DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD 8995]

RIN 1545–AY31

Mid-Contract Change in Taxpayer

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations concerning a mid-contract change in taxpayer of a contract accounted for under a long-term contract method of accounting. A taxpayer that is a party to such a contract will be affected by these regulations.

DATES: *Effective Date:* These regulations are effective May 15, 2002.

Applicability Date: These regulations apply to transactions on or after May 15, 2002.

FOR FURTHER INFORMATION CONTACT: John Aramburu at (202) 622–4960 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545–1732.

The collection of information in these final regulations is in § 1.460–6(g)(3)(ii)(D). This information is required to enable taxpayers to make look-back computations when the income from a long-term contract has been previously reported by another taxpayer.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number.

The estimated average annual disclosure burden per respondent is 2 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, W:CAR:MP:FP, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to a collection of information must be retained as long as their contents might become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

Section 460 generally requires that long-term contracts be accounted for under the percentage-of-completion method (PCM), under which a taxpayer must recognize income according to the estimated percentage of the contract that is completed during each taxable year and make a look-back computation of interest to compensate the government (or the taxpayer) for any underestimation (or overestimation) of income from the contract. However, home construction contracts and certain contracts of smaller construction contractors are exempt from these requirements. Moreover, residential builders are entitled to use the 70/30 percentage-of-completion/capitalized cost method (PCCM), and certain shipbuilders are entitled to use the 40/60 PCCM. A long-term contract or a portion of a long-term contract that is exempt from the PCM may be accounted for under any permissible method, including the completed contract method (CCM), under which a taxpayer does not report income until a contract is complete, even though progress payments are received in years prior to completion.

This document contains amendments to 26 CFR part 1. On February 16, 2001, a notice of proposed rulemaking (REG–105946–00) relating to a mid-contract change in taxpayer of a contract accounted for under a long-term contract method of accounting was published in the **Federal Register** (66 FR 10643). Written comments were received from the public in response to the notice of proposed rulemaking. No public hearing was requested or held. After consideration of all comments, the proposed regulations are adopted as amended by this Treasury decision.

Explanation and Summary of Comments

The proposed regulations divide the rules regarding a mid-contract change in taxpayer of a contract accounted for under a long-term contract method of accounting into two categories—constructive completion transactions and step-in-the-shoes transactions. Generally, a constructive completion transaction results in the taxpayer originally accounting for the long-term contract (old taxpayer) recognizing income from the contract based on a contract price that takes into account any amounts realized from the transaction or paid by the old taxpayer to the taxpayer subsequently accounting for the long-term contract (new taxpayer) that are allocable to the contract. Similarly, the new taxpayer in a constructive completion transaction is treated as though it entered into a new contract as of the date of the transaction, with the contract price taking into account the purchase price and any amount paid by the old taxpayer that is allocable to the contract. In the case of a step-in-the-shoes transaction, the old taxpayer's obligation to account for the contract terminates on the date of the transaction and is assumed by the new taxpayer. The new taxpayer must assume the old taxpayer's methods of accounting for the contract, with both the contract price and allocable contract costs based on amounts taken into account by both parties.

Commentators raised concerns regarding the general application of step-in-the-shoes treatment to contracts of S corporations accounted for using the CCM. For example, these commentators were concerned with the potential for income shifting that can occur when the stock of an S corporation that is accounting for a long-term contract using the CCM is sold to a party with a lower marginal tax rate or to a tax indifferent shareholder. Similarly, income from a CCM contract could be shifted to a party with a lower tax rate or a tax indifferent party by making an S election or transferring the contract in a section 351 transaction, followed by an S election and a sale of stock. To prevent such a shifting of income, these commentators generally recommend that the transferor be required to apply the PCM to CCM contracts in progress as of the transaction date.

While these commentators' concerns and recommendations relate solely to CCM contracts, the potential for such income shifting also exists with PCM contracts due to the fact that recognition of income under both the PCM and the CCM does not correspond to the receipt of progress payments. In addition, many of the commentators' concerns are not unique to the section 460 regulations as similar opportunities are presented whenever an S corporation or an electing S corporation has assets with built-in gain or loss. Moreover, adoption of the commentators' recommendation would trigger tax as of the transaction date and thus would be inconsistent with the policy of providing for tax-free reorganizations of going concerns. Thus, the commentators' proposals for

addressing this potential abuse were not adopted. However, as in the proposed regulations, the final regulations contain an anti-abuse rule that is designed to prevent such income shifting.

Commentators suggested that for purposes of the section 1374 built-in gain rules applicable to S corporation elections, long-term contracts should be valued at the amount of income reportable under the PCM on the date of the election. The section 1374 regulations currently measure recognized built-in gain attributable to a long-term contract accounted for using the CCM based on the amount of income reportable under the PCM on the date of the election. See § 1.1374–4(g). These final regulations, however, do not provide a specific rule to determine the value of a long-term contract because the fair market value of a long-term contract reflects a variety of factors, including the amount earned by the old taxpayer as compared to the progress payments received and retained by the old taxpayer, and the new taxpayer's estimates of future revenues and costs.

One commentator pointed out that while the preamble indicates the treatment of partnership transactions (i.e., transactions described in sections 721 and 731, and transfers of partnership interests) have been reserved, the proposed regulations, by default, place these transactions in the taxable, constructive completion category. This commentator suggested that the regulations reserve the treatment of partnership transactions and provide only that taxpayers use reasonable methods.

The final regulations provide that a contribution to a partnership in a transaction described in section 721(a), a transfer of a partnership interest, and a distribution by a partnership to which section 731 applies (other than a distribution of a contract accounted for using a long-term contract method of accounting) are step-in-the-shoes transactions. The final regulations, however, reserve on the special rules that will apply to such transfers. As described in Notice 2002–37 (2002–23 I.R.B.), the IRS and Treasury Department intend to publish regulations that will set forth the special rules that will apply to such partnership transactions in a separate project. These regulations will be effective for contributions of long-term contracts to partnerships and transfers of interests in partnerships that are engaged in long-term contracts on or after May 15, 2002.

