approved by the Manager, Seattle ACO, or per data meeting the type certification basis of the airplane approved by a Boeing Company Designated Engineering Representative who has been authorized by the Manager, Seattle ACO, to make such findings. For a repair method to be approved, the approval must specifically reference this AD.

Alternative Methods of Compliance

(e) In accordance with 14 CFR 39.19, the Manager, Seattle ACO, is authorized to approve alternative methods of compliance for this AD.

Incorporation by Reference

(f) Unless otherwise specified in this AD, the actions shall be done in accordance with Boeing Alert Service Bulletin 767–53A0105, dated April 10, 2003; or Boeing Alert Service Bulletin 767–53A0106, dated April 10, 2003; as applicable. This incorporation by reference was approved by the Director of the Federal Register in accordance with 5 U.S.C. 552(a) and 1 CFR part 51. Copies may be obtained from Boeing Commercial Airplanes, P.O. Box 3707, Seattle, Washington 98124–2207. Copies may be inspected at the FAA, Transport Airplane Directorate, 1601 Lind Avenue, SW., Renton, Washington; or at the National Archives and Records Administration (NARA). For information on the availability of this material at NARA, call (202) 741–6030, or go to: *http://www.archives.gov/federal_register/code_of_federal_regulations/ibr_locations.html.*

Effective Date

(g) This amendment becomes effective on August 20, 2004.

Issued in Renton, Washington, on July 1, 2004.

Kalene C. Yanamura,

Acting Manager, Transport Airplane Directorate, Aircraft Certification Service.

[FR Doc. 04–15759 Filed 7–15–04; 8:45 am]

BILLING CODE 4910–13–P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9137]

RIN 1545–BA81

Partnership Transactions Involving Long-Term Contracts

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to partnership transactions involving contracts accounted for under a long-term contract method of accounting. The regulations are necessary to resolve issues that were reserved in final regulations under section 460 that were published in the **Federal Register** on May 15, 2002, addressing other mid-contract changes in taxpayer engaged in completing such contracts. The effect of the regulations is to explain the tax consequences of these partnership transactions.

DATES: *Effective Date:* These regulations are effective July 16, 2004.

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

FOR FURTHER INFORMATION CONTACT: Richard Probst at (202) 622–3060 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Section 460 of the Internal Revenue Code generally requires that taxpayers determine taxable income from a long-term contract using the percentage-of-completion method (PCM). Under regulations finalized in 2001 (TD 8929, 2001–1 C.B. 756), a taxpayer using the PCM generally includes a portion of the total contract price in income for each taxable year that the taxpayer incurs contract costs allocable to the long-term contract. More specifically, to determine the income from a long-term contract, the taxpayer first computes the completion factor for the contract, which is the percentage of the estimated total allocable contract costs that the taxpayer has incurred (based on the all events test of section 461, including economic performance, regardless of the taxpayer's method of accounting) through the end of the taxable year. Second, the taxpayer computes the amount of cumulative gross receipts from the contract by multiplying the completion factor by the total contract price, which is the amount that the taxpayer reasonably expects to receive under the contract. Third, the taxpayer computes the amount of current-year gross receipts, which is the difference between the cumulative gross receipts for the current taxable year and the cumulative gross receipts for the immediately preceding taxable year. This difference may be a loss (a negative number) based on revisions to estimates of total allocable contract costs or total contract price. Fourth, the taxpayer takes into account both the current-year gross receipts and the amount of allocable contract costs actually incurred during the taxable year. To the extent any portion of the total contract price has not been included in taxable income by the completion year, section 460(b)(1) and the regulations require the taxpayer to include that portion in income for the taxable year following the completion year.

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 the CCM, a taxpayer does not take into account the gross contract price and allocable contract costs until the contract is complete, even though progress payments are received in years prior to completion.

A taxpayer generally must allocate costs to a contract subject to section 460(a) in the same manner as direct and indirect costs are capitalized to property produced by a taxpayer under section 263A. The regulations provide exceptions, however, that reflect the differences in the cost allocation rules of sections 263A and 460.

Section 460(h) directs the Secretary to prescribe regulations to the extent necessary or appropriate to carry out the purpose of section 460, including regulations to prevent a taxpayer from avoiding section 460 by using related parties, pass-through entities, intermediaries, options, and other similar arrangements.

On May 15, 2002, final regulations under section 460 were issued to address a mid-contract change in taxpayer engaged in completing a contract accounted for under a long-term contract method of accounting (TD 8995; 2002–23 I.R.B. 1070). The regulations divide the rules regarding a mid-contract change in taxpayer into two categories—constructive completion transactions and step-in-the-shoes transactions.

In a constructive completion transaction, the taxpayer that originally accounted for the long-term contract (old taxpayer) must recognize income from the contract as of the time of the transaction. The contract price used to determine the amount of income recognized by the taxpayer is the amount realized from the transaction, reduced by any amounts 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. The new taxpayer's contract price is the amount that the new taxpayer reasonably expects to receive under the contract, reduced by the price paid by the new taxpayer for the contract, and increased by any amounts paid by the old taxpayer to the new taxpayer that are allocable to the contract. In contrast, in 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.

The final section 460 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 under a long-term contract method of accounting) are step-in-the-shoes transactions. In a notice issued concurrently with the final regulations, Notice 2002–37 (2002–23 I.R.B. 1095), the Treasury Department and IRS announced their intention to publish regulations setting forth the special rules that apply to these partnership transactions and described many of these rules. The notice further provided that these regulations would apply to contributions, transfers, and distributions occurring on or after May 15, 2002. On August 6, 2003, a notice of proposed rulemaking (REG–128203–02) relating to partnership transactions involving contracts accounted for under a long-term contract method of accounting was published in the **Federal Register** (68 FR 46516). 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 Contents

The regulations proposed on August 6, 2003 provide that the constructive completion rules do not apply to a transfer by a partnership (transferor partnership) of all of its assets and liabilities to a second partnership (transferee partnership) in an exchange described in section 721, followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership, under § 1.708–1(b)(4) (relating to terminations under section 708(b)(1)(B)) or § 1.708–1(c)(3)(i) (relating to certain partnership mergers). One commentator suggested clarifying that the constructive completion rules apply to other distributions of an interest in a partnership (lower-tier partnership) holding one or more contracts accounted for under a long-term contract method of accounting by another partnership (upper-tier partnership). This comment has been adopted.

