# Chapter 6

# Uniform Capitalization Rules - §263A

# Long-term Contract Rules - §460

**Primary Authority** (read where referenced in this chapter)

- IRC §§263A, 460
- Regs. §1.263A-1; skim: §1.263A-2 and -3

**Learning Objectives** – This lesson will enable you to be able to answer these questions:

- What taxpayers are subject to the uniform capitalization rules of §263A?
- What is the basic operation of the uniform capitalization rules (what must taxpayers do to comply)?
- When is a taxpayer required to capitalize interest expense (rather than expense it currently)?
- What is a long-term contract?
- What are the basic rules to follow to account for long-term contract revenues and expenses?

**Sample taxpayer questions that arise regarding the material covered in this chapter:**

- Which taxpayers are subject to the uniform capitalization rules of §263A?
- What is the simplified cost method of complying with §263A for producers? What are the advantages and disadvantages of using a simplified method for computing §263A costs and calculating ending inventory?
- What taxpayers are likely to be subject to interest capitalization under §263A(f)?
- What taxpayers are likely to be subject to the long-term contract rules of §460?

**General Rules of §263A**

- Capitalize all direct materials, direct labor and certain indirect costs (including mixed service costs that benefit producing/reselling activities and non-producing/non-reselling activities)
- that are allocable to:
  - real property and tangible personal property produced by the taxpayer -
    - for sale
    - for self-use
  - real property and tangible and intangible personal property acquired for resale

Thus, rules apply to producers, retailers, wholesalers and resellers.

- Note that there are exceptions where §263A will not apply to certain types of expenditures (such as R & D) or to certain activities (such as resale activities of a retailer with average annual gross receipts over a 3-year period of $10,000,000 or less) - see §1.263A-1(b). Note that other capitalization rules might apply even though §263A does not (such as §263(a)).

**Keys to application of §263A**

- Determine if taxpayer subject to §263A
- Identify costs as direct materials, direct labor, indirect costs, mixed service costs (a type of indirect costs that requires further allocation between activities), other costs
- Producers using the simplified production method will also have to distinguish between §1.471-11 (full absorption) costs and additional §263A costs (see §1.263A-1(d))
- Determine if present methods used to allocate §263A costs to §263A property are in line with the final §263A costs. If not, change in method required - also see transitional rule Rev. Proc. to be issued in 1994 with respect to changes required by issuance of the final regulations.
- Determine if taxpayer wants to change its present allocation method, for example, if taxpayer wants to adopt a simplified method provided in the regulations. If so, must follow change in accounting procedures.

## Q&A Overview to §263A and §460

### §263A

1. What is the purpose of §263A?

Excerpt from the General Explanation of the Tax Reform Act of 1986, prepared by the Staff of the Joint Committee on Taxation - §263A - UNICAP (pages 508 - 509)

"Reasons for Change

The Congress believed that the rules of prior law regarding the capitalization of costs incurred in producing property were deficient in two respects. First, those rules allowed costs that were in reality costs of producing, acquiring, or carrying property to be deducted currently, rather than capitalized into the basis of the property and recovered when the property was sold or as it was used by the taxpayer. This treatment produced a mismatching of expenses and the related income and an unwarranted deferral of Federal income taxes. Second, different capitalization rules could apply depending on the nature of the property and its intended use. The Congress was concerned that these differences could create distortions in the allocation of economic resources and the manner in which certain economic activity was organized.

The Congress believed that, in order to more accurately reflect income and make the income tax system more neutral, a single, comprehensive set of rules should govern the capitalization of costs of producing, acquiring, and holding property, including interest expense, subject to appropriate exceptions where application of the rules might be unduly burdensome."

• raises revenue because of §481(a) adjustment in year §236A adopted and because more costs are capitalized into inventory, thus, expensed later

• §263A is broader than GAAP and full absorption rules of §1.471-11

2. What does "produce" mean? §263A(g), §1.263A-2(a)(1)) and Rev. Rul. 81-172 (Chapter 5)

• **construct, build, install, manufacture, develop, improve, create, raise, grow**

• **also if produced by another for the taxpayer under contract, taxpayer treated as producing**

