. Commissioner, 66 T.C. 213 (1976).) A document entitled 'Payment Estimate - Contract Performance" indicates that the subject contract was completed and the work accepted as satisfactory on behalf of the Government as of 8 April 1977: (Resp. Br., Rx. C.)

In light of the evidence presented, we must find that Job 3145 was, in fact, "completed' in 1977 and respondent's determination with respect to this issue must be sustained.

(3) Advances to Shareholders

During the period at issue, appellant made advances to its shareholders which it characterized as loans. In its tax returns, it accrued interest income arising from such advances. Upon audit, respondent determined that, in fact, the advances reflected in account number 111, were constructive dividends to its shareholders rather than loans, and, as a consequence, appellant's income must be reduced by such interest income which it had accrued. In the companion case, Appeal of Raymond J. and Lillian I. Lull, decided this same day, we addressed this same issue from appellant's shareholder's perspective and found that such advances were, in fact, constructive dividends to the extent of retained earnings. For the reasons outlined in A Raymond J. and Lillian I. Lull, we reach the same conclusion in this appeal and find that during the years at

issue, the advances reflected in account number 111 were constructive dividends to the extent of appellant's earnings and profits, and thereafter a return of capital. We note that respondent concedes that such determination will actually reduce appellant's income during the years at issue. (Resp. Br. at 9.)

(4) Exchange of Property

On November 30, 1977, in a qualified nontaxable exchange pursuant to section 24941, appellant exchanged vacant land for land which contained a rental building. Thereafter, on the same date, appellant sold the rental property it had just acquired to an unrelated third party in a taxable sale. Appellant reported the taxable sale and resulting gain as follows in its 1977 tax return:

Sales Price	$250,500
Basis	231,252
Gain	$ 19,248

Respondent determined that when appellant reported the taxable sale, it erroneously added the selling costs to the rental property's basis rather than subtracting those costs from the selling price. We note that whether selling costs are subtracted from the selling price, as respondent advocates, or are added to basis as appellant did in its return, the net effect here is the same. The real controversy centers around appellant's computation of basis resulting from the tax-free exchange. Respondent determined that appellant failed to properly account for the liabilities with respect to the properties exchanged when calculating the basis for the property received. As a consequence, the gain realized in the subsequent sale of that property was understated. (Resp. Br. at 26.) Appellant contends that it properly reported the gain resulting from these transactions.

In computing the appropriate basis, section 24941 is controlling. That section provides, in part, that "[n]o gain or loss shall be recognized if property held for . . . investment . . . is exchanged solely for property of a like kind. . . ." Notwithstanding the word "solely" in section 24941, section 24941 may apply if at least some property meeting all the requirements of section 24941 is transferred in exchange for at least some other qualified property. In addition, that section may apply when nonqualified property or "boot" is also transferred and/or received. (Rev. & Tax. Code, § 24941,

subd. (b).) Gain realized in such an exchange is recognized, but not in excess of the lesser of the gain realized on the exchange or the amount of the boot received. Root is defined as the amount of money and fair market value of property other than money received. (Rev. & Tax. Code, § 24941, subd. (b).) The amount of boot received by a taxpayer in an otherwise qualifying exchange is considered to be reduced by the amount of boot given by the taxpayer to the other party. (See Treas. Reg. S 1.1031, subd. (d)-2, examples (1) and (2).) Basis of property acquired in such a transaction is the same as the property exchanged, decreased by money received and increased in the amount of gain or decreased in the amount of loss recognized. (Rev. & Tax. Code, § 24941, eubd. (d).)

For this purpose, the amount of any liability of a taxpayer assumed, or taken subject to, by the other party to the exchange is considered to be money received by the taxpayer in the amount of such debt decrease. (Rev. & Tax. Code, § 24941, subd. (d).) On the other hand, the amount of any liability of the other party assumed, or taken subject to, by the taxpayer is considered to be money paid by the taxpayer in the amount of such debt increase. (See Treas. Reg. § 1.1031, subd. (d)-2, example (2), for examples of the netting procedures involving liabilities.)

As indicated above, respondent determined that appellant failed to properly account for the liabilities on the properties exchanged when accounting for boot and the resulting basis with respect to the nontaxable exchange in which it acquired the subject rental property. In addition, respondent determined that appellant improperly accounted for the selling costs of $6,477 on the subsequent sale transaction of that property. Accordingly, respondent determined gain to be as follows:

Sales Price	$250,500
Less Cost of Sale	6,477
	$244,023
Less Revised Basis	191,187
Gain	**$ 52,836**

Gain was thus determined to be $52,836 rather than $19,248. (Resp. Br. at 10; Ex. A, schedule Ia-8 of V.) The figures upon which respondent has relied have been

verified by escrow documents. (Resp. Nov. 6, 1985, Memo., Ex. B).

It is, of course, well settled that respondent's determinations with respect to basis and resulting gain will be sustained if taxpayers do not produce persuasive evidence in opposition. (Appeal of Penn Co., Ltd., Cal. St. Bd. of Equal., Feb. 19, 1974.) There is nothing in the record which would contradict respondent's computation of basis and the resulting gain. Accordingly, we must sustain respondent's determination with respect to this issue.

Based upon the foregoing discussion, and subject to its concessions, respondent's action must be sustained.

Appeal of **Maecon**, Inc.

O R D E R

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

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 **Maecon**, *Inc.*, against proposed assessments of additional franchise tax in the amounts of $13,647 and $109,759 for the income years 1976 and 1977, be and the same is hereby modified in accordance with its conclusions. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 17th **day of** June , 1987, by the State Board of Equalization, **with** Board Members Mr. Collis, Mr. Dronenburq, Mr. Bennett, Mr. Carpenter and Ms. Baker present.

Conway H. Collis, Chairman

Ernest **J.** Dronenburq, Jr., Member

William M. Bennett, Member

Paul Carpenter, Member

Anne Baker*, Member

***For** Gray Davis, per Government Code section 7.9