One commentator objected to the required use of the simplified marginal impact method of computing look back interest in the case of a step-in-the-shoes transaction. In response to this comment, the final regulations give taxpayers the option of using this method without requiring it, except in those cases in which the existing regulations require its use. See § 1.460–6(d)(4).

Questions have arisen as to whether the implementation of these rules requires a taxpayer to request a change in method of accounting by filing a Form 3115, "Application for Change in Accounting Method." In response to these questions, the final regulations clarify that the application of these rules to a transaction occurring after the effective date is not a change in method of accounting and, therefore, does not require the filing of Form 3115.

In addition to changes made in response to the comments and questions described above, the final regulations clarify the application of the step-in-the-shoes rules to certain transfers of contracts that result in the old taxpayer recognizing income with respect to the contract. Specifically, the final regulations explain how the old taxpayer calculates the gain realized with respect to the contract in these transactions, clarify the operation of the basis adjustment rule in certain cases of successive transfers of a contract, and provide that the contract price of a new taxpayer should be reduced to the extent that the old taxpayer recognizes income with respect to the contract in connection with these transactions. The final regulations also clarify that a taxpayer is not entitled to a loss in the amount of its basis in the contract (including the uncompleted property, if applicable) where that basis is determined under section 362 or 334. In addition, to the extent the basis of the contract (including the uncompleted property, if applicable) reflects the old taxpayer's recognition of income attributable to the contract in the step-in-the-shoes transaction, such income recognition reduces the total contract price. Accordingly, the new taxpayer recovers this additional basis over the time that it performs the contract. To the extent the basis of the contract (including the uncompleted property, if applicable) reflects costs incurred by the old taxpayer that have not yet been deducted (i.e., in the case of a CCM contract), such costs will give rise to a deduction upon completion of the contract. Therefore, disallowing the new taxpayer a loss for its basis in the contract (including the uncompleted property, if applicable) is necessary to prevent the new taxpayer from benefitting twice from the same item. Finally, the final regulations include new examples to illustrate these rules.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in this Treasury decision will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the relevant information is already maintained by taxpayers. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, the proposed regulations preceding these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is John Aramburu, Office of Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

2. In § 1.358–1, a sentence is added at the end of paragraph (a) to read as follows:

§ 1.358–1 Basis to distributees.

(a) * * * See § 1.460–4(k)(3)(iv)(A) for rules relating to stock basis adjustments required where a contract accounted for using a long-term contract method of accounting is transferred in a transaction described in section 351 or a reorganization described in section

368(a)(1)(D) with respect to which the requirements of section 355 (or so much of section 356 as relates to section 355) are met.

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3. In § 1.334–1, a sentence is added at the end of paragraph (b) to read as follows:

§ 1.334–1 Basis of property received in liquidations.

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(b) * * * See § 1.460–4(k)(3)(iv)(B)(*2*) for rules relating to adjustments to the basis of certain contracts accounted for using a long-term contract method of accounting that are acquired in certain liquidations described in section 332.

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4. In § 1.362–1, a sentence is added at the end of paragraph (a) to read as follows:

§ 1.362–1 Basis to corporations.

(a) * * * See § 1.460–4(k)(3)(iv)(B)(*2*) for rules relating to adjustments to the basis of certain contracts accounted for using a long-term contract method of accounting that are acquired in certain transfers described in section 351 and certain reorganizations described in section 368(a).

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5. In § 1.381(c)(4)–1, a sentence is added at the end of paragraph (a)(2) to read as follows:

§ 1.381(c)(4)–1 Method of accounting.

(a) * * *

(2) * * * See § 1.460–4(k) for rules relating to transfers of contracts accounted for using a long-term contract method of accounting in a transaction to which section 381 applies.

* * * * *

6. Section 1.460–0 is amended by:

1. Revising the entry for paragraph (k) of § 1.460–4.

2. Adding entries for paragraphs (k)(1) through (k)(6) of § 1.460–4.

3. Adding entries for paragraphs (g) through (g)(4) of § 1.460–6.

§ 1.460–0 Outline of regulations under section 460.

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§ 1.460–4 Methods of accounting for long-term contracts.

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(k) Mid-contract change in taxpayer.

(1) In general.

(2) Constructive completion transactions.

(i) Scope.

(ii) Old taxpayer.

(iii) New taxpayer.

(iv) Special rules relating to distributions of certain contracts by a partnership. [Reserved.]

(3) Step-in-the-shoes transactions.

(i) Scope.

(ii) Old taxpayer.

(A) In general.

(B) Gain realized on the transaction.

(iii) New taxpayer.

(A) Method of accounting.

(B) Contract price.

(C) Contract costs.

(iv) Special rules related to certain corporate transactions.

(A) Old taxpayer—basis adjustment.

(*1*) In general.

(*2*) Basis adjustment in excess of stock basis.

(*3*) Subsequent dispositions of certain contracts.

(B) New taxpayer.

(*1*) Contract price adjustment.

(*2*) Basis in contract.

(v) Special rules related to certain partnership transactions. [Reserved.]

(4) Anti-abuse rule.

(5) Examples.

(6) Effective date.

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§ 1.460–6 Look-back method.

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(g) Mid-contract change in taxpayer.

(1) In general.

(2) Constructive completion transactions.

(3) Step-in-the-shoes transactions.

(i) General rules.

(ii) Application of look-back method to pre-transaction period.

(A) Contract Price

(B) Method.

(C) Interest accrual period.

(D) Information old taxpayer must provide.

(iii) Application of look-back method to post-transaction years.

(iv) S corporation elections.

(4) Effective date.

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7. Section 1.460–4 is amended by:

1. Adding a sentence at the end of paragraph (a).

2. Adding paragraph (k).

The additions read as follows:

§ 1.460–4 Methods of accounting for long-term contracts.

(a) * * * Finally, paragraph (k) of this section provides rules relating to a mid-contract change in taxpayer of a contract accounted for using a long-term contract method of accounting.