3. What types of property and transactions are exempt from §263A?

- **See §263A(c), §1.263A-1(b)**
- **Also excludes personal use property such as individual constructing own residence**
    - *Ashley v. Comm'r.*, T.C. Memo 2000-376 – the court held that the taxpayer could not add to basis various operating costs related to a home he was renovating because he wasn't in the business of renovating homes for resale.
- **Qualified creative expenses -** TAM 9643003 (7/10/96) provides some clarification of the limited exception from §263A for "qualified creative expenses" (added by TAMRA '88, but retroactive back to the TRA'86). Taxpayer, a cash method individual, composed and recorded

songs on a "rough-cut demo tape" and incurred costs of a recording studio, musicians and a recording engineer. Taxpayer deducted these costs when paid; the IRS disallowed the deduction on the basis that such costs were required to be capitalized under §263A. Taxpayer argued that he is a "writer" excepted from §263A under §263A(h) and that his costs are similar in nature to word processing costs incurred by an author. The IRS reviewed §263A(h) and its legislative history to conclude that the taxpayer's production and engineering costs incurred to produce the sound recording was not a "qualified creative expense" under §263A(h) and therefore, was not excepted from §263A. The IRS pointed out that under §263A(h)(3)(A), a "writer" is a person who creates by writing; therefore the exception for qualified creative expense is limited to written creations, including a written musical composition. However, the demo tape is a not a writing and its production costs are expressly excluded from the definition of qualified creative expenses. Motion picture films and video tapes are specific examples of tangible personal property that is not qualified creative expenses and the demo tape is a "similar item."

4. What are the four categories of costs that a retailer must capitalize into inventory under §263A and the regulations? §1.263A-1(e) and §1.263A-3(c)

• **purchasing, handling, off-site storage and G&A (MSC)**

5. Retailer J has the following gross receipts:

| | |
|---|---|
| 1995 | $8,000,000 |
| 1996 | $9,500,000 |
| 1997 | 13,000,000 |
| 1998 | 15,000,000 |

When must J begin to follow §263A? How is the §481(a) adjustment computed for the change in method, what is the spread period for the adjustment and what administrative procedures must J follow?

• **1995 - 1997 average annual GR = $10,166,667, so adopt §263A in 1998**

• **§1.263A-7 - how to change method/revalue inventory**

• **change from large to small - follow Rev. Proc. 2002-9**

6. What is included in gross receipts? §1.263A-3(b)(2)

• **note that the definition is not the same as the GR definition at §1.448-1T(f)(2)(iv)**

7. Engineering consulting firm is also a reseller of various computer programs. Its gross receipts from the software sales averages $2,000,000 per year. Its gross receipts from consulting services averages $11,000,000 per year. Must engineering firm apply §263A to its retail sales?

• **YES - per holding of Rev. Rul. 89-26 and §1.263A-3(b)(2)(i)**

8. Does the $10 million gross receipts exception apply to the following reseller?

| Year | Parent | Sub 1 | Sub 2 | Sub 3 (FSC, can't consolidate) |
|---|---|---|---|---|
| 1984 | $5M | $2M | $4M | $2M |
| 1985 | $4M | $4M | $3M | $2M |
| 1986 | $6M | $3M | $3M | $2M |

**YES - see §1.263A-3(b)(3) - include GR of all members of controlled group, even if is treated as an excluded component member under §1563(b)**

Would the result change if there were no S2? What if S2 only joined the group in 1987?

**NO - average annual GR over prior 3-year period still exceeds $10,000,000; also note rule on predecessor and new taxpayers at (b)(2)(i)**

9. Does §263A apply to the following taxpayer? Explain and provide a cite to support your answer.

| Type of taxpayer | Gross receipts |
|---|---|
| a) computer manufacturer | > $10,000,000 |
| b) Harriet's Hardware Store<br>sells hardware, makes keys, mixes paints, cuts wood | < $10,000,000 |

| c) Architect<br>- designs buildings<br>- customer keeps copy of blueprint | > $10,000,000 |
|---|---|
| d) Bakery<br>Direct labor $250,000/year<br>Direct materials $180,000/year<br>Indirect costs $130,000/year | < $10,000,000 |

9. Per §1.263A-1(e)(3)(iii)(E) - depreciation on temporarily idle equipment and facilities does not have to be capitalized. What does this refer to?

- **equipment and facilities are temporarily idle when taken out of service for a finite period. But, not considered temporarily idle during worker breaks, non-working hours, or on regularly scheduled non-working days such as holidays or weekends; during normal interruptions in operation of equipment or facilities; when equipment is enroute to or located at a job site; or when under normal operating conditions, equipment is used or operated only during certain shifts**

10. Which of the following indirect production costs must be capitalized under §263A? §1.263A-1(e)

a. water bill?

**YES, -1(e)(ii)(N)**

b. engineering costs on new product?

**YES, unless is R&D (§174) -1(e)(ii)P)**

c. accounting department costs?

**YES, capitalizable service cost per -1(e)(4)(iii)(E), but tax services are generally not a capitalizable service cost per -1(e)(4)(iv)M)**

d. advertising?

**NO -1(e)(3)(iii)(A)**

e. recession causes corporation to go from 3 work shifts to 2, can it expense 1/3 of the costs of that facility?

