COURT OF APPEALS DECISION DATED AND FILED

November 9, 2000

Cornelia G. Clark
Clerk, Court of Appeals
of Wisconsin

NOTICE

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A party may file with the Supreme Court a petition to review an adverse decision by the Court of Appeals. *See* WIS. STAT. § 808.10 and RULE 809.62.

No. 00-0315

STATE OF WISCONSIN **IN COURT OF APPEALS**
DISTRICT IV

THE BABCOCK & WILCOX COMPANY,

PETITIONER-APPELLANT,

V.

WISCONSIN DEPARTMENT OF REVENUE,

RESPONDENT-RESPONDENT.

APPEAL from an order of the circuit court for Dane County: PAUL B. HIGGINBOTHAM, Judge. *Affirmed*.

Before Dykman, P.J., Deininger, J., and William Eich, Reserve Judge.

¶1 DEININGER, J. The Babcock & Wilcox Company (New B&W) appeals a circuit court order which affirmed a decision of the Tax Appeals Commission. New B&W's predecessor, Old B&W, had ongoing, multi-year contracts at the time of the corporate reorganization. New B&W reported all of the income earned on these contracts in the years it completed them. New B&W later filed amended state income tax returns to exclude income it asserted to be allocable to Old B&W. The Department of Revenue denied refunds, and New B&W appealed the determination. The commission concluded that New B&W is not entitled to a refund of taxes it paid on the income at issue. For the reasons which follow, we affirm.

BACKGROUND

¶2 The Tax Appeals Commission found the following facts, which are largely undisputed:

> 1. [New Babcock & Wilcox] is a Delaware corporation and a subsidiary of McDermott Incorporated ("McDermott").
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> 2. Commencing in 1977, McDermott began to acquire the stock of [Old Babcock & Wilcox], a New Jersey corporation.
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> 3. Subsequently, McDermott created a wholly owned subsidiary called McDermott Energy, Inc., organized as a Delaware corporation. Effective March 31, 1978, Old B&W was merged into McDermott Energy, Inc., and the name of McDermott Energy, Inc. was changed to "The Babcock & Wilcox Company" ["New B&W"]. Petitioner is [New B&W].
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> 4. Effective the same date, [New B&W] acquired all of the assets and liabilities of Old B&W. [New B&W] carried on the same business as Old B&W with the same management.
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> 5. During the years at issue in this matter (April 1, 1978 though March 31, 1984), [New B&W]'s primary business was the design, fabrication, and installation of steam

generation systems primarily for applications in electricity generation, pulp- and paper-making, chemical and petrochemical refining, grain processing, and marine propulsion.

6. In nearly every instance, [New B&W]'s products were constructed to specific and unique customer specifications under competitively bid contracts. The duration of these contracts typically covered several years.

7. [New B&W] and Old B&W used two different methods of accounting with respect to these long-term contracts. For state and federal tax reporting purposes, [New B&W] and Old B&W used the completed contract method of accounting. For financial reporting purposes, [New B&W] and Old B&W used the percentage of completion method of accounting.

8. Under the completed contract method of accounting, income and expenses associated with a particular contract are not reported until the year in which that contract is completed. Thus, tax liabilities from income on a particular contract are not incurred until the year in which the contract is completed.

9. Under the percentage of completion method of accounting, income and costs are reported in each year of the contract. In each year of the contract, costs actually incurred in that year are reported. In each year of the contract, the amount of income to be reported is a portion of the total income expected under the contract....

10. At the time of the 1978 merger, Old B&W had deferred approximately $600 million of income by use of the completed contract method of accounting for both federal and state tax purposes. This is income that had been earned by Old B&W through the performance of its long-term contracts, but which it did not report on its final return for the year ending March 31, 1978.

11. This $600 million was gradually reported by [New B&W] for both federal and state purposes in the years that followed the merger as these contracts were completed. In essence, [New B&W] picked up where Old B&W left off.

> 12. At the time of the merger, Old B&W had unused credits for Wisconsin sales tax paid on fuel and electricity used in manufacturing tangible personal property in Wisconsin. Likewise, Old B&W had an available net business loss carryover (from calendar year ending December 31, 1976).
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> 13. These unused credits and the net business loss were carried forward and claimed by [New B&W] on its returns in the years following the 1978 merger.
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> 14. …[The department] assessed [New B&W] … additional franchise tax, plus interest and penalty. Among other things, [the department] disallowed [New B&W]'s unused sales tax credits and the net business loss carried forward from Old B&W.
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> 15. …[New B&W] filed its petition for redetermination, objecting to the entire assessment. In its petition for redetermination, [New B&W] argued that it was entitled to deduct the credits and the loss carried forward from Old B&W. As an alternative basis [New B&W] argued that, effective with the merger, the $600 million in deferred income was properly taxable to Old B&W and that this deferred income should not have been reported by [New B&W]. (This $600 million would have been realized by Old B&W under the percentage of completion method of accounting.) Under this alternative theory, [New B&W] claimed that it would have no taxable income for tax years 1979, 1980, and 1981 (years ending March 31), and refunds … for tax years ending March 31, 1982, and March 31, 1983, respectively.
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> 16. …[New B&W] filed amended corporate franchise or income tax returns for the years ending March 31, 1982, and March 31, 1983, claiming refunds [for both years].