* * * * *

(k) *Mid-contract change in taxpayer*—(1) *In general.* The rules in this paragraph (k) apply if prior to the completion of a long-term contract accounted for using a long-term contract method by a taxpayer (old taxpayer), there is a transaction that makes another taxpayer (new taxpayer) responsible for accounting for income from the same contract. For purposes of this paragraph (k) and § 1.460–6(g), an old taxpayer also includes any old taxpayer(s) (e.g., predecessors) of the old taxpayer. In addition, a change in status from taxable to tax exempt or from domestic to foreign, or vice versa, will be considered a change in taxpayer. Finally, a contract will be treated as the same contract if the terms of the contract are not substantially changed in connection with the transaction, whether or not the customer agrees to release the old taxpayer from any or all of its obligations under the contract. The rules governing constructive completion transactions are provided in paragraph (k)(2) of this section, while the rules governing step-in-the-shoes transactions are provided in paragraph (k)(3) of this section. Special rules related to the treatment of certain partnership transactions are reserved under paragraphs (k)(2)(iv) and (k)(3)(v) of this section. For application of the look-back method to mid-contract changes in taxpayers for contracts accounted for using the PCM, see § 1.460–6(g).

(2) *Constructive completion transactions*—(i) *Scope.* The constructive completion rules in this paragraph (k)(2) apply to transactions (constructive completion transactions) that result in a change in the taxpayer responsible for reporting income from a contract and that are not described in paragraph (k)(3)(i) of this section. Constructive completion transactions generally include, for example, taxable sales under section 1001 and deemed asset sales under section 338.

(ii) *Old taxpayer.* The old taxpayer is treated as completing the contract on the date of the transaction. The total contract price (or, gross contract price in the case of a long-term contract accounted for under the CCM) for the old taxpayer is the sum of any amounts realized from the transaction that are allocable to the contract and any amounts the old taxpayer has received or reasonably expects to receive under the contract. Total contract price (or gross contract price) is reduced by any amount paid by the old taxpayer to the new taxpayer, and by any transaction costs, that are allocable to the contract. Thus, the old taxpayer's allocable contract costs determined under paragraph (b)(5) of this section do not include any consideration paid, or costs incurred, as a result of the transaction that are allocable to the contract. In the case of a transaction subject to section

338 or 1060, the amount realized from the transaction allocable to the contract is determined by using the residual method under §§ 1.338–6 and 1.338–7.

(iii) *New taxpayer.* The new taxpayer is treated as entering into a new contract on the date of the transaction. The new taxpayer must evaluate whether the new contract should be classified as a long-term contract within the meaning of § 1.460–1(b) and account for the contract under a permissible method of accounting. For a new taxpayer who accounts for a contract using the PCM, the total contract price is any amount the new taxpayer reasonably expects to receive under the contract consistent with paragraph (b)(4) of this section. Total contract price is reduced by the amount of any consideration paid by the new taxpayer as a result of the transaction, and by any transaction costs. that are allocable to the contract and is increased by the amount of any consideration received by the new taxpayer as a result of the transaction that is allocable to the contract. Similarly, the gross contract price for a contract accounted for using the CCM is all amounts the new taxpayer is entitled by law or contract to receive consistent with paragraph (d)(3) of this section, adjusted for any consideration paid (or received) by the new taxpayer as a result of the transaction, and for any transaction costs, that are allocable to the contract. Thus, the new taxpayer's allocable contract costs determined under paragraph (b)(5) of this section do not include any consideration paid, or costs incurred, as a result of the transaction that are allocable to the contract. In the case of a transaction subject to sections 338 or 1060, the amount of consideration paid that is allocable to the contract is determined by using the residual method under §§ 1.338–6 and 1.338–7.

(iv) *Special rules relating to distributions of certain contracts by a partnership.* [Reserved]

(3) *Step-in-the-shoes transactions*—(i) *Scope.* The step-in-the-shoes rules in this paragraph (k)(3) apply to the following transactions that result in a change in the taxpayer responsible for reporting income from a contract accounted for using a long-term contract method of accounting (step-in-the-shoes transactions)—

(A) Transfers to which section 361 applies if the transfer is in connection with a reorganization described in section 368(a)(1)(A), (C) or (F);

(B) Transfers to which section 361 applies if the transfer is in connection with a reorganization described in section 368(a)(1)(D) or (G), provided the requirements of section 354(b)(1)(A) and (B) are met;

(C) Distributions to which section 332 applies, provided the contract is transferred to an 80-percent distributee;

(D) Transfers described in section 351;

(E) Transfers to which section 361 applies if the transfer is in connection with a reorganization described in section 368(a)(1)(D) with respect to which the requirements of section 355 (or so much of section 356 as relates to section 355) are met;

(F) Transfers (e.g., sales) of S corporation stock;

(G) Conversion to or from an S corporation;

(H) Members joining or leaving a consolidated group;

(I) Contributions to which section 721(a) applies;

(J) Transfers of partnership interests;

(K) Distributions to which section 731 applies (other than the distribution of the contract); and

(L) Any other transaction designated in the Internal Revenue Bulletin by the Internal Revenue Service. See § 601.601(d)(2)(ii) of this chapter.

(ii) *Old taxpayer*—(A) *In general.* The new taxpayer will "step into the shoes" of the old taxpayer with respect to the contract. Thus, the old taxpayer's obligation to account for the contract terminates on the date of the transaction and is assumed by the new taxpayer, as set forth in paragraph (k)(3)(iii) of this section. As a result, an old taxpayer using the PCM is required to recognize income from the contract based on the cumulative allocable contract costs incurred as of the date of the transaction. Similarly, an old taxpayer using the CCM is not required to recognize any revenue and may not deduct allocable contract costs incurred with respect to the contract.

(B) *Gain realized on the transaction.* The amount of gain the old taxpayer realizes on the transfer of a contract in a step-in-the-shoes transaction must be determined after application of paragraph (k)(3)(ii)(A) of this section using the rules of paragraph (k)(2) of this section that apply to constructive completion transactions. (The amount of gain realized on a transfer of a contract is relevant, for example, in determining the amount of gain recognized with respect to the contract in a section 351 transaction in which the old taxpayer receives from the new taxpayer money or property other than stock of the transferee.)

