DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD 8929]

RIN 1545–AQ30

Accounting for Long-Term Contracts

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations describing how income from a long-term contract must be accounted for under section 460 of the Internal Revenue Code, which was enacted by the Tax Reform Act of 1986. A taxpayer manufacturing or constructing property under a long-term contract will be affected by these regulations.

DATES: *Effective Date:* These regulations are effective on January 11, 2001.

Applicability Date: These regulations apply to any contract entered into on or after January 11, 2001.

FOR FURTHER INFORMATION CONTACT: Leo F. Nolan II or John M. Aramburu of the Office of Associate Chief Counsel (Income Tax and Accounting) 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 1545–1650. Responses to this collection of information are mandatory.

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 assigned by the Office of Management and Budget.

The estimated annual burden per respondent and/or recordkeeper is 15 minutes.

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:S:O, 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, which was enacted by section 804 of the Tax Reform Act of 1986, Public Law 99–514 (100 Stat. 2085, 2358–2361), generally requires a taxpayer to determine the taxable income from a long-term contract using the percentage-of-completion method. Section 460 was amended by section 10203 of the Omnibus Budget Reconciliation Act of 1987, Public Law 100–203 (101 Stat. 1330, 1330–394); by sections 1008(c) and 5041 of the Technical and Miscellaneous Revenue Act of 1988, Public Law 100–647 (102 Stat. 3342, 3438–3439 and 3673–3676); by sections 7621 and 7811(e) of the Omnibus Budget Reconciliation Act of 1989, Public Law 101–239 (103 Stat. 2106, 2375–2377 and 2408–2409); by section 11812 of the Omnibus Budget Reconciliation Act of 1990, Public Law 101–508 (104 Stat. 1388, 1388–534 to 1388-536); by sections 1702(h)(15) and 1704(t)(28) of the Small Business Job Protection Act of 1996, Public Law 104–188 (110 Stat. 1755, 1874, 1888); and by section 1211 of the Taxpayer Relief Act of 1997, Public Law 105–34 (111 Stat. 788, 998–1000).

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 5, 1999, the IRS and Treasury Department published a notice of proposed rulemaking (64 FR 24096 [REG–208156–91, 1999–22 I.R.B. 11]) relating to section 460. Comments responding to the notice were received, and a public hearing was scheduled for September 14, 1999.

The IRS and Treasury Department received eleven comment letters concerning the notice of proposed rulemaking. After considering the comments contained in these letters, the IRS and Treasury Department adopt the proposed regulations as revised by this Treasury decision. The comments and revisions are discussed below.

Explanation of Provisions

1. Overview

Section 460 generally requires the income from a long-term contract to be determined using the percentage-of-completion method based on a cost-to-cost comparison (PCM). However, the income from exempt construction contracts still may be determined using the completed-contract method (CCM), the exempt-contract percentage-of-completion method (EPCM), or any other permissible method. Contracts that are not long-term contracts must be accounted for using a permissible method of accounting other than a long-term contract method (*i.e.,* a method other than the PCM, the CCM, or the EPCM). See section 446 and the regulations thereunder.

One commentator suggested that the exceptions to the mandatory use of the PCM included in the proposed regulations be expanded to include ''any portion of the long-term manufacturing contract for which no payment for the manufacture of the subject matter of the contract is required to be made before the manufacture of the item is completed.'' The exceptions contained in the proposed regulations were specifically provided by the statute and the statute does not include the suggestion made by the commentator. Thus, the IRS and Treasury Department did not adopt this suggestion.

2. Definition of Long-Term Contract

Under section 460(f), ''long-term contract'' generally means any contract for the building, installation, construction (construction), or the manufacture, of property if the contract is not completed within the taxable year the taxpayer enters into the contract (contracting year). However, a manufacturing contract is not a long-term contract unless it involves the manufacture of (1) a unique item of a type that is not normally included in the finished goods inventory of the taxpayer or (2) an item normally requiring more than 12 calendar months to complete, regardless of the duration of the contract.

Continuing the policy established in Notice 89–15 (1989–1 C.B. 634), the proposed regulations provide that it is not relevant whether the customer has title to, control over, or risk of loss with respect to the property. One commentator suggested that the final regulations should not retain the rule that requires a contractor to ignore title and risk-of-loss issues relative to the applicability of section 460 because a contractor has little freedom to restructure a contract to ''construct'' into a contract to ''sell.'' The IRS and Treasury Department did not adopt this suggestion because we believe that a contract's classification should be based on the performance required of the taxpayer under the contract regardless of whether that contract otherwise would be classified as a sales contract or a construction or manufacturing contract. Moreover, the IRS and Treasury Department continue to believe that the rule in the proposed regulations is necessary to prevent a taxpayer from circumventing section 460 by structuring a construction contract to resemble a sales contract without changing the taxpayer's obligations under the contract. Another commentator asked whether a contract is subject to section 460 if it requires the taxpayer to manufacture or construct property in order to fulfill its contractual obligation but the property is never delivered to the customer (*e.g.*, a research contract for test results). Again, the IRS and Treasury Department believe that a contract's classification should depend upon the performance required of the taxpayer under the contract. Thus, the final regulations clarify that it is irrelevant whether title in the property manufactured or constructed under the contract is delivered to the customer.

The proposed regulations provide that a contract is not a construction contract if it requires the taxpayer to provide land to the customer and the estimated total allocable contract costs attributable to the taxpayer's construction activities are less than 10 percent of the contract's total contract price. One commentator asked for clarification concerning whether the estimated total allocable contract costs attributable to the taxpayer's construction activities includes the cost of the land provided under the contract. The final regulations clarify that the cost of this land is not an allocable contract cost when the taxpayer determines whether the cost of its construction activities is less than 10 percent of the contract's total contract price.

3. Date Taxpayer Completes a Long-Term Contract

The proposed regulations provide that a long-term contract is completed in the earlier taxable year (completion year) that: (1) The customer uses the subject matter of the contract (other than for testing) and at least 95 percent of the total allocable contract costs attributable to the subject matter have been incurred by the taxpayer; or (2) the subject matter of the contract is finally completed and accepted. To the extent that the ''customer-use'' rule requires a taxpayer to treat a contract as completed before final completion and acceptance have occurred, the proposed regulations explicitly adopt a rule different from that considered in *Ball, Ball and Brosamer, Inc.* v. *Commissioner,* 964 F.2d 890 (9th Cir. 1992), *aff'g* T.C. Memo. 1990–454.

Some commentators argued against having a rule that will declare a contract completed earlier than under the finally-completed-and-accepted standard illustrated in *Ball.* Some commentators also argued that the customer-use rule is confusing to subcontractors because it is unclear whether a subcontractor's ''customer'' is the general, or ''prime,'' contractor or the ultimate owner of the property. On the other hand, one commentator asked for a bright-line standard for completion and suggested, among other possibilities, that completion occur when 95 percent of the estimated costs have been incurred.

The IRS and Treasury Department continue to believe that a contract is complete for all practical purposes when the customer uses the subject matter of that contract and the taxpayer has only five percent or less of the total allocable contract costs remaining to be incurred. Delaying a contract's completion beyond this point, as the Tax Court permitted in *Ball,* does not reflect the substance of the transaction and could encourage the use of formalities to delay a contract's completion unreasonably. Thus, the final regulations do not substantively change the customer-use rule contained in the proposed regulations. However, the final regulations clarify that a subcontractor's customer is the general contractor.

Several commentators expressed concern that the customer-use rule contained in the proposed regulations will create additional administrative burdens for taxpayers using the PCM because they often will have to apply the look-back method two times, first upon customer use and again upon final completion and acceptance. Though the IRS and Treasury Department believe that the customer-use rule results in an appropriate determination of completion, we understand these concerns. Thus, to simplify a taxpayer's reporting requirements under the look-back method, the IRS and Treasury Department have modified the look-back regulations to require a taxpayer to delay the first application of the look-back method until the taxable year in which a long-term contract is finally completed and accepted.

4. Severing and Aggregating Contracts

The proposed regulations allow the Commissioner, and generally require a taxpayer, to sever and aggregate contracts when necessary to clearly reflect income. The proposed regulations provide the following criteria for determining whether severance or aggregation is required: Independent versus interdependent pricing, separate delivery or acceptance, and the reasonable businessperson standard. However, under the proposed regulations, a taxpayer may not sever a contract subject to the PCM. In addition, the proposed regulations require a taxpayer to notify the Commissioner when severing a long-term contract not accounted for using the PCM and provide agreement-specific information, including the criteria for severing or aggregating the agreement.

Some commentators criticized the ''no severance'' rule for long-term contracts subject to the PCM. The ''no severance'' rule is provided in the proposed regulations because the IRS and Treasury Department believe that in most cases, a taxpayer's use of the PCM and look-back method will clearly reflect the taxpayer's income from a long-term contract. To date, the only identified reason to allow severance of a contract subject to the PCM related to the application of the 10-percent method as shown in § 1.460–1(j) *Example 8* of the proposed income tax regulations. Conversely, the IRS and Treasury Department believe that permitting a taxpayer to sever a contract subject to the PCM could allow the taxpayer to manipulate taxable income (*e.g.,* by severing to create a loss contract and accelerate the loss) or to avoid the application of section 460 (*e.g.,* by ''completing'' the contract during the contracting year). Nonetheless, the IRS and Treasury Department agree with the commentators' concerns that to the extent severance is necessary to clearly reflect income from a long-term contract (*e.g.,* due to the application of the 10-percent method), it should be permitted. Accordingly, the final regulations allow a taxpayer to sever a long-term contract if necessary to clearly reflect income, but only if the taxpayer has obtained the Commissioner's prior written consent.

Some commentators criticized the notification requirement for severed and aggregated contracts as being unduly burdensome. The IRS and Treasury Department continue to believe that notification will help taxpayers and the IRS consistently apply the severing and aggregating rules. In recognition of the potential burden associated with the proposed notification requirement, however, the final regulations simplify the notification by only requiring that a taxpayer inform the IRS when it has severed or aggregated agreements. Thus, the taxpayer is no longer required to provide agreement-specific information.

One commentator suggested that the reasonable businessperson standard be eliminated because it is merely a subset of independent pricing and interdependent pricing (the pricing standards), which should be the primary criteria for determining whether long-term contracts must be severed or aggregated to clearly reflect income. The IRS and Treasury Department agree that the pricing standards and the reasonable businessperson standard overlap, but believe that the pricing standard is a subset of the reasonable businessperson standard. Besides requiring an analysis of pricing, the reasonable businessperson standard requires an analysis of all the facts and circumstances of the business arrangement between the taxpayer and the customer. Thus, because the absence of the reasonable businessperson standard might change the decision to sever or aggregate in some cases, the final regulations retain this criterion and clarify its distinction from the pricing standards.

5. Hybrid Contracts

Under the proposed regulations, a taxpayer generally must classify a contract that requires the taxpayer to manufacture personal property and to construct real property (hybrid contract) as separate manufacturing and construction contracts. If at least 95 percent of the estimated allocable contract costs are reasonably allocable to manufacturing (or construction) activities, the taxpayer may classify the contract as a manufacturing (or construction) contract.

One commentator suggested that the final regulations allow a taxpayer to elect to use the PCM to account for a hybrid contract instead of requiring the taxpayer to account for both parts separately. The IRS and Treasury Department agree with the commentator's request for simplification. Accordingly, the final regulations allow a taxpayer to elect, on a contract-by-contract basis, to classify a hybrid contract as a long-term manufacturing contract subject to the PCM. In addition, because this election effectively supersedes the 95-percent election that would have applied to hybrid contracts that are primarily manufacturing contracts, the final regulations retain the 95-percent election as a second election that applies only to hybrid contracts that are primarily construction contracts.

6. Contracts of Related Parties

The proposed regulations provide that if a related party and its customer enter into a long-term contract subject to the PCM, and a taxpayer performs any activity that is incident to or necessary for the related party's long-term contract, the taxpayer must account for the gross receipts and costs attributable to the activity using the PCM. However, the proposed regulations contain an inventory exception for components and subassemblies produced by the taxpayer if the taxpayer regularly carries these items in its finished goods inventories and 80 percent or more of the gross receipts from the sale of these items typically comes from unrelated parties.

One commentator suggested that the percentage threshold be lowered from 80 percent to 50 percent and that the exception not be limited to items regularly carried in the taxpayer's finished goods inventories. The IRS and Treasury Department included the related party rule, originally promulgated in Notice 89–15, in the proposed regulations to prevent taxpayers from establishing special-purpose subsidiaries to avoid the application of section 460. However, in recognition that a related party that sells most units of a manufactured item to unrelated parties was not established for the purpose of avoiding section 460, the IRS and Treasury Department added the inventory exception to the proposed regulations to reduce the related party's accounting burden. The IRS and Treasury Department agree, however, that the inventory exception is too narrow. Accordingly, the final regulations lower the percentage threshold from ''80 percent or more'' to ''more than 50 percent'' and eliminate the requirement that the components or subassemblies be carried in finished goods inventories.

7. Unique Items

Section 460 applies if a taxpayer manufactures a unique item of a type that is not normally included in the finished goods inventory of the taxpayer and if the contract is not completed by the close of the contracting year. The proposed regulations provide that ''unique'' means specifically designed for the needs of a customer. In addition, the proposed regulations contain three safe harbors concerning contracts to manufacture unique items. First, an item is not unique if the taxpayer normally completes the item within 90 days. Second, an item is not unique if the total allocable contract costs attributable to customizing activities that are incident to or necessary for the production of the item do not exceed 5 percent of the estimated total costs allocable to the item. Third, a unique item ceases to be unique no later than when the taxpayer normally includes similar items in its finished goods inventory. For an item that does not satisfy one of these three safe harbors, the determination of whether the item is unique is based on the facts and circumstances.

Some commentators suggested that the final regulations contain either a 140-day or a 180-day safe harbor instead of the 90-day safe harbor. The IRS and Treasury Department did not adopt these suggestions because we believe that a 90-day safe harbor appropriately limits the meaning of ''unique'' in most cases. However, the IRS and Treasury Department have modified the 90-day safe harbor to clarify that in the case of a contract to manufacture multiple units of the same item, the 90-day safe harbor applies only if each unit normally is completed within 90 days.

Some commentators suggested that the final regulations contain either a 10-percent, 15-percent, or 20-percent safe harbor instead of the 5-percent safe harbor. In particular, these commentators stated that a 5-percent safe harbor will not alleviate any controversy between taxpayers and revenue agents because revenue agents generally do not raise the issue of unique items if the taxpayer's customizing costs do not exceed 5 percent. The IRS and Treasury Department agree that it is reasonable to assume that an item is not unique if the taxpayer's customizing costs do not exceed 10 percent. Thus, the customization safe harbor in the final regulations has been increased to 10 percent.

One commentator suggested that the cost of a taxpayer's customizing activities should not include the cost of any customized equipment purchased by a taxpayer from an unrelated party under a ''special accommodation'' arrangement with the customer that requires the taxpayer to acquire and install that customized equipment. The IRS and Treasury Department did not adopt this suggestion because such a special accommodation rule could enable taxpayers to avoid section 460 by having some long-term contract activities performed by outside parties.

Several commentators questioned the relevance of the ''basic design'' concept included in § 1.460–2(e) *Example 1* of the proposed regulations. To determine whether an item is unique, the relevant analysis is whether an item is customized (or manufactured according to a customer's specifications) regardless of whether the item is customized from a basic design. Accordingly, the final regulations delete the reference to the taxpayer's basic design in the example to eliminate any confusion.

One commentator questioned how the safe harbor applies in the case of a contract to manufacture multiple units of the same item. The IRS and Treasury Department believe that if significant customization is necessary to produce an item for a customer under the contract, that item is specifically designed for the needs of the customer, and thus is a unique item, regardless of the number of units produced for the customer under the contract. Thus, the final regulations clarify that for the purposes of applying the 10-percent safe harbor to a contract to manufacture multiple units of the same item, a taxpayer must allocate all customization costs to the first unit manufactured under the contract.

Some commentators suggested the addition of a fourth safe harbor that would exclude ''income on contracts for which progress payments have not been received by year end.'' The IRS and Treasury Department did not adopt this suggestion because we do not believe that such a rule bears any relationship to a determination of the uniqueness of an item and because such a rule is inconsistent with the statute.