¶3 The department denied New B&W's claims for refunds, and its petitions for redetermination. New B&W appealed the department's decisions to the commission, which affirmed the department's actions. In its petition for review to the commission, New B&W conceded that it was not entitled to carry over unused manufacturer's sales tax credits or net business losses attributable to Old B&W. The commission concluded that New B&W is not eligible for the claimed refunds because Wisconsin law did not require Old B&W to report the income, and because New B&W was attempting to change its accounting methods without the department's approval.

¶4 New B&W petitioned for judicial review of the commission's decision. The circuit court also concluded that New B&W was attempting to accomplish an unauthorized change in accounting methods on its amended returns. The court therefore affirmed the commission's determination, and New B&W appeals the circuit court's order.

ANALYSIS

¶5 We review the commission's decision and order de novo, applying the same standard of review as the circuit court, but owing no deference to the circuit court's conclusions. *See* ***Advance Pipe & Supply Co., Inc. v. DOR***, 128 Wis. 2d 431, 434, 383 N.W.2d 502 (Ct. App. 1986). When reviewing an agency's legal conclusion, such as the one presented in this appeal, a court may apply one of three levels of deference to the agency's interpretation of the law:

> First, if the administrative agency's experience, technical competence, and specialized knowledge aid the agency in its interpretation and application of the [law], the agency determination is entitled to "great weight." The second level of review provides that if the agency decision is "very nearly" one of first impression it is entitled to "due weight" or "great bearing." The lowest level of review, the de novo standard, is applied where it is clear from the lack of agency precedent that the case is one of first impression for the agency and the agency lacks special expertise or experience in determining the question presented.

Jicha v. DILHR, 169 Wis. 2d 284, 290-91, 485 N.W.2d 256 (1992) (citations omitted).

¶6 The parties disagree as to which level of deference we should accord the commission's legal conclusion in the present appeal. New B&W argues that we are as competent as the commission to decide a purely legal issue of first impression, and thus, our review should proceed de novo. The department argues that we must accord the commission's conclusion on the question at least "due weight" deference. Because we conclude that the commission's interpretation is correct under any level of deference, we do not further address the standard of review.

¶7 As New B&W notes, the parties in this case "appear to be on different planets in their views of the proper analysis of the issue in this case." The principal rationale of both the department and the commission in denying New B&W a refund is that, to obtain the refund, New B&W needed the department's authorization to change its accounting method, which it failed to obtain. *See* WIS. ADMIN. CODE § Tax 2.16(1)(c) (1986) ("No change in the method of accounting used in reporting income may be made without first obtaining the written permission of the department."). New B&W vigorously disputes that it changed its accounting method on its amended returns. Rather, according to New B&W, its amended returns merely corrected errors committed on its original returns by properly allocating a certain amount of income from New B&W to Old B&W.

¶8 We note that there are at least two methods of reporting income on multi-year contracts, the completed-contract method and the percentage-of-completion method. Under the completed-contract method of accounting, income and expenses associated with a particular contract are not reported until the year in which the contract is completed. Thus, tax liability for income on a particular contract is not incurred until the year in which the contract is completed. *See* 26 C.F.R. § 1.451-3(d) (1978). Under the percentage-of-completion method of accounting, some income and costs are reported in each year of the contract. Costs actually incurred in a given year are reported, as is a portion of the total income the taxpayer expects to receive under the contract. *See* 26 C.F.R. § 1.451-3(c) (1978).

¶9 Old B&W chose the completed-contract method of accounting, deferring the reporting of income from the contracts until their completion. At the time of the reorganization, some of Old B&W's long-term contracts were still in progress. After the reorganization, New B&W continued reporting via the completed-contract method, reporting the entire profit on each contract as it was completed, even though some part of the profit was arguably earned by Old B&W prior to the reorganization. Then, the company later attempted to amend its tax returns to exclude the percentage of profit it claimed was allocable to Old B&W. The commission concluded that the proposed amendments constituted a change in accounting method that required authorization from the department.