One commentator suggested that the final regulations clarify the application of the constructive completion rules if a partnership that holds a contract accounted for under a long-term contract method of accounting terminates under section 708(b)(1)(A) because the number of its owners is reduced to one. In response to this comment, the final regulations provide that the entire contract will be treated as being distributed from the partnership for purposes of the constructive completion rules, because the partnership ceases to exist for tax purposes. In addition, the final regulations provide that the partnership must apply the constructive completion rules immediately prior to the transaction or transactions resulting in the termination of the partnership.

Consistent with § 1.706–1(c)(2)(ii), the proposed regulations generally provide that upon the transfer or liquidation of an interest in a partnership holding a contract accounted for under a long-term contract method of accounting, the step-in-the-shoes rules apply to a contract accounted for under a long-term contract method of accounting only if the partnership's books are properly closed with respect to that contract under section 706. The proposed regulations provide that if the partnership's books are not closed with respect to the contract, the partnership shall compute its income or loss from each contract accounted for under a long-term contract method of accounting for the period that includes the date of the transfer or liquidation as though no change in taxpayer had occurred with respect to that contract, and may pro rate income from the contract under a reasonable method complying with section 706. The proposed regulations also provide similar rules for distributions of property (other than a contract accounted for under a long-term contract method of accounting) from a partnership holding a long-term contract, and for contributions of property (other than a contract accounted for under a long-term contract method of accounting) to a partnership holding a contract accounted for under a long-term contract method of accounting.

The proposed regulations requested comments regarding whether similar rules should be provided with respect to transfers of stock in an S corporation holding a contract accounted for under a long-term contract method of accounting. Under section 1377(a)(1) and § 1.1377–1(a), each shareholder's pro rata share of any S corporation item for any taxable year is generally the sum of the amounts determined with respect to the shareholder by assigning an equal portion of the item to each day of the S corporation's taxable year, and then dividing that portion pro rata among the shares outstanding on that day. Under section 1377(a)(2) and § 1.1377–1(b), an S corporation may elect to close its books if a shareholder's entire interest in an S corporation is terminated during the S corporation's taxable year, and the corporation and all affected shareholders agree. No comments were received.

The Treasury Department and IRS have concluded that similar rules should be provided for transfers of S corporation stock and conversions to and from S corporation status. Thus, the final regulations generally provide that upon the transfer of stock in an S corporation holding a contract accounted for under a long-term contract method of accounting, or the conversion to or from S corporation status by a corporation holding such a contract, the step-in-the-shoes rules apply to the contract only if the S corporation's books are closed under section 1362(e)(3), section 1362(e)(6)(C), section 1362(e)(6)(D), section 1377(a)(2), or § 1.1502–76. If the S corporation's books are not closed, the S corporation computes its income or loss from the contract for the period that includes the date of the transfer as though no change in taxpayer had occurred with respect to the contract, and must pro rate income from the contract in accordance with the rules generally applicable to such transfers or conversions.

In Rev. Rul. 73–301 (1973–2 C.B. 215), the IRS ruled that the progress payments described in the ruling did not constitute a liability within the meaning of section 752. See also Rev. Rul. 81–241 (1981–2 C.B. 146) (citing and following Rev. Rul. 73–301). The proposed regulations requested comments regarding whether there are circumstances under which the receipt of progress payments under a contract accounted for under a long-term contract method of accounting could give rise to a liability under section 752, and, if so, how the regulations would need to be revised to account for such liabilities. No written comments were received. However, if a contract accounted for under a long-term contract method of accounting is contributed to a partnership, then, to the extent that progress payments give rise to a liability, section 752(b) would require the transferring partner to reduce its basis in its partnership by the

amount of that liability, either when the contract is contributed (to the extent that the liability is allocated to other partners) or when the liability is extinguished. Thus, because the proposed regulations require the partner to reduce the partner's basis in its partnership interest by the amount of progress payments received, the proposed regulations could require two reductions in basis for the same payments.

Ordinarily, progress payments do not give rise to liabilities within the meaning of section 752 and the regulations thereunder. However, to the extent that there is a case in which a progress payment gives rise to such a liability, the Treasury Department and IRS agree that taxpayers should not be required to reduce their basis twice for the same progress payment, and believe that a similar rule should be provided for transfers to corporations. Accordingly, upon a contribution of a contract accounted for under a long-term contract method of accounting to a partnership or corporation, the final regulations provide that the required reduction in basis for progress payments received does not apply to the extent that such progress payments give rise to a liability (other than a liability described in section 357(c)(3)).

Finally, one commentator suggested that the regulations clarify that the fair market value of a contract contributed to a partnership does not necessarily equal the full amount of expected remaining profit on the contributed contract. The Treasury Department and IRS believe that it is sufficiently clear under the proposed regulations that the fair market value of the contributed contract is determined under general tax principles. Thus, this comment has not been adopted.

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, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

Drafting Information

The principal authors of these regulations are Matthew Lay and Richard Probst of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, personnel from other offices of the Treasury Department and IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

■ Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

■ **Paragraph 1**. The authority citation for part 1 continues to read, in part, as follows:

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

■ **Par. 2**. Section 1.460–0 is amended as follows:
■ 1. Revising the entry for paragraph 1.460–4(k)(2)(iv).
■ 2. Adding entries for § 1.460–4(k)(2)(iv)(A) through (E).
■ 3. Revising the entry for § 1.460–4(k)(3)(iv).
■ 4. Revising the entry for § 1.460–4(k)(3)(iv)(A)(*2*) and adding entries for § 1.460–4(k)(3)(iv)(C) and (D).
■ 5. Revising the entry for § 1.460–4(k)(3)(v).
■ 6. Adding entries for § 1.460–4(k)(3)(v)(A) through (D).
■ 7. Adding entries for § 1.460–6(g)(3)(ii)(D)(*1*) and (*2*).

The revisions and additions read as follows:

§ 1.460–0 Outline of regulations under section 460.

* * * * *

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

* * * * *

(k) * * *
(2) * * *
(iv) Special rules relating to distributions of certain contracts by a partnership.
(A) In general.
(B) Old taxpayer.
(C) New taxpayer.
(D) Basis rules.
(E) Section 751.
(*1*) In general.
(*2*) Ordering rules.
(3) * * *
(iv) Special rules related to certain corporate and partnership transactions.
(A) * * *
(*2*) Basis adjustment in excess of stock or partnership interest basis.