8. 12-Month Completion Period

The proposed regulations provide that a manufactured item normally requires more than 12 months to complete if its ''production period,'' as defined in § 1.263A–12, is reasonably expected to exceed 12 months, determined at the end of the contracting year. In general, the production period for an item or unit begins when the taxpayer incurs at least 5 percent of the estimated total allocable contract costs, including planning and design expenditures, allocable to the item or unit, and the production period ends when the item or unit is ready for shipment to the taxpayer's customer.

Some commentators suggested that the final regulations be clarified to provide that ''normal time to complete'' includes only the time of physical production activity and not the time of any research, development, planning, or design activity. The IRS and Treasury Department did not adopt this suggestion because we believe that the definition of ''production period'' under § 1.263A–12(c)(3), which includes the time required for planning and design activity, is consistent with the allocation of costs to extended-period long-term contracts under § 1.451–3(d)(6) and with section 460(c)(1), which requires that costs be allocated under the rules applicable to extended-period long-term contracts. In addition, if an item manufactured under a long-term contract requires a significant amount of design time to produce, it is appropriate to include the time needed to perform these activities when determining that item's ''normal time to complete'' because these activities are directly attributable to that contract and are necessary to manufacture the subject matter of the contract. However, the final regulations clarify that a taxpayer is not required to consider activities related to costs that are not allocable contract costs under section 460 (*e.g.*, independent research and development expenses, marketing expenses) when determining the item's normal time to complete.

Some commentators asked how the 12-month rule applies in the case of a contract to manufacture multiple units of the same item. The final regulations clarify, that for the purposes of applying the 12-month rule to this type of contract, the time required to design and manufacture the first unit generally does not reflect the item's ''normal time to complete.'' For example, the time required to design the first unit of an item should not be considered as time required to manufacture subsequent identical units. The final regulations also include an example illustrating the determination of normal time to complete an item in the case of a contract to manufacture multiple units of the same item.

9. Percentage-of-Completion Method

The proposed regulations provide that, under the PCM, a taxpayer 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. Under the proposed regulations, total contract price included all bonuses, awards, and incentive payments if it is reasonably estimated that they will be received, even if the all events test has not yet been met. If, by the end of the completion year, a taxpayer cannot reasonably estimate whether a contingency will be satisfied, the bonus, award, or incentive payment is not includible in total contract price.

Some commentators argued that a taxpayer should not have to include contingent compensation in ''total contract price'' until the all events test for the item has been satisfied. The IRS and Treasury Department did not adopt this suggestion because the all events test is a judicially created test applying to taxpayers using an accrual method. *U.S.* v. *Anderson*, 269 U.S. 422 (1926). Conversely, section 460 is a self-contained, statutorily created accounting method that requires taxpayers to use estimated amounts when computing taxable income under the PCM and to use actual amounts when applying the look-back method. In addition, using the most accurate estimate of total contract price and total contract costs will produce the most accurate annual reporting of income and costs and will minimize discrepancies that could necessitate paying look-back interest. See *Tutor-Saliba Corp.* v. *Commissioner*, 115 T.C. No. 1 (July 17, 2000). However, in response to comments and questions concerning the contingent income rule, the final regulations provide that contingent income is includible in total contract price not later than when it is included in income for financial reporting purposes under generally accepted accounting principles.

One commentator suggested that the final regulations incorporate the rule under § 1.451–3(a)(1) that allows a taxpayer to account for long-term contracts of less-than-substantial duration using a method of accounting other than a long-term contract method of accounting. The IRS and Treasury Department did not adopt this suggestion because such a rule would be inconsistent with the statutory definition of ''long-term contract.''

One commentator asked how a contractor should account for the subject matter of a long-term contract when the customer breaches that contract before the contractor has transferred title to the customer but after the contractor has reported taxable income from that contract under the PCM (*e.g.*, unfinished condominium unit). In response to this comment, the final regulations include new § 1.460–4(b)(7), which provides that if a long-term contract is terminated before completion and, as a result, the taxpayer retains ownership of the property that is the subject matter of that contract, the taxpayer must reverse the previously reported gross income (loss) from the transaction in the taxable year of termination. As a result of reversing its previously reported gross income under this rule, a taxpayer generally will have an adjusted basis in the retained property equal to its previously deducted allocable contract costs. The look-back method does not apply to any terminated contract to the extent it is subject to this rule. The IRS and Treasury Department request suggestions for rules that will apply when the customer acquires ownership of some, but not all, of the property that is the subject matter of the contract.

10. Cost Allocation Rules

The proposed and final regulations provide that 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.

One commentator argued that the final regulations should contain a single standard for determining when the cost of a direct material is allocable to a long-term contract. In response to this comment, the final regulations contain a single standard linked to the uniform capitalization (UNICAP) rules of section 263A. The final regulations also clarify that, among other methods, a taxpayer dedicates direct materials by associating them with a specific contract (*e.g.,* by purchase order, entry on books and records, shipping instructions).

One commentator suggested that the final regulations clarify that taxpayers should not treat software development and software implementation costs as customization costs for the purposes of the proposed 5-percent safe harbor. The IRS and Treasury Department did not adopt this suggestion because we believe that software costs are allocable contract costs (and thus customization costs) to the extent they are incident to or necessary for the manufacture of the subject matter of the contract.

This commentator also suggested that the final regulations clarify that taxpayers should not treat guarantee, warranty, and maintenance costs as customization costs for the purposes of the proposed 5-percent safe harbor. The IRS and Treasury Department modified § 1.460–1(d)(2) to clarify that these types of costs are not allocable contract costs.

11. Simplified Cost-to-Cost Method

The proposed regulations generally permit a taxpayer to elect to allocate contract costs using the simplified cost-to-cost method. Under the simplified cost-to-cost method, a taxpayer must determine a contract's completion factor based upon only direct material costs; direct labor costs; and depreciation, amortization, and cost recovery allowances on equipment and facilities directly used to manufacture or construct property under the contract.

One commentator suggested that the final regulations clarify whether a taxpayer using the simplified cost-to-cost method is allowed or required to include subcontracted costs in a contract's completion factor. In response to this comment, the final regulations clarify that subcontracted costs represent either direct material or direct labor costs and thus must be allocated to a contract under the simplified cost-to-cost method when incurred under § 1.461–4(d)(2)(ii). In addition, a taxpayer must allocate subcontracted costs for all section 460 purposes (*e.g.,* applying the 10-percent safe harbor under § 1.460–2(b)(2)(ii)).

12. Statute of Limitations and Compound Interest on Look-Back Interest

One commentator requested guidance concerning the statute of limitations applicable to payments of, and claims for, look-back interest. The final regulations amend § 1.460–6(f)(1) and (2) to clarify the reporting requirements and add new § 1.460–6(f)(3). New § 1.460–6(f)(3) provides guidance on the statute of limitations applicable to the assessment and collection of look-back interest owed by a taxpayer. In addition, new § 1.460–6(f)(3) provides that a taxpayer's claim for credit or refund of look-back interest previously paid by or collected from the taxpayer is a claim for credit or refund of an overpayment of tax for federal income tax purposes, which is subject to the section 6511 statute of limitations. In contrast, new § 1.460–6(f)(3) provides that a taxpayer's claim for look-back interest (or interest payable on look-back interest) that is not attributable to an amount previously paid by or collected from the taxpayer is a general claim against the federal government, which is subject to the statutes of limitations found in 28 U.S.C. sections 2401 and 2501.

13. Effective Date

These final regulations apply to any contract entered into on or after January 11, 2001.

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. Pursuant to section 7805(f) of the Internal Revenue Code, this Treasury decision was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business. 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. The regulations require a taxpayer to attach a statement to its original federal income tax return if the taxpayer severs or aggregates a long-term contract. The statement is needed so the Commissioner can determine whether the taxpayer properly severed or aggregated the contract. It is uncommon for a taxpayer that has a long-term contract to sever or aggregate that contract. In addition, if a contract is severed or aggregated and a statement is required, it is estimated that it will, on average, require only 15 minutes to complete.

Drafting Information

The principal author of these regulations is Leo F. Nolan II, 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 parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation is amended by removing the entry for ''Section 1.451–3 and 1.451–5'', revising the entry for ''Section 1.460–4'', and adding the following entries in numerical order to read as follows:

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

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Section 1.451–5 also issued under 96 Stat. 324, 493.

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Section 1.460–1 also issued under 26 U.S.C. 460(h).
Section 1.460–2 also issued under 26 U.S.C. 460(h).
Section 1.460–3 also issued under 26 U.S.C. 460(h).
Section 1.460–4 also issued under 26 U.S.C. 460(h) and 1502.
Section 1.460–5 also issued under 26 U.S.C. 460(h).

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§ 1.446–1 [Amended]

Par. 2. Section 1.446–1 is amended as follows:

1. In the second sentence of paragraph (c)(1)(iii), the language ''451'' is removed and ''460'' is added in its place.

2. In the fourth sentence of paragraph (e)(2)(ii)(*a*), the language ''§ 1.451–3'' is

removed and ''§ 1.460–4'' is added in its place.

§ 1.451–3 [Removed]

Par. 3. Section 1.451–3 is removed.

§ 1.451–5 [Amended]

Par. 4. Section 1.451–5 is amended by removing the language ''§ 1.451–3'' and adding ''§ 1.460–4'' in its place in the first sentence of paragraph (b)(3).

Par. 5. Section 1.460–0 is amended by:

1. Revising the introductory text.
2. Revising the entries for §§ 1.460–1 through 1.460–3, 1.460–4(a) through (i), and 1.460–5.
3. Adding an entry for § 1.460–4(k).
4. Removing the entry for § 1.460–6(c)(4)(iv).
5. Adding an entry for § 1.460–6(f)(3).
6. Removing the entries for §§ 1.460–7 and 1.460–8.

The revisions and addition read as follows:

§ 1.460–0 Outline of regulations under section 460.

This section lists the paragraphs contained in § 1.460–1 through § 1.460–6.

§ 1.460–1 Long-term contracts.

(a) Overview.
(1) In general.
(2) Exceptions to required use of PCM.
(i) Exempt construction contract.
(ii) Qualified ship or residential construction contract.
(b) Terms.
(1) Long-term contract.
(2) Contract for the manufacture, building, installation, or construction of property.
(i) In general.
(ii) De minimis construction activities.
(3) Allocable contract costs.
(4) Related party.
(5) Contracting year.
(6) Completion year.
(7) Contract commencement date.
(8) Incurred.
(9) Independent research and development expenses.
(10) Long-term contract methods of accounting.
(c) Entering into and completing long-term contracts.
(1) In general.
(2) Date contract entered into.
(i) In general.
(ii) Options and change orders.
(3) Date contract completed.
(i) In general.
(ii) Secondary items.
(iii) Subcontracts.
(iv) Final completion and acceptance.
(A) In general.
(B) Contingent compensation.
(C) Assembly or installation.
(D) Disputes.
(d) Allocation among activities.
(1) In general.
(2) Non-long-term contract activity.
(e) Severing and aggregating contracts.
(1) In general.
(2) Facts and circumstances.
(i) Pricing.
(ii) Separate delivery or acceptance.
(iii) Reasonable businessperson.
(3) Exceptions.
(i) Severance for PCM.
(ii) Options and change orders.
(4) Statement with return.
(f) Classifying contracts.
(1) In general.
(2) Hybrid contracts.
(i) In general.
(ii) Elections.
(3) Method of accounting.
(4) Use of estimates.
(i) Estimating length of contract.
(ii) Estimating allocable contract costs.
(g) Special rules for activities benefitting long-term contracts of a related party.
(1) Related party use of PCM.
(i) In general.
(ii) Exception for components and subassemblies.
(2) Total contract price.
(3) Completion factor.
(h) Effective date.
(1) In general.
(2) Change in method of accounting.
(i) [Reserved]
(j) Examples.

§ 1.460–2 Long-term manufacturing contracts.

(a) In general.
(b) Unique.
(1) In general.
(2) Safe harbors.
(i) Short production period.
(ii) Customized item.
(iii) Inventoried item.
(c) Normal time to complete.
(1) In general.
(2) Production by related parties.
(d) Qualified ship contracts.
(e) Examples.

§ 1.460–3 Long-term construction contracts.

(a) In general.
(b) Exempt construction contracts.
(1) In general.
(2) Home construction contract.
(i) In general.
(ii) Townhouses and rowhouses.
(iii) Common improvements.
(iv) Mixed use costs.
(3) $10,000,000 gross receipts test.
(i) In general.
(ii) Single employer.
(iii) Attribution of gross receipts.
(c) Residential construction contracts.

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

(a) Overview.
(b) Percentage-of-completion method.
(1) In general.
(2) Computations.
(3) Post-completion-year income.
(4) Total contract price.
(i) In general.
(A) Definition.
(B) Contingent compensation.
(C) Non-long-term contract activities.
(ii) Estimating total contract price.
(5) Completion factor.
(i) Allocable contract costs.
(ii) Cumulative allocable contract costs.
(iii) Estimating total allocable contract costs.
(iv) Pre-contracting-year costs.
(v) Post-completion-year costs.
(6) 10-percent method.
(i) In general.
(ii) Election.
(7) Terminated contract.
(i) Reversal of income.
(ii) Adjusted basis.
(iii) Look-back method.
(c) Exempt contract methods.
(1) In general.
(2) Exempt-contract percentage-of-completion method.
(i) In general.
(ii) Determination of work performed.
(d) Completed-contract method.
(1) In general.
(2) Post-completion-year income and costs.
(3) Gross contract price.
(4) Contracts with disputed claims.
(i) In general.
(ii) Taxpayer assured of profit or loss.
(iii) Taxpayer unable to determine profit or loss.
(iv) Dispute resolved.
(e) Percentage-of-completion/capitalized-cost method.
(f) Alternative minimum taxable income.
(1) In general.
(2) Election to use regular completion factors.
(g) Method of accounting.
(h) Examples.
(i) [Reserved]

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(k) Mid-contract change in taxpayer [Reserved]

§ 1.460–5 Cost allocation rules.

(a) Overview.
(b) Cost allocation method for contracts subject to PCM.
(1) In general.
(2) Special rules.
(i) Direct material costs.
(ii) Components and subassemblies.
(iii) Simplified production methods.
(iv) Costs identified under cost-plus long-term contracts and federal long-term contracts.
(v) Interest.
(A) In general.
(B) Production period.
(C) Application of section 263A(f).
(vi) Research and experimental expenses.
(vii) Service costs.
(A) Simplified service cost method.
(*1*) In general.
(*2*) Example.
(B) Jobsite costs.
(C) Limitation on other reasonable cost allocation methods.
(c) Simplified cost-to-cost method for contracts subject to the PCM.
(1) In general.
(2) Election.
(d) Cost allocation rules for exempt construction contracts reported using CCM.
(1) In general.
(2) Indirect costs.
(i) Indirect costs allocable to exempt construction contracts.

(ii) Indirect costs not allocable to exempt construction contracts.
(3) Large homebuilders.
(e) Cost allocation rules for contracts subject to the PCCM.
(f) Special rules applicable to costs allocated under this section.
(1) Nondeductible costs.
(2) Costs incurred for non-long-term contract activities.
(g) Method of accounting.

§ 1.460–6 Look-back method.

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(f) * * *

(3) Statutes of limitations and compounding of interest on look-back interest.

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Par. 6. Sections 1.460–1 through 1.460–3 are revised to read as follows:

§ 1.460–1 Long-term contracts.

(a) *Overview*—(1) *In general*. This section provides rules for determining whether a contract for the manufacture, building, installation, or construction of property is a long-term contract under section 460 and what activities must be accounted for as a single long-term contract. Specific rules for long-term manufacturing and construction contracts are provided in §§ 1.460–2 and 1.460–3, respectively. A taxpayer generally must determine the income from a long-term contract using the percentage-of-completion method described in § 1.460–4(b) (PCM) and the cost allocation rules described in § 1.460–5(b) or (c). In addition, after a contract subject to the PCM is completed, a taxpayer generally must apply the look-back method described in § 1.460-6 to determine the amount of interest owed on any hypothetical underpayment of tax, or earned on any hypothetical overpayment of tax, attributable to accounting for the long-term contract under the PCM.