(iii) *New taxpayer*—(A) *Method of accounting.* Beginning on the date of the transaction, the new taxpayer must account for the long-term contract by using the same method of accounting used by the old taxpayer prior to the transaction. The same method of accounting must be used for such contract regardless of whether the old taxpayer's method is the new taxpayer's principal method of accounting under § 1.381(c)(4)–1(b)(3) or whether the new taxpayer is otherwise eligible to use the old taxpayer's method. Thus, if the old taxpayer uses the PCM to account for the contract, the new taxpayer steps into the shoes of the old taxpayer with respect to its completion factor and percentage of completion methods (such as the 10-percent method), even if the new taxpayer has not elected such methods for similarly classified contracts. Similarly, if the old taxpayer uses the CCM, the new taxpayer steps into the shoes of the old taxpayer with respect to the CCM, even if the new taxpayer is not otherwise eligible to use the CCM. However, the new taxpayer is not necessarily bound by the old taxpayer's method for similarly classified contracts entered into by the new taxpayer subsequent to the transaction and must apply general tax principles, including section 381, to determine the appropriate method to account for these subsequent contracts. To the extent that general tax principles allow the taxpayer to account for similarly classified contracts using a method other than the old taxpayer's method, the taxpayer is not required to obtain the consent of the Commissioner to begin using such other method.

(B) *Contract price.* In the case of a long-term contract that has been accounted for under PCM, the total contract price for the new taxpayer is the sum of any amounts the old taxpayer or the new taxpayer has received or reasonably expects to receive under the contract consistent with paragraph (b)(4) of this section. Similarly, the gross contract price in the case of a long-term contract accounted for under the CCM includes all amounts the old taxpayer or the new taxpayer is entitled by law or by contract to receive consistent with paragraph (d)(3) of this section.

(C) *Contract costs.* Total allocable contract costs for the new taxpayer are the allocable contract costs as defined under paragraph (b)(5) of this section incurred by either the old taxpayer prior to, or the new taxpayer after, the transaction. Thus, any payments between the old taxpayer and the new taxpayer with respect to the contract in connection with the transaction are not treated as allocable contract costs.

(iv) *Special rules related to certain corporate transactions*—(A) *Old taxpayer—basis adjustment*—(*1*) *In general.* Except as provided in

paragraph (k)(3)(iv)(A)(*2*) of this section, in the case of a transaction described in paragraph (k)(3)(i)(D) or (E) of this section, the old taxpayer must adjust its basis in the stock of the new taxpayer by—

(*i*) Increasing such basis by the amount of gross receipts the old taxpayer has recognized under the contract; and

(*ii*) Reducing such basis by the amount of gross receipts the old taxpayer has received or reasonably expects to receive under the contract.

(*2*) *Basis adjustment in excess of stock basis.* If the old and new taxpayer do not join in the filing of a consolidated Federal income tax return, the old taxpayer may not adjust its basis in the stock of the new taxpayer under paragraph (k)(3)(iv)(A)(*1*) of this section below zero and the old taxpayer must recognize ordinary income to the extent the basis in the stock of the new taxpayer otherwise would be adjusted below zero. If the old and new taxpayer join in the filing of a consolidated Federal income tax return, the old taxpayer must create an (or increase an existing) excess loss account to the extent the basis in the stock of the new taxpayer otherwise would be adjusted below zero under paragraph (k)(3)(iv)(A)(*1*) of this section. See §§ 1.1502–19 and 1.1502–32(a)(3)(ii).

(*3*) *Subsequent dispositions of certain contracts.* If the old taxpayer disposes of a contract in a transaction described in paragraph (k)(3)(i)(D) or (E) of this section that the old taxpayer acquired in a transaction described in paragraph (k)(3)(i)(D) or (E) of this section, the basis adjustment rule of this paragraph (k)(3)(iv)(A) is applied by treating the old taxpayer as having recognized the amount of gross receipts recognized by the previous old taxpayer under the contract and any amount recognized by the previous old taxpayer with respect to the contract in connection with the transaction in which the old taxpayer acquired the contract. In addition, the old taxpayer is treated as having received or as reasonably expecting to receive under the contract any amount the previous old taxpayer received or reasonably expects to receive under the contract. Similar principles will apply in the case of multiple successive transfers described in paragraph (k)(3)(i)(D) or (E) of this section involving the contract.

(B) *New Taxpayer*—(*1*) *Contract price adjustment.* Generally, payments between the old taxpayer and the new taxpayer with respect to the contract in connection with the transaction do not affect the contract price. Notwithstanding the preceding sentence and paragraph (k)(3)(iii)(B) of this section, however, in the case of transactions described in paragraph (k)(3)(i)(B), (D) or (E) of this section, the total contract price (or gross contract price) must be reduced to the extent of any amount recognized by the old taxpayer with respect to the contract in connection with the transaction (e.g., any amount recognized under section 351(b) or 357 that is attributable to the contract and any income recognized by the old taxpayer pursuant to the basis adjustment rule of paragraph (k)(3)(iv)(A)).

(*2*) *Basis in Contract.* The new taxpayer's basis in a contract (including the uncompleted property, if applicable) acquired in a transaction described in paragraphs (k)(3)(i)(A) through (E) of this section will be computed under section 362 or section 334, as applicable. Upon a new taxpayer's completion (actual or constructive) of a CCM or a PCM contract acquired in a transaction described in paragraphs (k)(3)(i)(A) through (E) of this section, the new taxpayer's basis in the contract (including the uncompleted property, if applicable) is reduced to zero. The new taxpayer is not entitled to a deduction or loss in connection with any basis reduction pursuant to this paragraph (k)(3)(iv)(B)(*2*).