* * * * *

(C) Definition of old taxpayer and new taxpayer for certain partnership transactions.
(D) Exceptions to step-in-the-shoes rules for S corporations.
(v) Special rules relating to certain partnership transactions.
(A) Section 704(c).
(*1*) Contributions of contracts.
(*2*) Revaluations of partnership property.
(*3*) Allocation methods.
(B) Basis adjustments under sections 743(b) and 734(b).
(C) Cross reference.
(D) Exceptions to step-in-the-shoes rules.

* * * * *

§ 1.460–6 Look-back method.

* * * * *

(g) * * *
(3) * * *
(ii) * * *
(D) * * *
(*1*) In general.
(*2*) Special rules for certain pass-through entity transactions.

* * * * *

■ **Par. 3.** Section 1.460–4 is amended as follows:
■ 1. Revising the sixth sentence in paragraph (k)(1).
■ 2. Revising paragraph (k)(2)(iv).
■ 3. Removing the first word "The" in paragraph (k)(3)(i), adding in its place "Except as otherwise provided in paragraph (k)(3)(v)(D) of this section, the".
■ 4. Revising paragraph (k)(3)(i)(I).
■ 5. Redesignating paragraphs (k)(3)(i)(J), (K) and (L) as paragraphs (k)(3)(i)(K), (L) and (M), respectively.
■ 6. Adding a new paragraph (k)(3)(i)(J).
■ 7. Revising newly designated paragraph (k)(3)(i)(K).
■ 8. Revising paragraph (k)(3)(iv).
■ 9. Revising paragraph (k)(3)(v).
■ 10. Adding paragraph (k)(5) *Example 9* through *Example 13.*
■ 11. Revising the first sentence in paragraph (k)(6).

The additions and revisions read as follows.

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

* * * * *

(k) * * *

(1) * * * Special rules relating to the treatment of certain partnership transactions are provided in paragraphs (k)(2)(iv) and (k)(3)(v) of this section. * * *

(2) * * *

(iv) *Special rules relating to distributions of certain contracts by a partnership*—(A) *In general.* The constructive completion rules of paragraph (k)(2) of this section apply both to the distribution of a contract accounted for under a long-term contract method of accounting by a

partnership to a partner and to the distribution of an interest in a partnership (lower-tier partnership) holding (either directly or through other partnerships) one or more contracts accounted for under a long-term contract method of accounting by another partnership (upper-tier partnership). Notwithstanding the previous sentence, the constructive completion rules of paragraph (k)(2) of this section do not apply to a transfer by a partnership (transferor partnership) of all of its assets and liabilities to a second partnership (transferee partnership) in an exchange described in section 721, followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership, under § 1.708–1(b)(4) (relating to terminations under section 708(b)(1)(B)) or § 1.708–1(c)(3)(i) (relating to certain partnership mergers). If a partnership that holds a contract accounted for under a long-term contract method of accounting terminates under section 708(b)(1)(A) because the number of its owners is reduced to one, the entire contract will be treated as being distributed from the partnership for purposes of the constructive completion rules, and the partnership must apply paragraph (k)(2) of this section immediately prior to the transaction or transactions resulting in the termination of the partnership.

(B) *Old taxpayer.* The partnership that distributes the contract is treated as the old taxpayer for purposes of paragraph (k)(2)(ii) of this section. For purposes of determining the total contract price (or gross contract price) under paragraph (k)(2)(ii) of this section, the fair market value of the contract is treated as the amount realized from the transaction. For purposes of determining each partner's distributive share of partnership items, any income or loss resulting from the constructive completion must be allocated among the partners of the old taxpayer as though the partnership closed its books on the date of the distribution.

(C) *New taxpayer.* The partner receiving the distributed contract is treated as the new taxpayer for purposes of paragraph (k)(2)(iii) of this section. For purposes of determining the total contract price (or gross contract price) under paragraph (k)(2)(iii) of this section, the new taxpayer's basis in the contract (including the uncompleted property, if applicable) after the distribution (as determined under section 732) is treated as consideration paid by the new taxpayer that is allocable to the contract. Thus, the total contract price (or gross contract price) of the new contract is reduced by the partner's basis in the contract (including the uncompleted property, if applicable) immediately after the distribution.

(D) *Basis rules.* For purposes of determining the new taxpayer's basis in the contract (including the uncompleted property, if applicable) under section 732, and the amount of any basis adjustment under section 734(b), the partnership's basis in the contract (including the uncompleted property, if applicable) immediately prior to the distribution is equal to—

(*1*) The partnership's allocable contract costs (including transaction costs);

(*2*) Increased (or decreased) by the amount of cumulative taxable income (or loss) recognized by the partnership on the contract through the date of the distribution (including amounts recognized as a result of the constructive completion); and

(*3*) Decreased by the amounts that the partnership has received or reasonably expects to receive under the contract.

(E) *Section 751*—(*1*) *In general.* Contracts accounted for under a long-term contract method of accounting are unrealized receivables within the meaning of section 751(c). For purposes of section 751, the amount of ordinary income or loss attributable to a contract accounted for under a long-term contract method of accounting is the amount of income or loss that the partnership would take into account under the constructive completion rules of paragraph (k)(2) of this section if the contract were disposed of for its fair market value in a constructive completion transaction, adjusted to account for any income or loss from the contract that is allocated under section 706 to that portion of the taxable year of the partnership ending on the date of the distribution, sale, or exchange.

(*2*) *Ordering rules.* Because the distribution of a contract accounted for under a long-term contract method of accounting is the distribution of an unrealized receivable, section 751(b) may apply to the distribution. A partnership that distributes a contract accounted for under a long-term contract method of accounting must apply paragraph (k)(2)(ii) of this section before applying the rules of section 751(b) to the distribution.

(3) * * *

(i) * * *

(I) Contributions of contracts accounted for under a long-term contract method of accounting to which section 721(a) applies;

(J) Contributions of property (other than contracts accounted for under a long-term contract method of accounting) to a partnership that holds a contract accounted for under a long-term contract method of accounting;

(K) Transfers of partnership interests (other than transfers which cause the partnership to terminate under section 708(b)(1)(A));

* * * * *

(iv) *Special rules related to certain corporate and partnership 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), (E), or (I) of this section, the old taxpayer must adjust its basis in the stock or partnership interest 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 (except to the extent such gross receipts give rise to a liability other than a liability described in section 357(c)(3)).