(2) *Exceptions to required use of PCM*—(i) *Exempt construction contract.* The requirement to use the PCM does not apply to any exempt construction contract described in § 1.460–3(b). Thus, a taxpayer may determine the income from an exempt construction contract using any accounting method permitted by § 1.460–4(c) and, for contracts accounted for using the completed-contract method (CCM), any cost allocation method permitted by § 1.460–5(d). Exempt construction contracts that are not subject to the PCM or CCM are not subject to the cost allocation rules of § 1.460–5 except for the production-period interest rules of § 1.460–5(b)(2)(v). Exempt construction contractors that are large homebuilders described in § 1.460–5(d)(3) must capitalize costs under section 263A. All other exempt construction contractors must account for the cost of construction using the appropriate rules contained in other sections of the Internal Revenue Code or regulations.

(ii) *Qualified ship or residential construction contract.* The requirement to use the PCM applies only to a portion of a *qualified ship contract* described in § 1.460–2(d) or *residential construction contract* described in § 1.460–3(c). A taxpayer generally may determine the income from a qualified ship contract or residential construction contract using the percentage-of-completion/capitalized-cost method (PCCM) described in § 1.460–4(e), but must use a cost allocation method described in § 1.460–5(b) for the entire contract.

(b) *Terms*—(1) *Long-term contract. A long-term contract* generally is any contract for the manufacture, building, installation, or construction of property if the contract is not completed within the contracting year, as defined in paragraph (b)(5) of this section. However, a contract for the manufacture of property is a long-term contract only if it also satisfies either the unique item or 12-month requirements described in § 1.460–2. A contract for the manufacture of personal property is a *manufacturing contract*. In contrast, a contract for the building, installation, or construction of real property is a *construction contract.*

(2) *Contract for the manufacture, building, installation, or construction of property*—(i) *In general.* A contract is a *contract for the manufacture, building, installation, or construction of property* if the manufacture, building, installation, or construction of property is necessary for the taxpayer's contractual obligations to be fulfilled and if the manufacture, building, installation, or construction of that property has not been completed when the parties enter into the contract. If a taxpayer has to manufacture or construct an item to fulfill its obligations under the contract, the fact that the taxpayer is not required to deliver that item to the customer is not relevant. Whether the customer has title to, control over, or bears the risk of loss from, the property manufactured or constructed by the taxpayer also is not relevant. Furthermore, how the parties characterize their agreement (*e.g.,* as a contract for the sale of property) is not relevant.

(ii) *De minimis construction activities.* Notwithstanding paragraph (b)(2)(i) of this section, a contract is not a construction contract under section 460 if the contract includes the provision of land by the taxpayer and the estimated total allocable contract costs, as defined in paragraph (b)(3) of this section, attributable to the taxpayer's construction activities are less than 10 percent of the contract's total contract price, as defined in § 1.460–4(b)(4)(i). For the purposes of this paragraph (b)(2)(ii), the allocable contract costs attributable to the taxpayer's construction activities do not include the cost of the land provided to the customer. In addition, a contract's estimated total allocable contract costs include a proportionate share of the estimated cost of any common improvement that benefits the subject matter of the contract if the taxpayer is contractually obligated, or required by law, to construct the common improvement.

(3) *Allocable contract costs. Allocable contract costs* are costs that are allocable to a long-term contract under § 1.460–5.

(4) *Related party*. A *related party* is a person whose relationship to a taxpayer is described in section 707(b) or 267(b), determined without regard to section 267(f)(1)(A) and determined by replacing ''at least 80 percent'' with ''more than 50 percent'' for the purposes of determining the ownership of the stock of a corporation in sections 267(b)(2), (8), (10)(A), and (12).

(5) *Contracting year.* The *contracting year* is the taxable year in which a taxpayer enters into a contract as described in paragraph (c)(2) of this section.

(6) *Completion year.* The *completion year* is the taxable year in which a taxpayer completes a contract as described in paragraph (c)(3) of this section.

(7) *Contract commencement date.* The *contract commencement date* is the date that a taxpayer or related party first incurs any allocable contract costs, such as design and engineering costs, other than expenses attributable to bidding and negotiating activities. Generally, the contract commencement date is relevant in applying § 1.460–6(b)(3) (concerning the de minimis exception to the look-back method under section 460(b)(3)(B)); § 1.460–5(b)(2)(v)(B)(1)(*i*) (concerning the production period subject to interest allocation); § 1.460–2(d) (concerning qualified ship contracts); and § 1.460–3(b)(1)(ii) (concerning the construction period for exempt construction contracts).

(8) *Incurred. Incurred* has the meaning given in § 1.461–1(a)(2) (concerning the taxable year a liability is incurred under the accrual method of accounting), regardless of a taxpayer's overall method of accounting. See § 1.461–4(d)(2)(ii) for economic performance rules concerning the PCM.

(9) *Independent research and development expenses. Independent*

research and development expenses are any expenses incurred in the performance of research or development, except that this term does not include any expenses that are directly attributable to a particular long-term contract in existence when the expenses are incurred and this term does not include any expenses under an agreement to perform research or development.

(10) *Long-term contract methods of accounting. Long-term contract methods of accounting*, which include the PCM, the CCM, the PCCM, and the exempt-contract percentage-of-completion method (EPCM), are methods of accounting that may be used only for long-term contracts.

(c) *Entering into and completing long-term contracts*—(1) *In general*. To determine when a contract is entered into under paragraph (c)(2) of this section and completed under paragraph (c)(3) of this section, a taxpayer must consider all relevant allocable contract costs incurred and activities performed by itself, by related parties on its behalf, and by the customer, that are incident to or necessary for the long-term contract. In addition, to determine whether a contract is completed in the contracting year, the taxpayer may not consider when it expects to complete the contract.

(2) *Date contract entered into*—(i) *In general*. A taxpayer enters into a contract on the date that the contract binds both the taxpayer and the customer under applicable law, even if the contract is subject to unsatisfied conditions not within the taxpayer's control (such as obtaining financing). If a taxpayer delays entering into a contract for a principal purpose of avoiding section 460, however, the taxpayer will be treated as having entered into a contract not later than the contract commencement date.

(ii) *Options and change orders*. A taxpayer enters into a new contract on the date that the customer exercises an option or similar provision in a contract if that option or similar provision must be severed from the contract under paragraph (e) of this section. Similarly, a taxpayer enters into a new contract on the date that it accepts a change order or other similar agreement if the change order or other similar agreement must be severed from the contract under paragraph (e) of this section.

(3) *Date contract completed*—(i) *In general*. A taxpayer's contract is completed upon the earlier of—

(A) Use of the subject matter of the contract by the customer for its intended purpose (other than for testing) and at least 95 percent of the total allocable contract costs attributable to the subject matter have been incurred by the taxpayer; or

(B) Final completion and acceptance of the subject matter of the contract.

(ii) *Secondary items*. The date a contract accounted for using the CCM is completed is determined without regard to whether one or more secondary items have been used or finally completed and accepted. If any secondary items are incomplete at the end of the taxable year in which the primary subject matter of a contract is completed, the taxpayer must separate the portion of the gross contract price and the allocable contract costs attributable to the incomplete secondary item(s) from the completed contract and account for them using a permissible method of accounting. A permissible method of accounting includes a long-term contract method of accounting only if a separate contract for the secondary item(s) would be a long-term contract, as defined in paragraph (b)(1) of this section.

(iii) *Subcontracts*. In the case of a subcontract, a subcontractor's customer is the general contractor. Thus, the subject matter of the subcontract is the relevant subject matter under paragraph (c)(3)(i) of this section.

(iv) *Final completion and acceptance*—(A) *In general*. Except as otherwise provided in this paragraph (c)(3)(iv), to determine whether final completion and acceptance of the subject matter of a contract have occurred, a taxpayer must consider all relevant facts and circumstances. Nevertheless, a taxpayer may not delay the completion of a contract for the principal purpose of deferring federal income tax.

(B) *Contingent compensation*. Final completion and acceptance is determined without regard to any contractual term that provides for additional compensation that is contingent on the successful performance of the subject matter of the contract. A taxpayer must account for all contingent compensation that is not includible in total contract price under § 1.460–4(b)(4)(i), or in gross contract price under § 1.460–4(d)(3), using a permissible method of accounting. For application of the look-back method for contracts accounted for using the PCM, see § 1.460–6(c)(1)(ii) and (2)(vi).

(C) *Assembly or installation*. Final completion and acceptance is determined without regard to whether the taxpayer has an obligation to assist or supervise assembly or installation of the subject matter of the contract where the assembly or installation is not performed by the taxpayer or a related party. A taxpayer must account for the gross receipts and costs attributable to such an obligation using a permissible method of accounting, other than a long-term contract method.

(D) *Disputes*. Final completion and acceptance is determined without regard to whether a dispute exists at the time the taxpayer tenders the subject matter of the contract to the customer. For contracts accounted for using the CCM, see § 1.460–4(d)(4). For application of the look-back method for contracts accounted for using the PCM, see § 1.460–6(c)(1)(ii) and (2)(vi).

(d) *Allocation among activities*—(1) *In general*. Long-term contract methods of accounting apply only to the gross receipts and costs attributable to long-term contract activities. Gross receipts and costs attributable to long-term contract activities means amounts included in total contract price or gross contract price, whichever is applicable, as determined under § 1.460–4, and costs allocable to the contract, as determined under § 1.460–5. Gross receipts and costs attributable to non-long-term contract activities (as defined in paragraph (d)(2) of this section) generally must be taken into account using a permissible method of accounting other than a long-term contract method. See section 446(c) and § 1.446–1(c). However, if the performance of a non-long-term contract activity is incident to or necessary for the manufacture, building, installation, or construction of the subject matter of one or more of the taxpayer's long-term contracts, the gross receipts and costs attributable to that activity must be allocated to the long-term contract(s) benefitted as provided in §§ 1.460–4(b)(4)(i) and 1.460–5(f)(2), respectively. Similarly, if a single long-term contract requires a taxpayer to perform a non-long-term contract activity that is not incident to or necessary for the manufacture, building, installation, or construction of the subject matter of the long-term contract, the gross receipts and costs attributable to that non-long-term contract activity must be separated from the contract and accounted for using a permissible method of accounting other than a long-term contract method. But see paragraph (g) of this section for related party rules.

(2) *Non-long-term contract activity*. *Non-long-term contract activity* means the performance of an activity other than manufacturing, building, installation, or construction, such as the provision of architectural, design, engineering, and construction management services, and the development or implementation of computer software. In addition, performance under a guaranty,

warranty, or maintenance agreement is a non-long-term contract activity that is never incident to or necessary for the manufacture or construction of property under a long-term contract.

(e) *Severing and aggregating contracts*—(1) *In general*. After application of the allocation rules of paragraph (d) of this section, the severing and aggregating rules of this paragraph (e) may be applied by the Commissioner or the taxpayer as necessary to clearly reflect income (*e.g.*, to prevent the unreasonable deferral (or acceleration) of income or the premature recognition (or deferral) of loss). Under the severing and aggregating rules, one agreement may be treated as two or more contracts, and two or more agreements may be treated as one contract. Except as provided in paragraph (e)(3)(ii) of this section, a taxpayer must determine whether to sever an agreement or to aggregate two or more agreements based on the facts and circumstances known at the end of the contracting year.

(2) *Facts and circumstances*. Whether an agreement should be severed, or two or more agreements should be aggregated, depends on the following factors:

(i) *Pricing*. Independent pricing of items in an agreement is necessary for the agreement to be severed into two or more contracts. In the case of an agreement for similar items, if the price to be paid for the items is determined under different terms or formulas (e.g., if some items are priced under a cost-plus incentive fee arrangement and later items are to be priced under a fixed-price arrangement), then the difference in the pricing terms or formulas indicates that the items are independently priced. Similarly, interdependent pricing of items in separate agreements is necessary for two or more agreements to be aggregated into one contract. A single price negotiation for similar items ordered under one or more agreements indicates that the items are interdependently priced.

(ii) *Separate delivery or acceptance*. An agreement may not be severed into two or more contracts unless it provides for separate delivery or separate acceptance of items that are the subject matter of the agreement. However, the separate delivery or separate acceptance of items by itself does not necessarily require an agreement to be severed.

(iii) *Reasonable businessperson*. Two or more agreements to perform manufacturing or construction activities may not be aggregated into one contract unless a reasonable businessperson would not have entered into one of the agreements for the terms agreed upon without also entering into the other agreement(s). Similarly, an agreement to perform manufacturing or construction activities may not be severed into two or more contracts if a reasonable businessperson would not have entered into separate agreements containing terms allocable to each severed contract. Analyzing the reasonable businessperson standard requires an analysis of all the facts and circumstances of the business arrangement between the taxpayer and the customer. For purposes of this paragraph (e)(2)(iii), a taxpayer's expectation that the parties would enter into another agreement, when agreeing to the terms contained in the first agreement, is not relevant.

(3) *Exceptions*—(i) *Severance for PCM*. A taxpayer may not sever under this paragraph (e) a long-term contract that would be subject to the PCM without obtaining the Commissioner's prior written consent.

(ii) *Options and change orders*. Except as provided in paragraph (e)(3)(i) of this section, a taxpayer must sever an agreement that increases the number of units to be supplied to the customer, such as through the exercise of an option or the acceptance of a change order, if the agreement provides for separate delivery or separate acceptance of the additional units.

(4) *Statement with return*. If a taxpayer severs an agreement or aggregates two or more agreements under this paragraph (e) during the taxable year, the taxpayer must attach a statement to its original federal income tax return for that year. This statement must contain the following information —

(i) The legend NOTIFICATION OF SEVERANCE OR AGGREGATION UNDER SEC. 1.460–1(e);

(ii) The taxpayer's name; and

(iii) The taxpayer's employer identification number or social security number.

(f) *Classifying contracts*—(1) *In general*. After applying the severing and aggregating rules of paragraph (e) of this section, a taxpayer must determine the classification of a contract (*e.g.*, as a long-term manufacturing contract, long-term construction contract, non-long-term contract) based on all the facts and circumstances known no later than the end of the contracting year. Classification is determined on a contract-by-contract basis. Consequently, a requirement to manufacture a single unique item under a long-term contract will subject all other items in that contract to section 460.

(2) *Hybrid contracts*—(i) *In general*. A long-term contract that requires a taxpayer to perform both manufacturing and construction activities (hybrid contract) generally must be classified as two contracts, a manufacturing contract and a construction contract. A taxpayer may elect, on a contract-by-contract basis, to classify a hybrid contract as a long-term construction contract if at least 95 percent of the estimated total allocable contract costs are reasonably allocable to construction activities. In addition, a taxpayer may elect, on a contract-by-contract basis, to classify a hybrid contract as a long-term manufacturing contract subject to the PCM.

(ii) *Elections*. A taxpayer makes an election under this paragraph (f)(2) by using its method of accounting for similar construction contracts or for manufacturing contracts, whichever is applicable, to account for a hybrid contract entered into during the taxable year of the election on its original federal income tax return for the election year. If an electing taxpayer's method is the PCM, the taxpayer also must use the PCM to apply the look-back method under § 1.460–6 and to determine alternative minimum taxable income under § 1.460–4(f).

(3) *Method of accounting*. Except as provided in paragraph (f)(2)(ii) of this section, a taxpayer's method of classifying contracts is a method of accounting under section 446 and, thus, may not be changed without the Commissioner's consent. If a taxpayer's method of classifying contracts is unreasonable, that classification method is an impermissible accounting method.

(4) *Use of estimates*—(i) *Estimating length of contract*. A taxpayer must use a reasonable estimate of the time required to complete a contract when necessary to classify the contract (e.g., to determine whether the five-year completion rule for qualified ship contracts under § 1.460–2(d), or the two- year completion rule for exempt construction contracts under § 1.460–3(b), is satisfied, but not to determine whether a contract is completed within the contracting year under paragraph (b)(1) of this section). To be considered reasonable, an estimate of the time required to complete the contract must include anticipated time for delay, rework, change orders, technology or design problems, or other problems that reasonably can be anticipated considering the nature of the contract and prior experience. A contract term that specifies an expected completion or delivery date may be considered evidence that the taxpayer reasonably expects to complete or deliver the

subject matter of the contract on or about the date specified, especially if the contract provides bona fide penalties for failing to meet the specified date. If a taxpayer classifies a contract based on a reasonable estimate of completion time, the contract will not be reclassified based on the actual (or another reasonable estimate of) completion time. A taxpayer's estimate of completion time will not be considered unreasonable if a contract is not completed within the estimated time primarily because of unforeseeable factors not within the taxpayer's control, such as third-party litigation, extreme weather conditions, strikes, or delays in securing permits or licenses.