(v) *Special rules related to certain partnership transactions.* [Reserved]

(4) *Anti-abuse rule.* Notwithstanding this paragraph (k), in the case of a transaction entered into with a principal purpose of shifting the tax consequences associated with a long-term contract in a manner that substantially reduces the aggregate U.S. Federal income tax liability of the parties with respect to that contract, the Commissioner may allocate to the old (or new) taxpayer the income from that contract properly allocable to the old (or new) taxpayer. For example, the Commissioner may reallocate income from a long-term contract in a transaction in which a contract accounted for using the CCM, or using the PCM where the old taxpayer has received advance payments in excess of its contribution to the contract, is transferred to a tax indifferent party (e.g., a foreign person not subject to U.S. Federal income tax).

(5) *Examples.* The following examples illustrate the rules of this paragraph (k).

For purposes of these examples, it is assumed that the contract is a long-term construction contract accounted for using the PCM prior to the transaction unless stated otherwise and the contract is not transferred with a principal purpose of shifting the tax consequences associated with a long-term contract in a manner that substantially reduces the aggregate U.S. Federal income tax liability of the parties with respect to that contract. The examples are as follows:

Example 1. Constructive completion—PCM—(i) *Facts.* In Year 1, X enters into a contract. The total contract price is $1,000,000 and the estimated total allocable contract costs are $800,000. In Year 1, X incurs costs of $200,000. In Year 2, X incurs additional costs of $400,000 before selling the contract as part of a taxable sale of its business in Year 2 to Y, an unrelated party. At the time of sale, X has received $650,000 in progress payments under the contract. The consideration allocable to the contract under section 1060 is $150,000. Pursuant to the sale, the new taxpayer Y immediately assumes X's contract obligations and rights. Y is required to account for the contract using the PCM. In Year 2, Y incurs additional allocable contract costs of $50,000. Y correctly estimates at the end of Year 2 that it will have to incur an additional $75,000 of allocable contract costs in Year 3 to complete the contract.

(ii) *Old taxpayer.* For Year 1, X reports receipts of $250,000 (the completion factor multiplied by total contract price ($200,000/$800,000 x $1,000,000)) and costs of $200,000, for a profit of $50,000. X is treated as completing the contract in Year 2 because it sold the contract. For purposes of applying the PCM in Year 2, the total contract price is $800,000 (the sum of the amounts received under the contract and the amount realized in the sale ($650,000 + $150,000)) and the total allocable contract costs are $600,000 (the sum of the costs incurred in Year 1 and Year 2 ($200,000 + $400,000)). Thus, in Year 2, X reports receipts of $550,000 (total contract price minus receipts already reported ($800,000 − $250,000)) and costs incurred in year 2 of $400,000, for a profit of $150,000.

(iii) *New taxpayer.* Y is treated as entering into a new contract in Year 2. The total contract price is $200,000 (the amount remaining to be paid under the terms of the contract less the consideration paid allocable to the contract ($1,000,000 − $650,000 − $150,000)). The estimated total allocable contract costs at the end of Year 2 are $125,000 (the allocable contract costs that Y reasonably expects to incur to complete the contract ($50,000 + $75,000)). In Year 2, Y reports receipts of $80,000 (the completion factor multiplied by the total contract price [($50,000/$125,000) x $200,000] and costs of $50,000 (the costs incurred after the purchase), for a profit of $30,000. For Year 3, Y reports receipts of $120,000 (total contract price minus receipts already reported ($200,000 − $80,000)) and costs of $75,000, for a profit of $45,000.

Example 2. Constructive completion—CCM—(i) *Facts.* The facts are the same as in Example 1, except that X and Y properly account for the contract under the CCM.

(ii) *Old taxpayer.* X does not report any income or costs from the contract in Year 1. In Year 2, the contract is deemed complete for X, and X reports its gross contract price of $800,000 (the sum of the amounts received under the contract and the amount realized in the sale

($650,000 + $150,000)) and its total allocable contract costs of $600,000 (the sum of the costs incurred in Year 1 and Year 2 ($200,000 + $400,000)) in that year, for a profit of $200,000.

(iii) *New taxpayer.* Y is treated as entering into a new contract in Year 2. Under the CCM, Y reports no gross receipts or costs in Year 2. Y reports its gross contract price of $200,000 (the amount remaining to be paid under the terms of the contract less the consideration paid allocable to the contract ($1,000,000 − $650,000 − $150,000)) and its total allocable contract costs of $125,000 (the allocable contract costs that Y incurred to complete the contract ($50,000 + $75,000)) in Year 3, the completion year, for a profit of $75,000.

Example 3. Step-in-the-shoes—PCM—(i) *Facts.* The facts are the same as in Example 1, except that X transfers the contract (including the uncompleted property) to Y in exchange for stock of Y in a transaction that qualifies as a statutory merger described in section 368(a)(1)(A) and does not result in gain or loss to X under section 361(a).

(ii) *Old taxpayer.* For Year 1, X reports receipts of $250,000 (the completion factor multiplied by total contract price ($200,000/$800,000 x $1,000,000)) and costs of $200,000, for a profit of $50,000. Because the mid-contract change in taxpayer results from a transaction described in paragraph (k)(3)(i) of this section, X is not treated as completing the contract in Year 2. In Year 2, X reports receipts of $500,000 (the completion factor multiplied by the total contract price and minus the Year 1 gross receipts [($600,000/$800,000 × $1,000,000)–$250,000]) and costs of $400,000, for a profit of $100,000.

(iii) *New taxpayer.* Because the mid-contract change in taxpayer results from a step-in-the-shoes transaction, Y must account for the contract using the same methods of accounting used by X prior to the transaction. Total contract price is the sum of any amounts that X and Y have received or reasonably expect to receive under the contract, and total allocable contract costs are the allocable contract costs of X and Y. Thus, the estimated total allocable contract costs at the end of Year 2 are $725,000 (the cumulative allocable contract costs of X and the estimated total allocable contract costs of Y ($200,000 + $400,000 + $50,000 + $75,000)). In Year 2, Y reports receipts of $146,552 (the completion factor multiplied by the total contract price minus receipts reported by the old taxpayer ([($650,000/$725,000) × $1,000,000]–$750,000) and costs of $50,000, for a profit of $96,552. For Year 3, Y reports receipts of $103,448 (the total contract price minus prior year receipts ($1,000,000–$896,552)) and costs of $75,000, for a profit of $28,448.