**YES - not temporarily idle because still operated for 2 shifts, see Ex 1 at -1(e)(3)(iii)(E)(2)**

f. warranty costs on merchandise sold?

**NO -1(e)(3)(iii)(H)**

g. entertainment expenses of purchasing agent?

- **§1.263A-1(e)(ii)(F) & §1.263A-3(c)(3) - is it a cost attributable to purchasing activities? is it related to the establishment and maintenance of vendor contacts? PROBABLY**

- **note that per §1.263A-1(c)(2), only 50% would be capitalizable and 50% would be disallowed because any cost that may not be taken into account in computing taxable income is not treated as a cost properly allocable to property produced or acquired for resale under §263A and the regulations**

h. Unclassified labor costs: G Corporation's production workers track their time under three categories: 1) specific projects, 2) "unclassified" time spent on report preparation, training, general meetings, school visits, and breakdown time, and 3) vacation, sick and holiday time. The bulk of time spent by these workers is on production activities. How much of these workers' time is a capitalizable cost under §263A?

- Reg. §1.263A-1(e)(3)(ii)(A)

- Also see TAM 9426004 (3/22/94) and ISP on capitalization of Costs - Unclassified Labor Costs, for the Utilities Industry (3/96). Per the ISP paper: "Section 263A requires taxpayers to capitalize the costs of "unclassified time"; i.e., the time of an employee normally engaged in production activities that is not attributable to any particular production activity. The costs of unclassified time should be capitalized under section 263A because these costs are the indirect labor costs of a production department."

i. Officer compensation as Mixed Service Cost (MSC) - *PMT Inc. v. Commissioner*, T.C. Memo 1996-303 - in this reasonable compensation case, the court concluded that part of the officer compensation of the textile manufacturer had to be capitalized under §263A, as allocable to mixed service costs. "Compensation paid to officers attributable to services performed in connection with particular production activities is an example of an indirect cost that must be capitalized."

j. Might environmental remediation costs have to be included in inventory?

- Yes per Rev. Rul. 2005-42 if the costs are capitalizable and associated with production or resale activities.

k. Property taxes of a developer**?**

*Reichel v. Comm'r.*, 112 T.C. No. 2 (1999)—Taxpayer operated a real estate development business as a sole proprietor. The business operations consisted primarily of buying and developing raw land.

In 1991 and 1992, taxpayer purchased two parcels of land for development, but did not undertake any development activity because of adverse economic conditions in the county were the parcels are located. However, taxpayer continued to hold the parcels for development. In 1993, taxpayer paid about $72,000 of real estate taxes on the parcels and deducted this amount on his Schedule C. The Service denied the deduction on the basis that it had to be capitalized as a cost of production under §263A. Taxpayer argued that §263A did not apply unless he undertook positive steps to begin developing the raw land.

The court noted that §263A(g) defining "produce" is a broad definition and encompasses "develop." The general rule of §263A requires a taxpayer to capitalize direct and indirect costs incurred in developing property. Taxpayer argued that per *Von-Lusk*, 104 T.C. 207 (1995), indirect costs only need to be capitalized under §263A if some production activity has occurred with respect to the property. The court held that the taxpayer misinterpreted *Von-Lusk* because the legislative history to §263A provides that the capitalization provision is to apply from the acquisition of the property up until the time of disposition. The court also noted that if indirect costs did not have to be capitalized until the start of production activity, §263A(f)(1)(A) would be superfluous because it provides that *interest* is to be capitalized once production begins. Finally, the court also noted that S. Rept. 99-313 (1986, at page 140), includes a heading - "production, acquisition, and carrying costs."

Footnote 1 in this case refers to §1.263A-2(a)(3)(ii) which also supports the court's holding: "a real estate developer must capitalize property taxes incurred with respect to property if, at the time the taxes are incurred, it is reasonably likely that the property will be subsequently developed."

Comment: For disposition of property, classification is based on the purpose for which the property was held at the time of the disposition (such as investment or property held for sale); see *Neal T. Baker Enterprises Inc. v. Comm'r.,* T.C. Memo 1998-302. Cases in this area have also recognized that a taxpayer's intent is subject to change during the time the property is owned. Would a similar analysis apply under §263A to determine if property is being held for production? What must a developer do to show that certain property is not being held for development, or that his intent with respect to the property has changed? The *Reichel* case does not discuss what the taxpayer was doing with the property; it just states that he continued to hold the property for development.

In FSA 1999-1088 the IRS held that costs of obtaining building permits, negotiating permit fees, performing engineering and feasibility studies, and drafting landscape and architectural plans for real property acquired for production had to be capitalized under §263A. In addition, the real estate taxes on the property acquired for production must also be capitalized. However, interest on debt used to pay the real estate taxes is not capitalizable until production begins.