¶10 New B&W argues that it did not change its method of accounting: it still employed the completed-contract method in that it was still reporting all of the post-reorganization profit in the year of a contract's completion. It maintains that its amended returns merely "lop off" the portion of contract income that Old B&W was obligated to report as its own in its final year of existence. We are not persuaded. Under the theory advanced by New B&W in support of its amended returns, Old B&W was obligated to report a certain percentage of profit before a contract was completed. Thus, the effect of the amended returns, if not their technical form, is the same as if the method of accounting were changed from purely the completed-contract method to a hybrid of completed-contract and percentage-of-completion methods. *See* WIS. ADMIN. CODE § Tax 2.16(1)(b), (2) (1986) (defining accounting method change as an overall change of the entire accounting system or a single item, if material).

¶11 But even if New B&W is correct in asserting that its amended returns do not accomplish a true change in accounting methods, we conclude that the commission did not err in affirming the department's actions. New B&W argues that the controlling question in this case is the proper allocation of income earned on the long-term contracts. New B&W contends that income must first be properly allocated before any consideration may be given to the method of accounting used. Specifically, New B&W claims that it erroneously included income on its original state income tax returns that was required under then existing state tax law to be allocated to Old B&W, and thus, it is entitled to a refund for taxes it paid on that income. We disagree.

¶12 In support of its argument that Old B&W was obligated to report the income, New B&W points to several "assignment of income" cases. *See* ***Lucas v. Earl***, 281 U.S. 111 (1930); ***Wenger v. DOR***, 109 Wis. 2d 677, 327 N.W.2d 209 (Ct. App. 1982). However, ***Lucas*** and ***Wenger*** are inapplicable to the present facts because, in this case, neither Old nor New B&W attempted to assign anticipated income, nor did they attempt to effect gratuitous transfers between family members. *See* ***Lucas***, 281 U.S. at 114-15 (where husband attempted to transfer title to half his earnings to his wife, the court held that a gratuitous transfer of property rights is ineffective to accomplish an anticipatory assignment of income); ***Wenger***, 109 Wis. 2d at 681 (where taxpayers transferred assets to a family trust, including the right to earn income, the court affirmed the department's disregarding of the trust, and its taxation of the income to the individuals who earned it).[1]

¶13 At the time of B&W's reorganization, Wisconsin and federal tax law differed in that, under section 381 of the Internal Revenue Code (IRC), federal law treated a corporation following a reorganization as the same taxpayer as before the merger. *See* 26 U.S.C. § 381 (1978). Wisconsin tax law prior to 1987, however, contained no similar provision, and a company after a reorganization was treated as a separate and distinct taxpayer for state income tax purposes.[2] We acknowledge, therefore, that Old B&W and New B&W were considered separate taxpayers under Wisconsin tax law during the years relevant to this case. We conclude, however, that at the time of the reorganization, New B&W assumed the responsibility for the ongoing contracts of its predecessor. This included not only the obligation to complete the contracts, but, given Old B&W's selection of the completed-contract method of reporting income, New B&W also became obligated to report the income on these contracts for tax purposes. We are not convinced that the "separate taxpayer rule" precluded New B&W from reporting the disputed income in the years it completed the contracts, as it did on its original state tax returns.

¶14 In support of its view that contract income for years prior to the reorganization must be allocated to Old B&W, New B&W cites cases interpreting

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[1] New B&W also cites cases involving wholly-owned domestic international sales corporations (DISCs). *See* ***Kohler Co. v. DOR***, Wis. Tax Rep. (CCH) ¶202-641 (Tax App. Comm'n 1985); ***Vilter Int'l Corp. v. DOR***, Wis. Tax Rep. (CCH) ¶202-664 (Tax App. Comm'n 1986). However, these cases deal with the allocation of income between co-existing parent and subsidiary corporations, not predecessor and successor corporations. Therefore, these cases are also not relevant on the present facts.

[2] The Wisconsin Legislature in 1987 federalized the state's corporate tax structure.

federal tax law prior to the adoption of IRC § 381. The court in ***Jud Plumbing & Heating, Inc. v. Commissioner of Internal Revenue***, 153 F.2d 681, 684-85 (5th Cir. 1946) concluded that, where a corporation transferred its ongoing contracts to a shareholder of the corporation upon dissolution, the IRS commissioner had properly allocated to the corporation profit earned up to the date of its dissolution on contracts completed by the shareholder within the same tax year. The issue in ***Standard Paving Co. v. Commissioner of Internal Revenue***, 190 F.2d 330, 332-33 (10th Cir. 1951) was whether the IRS commissioner had abused his discretion in allocating profits to a subsidiary corporation up to the date of a corporate reorganization, under which the subsidiary had merged into its parent and transferred ongoing long-term contracts to the parent for completion. The court affirmed the commissioner's action. Finally, the court in ***Palmer v. Commissioner of Internal Revenue***, 267 F.2d 434, 438-39 (9th Cir. 1959) found "fair and equitable" an allocation by the IRS commissioner of a percentage of profits to a partnership which had performed the bulk of a construction contract, but which had dissolved prior to its completion and transferred the contract to a corporation formed by the former general partner.