Example 4. Step-in-the-shoes—CCM—(i) *Facts.* The facts are the same as in *Example 3*, except that X properly accounts for the contract under the CCM.

(ii) *Old taxpayer.* X reports no income or costs from the contract in Years 1, 2 or 3.

(iii) *New taxpayer.* Because the mid-contract change in taxpayer results from a step-in-the-shoes transaction, Y must account for the contract using the same method of accounting used by X prior to the transaction. Thus, in Year 3, the completion year, Y reports receipts of $1,000,000 and total contract costs of $725,000, for a profit of $275,000.

Example 5. Step in the shoes—PCM—basis adjustment.

The facts are the same as in Example 3, except that X transfers the contract (including the uncompleted property) with a basis of $0 and $125,000 of cash to a new corporation, Z, in exchange for all of the stock of Z in a section 351 transaction. Thus, under section 358(a), X's basis in the Z stock is $125,000. Pursuant to paragraph (k)(3)(iv)(A)(*1*) of this section, X must increase its basis in the Z stock by the amount of gross receipts X recognized under the contract, $750,000 ($250,000 receipts in Year 1 + $500,000 receipts in Year 2), and reduce its basis by the amount of gross receipts X received under the contract, the $650,000 in progress payments. Accordingly, X's basis in the Z stock is $225,000. All other results are the same.

Example 6. Step in the shoes—CCM—basis adjustment—(i) *Facts.* The facts are the same as in *Example 4*, except that X receives progress payments of $800,000 (rather than $650,000) and transfers the contract (including the uncompleted property) with a basis of $600,000 and $125,000 of cash to a new corporation, Z, in exchange for all of the stock of Z in a section 351 transaction. X and Z do not join in filing a consolidated Federal income tax return.

(ii) *Old taxpayer.* X reports no income or costs under the contract in Years 1, 2, or 3. Under section 358(a), X's basis in Z is $725,000. Pursuant to paragraph (k)(3)(iv)(A)(*1*), X must reduce its basis in the stock of Z by $800,000, the progress payments received by X. However, X may not reduce its basis in the Z stock below zero pursuant paragraph (k)(3)(iv)(A)(*2*) of this section. Accordingly, X's basis in the Z stock is reduced by $725,000 to zero and X must recognize ordinary income of $75,000.

(iii) *New taxpayer.* Upon completion of the contract in Year 3, Z reports gross receipts of $925,000 ($1,000,000 original contract price—$75,000 income recognized by the old taxpayer pursuant to the basis adjustment rule of paragraph (k)(3)(iv)(A)) and total contract costs of $725,000, for a profit of $200,000.

Example 7. Step in the shoes—PCM—gain recognized in transaction—(i) *Facts.* The facts are the same as in *Example 3*, except that X transfers the contract (including the uncompleted property) with a basis of $0 and an unrelated capital asset with a value of $100,000 and a basis of $0 to a new corporation, Z, in exchange for stock of Z with a value of $200,000 and $50,000 of cash in a section 351 transaction.

(ii) *Old taxpayer.* For year 1, X reports receipts of $250,000 ($200,000/$800,000 × $1,000,000) and costs of $200,000, for a profit of $50,000. X is not treated as completing the contract in Year 2. In Year 2, X reports receipts of $500,000 (($600,000/$800,000 × $1,000,000 = $750,000 cumulative gross receipts)—$250,000 prior year cumulative gross receipts) and costs of $400,000, for a profit of $100,000. Under paragraph (k)(3)(ii)(B) of this section, X determines that the gain realized on the transfer of the contract to Z under the constructive completion rules of paragraph (k)(2)(ii) of this section is $50,000 (total contract price of $800,000 ($150,000 value allocable to the contract + $650,000 progress payments)—$750,000 previously recognized cumulative gross receipts—$0 costs incurred but not recognized). The gain realized on the transfer of the unrelated capital asset to Z is $100,000. The amount of gain X must recognize due to the receipt of $50,000 cash in the exchange is $50,000, of which $30,000 is allocated to the contract ($150,000 value of contract/$250,000 total value of property transferred to Z × $50,000) and is treated as ordinary income, and $20,000 is allocated to the unrelated capital asset ($100,000 value of capital asset/$250,000 total value of property transferred to Z × $50,000). Under section 358(a), X's basis in the Z stock is $0. However, pursuant to paragraph (k)(3)(iv)(A)(*1*) of this section, X must increase its basis in the Z stock by $750,000, the amount of gross receipts recognized under the contract, and must reduce its basis in the Z stock by $650,000, the amount of gross receipts X received under the contract. Therefore, X's basis in the Z stock is $100,000.

(iii) *New taxpayer.* Z must account for the contract using the same PCM method used by X prior to the transaction. Pursuant to paragraph (k)(3)(iv)(B)(1) of this section, the total contract price is $970,000 ($1,000,000 amount X and Z have received or reasonably expect to receive under the contract—$30,000 income recognized by X with respect to the contract as a result of the receipt of $50,000 cash in the transaction). In Year 2, Z reports gross receipts of $119,655 ($650,000/$725,000 × $970,000 = $869,655 current year cumulative gross receipts—$750,000 cumulative gross receipts reported by the old taxpayer) and costs of $50,000, for a profit of $69,655. In Year 3, Z reports gross receipts of $100,345 ($970,000–$869,655) and costs of $75,000, for a profit of $25,345.

Example 8. Step in the shoes—CCM—gain recognized in transaction—(i) *Facts.* The facts are the same as in *Example 4*, except that X transfers the contract (including the uncompleted property) with a basis of $600,000 and an unrelated capital asset with a value of $125,000 and a basis of $0 to a new corporation, Z, in exchange for all the stock of Z with a value of $175,000 and $100,000 of cash in a section 351 transaction. X and Z do not join in filing a consolidated Federal income tax return.