(ii) *Estimating allocable contract costs.* A taxpayer must use a reasonable estimate of total allocable contract costs when necessary to classify the contract (e.g., to determine whether a contract is a home construction contract under § 1.460–(3)(b)(2)). If a taxpayer classifies a contract based on a reasonable estimate of total allocable contract costs, the contract will not be reclassified based on the actual (or another reasonable estimate of) total allocable contract costs.

(g) *Special rules for activities benefitting long-term contracts of a related party*—(1) *Related party use of PCM*—(i) *In general.* Except as provided in paragraph (g)(1)(ii) of this section, if a related party and its customer enter into a long-term contract subject to the PCM, and a taxpayer performs any activity that is incident to or necessary for the related party's long-term contract, the taxpayer must account for the gross receipts and costs attributable to this activity using the PCM, even if this activity is not otherwise subject to section 460(a). This type of activity may include, for example, the performance of engineering and design services, and the production of components and subassemblies that are reasonably expected to be used in the production of the subject matter of the related party's contract.

(ii) *Exception for components and subassemblies*. A taxpayer is not required to use the PCM under this paragraph (g) to account for a component or subassembly that benefits a related party's long-term contract if more than 50 percent of the average annual gross receipts attributable to the sale of this item for the 3-taxable-year-period ending with the contracting year comes from unrelated parties.

(2) *Total contract price.* If a taxpayer is required to use the PCM under paragraph (g)(1)(i) of this section, the total contract price (as defined in § 1.460–4(b)(4)(i)) is the fair market value of the taxpayer's activity that is incident to or necessary for the performance of the related party's long-term contract. The related party also must use the fair market value of the taxpayer's activity as the cost it incurs for the activity. The fair market value of the taxpayer's activity may or may not be the same as the amount the related party pays the taxpayer for that activity.

(3) *Completion factor.* To compute a contract's completion factor (as described in § 1.460–4(b)(5)), the related party must take into account the fair market value of the taxpayer's activity that is incident to or necessary for the performance of the related party's long-term contract when the related party incurs the liability to the taxpayer for the activity, rather than when the taxpayer incurs the costs to perform the activity.

(h) *Effective date*—(1) *In general.* Except as otherwise provided, this section and §§ 1.460–2 through 1.460–5 are applicable for contracts entered into on or after January 11, 2001.

(2) *Change in method of accounting.* Any change in a taxpayer's method of accounting necessary to comply with this section and §§ 1.460–2 through 1.460–5 is a change in method of accounting to which the provisions of section 446 and the regulations thereunder apply. For the first taxable year that includes January 11, 2001, a taxpayer is granted the consent of the Commissioner to change its method of accounting to comply with the provisions of this section and §§ 1.460–2 through 1.460–5 for long-term contracts entered into on or after January 11, 2001. A taxpayer that wants to change its method of accounting under this paragraph (h)(2) must follow the automatic consent procedures in Rev. Proc. 99–49 (1999–52 I.R.B. 725) (see § 601.601(d)(2) of this chapter), except that the scope limitations in section 4.02 of Rev. Proc. 99–49 do not apply. Because a change under this paragraph (h)(2) is made on a cut-off basis, a section 481(a) adjustment is not permitted or required. Moreover, the taxpayer does not receive audit protection under section 7 of Rev. Proc. 99–49 for a change in method of accounting under this paragraph (h)(2). A taxpayer that wants to change its exempt-contract method of accounting is not granted the consent of the Commissioner under this paragraph (h)(2) and must file a Form 3115, ''Application for Change in Accounting Method,'' to obtain consent. See Rev. Proc. 97–27 (1997–1 C.B. 680) (see § 601.601(d)(2) of this chapter).

(i) [Reserved]

(j) *Examples.* The following examples illustrate the rules of this section:

Example 1. Contract for manufacture of property. B notifies C, an aircraft manufacturer, that it wants to purchase an aircraft of a particular type. At the time C receives the order, C has on hand several partially completed aircraft of this type; however, C does not have any completed aircraft of this type on hand. C and B agree that B will purchase one of these aircraft after it has been completed. C retains title to and risk of loss with respect to the aircraft until the sale takes place. The agreement between C and B is a contract for the manufacture of property under paragraph (b)(2)(i) of this section, even if labeled as a contract for the sale of property, because the manufacture of the aircraft is necessary for C's obligations under the agreement to be fulfilled and the manufacturing was not complete when B and C entered into the agreement.

Example 2. De minimis construction activity. C, a master developer whose taxable year ends December 31, owns 5,000 acres of undeveloped land with a cost basis of $5,000,000 and a fair market value of $50,000,000. To obtain permission from the local county government to improve this land, a service road must be constructed on this land to benefit all 5,000 acres. In 2001, C enters into a contract to sell a 1,000-acre parcel of undeveloped land to B, a residential developer, for its fair market value, $10,000,000. In this contract, C agrees to construct a service road running through the land that C is selling to B and through the 4,000 adjacent acres of undeveloped land that C has sold or will sell to other residential developers for its fair market value, $40,000,000. C reasonably estimates that it will incur allocable contract costs of $50,000 (excluding the cost of the land) to construct this service road, which will be owned and maintained by the county. C must reasonably allocate the cost of the service road among the benefitted parcels. The portion of the estimated total allocable contract costs that C allocates to the 1,000-acre parcel being sold to B (based upon its fair market value) is $10,000 ($50,000 x ($10,000,000 $50,000,000)). Construction of the service road is finished in 2002. Because the estimated total allocable contract costs attributable to C's construction activities, $10,000, are less than 10 percent of the contract's total contract price, $10,000,000, C's contract with B is not a construction contract under paragraph (b)(2)(ii) of this section. Thus, C's contract with B is not a long-term contract under paragraph (b)(2)(i) of this section, notwithstanding that construction of the service road is not completed in 2001.

Example 3. Completion—customer use. In 2002, C, whose taxable year ends December 31, enters into a contract to construct a building for B. In November of 2003, the building is completed in every respect necessary for its intended use, and B occupies the building. In early December of 2003, B notifies C of some minor deficiencies that need to be corrected, and C agrees to correct them in January 2004. C reasonably estimates that the cost of correcting these deficiencies will be less than five percent of the total allocable contract costs. C's contract is complete under paragraph (c)(3)(i)(A) of this section in 2003 because in that year, B used the building and C had incurred at least 95 percent of the total allocable contract costs attributable to the building. C must use a permissible method of accounting for any deficiency-related costs incurred after 2003.

Example 4. Completion—customer use. In 2001, C, whose taxable year ends December 31, agrees to construct a shopping center, which includes an adjoining parking lot, for B. By October 2002, C has finished constructing the retail portion of the shopping center. By December 2002, C has graded the entire parking lot, but has paved only one-fourth of it because inclement weather conditions prevented C from laying asphalt on the remaining three-fourths. In December 2002, B opens the retail portion of the shopping center and the paved portion of the parking lot to the general public. C reasonably estimates that the cost of paving the remaining three-fourths of the parking lot when weather permits will exceed five percent of C's total allocable contract costs. Even though B is using the subject matter of the contract, C's contract is not completed in December 2002 under paragraph (c)(3)(i)(A) of this section because C has not incurred at least 95 percent of the total allocable contract costs attributable to the subject matter.

Example 5. Completion—customer use. In 2001, C, whose taxable year ends December 31, agrees to manufacture 100 machines for B. By December 31, 2002, C has delivered 99 of the machines to B. C reasonably estimates that the cost of finishing the related work on the contract will be less than five percent of the total allocable contract costs. C's contract is not complete under paragraph (c)(3)(i)(A) of this section in 2002 because in that year, B is not using the subject matter of the contract (all 100 machines) for its intended purpose.

Example 6. Non-long-term contract activity. On January 1, 2001, C, whose taxable year ends December 31, enters into a single long-term contract to design and manufacture a satellite and to develop computer software enabling B to operate the satellite. At the end of 2001, C has not finished manufacturing the satellite. Designing the satellite and developing the computer software are non-long-term contract activities that are incident to and necessary for the taxpayer's manufacturing of the subject matter of a long-term contract because the satellite could not be manufactured without the design and would not operate without the software. Thus, under paragraph (d)(1) of this section, C must allocate these non-long-term contract activities to the long-term contract and account for the gross receipts and costs attributable to designing the satellite and developing computer software using the PCM.

Example 7. Non-long-term contract activity. C agrees to manufacture equipment for B under a long-term contract. In a separate contract, C agrees to design the equipment being manufactured for B under the long-term contract. Under paragraph (d)(1) of this section, C must allocate the gross receipts and costs related to the design to the long-term contract because designing the equipment is a non-long-term contract activity that is incident to and necessary for the manufacture of the subject matter of the long-term contract.

Example 8. Severance. On January 1, 2001, C, a construction contractor, and B, a real estate investor, enter into an agreement requiring C to build two office buildings in different areas of a large city. The agreement provides that the two office buildings will be completed by C and accepted by B in 2002 and 2003, respectively, and that C will be paid $1,000,000 and $1,500,000 for the two office buildings, respectively. The agreement will provide C with a reasonable profit from the construction of each building. Unless C is required to use the PCM to account for the contract, C is required to sever this contract under paragraph (e)(2) of this section because the buildings are independently priced, the agreement provides for separate delivery and acceptance of the buildings, and, as each building will generate a reasonable profit, a reasonable businessperson would have entered into separate agreements for the terms agreed upon for each building.

Example 9. Severance. C, a large construction contractor whose taxable year ends December 31, accounts for its construction contracts using the PCM and has elected to use the 10-percent method described in § 1.460–4(b)(6). In September 2001, C enters into an agreement to construct four buildings in four different cities. The buildings are independently priced and the contract provides a reasonable profit for each of the buildings. In addition, the agreement requires C to complete one building per year in 2002, 2003, 2004, and 2005. As of December 31, 2001, C has incurred 25 percent of the estimated total allocable contract costs attributable to one of the buildings, but only five percent of the estimated total allocable contract costs attributable to all four buildings included in the agreement. C does not request the Commissioner's consent to sever this contract. Using the 10-percent method, C does not take into account any portion of the total contract price or any incurred allocable contract costs attributable to this agreement in 2001. Upon examination of C's 2001 tax return, the Commissioner determines that C entered into one agreement for four buildings rather than four separate agreements each for one building solely to take advantage of the deferral obtained under the 10-percent method. Consequently, to clearly reflect the taxpayer's income, the Commissioner may require C to sever the agreement into four separate contracts under paragraph (e)(2) of this section because the buildings are independently priced, the agreement provides for separate delivery and acceptance of the buildings, and a reasonable businessperson would have entered into separate agreements for these buildings.

Example 10. Aggregation. In 2001, C, a shipbuilder, enters into two agreements with the Department of the Navy as the result of a single negotiation. Each agreement obligates C to manufacture a submarine. Because the submarines are of the same class, their specifications are similar. Because C has never manufactured submarines of this class, however, C anticipates that it will incur substantially higher costs to manufacture the first submarine, to be delivered in 2007, than to manufacture the second submarine, to be delivered in 2010. If the agreements are treated as separate contracts, the first contract probably will produce a substantial loss, while the second contract probably will produce substantial profit. Based upon these facts, aggregation is required under paragraph (e)(2) of this section because the submarines are interdependently priced and a reasonable businessperson would not have entered the first agreement without also entering into the second.

Example 11. Aggregation. In 2001, C, a manufacturer of aircraft and related equipment, agrees to manufacture 10 military aircraft for foreign government B and to deliver the aircraft by the end of 2003. When entering into the agreement, C anticipates that it might receive production orders from B over the next 20 years for as many as 300 more of these aircraft. The negotiated contract price reflects C's and B's consideration of the expected total cost of manufacturing the 10 aircraft, the risks and opportunities associated with the agreement, and the additional factors the parties considered relevant. The negotiated price provides a profit on the sale of the 10 aircraft even if C does not receive any additional production orders from B. It is unlikely, however, that C actually would have wanted to manufacture the 10 aircraft but for the expectation that it would receive additional production orders from B. In 2003, B accepts delivery of the 10 aircraft. At that time, B orders an additional 20 aircraft of the same type for delivery in 2007. When negotiating the price for the additional 20 aircraft, C and B consider the fact that the expected unit cost for this production run of 20 aircraft will be lower than the unit cost of the 10 aircraft completed and accepted in 2003, but substantially higher than the expected unit cost of future production runs. Based upon these facts, aggregation is not permitted under paragraph (e)(2) of this section. Because the parties negotiated the prices of both agreements considering only the expected production costs and risks for each agreement standing alone, the terms and conditions agreed upon for the first agreement are independent of the terms and conditions agreed upon for the second agreement. The fact that the agreement to manufacture 10 aircraft provides a profit for C indicates that a reasonable businessperson would have entered into that agreement without entering into the agreement to manufacture the additional 20 aircraft.

Example 12. Classification and completion. In 2001, C, whose taxable year ends December 31, agrees to manufacture and install an industrial machine for B. C elects under paragraph (f) of this section to classify the agreement as a long-term manufacturing contract and to account for it using the PCM. The agreement requires C to deliver the machine in August 2003 and to install and test the machine in B's factory. In addition, the agreement requires B to accept the machine when the tests prove that the machine's performance will satisfy the environmental standards set by the Environmental Protection Agency (EPA), even if B has not obtained the required operating permit. Because of technical difficulties, C cannot deliver the machine until December 2003, when B conditionally accepts delivery. C installs the machine in December 2003 and then tests it through February 2004. B accepts the machine in February 2004, but does not obtain the operating permit from the EPA until January 2005. Under paragraph (c)(3)(i)(B) of this section, C's contract is finally completed and accepted in February 2004, even though B does not obtain the operating permit until January 2005, because C completed all its obligations under the contract and B accepted the machine in February 2004.

§ 1.460–2 Long-term manufacturing contracts.

(a) *In general.* Section 460 generally requires a taxpayer to determine the income from a long-term manufacturing contract using the percentage-of-completion method described in § 1.460–4(b) (PCM). A contract not completed in the contracting year is a long-term manufacturing contract if it involves the manufacture of personal property that is—

(1) A unique item of a type that is not normally carried in the finished goods inventory of the taxpayer; or

(2) An item that normally requires more than 12 calendar months to complete (regardless of the duration of the contract or the time to complete a deliverable quantity of the item).

(b) *Unique*—(1) *In general. Unique* means designed for the needs of a specific customer. To determine whether an item is designed for the needs of a specific customer, a taxpayer must consider the extent to which research, development, design, engineering, retooling, and similar activities (customizing activities) are required to manufacture the item and whether the item could be sold to other customers with little or no modification. A contract may require the taxpayer to manufacture more than one unit of a unique item. If a contract requires a taxpayer to manufacture more than one unit of the same item, the taxpayer must determine whether that item is unique by considering the customizing activities that would be needed to produce only the first unit. For the purposes of this paragraph (b), a taxpayer must consider the activities performed on its behalf by a subcontractor.

(2) *Safe harbors.* Notwithstanding paragraph (b)(1) of this section, an item is not unique if it satisfies one or more of the safe harbors in this paragraph (b)(2). If an item does not satisfy one or more safe harbors, the determination of uniqueness will depend on the facts and circumstances. The safe harbors are:

(i) *Short production period.* An item is not unique if it normally requires 90 days or less to complete. In the case of a contract for multiple units of an item, the item is not unique only if it normally requires 90 days or less to complete each unit of the item in the contract.

(ii) *Customized item.* An item is not unique if the total allocable contract costs attributable to customizing activities that are incident to or necessary for the manufacture of the item do not exceed 10 percent of the estimated total allocable contract costs allocable to the item. In the case of a contract for multiple units of an item, this comparison must be performed on the first unit of the item and the total allocable contract costs attributable to customizing activities that are incident to or necessary for the manufacture of the item must be allocated to the first unit.