(*2*) *Basis adjustment in excess of stock or partnership interest 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 or partnership interest 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 or partnership interest 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), (E), or (I) of this section that the old taxpayer acquired in a transaction described in paragraph (k)(3)(i)(D), (E), or (I) 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), (E), or (I) 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), (E), or (I) 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 section 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) of this section).

(*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) or paragraph (k)(3)(i)(I) of this section will be computed under section 362, section 334, or section 723, 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) or paragraph (k)(3)(i)(I) 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*).

(C) *Definition of old taxpayer and new taxpayer for certain partnership transactions.* For purposes of paragraphs (k)(3)(ii), (iii) and (iv) of this section, in the case of a transaction described in paragraph (k)(3)(i)(I) of this section, the partner contributing the contract to the partnership is treated as the old taxpayer, and the partnership receiving the contract from the partner is treated as the new taxpayer.

(D) *Exceptions to step-in-the-shoes rules for S corporations.* Upon a transfer described in paragraph (k)(3)(i)(F) of this section or a conversion described in paragraph (k)(3)(i)(G) of this section, paragraphs (k)(3)(ii) and (iii) of this section apply to a contract accounted for under a long-term contract method of accounting only if the S corporation's books are closed under section 1362(e)(3), section 1362(e)(6)(C), section 1362(e)(6)(D), section 1377(a)(2), or § 1.1502–76 on the date of the transfer or conversion. In these cases, the corporation is treated as both the old taxpayer and the new taxpayer for purposes of paragraphs (k)(3)(ii) and (iii) of this section. In all other cases involving these transfers, the corporation shall compute its income or loss from each contract accounted for under a long-term contract method of accounting for the period that includes the date of the transaction as though no change in taxpayer had occurred with respect to the contract, and must allocate the income or loss from the contract for that period in accordance with the rules generally applicable to transfers of S corporation stock and conversions to or from S corporation status. This paragraph (k)(3)(iv)(D) is applicable for transactions on or after July 16, 2004. In addition, this paragraph (k)(3)(iv)(D) may be relied upon for transactions on or after May 15, 2002.

(v) *Special rules relating to certain partnership transactions*—(A) *Section 704*(c)—(*1*) *Contributions of contracts.* The principles of section 704(c)(1)(A), section 737, and the regulations thereunder apply to income or loss with respect to a contract accounted for under a long-term contract method of accounting that is contributed to a partnership. The amount of built-in income or built-in loss attributable to a contributed contract that is subject to section 704(c)(1)(A) is determined as follows. First, the contributing partner must take into account any income or loss required under paragraph (k)(3)(ii)(A) of this section for the period ending on the date of the contribution. Second, the partnership must determine the amount of income or loss that the contributing partner would take into account if the contract were disposed of for its fair market value in a constructive completion transaction. This calculation is treated as occurring immediately after the partner has applied paragraph (k)(3)(ii)(A) of this section, but before the contribution to the partnership. Finally, this amount is reduced by the amount of income, if any, that the contributing partner is required to recognize as a result of the contribution.

(*2*) *Revaluations of partnership property.* The principles of section 704(c) and § 1.704–3 apply to allocations of income or loss with respect to a long-term contract that is revalued by a partnership under § 1.704–1(b)(2)(iv)(*f*). The amount of built-in income or built-in loss attributable to such a contract is equal to the amount of income or loss that would be taken into account if, at the time of the revaluation, the contract were disposed of for its fair market value in a constructive completion transaction.

(*3*) *Allocation methods.* In the case of a contract accounted for under the CCM, any built-in income or loss under section 704(c) is taken into account in the year the contract is completed. In the case of a contract accounted for under a long-term contract method of accounting other than the CCM, any built-in income or loss under section 704(c) must be taken into account in a manner that reasonably accounts for the section 704(c) income or loss over the remaining term of the contract.

(B) *Basis adjustments under sections 743(b) and 734(b).* For purposes of §§ 1.743–1(d), 1.755–1(b), and 1.755–1(c), the amount of ordinary income or loss attributable to a contract accounted for under a long-term contract method of accounting is the amount of income or loss that the partnership would take into account under the constructive completion rules of paragraph (k)(2) of this section if, at the time of the sale of a partnership interest or the distribution to a partner, the partnership disposed of the contract for its fair market value in a constructive completion transaction. If all or part of the transferee's basis adjustment under section 743(b) or the partnership's basis adjustment under section 734(b) is allocated to a contract accounted for under a long-term contract method of accounting, the basis adjustment shall reduce or increase, as the case may be, the affected party's income or loss from the contract. In the case of a contract accounted for under the CCM, the basis adjustment is taken into account in the year in which the contract is completed. In the case of a contract accounted for under a long-term contract method of accounting other than the CCM, the portion of that basis adjustment that is recovered in each taxable year of the partnership must be determined by the partnership in a manner that reasonably accounts for the adjustment over the remaining term of the contract.

(C) *Cross reference.* See paragraph (k)(2)(iv)(E) of this section for rules relating to the application of section 751 to the transfer of an interest in a partnership holding a contract accounted for under a long-term contract method of accounting.

(D) *Exceptions to step-in-the-shoes rules.* Upon a contribution described in

paragraph (k)(3)(i)(J) of this section, a transfer described in paragraph (k)(3)(i)(K) of this section, or a distribution described in paragraph (k)(3)(i)(L) of this section, paragraphs (k)(3)(ii) and (iii) of this section apply to a contract accounted for under a long-term contract method of accounting only if the partnership's books are properly closed with respect to that contract under section 706. In these cases, the partnership is treated as both the old taxpayer and the new taxpayer for purposes of paragraphs (k)(3)(ii) and (iii) of this section. In all other cases involving these transactions, the partnership shall compute its income or loss from each contract accounted for under a long-term contract method of accounting for the period that includes the date of the transaction as though no change in taxpayer had occurred with respect to the contract, and must allocate the income or loss from the contract for that period under a reasonable method complying with section 706.

