

CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 026

June 30, 1958

GROSS INCOME: RENEGOTIATION REBATE

Syllabus:

A renegotiation rebate should be included in gross income for the renegotiated year.

Taxpayer's wartime cost-plus-a-fixed-fee contracts were renegotiated under federal law. Taxpayer repaid profits earned in 1944 and claimed tax refunds for that year under IRC Section 3806 and FTA Section 9.1. On September 29, 1945, the war was officially declared to be ended for the purpose of amortization of emergency facilities. Thereupon, taxpayer recomputed its amortization schedules to account for termination of the amortization period prior to the normal sixty months, and tax refunds were claimed pursuant to IRC Section 124(d) and FTA Section 8(f). To the extent that amortization costs for the renegotiated year of 1944 were thereby increased, taxpayer became entitled to a renegotiation rebate under the provisions of Subsection (a)(4)(D) of the Renegotiation Act of 1943.

The Amount of the claimed renegotiation rebate was added to taxpayer's 1944 gross income by the Franchise Tax Board. Taxpayer has claimed a refund of the tax on this amount. In support of the refund claim it is argued that a renegotiation rebate is not properly includible in gross income as defined by Section 6 of the Franchise Tax Act, and that even if it is considered income it cannot be taxed as 1944 income because the right to it did not accrue until a later year and the rebate has not yet been received to date.

The questions for decision are:

- (a) Is a renegotiation rebate properly includible in gross income?
- (b) If so, is it includible in income for the renegotiated year?

A renegotiation rebate is a gross income item. When taxpayer's contract was renegotiated and certain costs were disallowed, taxpayer was obliged to pay back to the government some of its profits which were included in gross income for the year received. A refund or credit for overpayment of franchise tax was then allowed under Section 9.1 of the Franchise Tax Act. Later, an addition was made to allowable costs because of accelerated amortization and taxpayer claimed a rebate of some of the profits it had paid back to the government. The effect of the rebate is to restore income to the taxpayer. The rebate money is in reality

the same money which taxpayer had reported as gross income before the renegotiation.

Under the annual accounting concept the general rule is that income of the taxable year is computed without regard to prior or subsequent transactions. However, it is evident that special rules are applicable to the renegotiation of war contracts and to the adjustment of allowances for accelerated amortization. Both IRC Section 3806 and FTA Section 9.1 provide that reduction of profit for a prior year by renegotiation reduces income tax in that year and not in the year when the renegotiation was transacted, thus departing from the annual accounting concept. Where accelerated amortization results from early termination of the amortization period, Franchise Tax Regulation 15070 expressly states that the tax liability for each income year shall be recomputed, again departing from the general rule. And with regard to renegotiation rebates, Federal ruling, Mim. 6597 (CB 1946-2, 187) contains the following statement: "Income for a renegotiated year will be increased by the amount of the gross renegotiation rebate determined for that year".

The foregoing legislative and administrative declarations seem clearly to demonstrate that a departure from the annual accounting concept is proper in the instant case. Indeed, taxpayer has taken advantage of these special rules to secure a reduction of its tax liability after the renegotiation and again upon revising its amortization deductions. Now, however, taxpayer contends that the annual accounting concept must be adhered to in allocating the renegotiation rebate to the year in which the rebate was determined.

Since matters of renegotiated profits and of accelerated amortization are both handled by a tax readjustment in the earlier year, and since the Federal government is authorized by statute to make such an adjustment for federal taxes before paying a renegotiation rebate based on accelerated amortization, it is proper in the instant case to add the amount of the claimed rebate to taxpayer's 1944 gross income.

It may be added that since taxpayer is on an accrual basis; the fact that it has not yet received payment of the rebate is of no consequence.