(iii) *Inventoried item.* A unique item ceases to be unique no later than when the taxpayer normally includes similar items in its finished goods inventory.

(c) *Normal time to complete*—(1) *In general.* The amount of time normally required to complete an item is the item's reasonably expected *production period,* as described in § 1.263A–12, determined at the end of the contracting year. Thus, in general, the expected production period for an item begins when a taxpayer incurs at least five percent of the costs that would be allocable to the item under § 1.460–5 and ends when the item is ready to be held for sale and all reasonably expected production activities are complete. In the case of components that are assembled or reassembled into an item or unit at the customer's facility by the taxpayer's employees or agents, the production period ends when the components are assembled or reassembled into an operable item or unit. To the extent that several distinct activities related to the production of the item are expected to occur simultaneously, the period during which these distinct activities occur is not counted more than once. Furthermore, when determining the normal time to complete an item, a taxpayer is not required to consider activities performed or costs incurred that would not be allocable contract costs under section 460 (*e.g.,* independent research and development expenses (as defined in § 1.460–1(b)(9)) and marketing expenses). Moreover, the time required to design and manufacture the first unit of an item for which the taxpayer intends to produce multiple units generally does not indicate the normal time to complete the item.

(2) *Production by related parties.* To determine the time normally required to complete an item, a taxpayer must consider all relevant production activities performed and costs incurred by itself and by related parties, as defined in § 1.460–1(b)(4). For example, if a taxpayer's item requires a component or subassembly manufactured by a related party, the taxpayer must consider the time the related party takes to complete the component or subassembly and, for purposes of determining the beginning of an item's production period, the costs incurred by the related party that are allocable to the component or subassembly. However, if both requirements of the exception for components and subassemblies under § 1.460–1(g)(1)(ii) are satisfied, a taxpayer does not consider the activities performed or the costs incurred by a related party when determining the normal time to complete an item.

(d) *Qualified ship contracts.* A taxpayer may determine the income from a long-term manufacturing contract that is a qualified ship contract using either the PCM or the percentage-of-completion/capitalized-cost method (PCCM) of accounting described in § 1.460–4(e). A *qualified ship contract* is any contract entered into after February 28, 1986, to manufacture in the United States not more than 5 seagoing vessels if the vessels will not be manufactured directly or indirectly for the United States Government and if the taxpayer reasonably expects to complete the contract within 5 years of the contract commencement date. Under § 1.460–1(e)(3)(i), a contract to produce more than 5 vessels for which the PCM would be required cannot be severed in order to be classified as a qualified ship contract.

(e) *Examples.* The following examples illustrate the rules of this section:

Example 1. Unique item and classification. In December 2001, C enters into a contract with B to design and manufacture a new type of industrial equipment. C reasonably expects the normal production period for this type of equipment to be eight months. Because the new type of industrial equipment requires a substantial amount of research, design, and engineering to produce, C determines that the equipment is a unique item and its contract with B is a long-term contract. After delivering the equipment to B in September 2002, C contracts with B to produce five additional units of that industrial equipment with certain different specifications. These additional units, which also are expected to take eight months to produce, will be delivered to B in 2003. C determines that the research, design, engineering, retooling, and similar customizing costs necessary to produce the five additional units of equipment does not exceed 10 percent of the first unit's share of estimated total allocable contract costs. Consequently, the additional units of equipment satisfy the safe harbor in paragraph (b)(2)(ii) of this section and are not unique items. Although C's contract with B to produce the five additional units is not completed within the contracting year, the contract is not a long-term contract since the additional units of equipment are not unique items and do not normally require more than 12 months to produce. C must classify its second contract with B as a non-long term contract, notwithstanding that it classified the previous contract with B for a similar item as a long-term contract, because the determination of whether a contract is a long-term contract is made on a contract-by-contract basis. A change in classification is not a change in method of accounting because the change in classification results from a change in underlying facts.

Example 2. 12-month rule—related party. C manufactures cranes. C purchases one of the crane's components from R, a related party under § 1.460–1(b)(4). Less than 50 percent of R's gross receipts attributable to the sale of this component comes from sales to unrelated parties; thus, the exception for components and subassemblies under § 1.460–1(g)(1)(ii) is not satisfied. Consequently, C must consider the activities of R as R incurs costs and performs the activities rather than as C incurs a liability to R. The normal time period between the time that both C and R incur five percent of the costs allocable to the crane and the time that R completes the component is five months. C normally requires an additional eight months to complete production of the crane after receiving the integral component from R. C's crane is an item of a type that normally requires more than 12 months to complete under paragraph (c) of this section because the production period from the time that both C and R incur five percent of the costs allocable to the crane until the time that production of the crane is complete is normally 13 months.

Example 3. 12-month rule—duration of contract. The facts are the same as in *Example 2,* except that C enters into a sales contract with B on December 31, 2001 (the last day of C's taxable year), and delivers a completed crane to B on February 1, 2002. C's contract with B is a long-term contract under paragraph (a)(2) of this section because the contract is not completed in the contracting year, 2001, and the crane is an item that normally requires more than 12 calendar months to complete (regardless of the duration of the contract).

Example 4. 12-month rule—normal time to complete. The facts are the same as in *Example 2,* except that C (and R) actually complete B's crane in only 10 calendar months. The contract is a long-term contract because the normal time to complete a crane, not the actual time to complete a crane, is the relevant criterion for determining whether an item is subject to paragraph (a)(2) of this section.

Example 5. Normal time to complete. C enters into a multi-unit contract to produce four units of an item. C does not anticipate producing any additional units of the item. C expects to perform the research, design, and development that are directly allocable to the particular item and to produce the first unit in the first 24 months. C reasonably expects the production period for each of the three remaining units will be 3 months. This contract is not a contract that involves the manufacture of an item that normally requires more than 12 months to complete because the normal time to complete the item is 3 months. However, the contract does not satisfy the 90-day safe harbor for unique items because the normal time to complete the first unit of this item exceeds 90 days. Thus, the contract might involve the manufacture of a unique item depending on the facts and circumstances.

§ 1.460–3 Long-term construction contracts.

(a) *In general.* Section 460 generally requires a taxpayer to determine the income from a long-term construction contract using the percentage-of-completion method described in § 1.460–4(b) (PCM). A contract not completed in the contracting year is a long-term construction contract if it involves the building, construction, reconstruction, or rehabilitation of real property; the installation of an integral component to real property; or the improvement of real property (collectively referred to as construction). *Real property* means land, buildings, and *inherently permanent structures*, as defined in § 1.263A–8(c)(3), such as roadways, dams, and bridges. Real property does not include vessels, offshore drilling platforms, or unsevered natural products of land. An *integral component to real property* includes property not produced at the site of the real property but intended to be permanently affixed to the real property, such as elevators and central heating and cooling systems. Thus, for example, a contract to install an elevator in a building is a construction contract because a building is real property, but a contract to install an elevator in a ship is not a construction contract because a ship is not real property.

(b) *Exempt construction contracts*—(1) *In general.* The general requirement to use the PCM and the cost allocation rules described in § 1.460–5(b) or (c) does not apply to any long-term construction contract described in this paragraph (b) (exempt construction contract). *Exempt construction contract* means any—

(i) Home construction contract; and

(ii) Other construction contract that a taxpayer estimates (when entering into the contract) will be completed within 2 years of the contract commencement date, provided the taxpayer satisfies the $10,000,000 gross receipts test described in paragraph (b)(3) of this section.

(2) *Home construction contract*—(i) *In general.* A long-term construction contract is a *home construction contract* if a taxpayer (including a subcontractor working for a general contractor) reasonably expects to attribute 80 percent or more of the estimated total allocable contract costs (including the cost of land, materials, and services), determined as of the close of the contracting year, to the construction of—

(A) Dwelling units, as defined in section 168(e)(2)(A)(ii)(I), contained in buildings containing 4 or fewer dwelling units (including buildings with 4 or fewer dwelling units that also have commercial units); and

(B) Improvements to real property directly related to, and located at the site of, the dwelling units.

(ii) *Townhouses and rowhouses.* Each townhouse or rowhouse is a separate building.

(iii) *Common improvements.* A taxpayer includes in the cost of the dwelling units their allocable share of the cost that the taxpayer reasonably expects to incur for any common improvements (e.g., sewers, roads, clubhouses) that benefit the dwelling units and that the taxpayer is contractually obligated, or required by law, to construct within the tract or tracts of land that contain the dwelling units.

(iv) *Mixed use costs.* If a contract involves the construction of both commercial units and dwelling units within the same building, a taxpayer must allocate the costs among the commercial units and dwelling units using a reasonable method or combination of reasonable methods, such as specific identification, square footage, or fair market value.

(3) *$10,000,000 gross receipts test*—(i) *In general.* Except as otherwise provided in paragraphs (b)(3)(ii) and (iii) of this section, the $10,000,000 gross receipts test is satisfied if a taxpayer's (or predecessor's) average annual gross receipts for the 3 taxable years preceding the contracting year do not exceed $10,000,000, as determined using the principles of the gross receipts test for small resellers under § 1.263A–3(b).

(ii) *Single employer.* To apply the gross receipts test, a taxpayer is not required to aggregate the gross receipts of persons treated as a single employer solely under section 414(m) and any regulations prescribed under section 414.

(iii) *Attribution of gross receipts.* A taxpayer must aggregate a proportionate share of the construction-related gross receipts of any person that has a five percent or greater interest in the taxpayer. In addition, a taxpayer must aggregate a proportionate share of the construction-related gross receipts of any person in which the taxpayer has a five percent or greater interest. For this purpose, a taxpayer must determine ownership interests as of the first day of the taxpayer's contracting year and must include indirect interests in any corporation, partnership, estate, trust, or sole proprietorship according to principles similar to the constructive ownership rules under sections 1563(e), (f)(2), and (f)(3)(A). However, a taxpayer is not required to aggregate under this paragraph (b)(3)(iii) any construction-related gross receipts required to be aggregated under paragraph (b)(3)(i) of this section.

(c) *Residential construction contracts.* A taxpayer may determine the income from a long-term construction contract that is a residential construction contract using either the PCM or the percentage-of-completion/capitalized-cost method (PCCM) of accounting described in § 1.460–4(e). A *residential construction contract* is a home construction contract, as defined in paragraph (b)(2) of this section, except that the building or buildings being constructed contain more than 4 dwelling units.

Par. 7. Section 1.460–4 is amended by adding paragraphs (a) through (i) to read as follows:

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

(a) *Overview.* This section prescribes permissible methods of accounting for long-term contracts. Paragraph (b) of this section describes the percentage-of-completion method under section 460(b) (PCM) that a taxpayer generally must use to determine the income from a long-term contract. Paragraph (c) of this section lists permissible methods of accounting for exempt construction contracts described in § 1.460–3(b)(1) and describes the exempt-contract percentage-of-completion method (EPCM). Paragraph (d) of this section describes the completed-contract method (CCM), which is one of the permissible methods of accounting for exempt construction contracts. Paragraph (e) of this section describes the percentage-of-completion/capitalized-cost method (PCCM), which is a permissible method of accounting for qualified ship contracts described in § 1.460–2(d) and residential construction contracts described in § 1.460–3(c). Paragraph (f) of this section provides rules for determining the alternative minimum taxable income (AMTI) from long-term contracts that are not exempted under section 56. Paragraph (g) of this section provides rules concerning consistency in methods of accounting for long-term contracts. Paragraph (h) of this section provides examples illustrating the principles of this section. Paragraph (j) of this section provides rules for taxpayers that file consolidated tax returns.

(b) *Percentage-of-completion method*—(1) *In general.* Under the PCM, a taxpayer generally must include in income the portion of the *total contract price,* as defined in paragraph (b)(4)(i) of this section, that corresponds to the percentage of the entire contract that the taxpayer has completed during the taxable year. The percentage of completion must be determined by comparing allocable contract costs incurred with estimated total allocable contract costs. Thus, the taxpayer includes a portion of the total contract price in gross income as the taxpayer incurs allocable contract costs.

(2) *Computations.* To determine the income from a long-term contract, a taxpayer—

(i) Computes the *completion factor* for the contract, which is the ratio of the cumulative allocable contract costs that the taxpayer has incurred through the end of the taxable year to the estimated total allocable contract costs that the taxpayer reasonably expects to incur under the contract;

(ii) Computes the amount of *cumulative gross receipts* from the contract by multiplying the completion factor by the total contract price;

(iii) Computes the amount of *current-year gross receipts,* which is the difference between the amount of cumulative gross receipts for the current taxable year and the amount of cumulative gross receipts for the immediately preceding taxable year (the difference can be a positive or negative number); and

(iv) Takes both the current-year gross receipts and the allocable contract costs incurred during the current year into account in computing taxable income.

(3) *Post-completion-year income.* If a taxpayer has not included the total contract price in gross income by the completion year, as defined in § 1.460–1(b)(6), the taxpayer must include the remaining portion of the total contract price in gross income for the taxable year following the completion year. For the treatment of post-completion costs, see paragraph (b)(5)(v) of this section. See § 1.460–6(c)(1)(ii) for application of the look-back method as a result of adjustments to total contract price.

(4) *Total contract price*—(i) *In general*—(A) *Definition. Total contract price* means the amount that a taxpayer reasonably expects to receive under a long-term contract, including holdbacks, retainages, and cost reimbursements. See § 1.460–6(c)(1)(ii) and (2)(vi) for application of the look-back method as a result of changes in total contract price.

(B) *Contingent compensation.* Any amount related to a contingent right under a contract, such as a bonus, award, incentive payment, and amount in dispute, is included in total contract price as soon as the taxpayer can reasonably predict that the amount will be earned, even if the all events test has not yet been met. For example, if a bonus is payable to a taxpayer for meeting an early completion date, the bonus is includible in total contract price at the time and to the extent that the taxpayer can reasonably predict the achievement of the corresponding objective. Similarly, a portion of the contract price that is in dispute is includible in total contract price at the time and to the extent that the taxpayer can reasonably predict that the dispute will be resolved in the taxpayer's favor (regardless of when the taxpayer actually receives payment or when the dispute is finally resolved). Total contract price does not include compensation that might be earned under any other agreement that the taxpayer expects to obtain from the same customer (*e.g.,* exercised option or follow-on contract) if that other agreement is not aggregated under § 1.460–1(e). For the purposes of this paragraph (b)(4)(i)(B), a taxpayer can reasonably predict that an amount of contingent income will be earned not later than when the taxpayer includes that amount in income for financial reporting purposes under generally accepted accounting principles. If a taxpayer has not included an amount of contingent compensation in total contract price under this paragraph (b)(4)(i) by the taxable year following the completion year, the taxpayer must account for that amount of contingent compensation using a permissible method of accounting. If it is determined after the taxable year following the completion year that an amount included in total contract price will not be earned, the taxpayer should deduct that amount in the year of the determination.

(C) *Non-long-term contract activities.* Total contract price includes an allocable share of the gross receipts attributable to a non-long-term contract activity, as defined in § 1.460–1(d)(2), if the activity is incident to or necessary for the manufacture, building, installation, or construction of the subject matter of the long-term contract. Total contract price also includes amounts reimbursed for independent research and development expenses (as defined in § 1.460–1(b)(9)), or for bidding and proposal costs, under a federal or cost-plus long-term contract (as defined in section 460(d)), regardless of whether the research and development, or bidding and proposal, activities are incident to or necessary for the performance of that long-term contract.

(ii) *Estimating total contract price.* A taxpayer must estimate the total contract price based upon all the facts and circumstances known as of the last day of the taxable year. For this purpose, an event that occurs after the end of the taxable year must be taken into account if its occurrence was reasonably predictable and its income was subject to reasonable estimation as of the last day of that taxable year.

(5) *Completion factor*—(i) *Allocable contract costs.* A taxpayer must use a cost allocation method permitted under either § 1.460–5(b) or (c) to determine the amount of cumulative allocable contract costs and estimated total allocable contract costs that are used to determine a contract's completion factor. Allocable contract costs include a reimbursable cost that is allocable to the contract.

(ii) *Cumulative allocable contract costs.* To determine a contract's completion factor for a taxable year, a taxpayer must take into account the cumulative allocable contract costs that have been incurred, as defined in § 1.460–1(b)(8), through the end of the taxable year.