* * * * *

(5) * * *

Example 9. Constructive completion—PCM—distribution of contract by partnership —(i) *Facts.* In Year 1, W, X, Y, and Z each contribute $100,000 to form equal partnership PRS. In Year 1, PRS 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, PRS incurs costs of $600,000 and receives $650,000 in progress payments under the contract. Under the contract, PRS performed all of the services required in order to be entitled to receive the progress payments, and there was no obligation to return the payments or perform any additional services in order to retain the payments. PRS properly accounts for the contract under the PCM. In Year 2, PRS distributes the contract to X in liquidation of X's interest. PRS incurs no costs and receives no progress payments in Year 2 prior to the distribution. At the time of the distribution, PRS's only asset other than the long-term contract and the partially constructed property is $450,000 cash ($400,000 initially contributed and $50,000 in excess progress payments). The fair market value of the contract is $150,000. Pursuant to the distribution, X assumes PRS's contract obligations and rights. In Year 2, X incurs additional allocable contract costs of $50,000. X correctly estimates at the end of Year 2 that X will have to incur an additional $75,000 of allocable contract costs in Year 3 to complete the contract (rather than $150,000 as originally estimated by PRS). Assume that X properly accounts for the contract under the PCM, that PRS has no income or loss other than income or loss from the contract, and that PRS has an election under section 754 in effect in Year 2.

(ii) *Tax consequences to PRS.* For Year 1, PRS reports receipts of $750,000 (the completion factor multiplied by total contract price ($600,000/$800,000 × $1,000,000)) and costs of $600,000, for a profit of $150,000, which is allocated equally among W, X, Y, and Z ($37,500 each). Immediately prior to the distribution of the contract to X in Year 2, the contract is deemed completed. Under paragraph (k)(2)(iv)(B) of this section, the fair market value of the contract ($150,000) is treated as the amount realized from the transaction. 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 treated as realized from the transaction ($650,000 + $150,000)) and the total allocable contract costs are $600,000. Thus, in Year 2 PRS reports receipts of $50,000 (total contract price minus receipts already reported ($800,000 − $750,000)), and costs incurred in Year 2 of $0, for a profit of $50,000. Under paragraph (k)(2)(iv)(B) of this section, this profit must be allocated among W, X, Y, and Z as though the partnership closed its books on the date of the distribution. Accordingly, each partner's distributive share of this income is $12,500.

(iii) *Tax consequences to X.* X's basis in its interest in PRS immediately prior to the distribution is $150,000 (X's $100,000 initial contribution, increased by $37,500, X's distributive share of Year 1 income, and $12,500, X's distributive share of Year 2 income). Under paragraph (k)(2)(iv)(D) of this section, PRS's basis in the contract (including the uncompleted property, if applicable) immediately prior to the distribution is equal to $150,000 (the partnership's allocable contract costs, $600,000, increased by the amount of income recognized by PRS on the contract through the date of the distribution (including amounts recognized as a result of the constructive completion), $200,000, decreased by the amounts that the partnership has received or reasonably expects to receive under the contract, $650,000). Under section 732, X's basis in the contract (including the uncompleted property) after the distribution is $150,000. Under paragraph (k)(2)(iv)(C) of this section, X's basis in the contract (including the uncompleted property) is treated as consideration paid by X that is allocable to the contract. X's total contract price is $200,000 (the amount remaining to be paid under the terms of the contract less the consideration allocable to the contract ($350,000–$150,000)). For Year 2, X 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 distribution of the contract), for a profit of $30,000. For Year 3, X reports receipts of $120,000 (the total contract price minus receipts already reported ($200,000 − $80,000)) and costs of $75,000, for a profit of $45,000.

(iv) *Section 734(b).* Because X's basis in the contract (including the uncompleted property) immediately after the distribution, $150,000, is equal to PRS's basis in the contract (including the uncompleted property) immediately prior to the distribution, there is no basis adjustment under section 734(b).

Example 10. Constructive completion—CCM—distribution of contract by partnership —(i) *Facts.* The facts are the same as in *Example 9,* except that PRS and X properly account for the contract under the CCM.

(ii) *Tax consequences to PRS.* PRS reports no income or costs from the contract in Year 1. Immediately prior to the distribution of the contract to X in Year 2, the contract is deemed completed. Under paragraph (k)(2)(iv)(B) of this section, the fair market value of the contract ($150,000) is treated as the amount realized from the transaction. For purposes of applying the CCM in Year 2, the gross contract price is $800,000 (the sum of the amounts received under the contract and the amount treated as realized from the transaction ($650,000 + $150,000)) and the total allocable contract costs are $600,000. Thus, in Year 2 PRS reports profits of $200,000 ($800,000 − $600,000). This profit must be allocated among W, X, Y, and Z as though the partnership closed its books on the date of the distribution. Accordingly, each partner's distributive share of this income is $50,000.

(iii) *Tax consequences to X.* X's basis in its interest in PRS immediately prior to the distribution is $150,000 ($100,000 initial contribution, increased by $50,000, X's distributive share of Year 2 income). Under paragraph (k)(2)(iv)(D) of this section, PRS's basis in the contract (including the uncompleted property, if applicable) immediately prior to the distribution is equal to $150,000 (the partnership's allocable contract costs, $600,000, increased by the amount of cumulative taxable income recognized by PRS on the contract through the date of the distribution (including amounts recognized as a result of the constructive completion), $200,000, decreased by the amounts that the partnership has received or reasonably expects to receive under the contract, $650,000). Under section 732, X's basis in the contract (including the uncompleted property) after the distribution is $150,000. Under paragraph (k)(2)(iv)(C) of this section, X's basis in the contract is treated as consideration paid by X that is allocable to the contract. Under the CCM, X reports no gross receipts or costs in Year 2. For Year 3, the completion year, X reports its gross contract price of $200,000 (the amount remaining to be paid under the terms of the contract less the consideration allocable to the contract ($350,000 − $150,000)) and its total allocable contract costs of $125,000 (the allocable contract costs that X incurred to complete the contract ($50,000 + $75,000)), for a profit of $75,000.

(iv) *Section 734(b).* The results under section 734(b) are the same as in Example 9.

Example 11. Step-in-the-shoes—PCM—contribution of contract to partnership —(i) *Facts.* In Year 1, X enters into a contract that X properly accounts for under the PCM. 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 $600,000 and receives $650,000 in progress payments under the contract. Under the contract, X performed all of the services required in order to be entitled to receive the progress payments, and there was no obligation to return the payments or perform any additional services in order to retain the

payments. In Year 2, X contributes the contract (including the uncompleted property) with a basis of $0 and $125,000 of cash to partnership PRS in exchange for a one-fourth partnership interest. X incurs costs of $10,000, and receives no progress payments in Year 2 prior to the contribution of the contract. X and the other three partners of PRS share equally in its capital, profits, and losses. The parties determine that, at the time of the contribution, the fair market value of the contract is $160,000. Following the contribution in Year 2, PRS incurs additional allocable contract costs of $40,000. PRS 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 (rather than $150,000 as originally estimated by PRS).