(ii) *Old taxpayer.* X reports no income or costs under the contract in Years 1, 2, or 3. Under paragraph (k)(3)(ii)(B), X determines that the gain realized on the transfer of the contract to Z under the constructive completion rules of paragraph (k)(2)(ii) of this section is $200,000 ($800,000 total contract price ($150,000 value allocable to the contract + $650,000 progress payments)—$600,000 costs incurred but not recognized). The gain realized on the transfer of the unrelated capital asset to Z is $125,000. The amount of gain X must recognize due to the receipt of $100,000 of cash in the exchange is $100,000, of which $54,545 is allocated to the contract ($150,000 value of the contract/

$275,000 total value of property transferred to Z × $100,000) and is treated as ordinary income, and $45,455 is allocated to the unrelated capital asset ($125,000 value of capital asset/$275,000 total value of property transferred to Z × $100,000). Under section 358(a), X's basis in the Z stock is $600,000 ($600,000 basis in the contract and unrelated capital asset transferred—$100,000 cash received + $100,000 gain recognized). Pursuant to paragraph (k)(3)(iv)(A)(*1*) of this section, X must reduce its basis in the stock of Z by $650,000, the progress payments received under the contract. However, X may not reduce its basis in the Z stock below zero pursuant to paragraph (k)(3)(iv)(A)(*2*) of this section. Accordingly, X's basis in the Z stock is reduced by $600,000 to zero and X must recognize income of $50,000.

(iii) *New taxpayer.* Z must account for the contract using the same CCM used by X prior to the transaction. Pursuant to paragraph (k)(3)(iv)(B)(*1*) of this section, the total contract price is $895,455 ($1,000,000 original contract price—$54,545 income recognized by old taxpayer with respect to the contract as a result of the receipt of cash in the transaction—$50,000 income recognized by the old taxpayer pursuant to the basis adjustment rule of paragraph (k)(3)(iv)(A)). Accordingly, upon completion of the contract in Year 3, Z reports gross receipts of $895,455 and total contract costs of $725,000, for a profit of $170,455.

(6) *Effective date.* This paragraph (k) is applicable for transactions on or after May 15, 2002. Application of the rules of this paragraph (k) to a transaction that occurs on or after May 15, 2002 is not a change in method of accounting.

8. In § 1.460–6, paragraph (g) is revised to read as follows:

§ 1.460–6 Look-back method.

* * * * *

(g) *Mid-contract change in taxpayer*—(1) *In general.* The rules in this paragraph (g) apply if, as described in § 1.460–4(k), prior to the completion of a long-term contract accounted for using the PCM or the PCCM by a taxpayer (old taxpayer), there is a transaction that makes another taxpayer (new taxpayer) responsible for accounting for income from the same contract. The rules governing constructive completion transactions are provided in paragraph (g)(2) of this section, while the rules governing step-in-the-shoes transactions are provided in paragraph (g)(3) of this section. For purposes of this paragraph, pre-transaction years are all taxable years of the old taxpayer in which the old taxpayer accounted for (or should have accounted for) gross receipts from the contract, and post-transaction years are all taxable years of the new taxpayer in which the new taxpayer accounted for (or should have accounted for) gross receipts from the contract.

(2) *Constructive completion transactions.* In the case of a transaction described in § 1.460–4(k)(2)(i) (constructive completion transaction), the look-back method is applied by the old taxpayer with respect to pre-transaction years upon the date of the transaction and, if the new taxpayer uses the PCM or the PCCM to account for the contract, by the new taxpayer with respect to post-transaction years upon completion of the contract. The contract price and allocable contract costs to be taken into account by the old taxpayer or the new taxpayer in applying the look-back method are described in § 1.460–4(k)(2).

(3) *Step-in-the-shoes transactions*—(i) *General rules.* In the case of a transaction described in § 1.460–4(k)(3)(i) (step-in-the-shoes transaction), the look-back method is not applied at the time of the transaction, but is instead applied for the first time when the contract is completed by the new taxpayer. Upon completion of the contract, the look-back method is applied by the new taxpayer with respect to both pre-transaction years and post-transaction years, taking into account all amounts reasonably expected to be received by either the old or new taxpayer and all allocable contract costs incurred during both periods as described in § 1.460–4(k)(3). The new taxpayer is liable for filing the Form 8697 and for interest computed on hypothetical underpayments of tax, and is entitled to receive interest with respect to hypothetical overpayments of tax, for both pre- and post-transaction years. The old taxpayer will be secondarily liable for any interest required to be paid with respect to pre-transaction years reduced by any interest on pre-transaction overpayments.

(ii) *Application of look-back method to pre-transaction period*—(A) *Contract price.* The actual contract price for pre-transaction taxable years must be determined by the new taxpayer without regard to any contract price adjustment described in paragraph (k)(3)(iv)(B)(1) of this section.

(B) *Method.* The new taxpayer may apply the look-back method to each pre-transaction taxable year that is a redetermination year using the simplified marginal impact method described in paragraph (d) of this section (regardless of whether or not the old taxpayer would have actually used that method and without regard to the tax liability ceiling). But see paragraph (d)(4) of this section, which requires use of the simplified marginal impact method by certain pass-through entities.

(C) *Interest accrual period.* With respect to any hypothetical underpayment or overpayment of tax for a pre-transaction taxable year, interest accrues from the due date of the old taxpayer's tax return (not including extensions) for the taxable year of the underpayment or overpayment until the due date of the new taxpayer's return (not including extensions) for the completion year or the year of a post-completion adjustment, whichever is applicable.