(iii) *Estimating total allocable contract costs.* A taxpayer must estimate total allocable contract costs for each long-term contract based upon all the facts and circumstances known as of the last day of the taxable year. For this purpose, an event that occurs after the end of the taxable year must be taken into account if its occurrence was reasonably predictable and its cost was subject to reasonable estimation as of the last day of that taxable year. To be considered reasonable, an estimate of total allocable contract costs must include costs attributable to delay, rework, change orders, technology or design problems, or other problems that reasonably can be predicted considering the nature of the contract and prior experience. However, estimated total allocable contract costs do not include any contingency allowance for costs that, as of the end of the taxable year, are not reasonably predicted to be incurred in the performance of the contract. For example, estimated total allocable contract costs do not include any costs attributable to factors not reasonably predictable at the end of the taxable year, such as third-party litigation, extreme weather conditions, strikes, and delays in securing required permits and licenses. In addition, the estimated costs of performing other agreements that are not aggregated with the contract under § 1.460–1(e) that the taxpayer expects to incur with the same customer (*e.g.*, follow-on contracts) are not included in estimated total allocable contract costs for the initial contract.

(iv) *Pre-contracting-year costs.* If a taxpayer reasonably expects to enter into a long-term contract in a future taxable year, the taxpayer must capitalize all costs incurred prior to entering into the contract that will be allocable to that contract (*e.g.*, bidding and proposal costs). A taxpayer is not required to compute a completion factor, or to include in gross income any amount, related to allocable contract costs for any taxable year ending before the contracting year or, if applicable, the 10-percent year defined in paragraph (b)(6)(i) of this section. In that year, the taxpayer is required to compute a completion factor that includes all allocable contract costs that have been incurred as of the end of that taxable year (whether previously capitalized or deducted) and to take into account in computing taxable income the related gross receipts and the previously capitalized allocable contract costs. If, however, a taxpayer determines in a subsequent year that it will not enter into the long-term contract, the taxpayer must account for these pre-contracting-year costs in that year (*e.g.*, as a deduction or an inventoriable cost) using the appropriate rules contained in other sections of the Code or regulations.

(v) *Post-completion-year costs.* If a taxpayer incurs an allocable contract cost after the completion year, the taxpayer must account for that cost using a permissible method of accounting. See § 1.460–6(c)(1)(ii) for application of the look-back method as a result of adjustments to allocable contract costs.

(6) *10-percent method*—(i) *In general.* Instead of determining the income from a long-term contract beginning with the contracting year, a taxpayer may elect to use the 10-percent method under section 460(b)(5). Under the 10-percent method, a taxpayer does not include in gross income any amount related to allocable contract costs until the taxable year in which the taxpayer has incurred at least 10 percent of the estimated total allocable contract costs (10-percent year). A taxpayer must treat costs incurred before the 10-percent year as pre-contracting-year costs described in paragraph (b)(5)(iv) of this section.

(ii) *Election.* A taxpayer makes an election under this paragraph (b)(6) by using the 10-percent method for all long-term contracts entered into during the taxable year of the election on its original federal income tax return for the election year. This election is a method of accounting and, thus, applies to all long-term contracts entered into during and after the taxable year of the election. An electing taxpayer must use the 10-percent method to apply the look-back method under § 1.460–6 and to determine alternative minimum taxable income under paragraph (f) of this section. This election is not available if a taxpayer uses the simplified cost-to-cost method described in § 1.460-5(c) to compute the completion factor of a long-term contract.

(7) *Terminated contract*—(i) *Reversal of income.* If a long-term contract is terminated before completion and, as a result, the taxpayer retains ownership of the property that is the subject matter of that contract, the taxpayer must reverse the transaction in the taxable year of termination. To reverse the transaction, the taxpayer reports a loss (or gain) equal to the cumulative allocable contract costs reported under the contract in all prior taxable years less the cumulative gross receipts reported under the contract in all prior taxable years.

(ii) *Adjusted basis.* As a result of reversing the transaction under paragraph (b)(7)(i) of this section, a taxpayer will have an adjusted basis in the retained property equal to the cumulative allocable contract costs reported under the contract in all prior taxable years. However, if the taxpayer received and retains any consideration or compensation from the customer, the taxpayer must reduce the adjusted basis in the retained property (but not below zero) by the fair market value of that consideration or compensation. To the extent that the amount of the consideration or compensation described in the preceding sentence exceeds the adjusted basis in the retained property, the taxpayer must include the excess in gross income for the taxable year of termination.

(iii) *Look-back method.* The look-back method does not apply to a terminated contract that is subject to this paragraph (b)(7).

(c) *Exempt contract methods*—(1) *In general.* An *exempt contract method* means the method of accounting that a taxpayer must use to account for all its long-term contracts (and any portion of a long-term contract) that are exempt from the requirements of section 460(a). Thus, an exempt contract method applies to exempt construction contracts, as defined in § 1.460–3(b); the non-PCM portion of a qualified ship contract, as defined in § 1.460–2(d); and the non-PCM portion of a residential construction contract, as defined in § 1.460–3(c). Permissible exempt contract methods include the PCM, the EPCM described in paragraph (c)(2) of this section, the CCM described in paragraph (d) of this section, or any other permissible method. See section 446.

(2) *Exempt-contract percentage-of-completion method*—(i) *In general.* Similar to the PCM described in paragraph (b) of this section, a taxpayer using the EPCM generally must include in income the portion of the total contract price, as described in paragraph (b)(4) of this section, that corresponds to the percentage of the entire contract that the taxpayer has completed during the taxable year. However, under the EPCM, the percentage of completion may be determined as of the end of the taxable year by using any method of cost comparison (such as comparing direct labor costs incurred to date to estimated total direct labor costs) or by comparing the work performed on the contract with the estimated total work to be performed, rather than by using the cost-to-cost comparison required by paragraphs (b)(2)(i) and (5) of this section, provided such method is used consistently and clearly reflects income. In addition, paragraph (b)(3) of this section (regarding post-completion-year income), paragraph (b)(6) of this section (regarding the 10-percent method) and § 1.460–6 (regarding the look-back method) do not apply to the EPCM.

(ii) *Determination of work performed.* For purposes of the EPCM, the criteria used to compare the work performed on a contract as of the end of the taxable year with the estimated total work to be performed must clearly reflect the earning of income with respect to the contract. For example, in the case of a roadbuilder, a standard of completion solely based on miles of roadway completed in a case where the terrain is substantially different may not clearly reflect the earning of income with respect to the contract.

(d) *Completed-contract method*—(1) *In general.* Except as otherwise provided in paragraph (d)(4) of this section, a taxpayer using the CCM to account for a long-term contract must take into account in the contract's completion year, as defined in § 1.460–1(b)(6), the gross contract price and all allocable contract costs incurred by the completion year. A taxpayer may not treat the cost of any materials and supplies that are allocated to a contract, but actually remain on hand when the contract is completed, as an allocable contract cost.

(2) *Post-completion-year income and costs.* If a taxpayer has not included an item of contingent compensation (*i.e.*, amounts for which the all events test has not been satisfied) in gross contract price under paragraph (d)(3) of this section by the completion year, the taxpayer must account for this item of contingent compensation using a permissible method of accounting. If a taxpayer incurs an allocable contract cost after the completion year, the taxpayer must account for that cost using a permissible method of accounting.

(3) *Gross contract price.* Gross contract price includes all amounts (including holdbacks, retainages, and reimbursements) that a taxpayer is entitled by law or contract to receive, whether or not the amounts are due or have been paid. In addition, gross contract price includes all bonuses, awards, and incentive payments, such as a bonus for meeting an early completion date, to the extent the all events test is satisfied. If a taxpayer performs a non-long-term contract activity, as defined in § 1.460–1(d)(2), that is incident to or necessary for the manufacture, building, installation, or construction of the subject matter of one or more of the taxpayer's long-term contracts, the taxpayer must include an allocable share of the gross receipts attributable to that activity in the gross contract price of the contract(s) benefitted by that activity. Gross contract price also includes amounts reimbursed for independent research and development expenses (as defined in § 1.460–1(b)(9)), or bidding and proposal costs, under a federal or cost-plus long-term contract (as defined in section 460(d)), regardless of whether the research and development, or bidding and proposal, activities are incident to or necessary for the performance of that long-term contract.

(4) *Contracts with disputed claims*—(i) *In general.* The special rules in this paragraph (d)(4) apply to a long-term contract accounted for using the CCM with a dispute caused by a customer's requesting a reduction of the gross contract price or the performance of additional work under the contract or by a taxpayer's requesting an increase in gross contract price, or both, on or after the date a taxpayer has tendered the subject matter of the contract to the customer.

(ii) *Taxpayer assured of profit or loss.* If the disputed amount relates to a customer's claim for either a reduction in price or additional work and the taxpayer is assured of either a profit or a loss on a long-term contract regardless of the outcome of the dispute, the gross contract price, reduced (but not below zero) by the amount reasonably in dispute, must be taken into account in the completion year. If the disputed amount relates to a taxpayer's claim for an increase in price and the taxpayer is assured of either a profit or a loss on a long-term contract regardless of the outcome of the dispute, the gross contract price must be taken into account in the completion year. If the taxpayer is assured a profit on the contract, all allocable contract costs incurred by the end of the completion year are taken into account in that year. If the taxpayer is assured a loss on the contract, all allocable contract costs incurred by the end of the completion year, reduced by the amount reasonably in dispute, are taken into account in the completion year.

(iii) *Taxpayer unable to determine profit or loss.* If the amount reasonably in dispute affects so much of the gross contract price or allocable contract costs that a taxpayer cannot determine whether a profit or loss ultimately will be realized from a long-term contract, the taxpayer may not take any of the gross contract price or allocable contract costs into account in the completion year.

(iv) *Dispute resolved.* Any part of the gross contract price and any allocable contract costs that have not been taken into account because of the principles described in paragraph (d)(4)(i), (ii), or (iii) of this section must be taken into account in the taxable year in which the dispute is resolved. If a taxpayer performs additional work under the contract because of the dispute, the term *taxable year in which the dispute is resolved* means the taxable year the additional work is completed, rather than the taxable year in which the outcome of the dispute is determined by agreement, decision, or otherwise.

(e) *Percentage-of-completion/capitalized-cost method.* Under the PCCM, a taxpayer must determine the income from a long-term contract using the PCM for the applicable percentage of the contract and its exempt contract method, as defined in paragraph (c) of this section, for the remaining percentage of the contract. For residential construction contracts described in § 1.460–3(c), the applicable percentage is 70 percent, and the remaining percentage is 30 percent. For qualified ship contracts described in § 1.460–2(d), the applicable percentage is 40 percent, and the remaining percentage is 60 percent.

(f) *Alternative minimum taxable income*—(1) *In general*. Under section 56(a)(3), a taxpayer (not exempt from the AMT under section 55(e)) must use the PCM to determine its AMTI from any long-term contract entered into on or after March 1, 1986, that is not a home construction contract, as defined in § 1.460–3(b)(2). For AMTI purposes, the PCM must include any election under paragraph (b)(6) of this section (concerning the 10-percent method) or under § 1.460–5(c) (concerning the simplified cost-to-cost method) that the taxpayer has made for regular tax purposes. For exempt construction contracts described in § 1.460–3(b)(1)(ii), a taxpayer must use the simplified cost-to-cost method to determine the completion factor for AMTI purposes. Except as provided in paragraph (f)(2) of this section, a taxpayer must use AMTI costs and AMTI methods, such as the depreciation method described in section 56(a)(1), to determine the completion factor of a long-term contract (except a home construction contract) for AMTI purposes.

(2) *Election to use regular completion factors*. Under this paragraph (f)(2), a taxpayer may elect for AMTI purposes to determine the completion factors of all of its long-term contracts using the methods of accounting and allocable contract costs used for regular federal income tax purposes. A taxpayer makes this election by using regular methods and regular costs to compute the completion factors of all long-term contracts entered into during the taxable year of the election for AMTI purposes on its original federal income tax return for the election year. This election is a method of accounting and, thus, applies to all long-term contracts entered into during and after the taxable year of the election. Although a taxpayer may elect to compute the completion factor of its long-term contracts using regular methods and regular costs, an election under this paragraph (f)(2) does not eliminate a taxpayer's obligation to comply with the requirements of section 55 when computing AMTI. For example, although a taxpayer may elect to use the depreciation methods used for regular tax purposes to compute the completion factor of its long-term contracts for AMTI purposes, the taxpayer must use the depreciation methods permitted by section 56 to compute AMTI.

(g) *Method of accounting*. A taxpayer that uses the PCM, EPCM, CCM, PCCM, or elects the 10-percent method or special AMTI method (or changes to another method of accounting with the Commissioner's consent) must apply the method(s) consistently for all similarly classified long-term contracts, until the taxpayer obtains the Commissioner's consent under section 446(e) to change to another method of accounting. A taxpayer-initiated change in method of accounting will be permitted only on a cut-off basis (*i.e.*, for contracts entered into on or after the year of change), and thus, a section 481(a) adjustment will not be permitted or required.

(h) *Examples*. The following examples illustrate the rules of this section:

Example 1. PCM—estimating total contract price. C, whose taxable year ends December 31, determines the income from long-term contracts using the PCM. On January 1, 2001, C enters into a contract to design and manufacture a satellite (a unique item). The contract provides that C will be paid $10,000,000 for delivering the completed satellite by December 1, 2002. The contract also provides that C will receive a $3,000,000 bonus for delivering the satellite by July 1, 2002, and an additional $4,000,000 bonus if the satellite successfully performs its mission for five years. C is unable to reasonably predict if the satellite will successfully perform its mission for five years. If on December 31, 2001, C should reasonably expect to deliver the satellite by July 1, 2002, the estimated total contract price is $13,000,000 ($10,000,000 unit price + $3,000,000 production-related bonus). Otherwise, the estimated total contract price is $10,000,000. In either event, the $4,000,000 bonus is not includible in the estimated total contract price as of December 31, 2001, because C is unable to reasonably predict that the satellite will successfully perform its mission for five years.

Example 2. PCM—computing income. (i) C, whose taxable year ends December 31, determines the income from long-term contracts using the PCM. During 2001, C agrees to manufacture for the customer, B, a unique item for a total contract price of $1,000,000. Under C's contract, B is entitled to retain 10 percent of the total contract price until it accepts the item. By the end of 2001, C has incurred $200,000 of allocable contract costs and estimates that the total allocable contract costs will be $800,000. By the end of 2002, C has incurred $600,000 of allocable contract costs and estimates that the total allocable contract costs will be $900,000. In 2003, after completing the contract, C determines that the actual cost to manufacture the item was $750,000.

(ii) For each of the taxable years, C's income from the contract is computed as follows:

	Taxable Year		
	2001	2002	2003
(A) Cumulative incurred costs	$200,000	$600,000	$750,000
(B) Estimated total costs	800,000	900,000	750,000
(C) Completion factor: (A) (B)	25.00%	66.67%	100.00%
(D) Total contract price	1,000,000	1,000,000	1,000,000
(E) Cumulative gross receipts: (C) (D)	250,000	666,667	1,000,000
(F) Cumulative gross receipts (prior year)	(0)	(250,000)	(666,667)
(G) Current-year gross receipts (H)	250,000	416,667	333,333
Cumulative incurred costs	200,000	600,000	750,000
(I) Cumulative incurred costs (prior year)	(0)	(200,000)	(600,000)
(J) Current-year costs	200,000	400,000	150,000
(K) Gross income: (G) ¥ (J)	$50,000	$16,667	$183,333

Example 3. PCM—computing income with cost sharing. (i) C, whose taxable year ends December 31, determines the income from long-term contracts using the PCM. During 2001, C enters into a contract to manufacture a unique item. The contract specifies a target price of $1,000,000, a target cost of $600,000, and a target profit of $400,000. C and B will share the savings of any cost underrun (actual total incurred cost is less than target cost) and the additional cost of any cost overrun (actual total incurred cost is greater than target cost) as follows: 30 percent to C and 70 percent to B. By the end of 2001, C has incurred $200,000 of allocable contract costs and estimates that the total allocable contract costs will be $600,000. By the end of 2002, C has incurred $300,000 of allocable contract costs and estimates that the total allocable contract costs will be $400,000. In 2003, after completing the contract, C determines that the actual cost to manufacture the item was $700,000.