(ii) *Tax consequences to X.* For Year 1, X reports receipts of $750,000 (the completion factor multiplied by the total contract price ($600,000/$800,000 × $1,000,000)) and costs of $600,000, for a profit of $150,000. Because the mid-contract change in taxpayer results from a transaction described in paragraph (k)(3)(i)(I) of this section, X is not treated as completing the contract in Year 2. Under paragraph (k)(3)(ii)(A) of this section, for Year 2, X reports receipts of $12,500 (the completion factor multiplied by the total contract price ($610,000/$800,000 × $1,000,000, or $762,500), decreased by receipts already reported, $750,000) and costs of $10,000, for a profit of $2,500. Under section 722, X's initial basis in its interest in PRS is $125,000. Pursuant to paragraph (k)(3)(iv)(A)(1) of this section, X must increase its basis in its interest in PRS by the amount of gross receipts X recognized under the contract, $762,500, 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 its interest in PRS is $237,500.

(iii) *Tax consequences to PRS.* Because the mid-contract change in taxpayer results from a step-in-the-shoes transaction, PRS must account for the contract using the same methods of accounting used by X prior to the transaction. The total contract price is the sum of any amounts that X and PRS have received or reasonably expect to receive under the contract, and total allocable contract costs are the allocable contract costs of X and PRS. For Year 2, PRS reports receipts of $134,052 (the completion factor multiplied by the total contract price [($650,000/$725,000) − $1,000,000], $896,552, decreased by receipts reported by X, $762,500) and costs of $40,000, for a profit of $94,052. For Year 3, PRS 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.

(iv) *Section 704(c).* The principles of section 704(c) and § 1.704–3 apply to allocations of income or loss with respect to the contract contributed by X. In this case, the amount of built-in income that is subject to section 704(c) is the amount of income or loss that the contributing partner would take into account if the contract were disposed of for its fair market value in a constructive completion transaction. This calculation is treated as occurring immediately after the partner has applied paragraph (k)(3)(ii)(A) of this section, but before the contribution to the partnership. In a constructive completion transaction, the total contract price would be $810,000 (the sum of the amounts received under the contract and the amount realized in the deemed sale ($650,000 + $160,000)). X would report receipts of $47,500 (total contract price minus receipts already reported ($810,000 − $762,500)) and costs of $0, for a profit of $47,500. Thus, the amount of built-in income that is subject to section 704(c) is $47,500. The partnership must apply section 704(c) to this income in a manner that reasonably accounts for the income over the remaining term of the contract. For example, in Year 2, PRS could allocate $26,810 to X under section 704(c) (the amount of built-in income, $47,500, multiplied by a fraction, the numerator of which is the completion factor for the year, $650,000/725,000, less the completion factor for the prior year, $610,000/$800,000, and the denominator of which is 100 percent reduced by the completion factor for the taxable year preceding the event creating the section 704(c) income or loss, $610,000/$800,000). The remaining $67,242 would be allocated equally among all of the partners. In Year 3, the completion year, PRS could allocate $20,690 to X under section 704(c) ($47,500 × [($725,000/$725,000 −$650,000/$725,000) / (100 percent − $610,000/$800,000)]). The remaining $7,758 would be allocated equally among all the partners.

Example 12. Step-in-the-shoes—CCM—contribution of contract to partnership —(i) *Facts.* The facts are the same as in *Example 11,* except that X and PRS properly account for the contract under the CCM, and X has a basis of $610,000 in the contract (including the uncompleted property).

(ii) *Tax consequences to X.* X reports no income or costs from the contract in Years 1 or 2. X is not treated as completing the contract in Year 2. Under section 722, X's initial basis in its interest in PRS is $735,000 (the sum of $125,000 cash and X's basis of $610,000 in the contract (including the uncompleted property)). Pursuant to paragraph (k)(3)(iv)(A)(*1*)(*ii*) of this section, X must reduce its basis in its interest in PRS by the amount of gross receipts X received under the contract, or $650,000. Accordingly, X's basis in its interest in PRS is $85,000.

(iii) *Tax consequences to PRS.* PRS must account for the contract using the same methods of accounting used by X prior to the transaction. Under the CCM, PRS reports no gross receipts or costs in Year 2. For Year 3, the completion year, PRS reports its gross contract price of $1,000,000 (the sum of any amounts that X and PRS have received or reasonably expect to receive under the contract), and total allocable contract costs of $725,000 (the allocable contract costs of X and PRS), for a profit of $275,000.

(iv) *Section 704(c).* In this case, the amount of built-in income that is subject to section 704(c) is the amount of income or loss that the contributing partner would take into account if the contract were disposed of for its fair market value in a constructive completion transaction. This calculation is treated as occurring immediately after the partner has applied paragraph (k)(3)(ii)(A) of this section, but before the contribution to the partnership. In a constructive completion transaction, X would report its gross contract price of $810,000 (the sum of the amounts received under the contract and the amount realized in the deemed sale ($650,000 + $160,000)) and its total allocable contract costs of $610,000, for a profit of $200,000. Thus, the amount of built-in income that is subject to section 704(c) is $200,000. Out of PRS's income of $275,000, in Year 3, $200,000 must be allocated to X under section 704(c), and the remaining $75,000 is allocated equally among all of the partners.

Example 13. Step-in-the-shoes—PCM—transfer of a partnership interest —(i) *Facts.* In Year 1, W, X, Y, and Z each contribute $100,000 to form equal partnership PRS. In Year 1, PRS 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, PRS incurs costs of $600,000 and receives $650,000 in progress payments under the contract. Under the contract, PRS performed all of the services required in order to be entitled to receive the progress payments, and there was no obligation to return the payment or perform any additional services in order to retain the payments. PRS properly accounts for the contract under the PCM. In Year 2, W transfers W's interest in PRS to T for $150,000. Assume that $10,000 of PRS's Year 2 costs are incurred prior to the transfer, $40,000 are incurred after the transfer; and that PRS receives no progress payments in Year 2. Also assume that the fair market value of the contract on the date of the transfer is $160,000, that PRS closes its books with respect to the contract under section 706 on the date of the transfer, and that PRS 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 (rather than $150,000 as originally estimated by PRS).