¶15 In each of the foregoing cases, the IRS commissioner, exercising statutorily granted discretion, determined the method of accounting which, in his opinion, "clearly reflected" the income of the taxpayers. *See* 26 U.S.C. § 41 (1939).[3] The department contends that it possesses discretion similar to that

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[3] Section 41 provided as follows:

> The net income should be computed upon the basis of the taxpayer's annual accounting period … in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with

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exercised by the IRS commissioner in the cited cases,[4] and that, under the circumstances of this case, it could properly deem the contract income "clearly reflected" in the manner reported by New B&W in its original returns. We agree.

¶16 We acknowledge that each of the cited federal cases affirmed the IRS commissioner's authority to override an allocation of income resulting from a taxpayer's use of the completed-contract method. Here, the parties' positions are reversed, in that the department is seeking to hold the taxpayer to precisely that allocation. Nonetheless, we conclude that the department acted within its authority in disallowing the amended returns because, in its opinion, New B&W's original returns clearly reflected its income. Although the circumstances presently under review differ from those in the federal cases, what is common to those cases and this one, is the taxing authorities' refusal to accept a taxpayer-proffered income allocation that would potentially result in the avoidance of taxes on the

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> such method as in the opinion of the Commissioner does clearly reflect the income.…

26 U.S.C. § 41 (1939).

[4] WISCONSIN STAT. § 71.11(8)(a) (1983-84) provided as follows (see footnote three for similar wording of 26 U.S.C. § 41 (1939)):

> The income and profits of corporations for the income year shall be computed in accordance with the method of accounting regularly employed in keeping the books of the taxpayer, but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the department of revenue does clearly reflect the income.

disputed income.[5] As we understand the present circumstances, if New B&W were permitted to file amended tax returns which exclude the income it claims allocable to Old B&W, the excluded income would avoid taxation because a statute of limitations bars the department from collecting taxes from Old B&W on that income. The department's refusal to accept the reallocation of contract income on New B&W's amended returns is thus not unreasonable. As the commission has previously noted:

> In our view, a taxpayer can impeach his own form and assert substance only when he can show that the form or character he attached to the transaction was truly a mistake. Any other rule, we submit, would soon result in a flood-tide of *ex post facto* tax tinkering from wait-and-see taxpayers seeking to characterize or recharacterize completed transactions, not according to their spontaneous reality, but according to retrospective and calculated tax expediency.

Ladish Co., Inc. v. DOR, No. 89-I-456, Wis. Tax Rptr. (CCH) ¶203-326, at 15,424 (Tax App. Comm'n May 1, 1992).

¶17 Finally, we note that New B&W's argument is, in part, premised on a demand for consistency in the treatment of income and deductions or credits. New B&W concedes that state tax law prior to 1987 did not allow it to carry over unused credits and operating losses from Old B&W. It thus argues that, to be consistent, state tax law should not be interpreted to require New B&W to report Old B&W's income. Credits and deductions are matters of legislative grace, however. *See* ***Comet Co. v. Dep't of Taxation***, 243 Wis. 117, 123, 9 N.W.2d 620

[5] The court in ***Standard Paving*** noted: "To permit this [the taxpayer's method of reporting income] would enable the parent corporation to evade tax by dissolving a subsidiary which had realized income from incompleted long term contracts." ***Standard Paving***, 190 F.2d at 333. And, in ***Jud Plumbing & Heating***, the court observed that while a taxpayer could opt for the completed-contract method of accounting, "it cannot avoid taxes by the simple expedient of not completing its contracts." ***Jud Plumbing & Heating***, 153 F.2d at 685.

(1943) (stating that "the well established rules of construction that tax exemptions, deductions and privileges are matters purely of legislative grace and tax statutes are to be strictly construed against the granting of the same…"). We see no necessary linkage, therefore, between a taxpayer's inability to carry over unused credits and losses from a predecessor entity, while at the same time, being denied the opportunity to amend its tax returns in order to reallocate a portion of contract income to that entity.

CONCLUSION

¶18 For the reasons discussed above, we affirm the order of the circuit court.

By the Court.—Order affirmed.

Not recommended for publication in the official reports.