(ii) For each of the taxable years, C's income from the contract is computed as follows (note that the sharing of any cost underrun or cost overrun is reflected as an adjustment to C's target price under paragraph (b)(4)(i) of this section):

	Taxable Year		
	2001	2002	2003
(A) Cumulative incurred costs	$200,000	$300,000	$700,000
(B) Estimated total costs	600,000	400,000	700,000
(C) Completion factor: (A) (B)	33.33%	75.00%	100.00%
(D) Target price	$1,000,000	$1,000,000	$1,000,000
(E) Estimated total costs	600,000	400,000	700,000
(F) Target costs	600,000	600,000	600,000
(G) Cost (underrun)/overrun: (E) ¥ (F)	0	(200,000)	100,000
(H) Adjustment rate	70%	70%	70%
(I) Target price adjustment	0	(140,000)	70,000
(J) Total contract price: (D) + (I)	$1,000,000	$860,000	$1,070,000
(K) Cumulative gross receipts: (C) (J)	$333,333	$645,000	$1,070,000
(L) Cumulative gross receipts (prior year):	(0)	(333,333)	(645,000)
(M) Current-year gross receipts	333,333	311,667	425,000
(N) Cumulative incurred costs	200,000	300,000	700,000
(O) Cumulative incurred costs (prior year):	(0)	(200,000)	(300,000)
(P) Current-year costs	200,000	100,000	400,000
(Q) Gross income: (M) ¥ (P)	$133,333	$211,667	$25,000

Example 4. PCM—10 percent method. (i) C, whose taxable year ends December 31, determines the income from long-term contracts using the PCM. In November 2001, C agrees to manufacture a unique item for $1,000,000. C reasonably estimates that the total allocable contract costs will be $600,000. By December 31, 2001, C has received $50,000 in progress payments and incurred $40,000 of costs. C elects to use the 10 percent method effective for 2001 and all subsequent taxable years. During 2002, C receives $500,000 in progress payments and incurs $260,000 of costs. In 2003, C incurs an additional $300,000 of costs, C finishes manufacturing the item, and receives the final $450,000 payment.

(ii) For each of the taxable years, C's income from the contract is computed as follows:

	Taxable Year		
	2001	2002	2003
(A) Cumulative incurred costs	$40,000	$300,000	$600,000
(B) Estimated total costs	600,000	600,000	600,000
(C) Completion factor (A) (B)	6.67%	50.00%	100.00%
(D) Total contract price	1,000,000	1,000,000	1,000,000
(E) Cumulative gross receipts: (C) (D)*	0	500,000	1,000,000
(F) Cumulative gross receipts (prior year):	(0)	(0)	(500,000)
(G) Current-year gross receipts	0	500,000	500,000
(H) Cumulative incurred costs (I)	0	300,000	600,000
Cumulative incurred costs (prior year):	(0)	(0)	(300,000)
(J) Current-year costs	0	300,000	300,000
(K) Gross income: (G) ¥ (J)	$0	$200,000	$200,000

*Unless (C) <10 percent.

Example 5. PCM—contract terminated. C, whose taxable year ends December 31, determines the income from long-term contracts using the PCM. During 2001, C buys land and begins constructing a building that will contain 50 condominium units on that land. C enters into a contract to sell one unit in this condominium to B for $240,000. B gives C a $5,000 deposit toward the purchase price. By the end of 2001, C has incurred $50,000 of allocable contract costs on B's unit and estimates that the total allocable contract costs on B's unit will be $150,000. Thus, for 2001, C reports gross receipts of $80,000 ($50,000 $150,000 $240,000), current-year costs of $50,000, and gross income of $30,000 ($80,000—$50,000). In 2002, after C has incurred an additional $25,000 of allocable contract costs on B's unit, B files for bankruptcy protection and defaults on the contract with C, who is permitted to keep B's $5,000 deposit as liquidated damages. In 2002, C reverses the transaction with B under paragraph (b)(7) of this section and reports a loss of $30,000 ($50,000–$80,000). In addition, C obtains an adjusted basis in the unit sold to B of $70,000 ($50,000 (current-year costs deducted in 2001)—$5,000 (B's forfeited deposit) + $25,000 (current-year costs incurred in 2002). C may not apply the look-back method to this contract in 2002.

Example 6. CCM—contracts with disputes from customer claims. In 2001, C, whose taxable year ends December 31, uses the CCM to account for exempt construction contracts. C enters into a contract to construct a bridge for B. The terms of the contract provide for a $1,000,000 gross contract price. C finishes the bridge in 2002 at a cost of $950,000. When B examines the bridge, B insists that C either repaint several girders or reduce the contract price. The amount reasonably in dispute is $10,000. In 2003, C and B resolve their dispute, C repaints the girders at a cost of $6,000, and C and B agree that the contract price is not to be reduced. Because C is assured a profit of $40,000 ($1,000,000—$10,000—$950,000) in 2002 even if the dispute is resolved in B's favor, C must take this $40,000 into account in 2002. In 2003, C will earn an additional $4,000 profit ($1,000,000—$956,000—$40,000) from the contract with B. Thus, C must take into account an additional $10,000 of gross contract price and $6,000 of additional contract costs in 2003.

Example 7. CCM—contracts with disputes from taxpayer claims. In 2003, C, whose taxable year ends December 31, uses the CCM to account for exempt construction contracts. C enters into a contract to construct a building for B. The terms of the contract provide for a $1,000,000 gross contract price. C finishes the building in 2004 at a cost of $1,005,000. B examines the building in 2004 and agrees that it meets the contract's specifications; however, at the end of 2004, C and B are unable to agree on the merits of C's claim for an additional $10,000 for items that C alleges are changes in contract specifications and B alleges are within the scope of the contract's original specifications. In 2005, B agrees to pay C an additional $2,000 to satisfy C's claims under the contract. Because the amount in dispute affects so much of the gross contract price that C cannot determine in 2004 whether a profit or loss will ultimately be realized, C may not taken any of the gross contract price or allocable contract costs into account in 2004. C must take into account $1,002,000 of gross contract price and $1,005,000 of allocable contract costs in 2005.

Example 8. CCM—contracts with disputes from taxpayer and customer claims. C, whose taxable year ends December 31, uses the CCM to account for exempt construction contracts. C constructs a factory for B pursuant to a long-term contract. Under the terms of the contract, B agrees to pay C a total of $1,000,000 for construction of the factory. C finishes construction of the factory in 2002 at a cost of $1,020,000. When B takes possession of the factory and begins operations in December 2002, B is dissatisfied with the location and workmanship of certain heating ducts. As of the end of 2002, C contends that the heating ducts are constructed in accordance with contract specifications. The amount of the gross contract price reasonably in dispute with respect to the heating ducts is $6,000. As of this time, C is claiming $14,000 in addition to the original contract price for certain changes in contract specifications which C alleges have increased his costs. B denies that these changes have increased C's costs. In 2003, the disputes between C and B are resolved by performance of additional work by C at a cost of $1,000 and by an agreement that the contract price would be revised downward to $996,000. Under these circumstances, C must include in his gross income for 2002, $994,000 (the gross contract price less the amount reasonably in dispute because of B's claim, or $1,000,000—$6,000). In 2002, C must also take into account $1,000,000 of allocable contract costs (costs incurred less the amounts in dispute attributable to both B's and C's claims, or $1,020,000—$6,000—$14,000). In 2003, C must take into account an additional $2,000 of gross contract price ($996,000—$994,000) and $21,000 of allocable contract costs ($1,021,000—$1,000,000).

(i) [Reserved]

* * * * *

(k) *Mid-contract change in taxpayer.* [Reserved]

Par. 8. Section 1.460–5 is added to read as follows:

§ 1.460–5 Cost allocation rules.

(a) *Overview.* This section prescribes methods of allocating costs to long-term contracts accounted for using the percentage-of-completion method described in § 1.460–4(b) (PCM), the completed-contract method described in § 1.460–4(d) (CCM), or the percentage-of-completion/capitalized-cost method described in § 1.460–4(e) (PCCM). Exempt construction contracts described in § 1.460–3(b) accounted for using a method other than the PCM or CCM are not subject to the cost allocation rules of this section (other than the requirement to allocate production-period interest under paragraph (b)(2)(v) of this section). Paragraph (b) of this section describes the regular cost allocation methods for contracts subject to the PCM. Paragraph (c) of this section describes an elective simplified cost allocation method for contracts subject to the PCM. Paragraph (d) of this section describes the cost allocation methods for exempt construction contracts reported using the CCM. Paragraph (e) of this section describes the cost allocation rules for contracts subject to the PCCM. Paragraph (f) of this section describes additional rules applicable to the cost allocation methods described in this section. Paragraph (g) of this section provides rules concerning consistency in method of allocating costs to long-term contracts.

(b) *Cost allocation method for contracts subject to PCM*—(1) *In general.* Except as otherwise provided in paragraph (b)(2) of this section, a taxpayer must allocate costs to each long-term contract subject to the PCM in the same manner that direct and indirect costs are capitalized to property produced by a taxpayer under § 1.263A–1(e) through (h). Thus, a taxpayer must allocate to each long-term contract subject to the PCM all direct costs and certain indirect costs properly allocable to the long-term contract (*i.e.,* all costs that directly benefit or are incurred by reason of the performance of the long-term contract). However, see paragraph (c) of this section concerning an election to allocate contract costs using the simplified cost-to-cost method. As in section 263A, the use of the practical capacity concept is not permitted. See § 1.263A–2(a)(4).

(2) *Special rules*—(i) *Direct material costs.* The costs of direct materials must be allocated to a long-term contract when dedicated to the contract under principles similar to those in § 1.263A–11(b)(2). Thus, a taxpayer dedicates direct materials by associating them with a specific contract, including by purchase order, entry on books and records, or shipping instructions. A taxpayer maintaining inventories under § 1.471–1 must determine allocable contract costs attributable to direct materials using its method of accounting for those inventories (*e.g.,* FIFO, LIFO, specific identification).

(ii) *Components and subassemblies.* The costs of a component or subassembly (component) produced by the taxpayer must be allocated to a long-term contract as the taxpayer incurs costs to produce the component if the taxpayer reasonably expects to incorporate the component into the subject matter of the contract. Similarly, the cost of a purchased component (including a component purchased from a related party) must be allocated to a long-term contract as the taxpayer incurs the cost to purchase the component if the taxpayer reasonably expects to incorporate the component into the subject matter of the contract. In all other cases, the cost of a component must be allocated to a long-term contract when the component is dedicated, under principles similar to those in § 1.263A–11(b)(2). A taxpayer maintaining inventories under § 1.471–1 must determine allocable contract costs attributable to components using its method of accounting for those inventories (*e.g.*, FIFO, LIFO, specific identification).

(iii) *Simplified production methods.* A taxpayer may not determine allocable contract costs using the simplified production methods described in § 1.263A–2(b) and (c).

(iv) *Costs identified under cost-plus long-term contracts and federal long-term contracts.* To the extent not otherwise allocated to the contract under this paragraph (b), a taxpayer must allocate any identified costs to a cost-plus long-term contract or federal long-term contract (as defined in section 460(d)). *Identified cost* means any cost, including a charge representing the time-value of money, identified by the taxpayer or related person as being attributable to the taxpayer's cost-plus long-term contract or federal long-term contract under the terms of the contract itself or under federal, state, or local law or regulation.

(v) *Interest*—(A) *In general.* If property produced under a long-term contract is *designated property*, as defined in § 1.263A–8(b) (without regard to the exclusion for long-term contracts under § 1.263A–8(d)(2)(v)), a taxpayer must allocate interest incurred during the production period to the long-term contract in the same manner as interest is allocated to property produced by a taxpayer under section 263A(f). See §§ 1.263A–8 to 1.263A–12 generally.

(B) *Production period.* Notwithstanding § 1.263A–12(c) and (d), for purposes of this paragraph (b)(2)(v), the production period of a long-term contract—

(*1*) Begins on the later of—

(*i*) The contract commencement date, as defined in § 1.460–1(b)(7); or

(*ii*) For a taxpayer using the accrual method of accounting for long-term contracts, the date by which 5 percent or more of the total estimated costs, including design and planning costs, under the contract have been incurred; and

(*2*) Ends on the date that the contract is completed, as defined in § 1.460–1(c)(3).

(C) *Application of section 263A(f).* For purposes of this paragraph (b)(2)(v), section 263A(f)(1)(B)(iii) (regarding an estimated production period exceeding 1 year and a cost exceeding $1,000,000) must be applied on a contract-by-contract basis; except that, in the case of a taxpayer using an accrual method of accounting, that section must be applied on a property-by-property basis.

(vi) *Research and experimental expenses.* Notwithstanding § 1.263A–1(e)(3)(ii)(P) and (iii)(B), a taxpayer must allocate research and experimental expenses, other than independent research and development expenses (as defined in § 1.460–1(b)(9)), to its long-term contracts.

(vii) *Service costs*—(A) *Simplified service cost method*—(1) *In general.* To use the simplified service cost method under § 1.263A–1(h), a taxpayer must allocate the otherwise capitalizable mixed service costs among its long-term contracts using a reasonable method. For example, otherwise capitalizable mixed service costs may be allocated to each long-term contract based on labor hours or contract costs allocable to the contract. To be considered reasonable, an allocation method must be applied consistently and must not disproportionately allocate service costs to contracts expected to be completed in the near future.

(2) *Example.* The following example illustrates the rule of this paragraph (b)(2)(vii)(A):

Example. Simplified service cost method. During 2001, C, whose taxable year ends December 31, produces electronic equipment for inventory and enters into long-term contracts to manufacture specialized electronic equipment. C's method of allocating mixed service costs to the property it produces is the labor-based, simplified service cost method described in § 1.263A–1(h)(4). For 2001, C's total mixed service costs are $100,000, C's section 263A labor costs are $500,000, C's section 460 labor costs (*i.e.*, labor costs allocable to C's long-term contracts) are $250,000, and C's total labor costs are $1,000,000. To determine the amount of mixed service costs capitalizable under section 263A for 2001, C multiplies its total mixed service costs by its section 263A allocation ratio (section 263A labor costs total labor costs). Thus, C's capitalizable mixed service costs for 2001 are $50,000 ($100,000 x $500,000 $1,000,000). Thereafter, C allocates its capitalizable mixed service costs to produced property remaining in ending inventory using its 263A allocation method (*e.g.*, burden rate, simplified production). Similarly, to determine the amount of mixed service costs that are allocable to C's long-term contracts for 2001, C multiplies its total mixed service costs by its section 460 allocation ratio (section 460 labor total labor costs). Thus, C's allocable mixed service contract costs for 2001 are $25,000 ($100,000 x $250,000 $1,000,000). Thereafter, C allocates its allocable mixed service costs to its long-term contracts proportionately based on its section 460 labor costs allocable to each long-term contract.

(B) *Jobsite costs.* If an administrative, service, or support function is performed solely at the jobsite for a specific long-term contract, the taxpayer may allocate all the direct and indirect costs of that administrative, service, or support function to that long-term contract. Similarly, if an administrative, service, or support function is performed at the jobsite solely for the taxpayer's long-term contract activities, the taxpayer may allocate all the direct and indirect costs of that administrative, service, or support function among all the long-term contracts performed at that jobsite. For this purpose, jobsite means a production plant or a construction site.

(C) *Limitation on other reasonable cost allocation methods.* A taxpayer may use any other reasonable method of allocating service costs, as provided in § 1.263A–1(f)(4), if, for the taxpayer's long-term contracts considered as a whole, the—

(*1*) Total amount of service costs allocated to the contracts does not differ significantly from the total amount of service costs that would have been allocated to the contracts under § 1.263A–1(f)(2) or (3);

(*2*) Service costs are not allocated disproportionately to contracts expected to be completed in the near future because of the taxpayer's cost allocation method; and

(*3*) Taxpayer's cost allocation method is applied consistently.