(ii) *Income reporting for period ending on date of transfer.* For Year 1, PRS reports receipts of $750,000 (the completion factor multiplied by total contract price ($600,000/$800,000 × $1,000,000)) and costs of $600,000, for a profit of $150,000. This profit is allocated equally among W, X, Y, and Z ($37,500 each). Under paragraph (k)(3)(ii)(A) of this section, for the part of Year 2 ending on the date of the transfer of W's interest, PRS reports receipts of $12,500 (the completion factor multiplied by the total contract price ($610,000/$800,000 × $1,000,000) minus receipts already reported ($750,000)) and costs of $10,000 for a profit of $2,500. This profit is allocated equally among W, X, Y, and Z ($625 each).

(iii) *Income reporting for period after transfer.* PRS must continue to use the PCM. For the part of Year 2 beginning on the day after the transfer, PRS reports receipts of $134,052 (the completion factor multiplied by the total contract price decreased by receipts reported by PRS for the period ending on the date of the transfer [($650,000/$725,000 × $1,000,000)—$762,500]) and costs of $40,000, for a profit of $94,052. This profit is shared equally among T, X, Y, and Z ($23,513 each). For Year 3, PRS 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. The profit for Year 3 is shared equally among T, X, Y, and Z ($7,112 each).

(iv) *Tax Consequences to W.* W's amount realized is $150,000. W's adjusted basis in its interest in PRS is $138,125 ($100,000 originally contributed, plus $37,500, W's distributive share of PRS's Year 1 income, and $625, W's distributive share of PRS's Year 2 income prior to the transfer). Accordingly, W's income from the sale of W's interest in PRS is $11,875. Under paragraph (k)(2)(iv)(E) of this section, for purposes of section 751(a), the amount of ordinary income attributable to the contract is determined as follows. First, the partnership must determine the amount of income or loss from the contract that is allocated under section 706 to the period ending on the date of the sale ($625). Second, the partnership must determine the amount of income or loss that the partnership would take into account under the constructive completion rules of paragraph (k)(2) of this section if the contract were disposed of for its fair market value in a constructive completion transaction. Because PRS closed its books under section 706 with respect to the contract on the date of the sale, this calculation is treated as occurring immediately after the partnership has applied paragraph (k)(3)(ii)(A) of this section on the date of the sale. In a constructive completion transaction, the total contract price would be $810,000 (the sum of the amounts received under the contract and the amount realized in the deemed sale ($650,000 + $160,000)). PRS would report receipts of $47,500 (total contract price minus receipts already reported ($810,000 − $762,500)) and costs of $0, for a profit of $47,500. Thus, the amount of ordinary income attributable to the contract is $47,500, and W's share of that income is $11,875. Thus, under § 1.751–1(a), all of W's $11,875 of income from the sale of W's interest in PRS is ordinary income.

(v) *Tax Consequences to T.* T's adjusted basis for its interest in PRS is $150,000. Under § 1.743–1(d)(2), the amount of income that would be allocated to T if the contract were disposed of for its fair market value (adjusted to account for income from the contract for the portion of PRS's taxable year that ends on the date of the transfer) is $11,875. Under § 1.743–1(b), the amount of T's basis adjustment under section 743(b) is $11,875. Under paragraph (k)(3)(v)(B) of this section, the portion of T's basis adjustment that is recovered in Year 2 and Year 3 must be determined by PRS in a manner that reasonably accounts for the adjustment over the remaining term of the contract. For example, PRS could recover $6,703 of the adjustment in Year 2 (the amount of the basis adjustment, $11,875, multiplied by a fraction, the numerator of which is the excess of the completion factor for the year, $650,000/$725,000, less the completion factor for the prior year, $610,000/$800,000, and the denominator of which is 100 percent reduced by the completion factor for the taxable year preceding the transfer, $610,000/$800,000). T's distributive share of income in Year 2 from the contract would be adjusted from $23,513 to $16,810 as a result of the basis adjustment. In Year 3, the completion year, PRS could recover $5,172 of the adjustment ($11,875 × [($725,000/$725,000 − $650,000/$725,000) / (100 percent − $610,000/$800,000)]). T's distributive share of income in Year 3, the completion year, from the contract would be adjusted from $7,112 to $1,940 as a result of the basis adjustment.

* * * * *

(6) *Effective date.* Except as provided in paragraph (k)(3)(iv)(D) of this section, this paragraph (k) is applicable for transactions on or after May 15, 2002.

* * *

■ **Par. 4.** Section 1.460–6 is amended by revising paragraphs (g)(3)(ii)(D) and (g)(4) to read as follows:

§ 1.460–6 Look-back method.

* * * * *

(g) * * *

(3) * * *

(ii) * * *

(D) *Information old taxpayer must provide*—(*1*) *In general.* Except as provided in paragraph (g)(3)(ii)(D)(*2*) of this section, 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—

(*i*) 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);

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

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

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

(*v*) 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;

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

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

(2) Special rules for certain pass-through entity transactions. For purposes of paragraph (g)(3)(ii)(D)(*1*) of this section, in the case of a transaction described in § 1.460–4(k)(3)(i)(I), the contributing partner is treated as the old taxpayer, and the partnership is treated as the new taxpayer. In the case of transactions described in § 1.460–4(k)(3)(i)(F), (G), (J), (K), or (L), the old taxpayer is not required to provide the information described in paragraph (g)(3)(ii)(D)(*1*) of this section, because information necessary for the new taxpayer to apply the look-back method is provided by the pass-through entity. This paragraph (g)(3)(ii)(D) is applicable for transactions on or after August 6, 2003.

* * * * *

(4) *Effective date.* Except as provided in paragraph (g)(3)(ii)(D) of this section, this paragraph (g) is applicable for transactions on or after May 15, 2002.

* * * * *

■ **Par. 5.** In § 1.704–3, a sentence is added at the end of paragraph (a)(3)(ii) to read as follows:

§ 1.704–3 Contributed property.

(a) * * *

(3) * * *

(ii) * * * *See* § 1.460–4(k)(3)(v)(A) for a rule relating to the amount of built-in income or built-in loss attributable to a contract accounted for under a long-term contract method of accounting.