(D) *Information old taxpayer must provide.* In order to help the new taxpayer to apply the look-back method with respect to pre-transaction taxable years, any old taxpayer that accounted for income from a long-term contract under the PCM or PCCM for either regular or alternative minimum tax purposes is required to provide the information described in this paragraph to the new taxpayer by the due date (not including extensions) of the old taxpayer's income tax return for the first taxable year ending on or after a step-in-the-shoes transaction described in § 1.460–4(k)(3)(i). The required information is as follows—

(*1*) The portion of the contract reported by the old taxpayer under PCM for regular and alternative minimum tax purposes (i.e., whether the old taxpayer used PCM, the 40/60 PCCM method, or the 70/30 PCCM method);

(*2*) Any submethods used in the application of PCM (e.g., the simplified cost-to-cost method or the 10-percent method);

(*3*) The amount of total contract price reported by year;

(*4*) The numerator and the denominator of the completion factor by year;

(*5*) The due date (not including extensions) of the old taxpayer's income tax returns for each taxable year in which income was required to be reported;

(*6*) Whether the old taxpayer was a corporate or a noncorporate taxpayer by year; and

(*7*) Any other information required by the Commissioner by administrative pronouncement.

(iii) *Application of look-back method to post-transaction years.* With respect to post-transaction taxable years, the new taxpayer must use the same look-back method it uses for other contracts (i.e., the simplified marginal impact method or the actual method) to determine the amount of any hypothetical overpayment or underpayment of tax and the time period for computing interest on these amounts.

(iv) *S corporation elections.* Following the conversion of a C corporation into an S corporation, the look-back method is applied at the entity level with

respect to contracts entered into prior to the conversion, notwithstanding section 460(b)(4)(B)(i).

(4) *Effective date.* This paragraph (g) is applicable for transactions on or after May 15, 2002.

§ 1.1362–2 [Amended]

9. In § 1.1362–2, paragraph (c)(6) Example 2, first sentence is amended by removing the language "§ 1.451–3(b)" and adding "§ 1.460–1(b)(1)" in its place, and removing the language "§ 1.451–3(c)(1)" and adding "§ 1.460–4(b)" in its place.

§ 1.1374–4 [Amended]

10. In § 1.1374–4, paragraph (g), first sentence is amended by removing the language "§ 1.451–3(d)" and adding "§ 1.460–4(d)" in its place, and removing the language "§ 1.451–3(c)" and adding "§ 1.460–4(b)" in its place.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

11. The authority section for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

12. In § 602.101, paragraph (b) is amended by revising the entry for 1.460–6 to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * * * *	
1.460–6	1545–1031; 1545–1572; 1545–1732
* * * * * * *	

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved: May 2, 2002.

Pamela F. Olson,
Acting Assistant Secretary of the Treasury.

[FR Doc. 02–11792 Filed 5–14–02; 8:45 am]
BILLING CODE 4830–01–P

PENSION BENEFIT GUARANTY CORPORATION

29 CFR Parts 4022 and 4044

Benefits Payable in Terminated Single-Employer Plans; Allocation of Assets in Single-Employer Plans; Interest Assumptions for Valuing and Paying Benefits

AGENCY: Pension Benefit Guaranty Corporation.

ACTION: Final rule.

SUMMARY: The Pension Benefit Guaranty Corporation's regulations on Benefits Payable in Terminated Single-Employer Plans and Allocation of Assets in Single-Employer Plans prescribe interest assumptions for valuing and paying benefits under terminating single-employer plans. This final rule amends the regulations to adopt interest assumptions for plans with valuation dates in June 2002. Interest assumptions are also published on the PBGC's Web site (*http://www.pbgc.gov*).

EFFECTIVE DATE: June 1, 2002.

FOR FURTHER INFORMATION CONTACT: Harold J. Ashner, Assistant General Counsel, Office of the General Counsel, Pension Benefit Guaranty Corporation, 1200 K Street, NW., Washington, DC 20005, 202–326–4024. (TTY/TDD users may call the Federal relay service toll-free at 1–800–877–8339 and ask to be connected to 202–326–4024.)

SUPPLEMENTARY INFORMATION: The PBGC's regulations prescribe actuarial assumptions—including interest assumptions—for valuing and paying plan benefits of terminating single-employer plans covered by title IV of the Employee Retirement Income Security Act of 1974. The interest assumptions are intended to reflect current conditions in the financial and annuity markets.

Three sets of interest assumptions are prescribed: (1) A set for the valuation of benefits for allocation purposes under section 4044 (found in appendix B to part 4044), (2) a set for the PBGC to use to determine whether a benefit is payable as a lump sum and to determine lump-sum amounts to be paid by the PBGC (found in appendix B to Part 4022), and (3) a set for private-sector pension practitioners to refer to if they wish to use lump-sum interest rates determined using the PBGC's historical methodology (found in Appendix C to Part 4022).

Accordingly, this amendment (1) adds to appendix B to part 4044 the interest assumptions for valuing benefits for allocation purposes in plans with valuation dates during June 2002, (2) adds to appendix B to Part 4022 the interest assumptions for the PBGC to use for its own lump-sum payments in plans with valuation dates during June 2002, and (3) adds to Appendix C to Part 4022 the interest assumptions for private-sector pension practitioners to refer to if they wish to use lump-sum interest rates determined using the PBGC's historical methodology for valuation dates during June 2002.

For valuation of benefits for allocation purposes, the interest assumptions that the PBGC will use (set forth in appendix B to part 4044) will be 5.70 percent for the first 25 years following the valuation date and 4.25 percent thereafter. These interest assumptions represent a decrease (from those in effect for May 2002) of 0.20 percent for the first 25 years following the valuation date and are otherwise unchanged.

The interest assumptions that the PBGC will use for its own lump-sum payments (set forth in appendix B to part 4022) will be 4.50 percent for the period during which a benefit is in pay status and 4.00 percent during any years preceding the benefit's placement in pay status. These interest assumptions represent a decrease (from those in effect for May 2002) of 0.25 percent for the period during which a benefit is in pay status and are otherwise unchanged.

For private-sector payments, the interest assumptions (set forth in Appendix C to part 4022) will be the same as those used by the PBGC for determining and paying lump sums (set forth in appendix B to part 4022).

The PBGC has determined that notice and public comment on this amendment are impracticable and contrary to the public interest. This finding is based on the need to determine and issue new interest assumptions promptly so that the assumptions can reflect, as accurately as possible, current market conditions.

Because of the need to provide immediate guidance for the valuation and payment of benefits in plans with valuation dates during June 2002, the