(c) *Simplified cost-to-cost method for contracts subject to the PCM*—(1) *In general.* Instead of using the cost allocation method prescribed in paragraph (b) of this section, a taxpayer may elect to use the simplified cost-to-cost method, which is authorized under section 460(b)(3)(A), to allocate costs to a long-term contract subject to the PCM. Under the simplified cost-to-cost method, a taxpayer determines a contract's completion factor based upon only direct material costs; direct labor costs; and depreciation, amortization, and cost recovery allowances on equipment and facilities directly used to manufacture or construct the subject matter of the contract. For this purpose, the costs associated with any manufacturing or construction activities performed by a subcontractor are considered either direct material or direct labor costs, as appropriate, and therefore must be allocated to the contract under the simplified cost-to-cost method. An electing taxpayer must use the simplified cost-to-cost method to apply the look-back method under § 1.460–6 and to determine alternative minimum taxable income under § 1.460–4(f).

(2) *Election.* A taxpayer makes an election under this paragraph (c) by using the simplified cost-to-cost method for all long-term contracts entered into during the taxable year of the election on its original federal income tax return for the election year. This election is a method of accounting and, thus, applies to all long-term contracts entered into during and after the taxable year of the election. This election is not available if a taxpayer does not use the PCM to account for all long-term contracts or if a taxpayer elects to use the 10-percent method described in § 1.460–4(b)(6).

(d) *Cost allocation rules for exempt construction contracts reported using the CCM*—(1) *In general.* For exempt construction contracts reported using the CCM, other than contracts described in paragraph (d)(3) of this section (concerning contracts of homebuilders that do not satisfy the $10,000,000 gross receipts test described in § 1.460–3(b)(3) or will not be completed within two years of the contract commencement date), a taxpayer must annually allocate the cost of any activity that is incident to or necessary for the taxpayer's performance under a long-term contract. A taxpayer must allocate to each exempt construction contract all direct costs as defined in § 1.263A–1(e)(2)(i) and all indirect costs either as provided in § 1.263A–1(e)(3) or as provided in paragraph (d)(2) of this section.

(2) *Indirect costs*—(i) *Indirect costs allocable to exempt construction contracts.* A taxpayer allocating costs under this paragraph (d)(2) must allocate the following costs to an exempt construction contract, other than a contract described in paragraph (d)(3) of this section, to the extent incurred in the performance of that contract—

(A) Repair of equipment or facilities;

(B) Maintenance of equipment or facilities;

(C) Utilities, such as heat, light, and power, allocable to equipment or facilities;

(D) Rent of equipment or facilities;

(E) Indirect labor and contract supervisory wages, including basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d) as it existed prior to its repeal in 1983), shift differential, payroll taxes, and contributions to a supplemental unemployment benefits plan;

(F) Indirect materials and supplies;

(G) Noncapitalized tools and equipment;

(H) Quality control and inspection;

(I) Taxes otherwise allowable as a deduction under section 164, other than state, local, and foreign income taxes, to the extent attributable to labor, materials, supplies, equipment, or facilities;

(J) Depreciation, amortization, and cost-recovery allowances reported for the taxable year for financial purposes on equipment and facilities to the extent allowable as deductions under chapter 1 of the Internal Revenue Code;

(K) Cost depletion;

(L) Administrative costs other than the cost of selling or any return on capital;

(M) Compensation paid to officers other than for incidental or occasional services;

(N) Insurance, such as liability insurance on machinery and equipment; and

(O) Interest, as required under paragraph (b)(2)(v) of this section.

(ii) *Indirect costs not allocable to exempt construction contracts.* A taxpayer allocating costs under this paragraph (d)(2) is not required to allocate the following costs to an exempt construction contract reported using the CCM—

(A) Marketing and selling expenses, including bidding expenses;

(B) Advertising expenses;

(C) Other distribution expenses;

(D) General and administrative expenses attributable to the performance of services that benefit the taxpayer's activities as a whole (*e.g.,* payroll expenses, legal and accounting expenses);

(E) Research and experimental expenses (described in section 174 and the regulations thereunder);

(F) Losses under section 165 and the regulations thereunder;

(G) Percentage of depletion in excess of cost depletion;

(H) Depreciation, amortization, and cost recovery allowances on equipment and facilities that have been placed in service but are temporarily idle (for this purpose, an asset is not considered to be temporarily idle on non-working days, and an asset used in construction is considered to be idle when it is neither en route to nor located at a job-site), and depreciation, amortization and cost recovery allowances under chapter 1 of the Internal Revenue Code in excess of depreciation, amortization, and cost recovery allowances reported by the taxpayer in the taxpayer's financial reports;

(I) Income taxes attributable to income received from long-term contracts;

(J) Contributions paid to or under a stock bonus, pension, profit-sharing, or annuity plan or other plan deferring the receipt of compensation whether or not the plan qualifies under section 401(a), and other employee benefit expenses paid or accrued on behalf of labor, to the extent the contributions or expenses are otherwise allowable as deductions under chapter 1 of the Internal Revenue Code. Other employee benefit expenses include (but are not limited to): Worker's compensation; amounts deductible or for whose payment reduction in earnings and profits is allowed under section 404A and the regulations thereunder; payments pursuant to a wage continuation plan under section 105(d) as it existed prior to its repeal in 1983; amounts includible in the gross income of employees under a method or arrangement of employer contributions or compensation which has the effect of a stock bonus, pension, profit-sharing, or annuity plan, or other plan deferring the receipt of compensation or providing deferred benefits; premiums on life and health insurance; and miscellaneous benefits provided for employees such as safety, medical treatment, recreational and eating facilities, membership dues, *etc.*;

(K) Cost attributable to strikes, rework labor, scrap and spoilage; and

(L) Compensation paid to officers attributable to the performance of services that benefit the taxpayer's activities as a whole.

(3) *Large homebuilders.* A taxpayer must capitalize the costs of home construction contracts under section 263A and the regulations thereunder, unless the contract will be completed within two years of the contract commencement date and the taxpayer satisfies the $10,000,000 gross receipts test described in § 1.460–3(b)(3).

(e) *Cost allocation rules for contracts subject to the PCCM.* A taxpayer must use the cost allocation rules described in paragraph (b) of this section to determine the costs allocable to the entire qualified ship contract or residential construction contract accounted for using the PCCM and may not use the simplified cost-to-cost method described in paragraph (c) of this section.

(f) *Special rules applicable to costs allocated under this section*—(1) *Nondeductible costs.* A taxpayer may not allocate any otherwise allocable contract cost to a long-term contract if any section of the Internal Revenue Code disallows a deduction for that type of payment or expenditure (*e.g.,* an illegal bribe described in section 162(c)).

(2) *Costs incurred for non-long-term contract activities.* If a taxpayer performs a non-long-term contract activity, as defined in § 1.460–1(d)(2), that is incident to or necessary for the manufacture, building, installation, or construction of the subject matter of one or more of the taxpayer's long-term contracts, the taxpayer must allocate the costs attributable to that activity to such contract(s).

(g) *Method of accounting.* A taxpayer that adopts or elects a cost allocation method of accounting (or changes to another cost allocation method of accounting with the Commissioner's consent) must apply that method consistently for all similarly classified contracts, until the taxpayer obtains the Commissioner's consent under section 446(e) to change to another cost allocation method. A taxpayer-initiated change in cost allocation method will be permitted only on a cut-off basis (*i.e.,* for contracts entered into on or after the year of change) and thus, a section 481(a) adjustment will not be permitted or required.

Par. 9. Section 1.460–6 is amended as follows:

1. A sentence is added to the end of paragraph (a)(2).

2. The third sentence of paragraph (b)(1) is removed.

3. In the fourth sentence of paragraph (b)(1), ''Therefore, to the extent that the percentage of completion method is required to be used'' is removed and ''To the extent that the percentage of completion method is required to be used under § 1.460–1(g)'' is added in its place.

4. The first sentence of paragraph (c)(1)(ii)(A) is revised.

5. In the first sentence of paragraph (c)(1)(ii)(B), the language ''no later than the year'' is removed and ''in the year'' is added in its place and ''§ 1.451–3(b)(*2*)'' is removed and ''§ 1.460–1(c)(3)'' is added in its place.

6. The last two sentences of paragraph (c)(1)(ii)(B) are removed.

7. In the last sentence of paragraph (c)(1)(ii)(C)(*2*), the language ''§ 5h.6'' is removed and ''§ 301.9100–8 of this chapter'' is added in its place.

8. In the fourth sentence of paragraph (c)(2)(v)(A), the language ''similarly'' is removed.

9. The first, second, fifth, and sixth sentences of paragraph (c)(2)(v)(A) are removed.

10. In the first sentence of paragraph (c)(2)(vi)(B), the language ''§ 1.453(b)(2)(ii), (iii), (iv), and § 1.451–3(d)(2), (3), and (4)'' is removed and ''§ 1.460–4(b)(4)(i)'' is added in its place.

11. In the second sentence of paragraph (c)(2)(vi)(B), the language ''the percentage of completion method and'' is removed.

12. In the third sentence of paragraph (c)(2)(vi)(B), the language '', for purposes of both the percentage of completion method and the look-back method'' is removed.

13. In the fourth sentence of paragraph (c)(2)(vi)(B), the language ''Similarly, a'' is removed and ''A'' is added in its place.

14. In the first sentence of paragraph (c)(2)(vi)(C), the language ''§ 1.451–3(e)'' is removed and ''§ 1.460–1(e)'' is added in its place.

15. Paragraph (c)(4)(iv) is removed.

16. In the first sentence of paragraph (d)(4)(ii)(C), the language ''within the meaning of section 1504(a)'' is removed and '', as defined in § 1.1502–1(h)'' is added in its place.

17. In the fourth sentence of paragraph (e)(2), the language ''within the meaning of section 1504(a)'' is removed and '', as defined in § 1.1502–1(h)'' is added in its place.

18. In the first sentence of paragraph (f)(1), the language ''or to be refunded'' is removed and ''from, or payable to, a taxpayer'' is added in its place.

19. In the first sentence of paragraph (f)(1), the language ''and reported'' is removed.

20. In the second sentence of paragraph (f)(1), the language ''and Form 8697 is filed by'' is removed.

21. In the second sentence of paragraph (f)(2)(i), the language ''fails to file Form 8697 with respect to interest required to be paid or that'' is removed.

22. In the second sentence of paragraph (f)(2)(i), the language ''a penalty for failing to file Form 8697'' is removed and ''an underpayment penalty under section 6651, and the taxpayer also is liable for underpayment interest under section 6601'' is added in its place.

23. In the third sentence of paragraph (f)(2)(i), the language ''penalty'' is removed and ''subtitle F'' is added in its place.

24. In the fourth sentence of paragraph (f)(2)(i), the language ''or a tax refund'' is added after ''liability''.

25. In the first sentence of paragraph (f)(2)(ii), the language ''refunded'' is removed and ''payable'' is added in its place.

26. Paragraph (f)(3) is added.

The revisions and additions read as follows:

§ 1.460–6 Look-back method.

(a) * * *

(2) * * * Paragraph (j) of this section provides guidance concerning the election not to apply the look-back method in de minimis cases.

* * * * *

(c) * * * (1) * * *

(ii) * * * (A) *In general.* Except as otherwise provided in section 460(b)(6) (see § 1.460–6(j) for method of electing) or § 1.460–6(e), a taxpayer must apply the look-back method to a long-term contract in the completion year and in any post-completion year for which the taxpayer must adjust total contract price or total allocable contract costs, or both, under the PCM. * * *

* * * * *

(f) * * *

(3) *Statute of limitations and compounding of interest on look-back interest.* For guidance on the statute of limitations applicable to the assessment and collection of look-back interest owed by a taxpayer, see sections 6501 and 6502. A taxpayer's claim for credit or refund of look-back interest previously paid by or collected from a taxpayer is a claim for credit or refund of an overpayment of tax and is subject to the statute of limitations provided in section 6511. A taxpayer's claim for look-back interest (or interest payable on look-back interest) that is not attributable to an amount previously paid by or collected from a taxpayer is a general, non-tax claim against the federal government. For guidance on the statute of limitations that applies to general, non-tax claims against the federal government, see 28 U.S.C. sections 2401 and 2501. For guidance applicable to the compounding of interest when the look-back interest is not paid, see sections 6601 to 6622.

* * * * *

§§ 1.460–7 and 1.460–8 [Removed]

Par. 10. Sections 1.460–7 and 1.460–8 are removed.

§ 1.471–10 [Amended]

Par. 11. Section 1.471–10 is amended by removing the language ''§ 1.451–3'' and adding ''§ 1.460–2'' in its place.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 12. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 13. In § 602.101, paragraph (b) is amended by:

1. Removing the entry for ''1.451–3''.

2. The following entries are added in numerical order to the table:

§ 602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.460–1	1545–1650
* * * * *	

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved: December 20, 2000.

Jonathan Talisman,
Acting Assistant Secretary of the Treasury.

[FR Doc. 01–6 Filed 1–10–01; 8:45 am]

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DEPARTMENT OF THE TREASURY

Internal Revenue Service (IRS)

26 CFR Parts 1 and 602

[TD 8933]

RIN 1545–AX33

Qualified Transportation Fringe Benefits

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulation.

SUMMARY: This document contains final regulations relating to qualified transportation fringe benefits. These final regulations provide rules to ensure that transportation benefits provided to employees are excludable from gross income. These final regulations reflect changes to the law made by the Energy Policy Act of 1992, the Taxpayer Relief Act of 1997, and the Transportation Equity Act for the 21st Century. These final regulations affect employers that offer qualified transportation fringes and employees who receive these benefits.

DATES: *Effective Date:* These regulations are effective January 11, 2001.

Applicability Date: For dates of applicability, see § 1.132–9(b), Q/A–25.

FOR FURTHER INFORMATION CONTACT: John Richards, (202) 622–6040 (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) under control number 1545–1676. Responses to this collection of information are mandatory to obtain the benefit described under section 132(f).

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 assigned by the Office of Management and Budget.

The estimated average annual recordkeeping burden per recordkeeper is 26.5 hours. The estimated annual reporting burden per respondent is .8 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:S:O, 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

This document contains amendments to 26 CFR part 1 (Income Tax Regulations). On January 27, 2000, a proposed regulation (REG–113572–99) relating to qualified transportation fringes was published in the **Federal Register** (65 FR 4388). A public hearing was held on June 1, 2000. Written or electronic comments responding to the notice of proposed rulemaking were received. After consideration of all the comments, the proposed regulations are adopted as amended by this Treasury decision. The revisions are discussed below.

Explanation of Provisions and Summary of Comments

In general, comments received on the proposed regulations were favorable and, accordingly, the final regulations retain the general structure of the proposed regulations, including the question and answer format and a variety of examples illustrating the substance of the final regulations. However, commentators made a number of specific recommendations for modifications and clarifications of the regulations. In response to these comments, the final regulations incorporate the modifications and clarifications described below.

A. Whether Vouchers are Readily Available

Section 132(f)(3) provides that qualified transportation fringes include cash reimbursement for transit passes ‘‘only if a voucher or similar item which may be exchanged only for a transit pass is not readily available for direct distribution by the employer to the employee.’’ Thus, if vouchers are readily available, the employer must use vouchers and cash reimbursement of a mass transit expense would not be a qualified transportation fringe.

Most of the comments received addressed the issue of whether vouchers are ‘‘readily available.’’ Commentators representing employers generally favored rules permitting cash reimbursement. Commentators representing transit operators and voucher providers generally favored rules not permitting cash reimbursement. The following discusses three issues raised by commentators: first, whether the proposed regulations’ 1 percent safe harbor should be retained; second, whether internal administrative costs should be considered in applying the 1 percent test; and third, whether other nonfinancial restrictions should be considered in determining whether vouchers are readily available.

1. The 1 Percent Safe Harbor

Under Notice 94–3, 1994–1 C.B. 327, and the proposed regulations, a voucher is readily available if an employer can obtain it on terms no less favorable than those available to an individual employee and without incurring a significant administrative cost. Under the proposed regulations, administrative costs relate only to fees paid to fare media providers, and the determination of whether obtaining a voucher would result in a significant administrative cost is made with respect to each transit system voucher. The proposed regulations provide a rule under which administrative costs are treated as significant if the average monthly administrative costs incurred by the employer for a voucher (disregarding delivery charges imposed by the fare media provider to the extent not in excess of $15 per order) are more than 1 percent of the average monthly value of the vouchers for a system.

Commentators, in particular those representing fare media providers and transit operators, suggested that the fare media provider fee percentage causing vouchers to not be readily available should be raised because many fare media providers charge fees in excess of the 1 percent limit and, thus, under this