* * * * *

■ **Par. 6.** Section 1.722–1 is amended by adding a sentence between the sixth and seventh sentences to read as follows:

§ 1.722–1 Basis of contributing partner's interest.

* * * See § 1.460–4(k)(3)(iv)(A) for rules relating to basis adjustments required where a contract accounted for under a long-term contract method of accounting is transferred in a contribution to which section 721(a) applies.

* * * * *

■ **Par. 7.** A sentence is added at the end of § 1.723–1 to read as follows:

§ 1.723–1 Basis of property contributed to partnership.

* * * See § 1.460–4(k)(3)(iv)(B)(*2*) for rules relating to adjustments to the basis of contracts accounted for using a long-term contract method of accounting that are acquired in certain contributions to which section 721(a) applies.

■ **Par. 8.** In § 1.732–1, a sentence is added at the end of paragraph (c)(1)(i) to read as follows:

§ 1.732–1 Basis of distributed property other than money.

* * * * *

(c) * * *

(1) * * *

(i) * * * See § 1.460–4(k)(2)(iv)(D) for a rule determining the partnership's basis in a long-term contract accounted for under a long-term contract method of accounting.

* * * * *

■ **Par. 9.** In § 1.734–1, the undesignated paragraph immediately following paragraph (b)(1)(ii) is revised to read as follows:

§ 1.734–1 Optional adjustment to basis of undistributed partnership property.

* * * * *

(b) * * *

(1) * * *

(ii) * * *

See § 1.460–4(k)(2)(iv)(D) for a rule determining the partnership's basis in a long-term contract accounted for under a long-term contract method of accounting. The provisions of this paragraph (b)(1) are illustrated by the following examples:

* * * * *

■ **Par. 10.** Section 1.743–1 is amended as follows:

■ 1. A sentence is added at the end of paragraph (d)(2).

■ 2. A sentence is added at the end of paragraph (j)(2).

The additions read as follows:

§ 1.743–1 Optional adjustment to basis of partnership property.

* * * * *

(d) * * *

(2) * * * See § 1.460–4(k)(3)(v)(B) for a rule relating to the computation of income or loss that would be allocated to the transferee from a contract accounted for under a long-term contract method of accounting as a result of the hypothetical transaction.

* * * * *

(j) * * *

(2) * * * See § 1.460–4(k)(3)(v)(B) for rules relating to the effect of a basis adjustment under section 743(b) that is allocated to a contract accounted for under a long-term contract method of accounting in determining the transferee's distributive share of income or loss from the contract.

* * * * *

■ **Par. 11.** In § 1.751–1, a sentence is added at the end of paragraph (a)(2) to read as follows:

§ 1.751–1 Unrealized receivables and inventory items.

(a) * * *

(2) * * * See § 1.460–4(k)(2)(iv)(E) for rules relating to the amount of ordinary income or loss attributable to a contract accounted for under a long-term contract method of accounting.

* * * * *

■ **Par. 12.** Section 1.755–1 is amended as follows.

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

■ 2. Paragraph (c)(5) is redesignated as paragraph (c)(6).

■ 3. New paragraph (c)(5) is added.

The additions read as follows:

§ 1.755–1 Rules for allocation of basis.

* * * * *

(b) * * *

(1) * * *

(ii) * * * See § 1.460–4(k)(3)(v)(B) for a rule relating to the computation of income or loss that would be allocated to the transferee from a contract accounted for under a long-term contract method of accounting as a result of the hypothetical transaction.

* * * * *

(c) * * *

(5) *Cross reference.* See § 1.460–4(k)(3)(v)(B) for a rule relating to the computation of unrealized appreciation or depreciation in a contract accounted for under a long-term contract method of accounting.

* * * * *

■ **Par. 13.** Section 1.1362–3 is amended by adding a sentence at the end of paragraph (a) to read as follows:

§ 1.1362–3 Treatment of S termination year.

(a) * * * See § 1.460–4(k)(3)(iv)(D) for rules relating to the computation of the S corporation's income or loss from a contract accounted for under a long-term contract method of accounting in the S termination year.

* * * * *

■ **Par. 14.** Section 1.1377–1 is amended by adding a sentence is at the end of paragraph (a)(1) to read as follows:

§ 1.1377–1 Pro rata share.

(a) * * *

(1) * * * See § 1.460–4(k)(3)(iv)(D) for rules relating to the computation of the shareholders' pro rata share of S corporation's income or loss from a contract accounted for under a long-term contract method of accounting.

* * * * *

Mark E. Matthews,

Deputy Commissioner for Services and Enforcement.

Approved: July 1, 2004.

Gregory Jenner,

Acting Assistant Secretary of the Treasury.

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9138]

RIN 1545–BD12

Transitional Rule for Vested Accrued Vacation Pay

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Removal of temporary regulation.

SUMMARY: This document removes a temporary regulation that provides a rule for an election to deduct vested accrued vacation pay for the first taxable year ending after July 18, 1984. The repeal of the underlying code section in 1987 has rendered the temporary regulation obsolete. The removal of this regulation will not affect taxpayers.

DATE: This Treasury decision is effective on July 15, 2004.

FOR FURTHER INFORMATION CONTACT: Jamie J. Kim at (202) 622–4950 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Prior to repeal in 1987, section 463 of the Internal Revenue Code (Code) permitted taxpayers to elect to deduct reasonable additions to a reserve account for vacation pay, including amounts earned by employees before the close of the taxable year that, because of contingencies, would not be deductible under section 162(a) as an accrued expense. In connection with the enactment of the economic performance rules under section 461(h), section 91(i) of the Tax Reform Act of 1984, Public Law 98–369 (98 Stat. 494, 609), provided a transitional rule under which certain taxpayers could make an election under section 463 for the first taxable year ending after July 18, 1984. On February 4, 1986, the IRS and Treasury published temporary regulation § 1.463–1T (TD 8073) in the **Federal Register** (51 FR 4312), as amended on April 2, 1986, (51 FR 11302), to provide guidance on making the election under section 463 pursuant to the transitional rule. The repeal of section 463 by section 10201(a) of the Revenue Act of 1987, Public Law 100–203 (101 Stat. 1330–382, 1330–387), has rendered temporary regulation § 1.463–1T obsolete.

Special Analyses

It has been determined that the removal of this regulation is not a