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TERRITORY OF HAWAII
Department of the Attorney General
Honolulu

November 5, 1957

Honorable Earl W. Fase
Tax Commissioner
Territory of Hawaii
Honolulu, Hawaii

Dear Sir:

Reference is made to your letter of September 16, 1957 in which you present the question whether a contractor who uses the completed contract basis in computing his net income for income tax purposes is entitled to report on the completed contract basis for General Excise Tax purposes. We have reached the conclusion that the completed contract basis may not be used for General Excise Tax purposes.

The cash, accrual, and long-term contract methods are three different methods, the last being a modification of the accrual method. The long-term contract method in turn consists of two different types, percentage of completion basis and completed contract basis. See G.C.M. 22682, C.B. 1941-1, 307; Fort Pitt Bridge Works, 24 B.T.A. 626, 641; Bent v. Commissioner, 56 F.2d 99, 104; R. G. Bent Co., 26 B.T.A. 1369, 1374; Daley v. United States, 139 F.Supp. 376; Reg. 118, Sec. 39.41-2(c), continued in effect by T.D. 6091.

"The completed contract method is not an accounting method in the sense that it accounts for receipts and disbursements on a day to day basis. It is a practice of treating receipts from a contract as income as of a particular time; namely, the completion date of the contract. This is its fundamental feature."

(Daley v. United States, supra,
139 F.Supp. at p. 378.)

As explained in Fort Pitt Bridge Works, supra, when the completed contract basis is used items of income and expense are recorded in the primary accounts when accrued or incurred, but are not carried into profit and loss until the contract is completed.

Section 117-3 of the General Excise Tax Law provides:

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"Every taxpayer shall be presumed to be dealing on a cash basis unless he proves to the satisfaction of the commissioner that he is dealing on an accrual basis and his books are so kept, or unless he employs or is required to employ the accrual basis for the purposes of the tax imposed by chapter 121 for any taxable year in which event he shall report his gross income for the purposes of this chapter on the accrual basis for the same period."

Section 121-18(b) of the Income Tax Law of 1932 is as follows:

"(b) Period for which items of gross income included. The amount of all items of gross income shall be included in gross income for the taxable year in which received by the taxpayer unless under methods of accounting permitted or required under this chapter any such amounts are to be properly accounted for as of a different period."

This is to be read with section 121-18(a), which reads in pertinent part as follows:

"(a) General rule. Net income shall be computed upon the basis of the taxpayer's taxable year (fiscal year or calendar year as the case may be) in accordance with the method of accounting regularly employed in keeping his books. If no such method of accounting has been employed or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the commissioner does clearly reflect the income."

The long-term contract method, whether the percentage of completion basis or the completed contract basis is used, is permissible for the computation of net income for Net Income Tax purposes in order to "clearly reflect the income". No such consideration enters into the application of section 117-3.

Under the General Excise Tax Law only the cash basis or the accrual basis may be used. No long-term contract method may be used because, though a modification of the accrual method, it nevertheless is not the accrual method, being so distinct as to require permission for a change from the accrual method to the long-term contract method or vice versa, as shown by the authorities above cited. The difference between the methods lies in the period for which the income is reported, as clearly brought out by Daley v. United States, supra.

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A contractor who uses the completed contract basis does not "employ the accrual basis for the purposes of the tax imposed by chapter 121 for any taxable year" within the meaning of section 117-3 above quoted. That is, he does not for any taxable year report the gross income accruing within that taxable year, but instead he reports the gross income accruing from contracts completed in that year.

This still leaves the question whether the contractor is dealing on and keeping his books on an accrual basis within the meaning of section 117-3. As above noted, the only possible bases under section 117-3 are the accrual basis, which calls for the reporting for each calendar month and year of the accruals in that period, and the cash basis, which calls for the reporting for each calendar month and year of the cash payments in that period. From the information available to us it would seem that the books sufficiently support the use for General Excise Tax purposes of the accrual basis as distinguished from the cash basis. Should the taxpayer desire to make a further presentation as to that particular matter we would be glad to consider it.

Respectfully,

/s/ Rhoda V. Lewis

RHODA V. LEWIS
Deputy Attorney General

APPROVED:

/s/ Herbert Y. C. Choy

HERBERT Y. C. CHOY
Attorney General