11. Apply the simplified production method to the following facts to compute this manufacturer's §263A adjustment:

Production costs:

| | |
|---|---|
| Direct costs | $21,000 |
| Variable manufacturing overhead | $ 3,000 |
| Fixed manufacturing overhead | $ 5,000 |

Additional §263A costs (includes production service costs of $1,000) = $3,200

G & A Costs (Category 2):

| | |
|---|---|
| Production service costs | $1,000 |
| Mixed service costs | $1,200 |
| Policy service costs | $ 900 |

Federal taxes $2,000

**total full absorption costs = $29,000**

**add'l §263A costs = $ 3,200**

**Total §263A costs = $32,200**

**Allocation of MSC using simplified service cost-production cost allocation ratio method:**

$$\frac{\$32{,}200}{\$32{,}200 + \$900} = .9728$$

**(note, per §1.263A-1(h)(5), numerator and denominator exclude MSC & interest & taxes described at §1.263A-1(e)(3)(iii)(F) - income taxes[1])**

**$1,200 x .9728 = $1,167**

**Additional capitalized costs $3,200 + $1,167 = $4,367**

**Absorption ratio =** $$\frac{\$4{,}367}{\$29{,}000} = .1506$$

**EI x .1506 = §263A adjustment**

Permissible §263A allocation method - in TAM 9717002, the IRS ruled that taxpayer's §263A cost allocation method was not permissible because it did not follow the simplified production method which is intended to be the only exception to the "general rule that costs required to be capitalized under section 263A must be allocated to specific items in a taxpayer's inventory." The IRS did not find the taxpayer's burden rate method to be reasonable compared to the simplified production method because it allocated less costs to ending inventory.

The second issue was how to select a replacement method once the IRS held that the originally selected method was impermissible. The taxpayer argued that per *Silver Queen Motel*, 55 T.C. 1101 (1971), acq. 1972-2 C.B. 3, it could select its replacement method of accounting. In *Silver Queen*, the court ruled that a taxpayer could amend its return to use the allowable 150% DB method of depreciation, rather than the straight-line method the IRS said it should use when the taxpayer had originally adopted an impermissible method. The rationale was that since the IRS disallowed the method the taxpayer originally adopted, it had never regularly used a method of depreciation for the property, and therefore was not changing its method, and §446(e) did not apply. In the TAM, the IRS ruled that the holding in *Silver Queen* is "limited to situations where a taxpayer has adopted an impermissible method of depreciation. See Rev. Rul. 72-491, 1972-2 C.B. 104. *Silver Queen Motel* does not apply to other situations where a taxpayer has adopted an impermissible method of accounting. Also see TAM 9821001.

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[1] Per TAM 200624067, "Federal income taxes are not includible in the denominator of the production cost allocation ratio provided by §1.263A-1(h)(5)."

12. What is the dividing line between a producer subject to 263A and a reseller only subject if it meets the $10 million gross receipts test?

- See 263A(g) and regulations under 1.263A-1
- *Suzy's Zoo v. Commissioner*, 114 T.C. 1 (2000); aff'd 88 AFTR2d 2001-6916 (9th Cir.)
  Tax Court Syllabus:

  "P, a corporation the stock of which is owned 84 percent by S and 16 percent by two individuals unrelated to S, sells greeting cards and other paper products bearing an image of one or more of P's licensed cartoon characters. P's employees develop and draw the originals of all of the characters, and P transfers the original drawings to independent printing companies to reproduce images of the drawings onto P's paper products, which are made by the printers on P's behalf. The printers must reproduce the drawings and make the products in accordance with P's specifications, and they may not sell to a third party either P's original drawings, or reproductions thereof, or P's paper products.

  HELD: P produces, rather than resells, its paper products; thus, P does not qualify for the "small reseller" exception to the uniform capitalization (UNICAP) rules of sec. 263A, I.R.C.

  HELD, further, P is not excepted from the UNICAP rules by virtue of the artist exemption of sec. 263A(h), I.R.C.; none of P's shareholders owns "substantially all" of P's stock within the meaning of sec. 263A(h)(3)(D)(i)(I), I.R.C.

  HELD, further, the "year of change" for purposes of sec. 481, I.R.C., is the subject year (i.e., the year in which P's method of accounting is changed to conform to the UNICAP rules), rather than the first year to which the UNICAP rules apply."

  The 9th Circuit agreed with the Tax Court, finding that a producer does not have to manufacture its own products in order to be subject to §263A.

13. How are gross receipts measured for purposes of determining if the reseller is excepted from §263A?

- Rev. Rul. 89-26, 1989-1 C.B. 87: "Gross receipts from all businesses of the taxpayer are included in the computation for purposes of the $10 million test."

14. Which of the following costs must be capitalized by a reseller subject to §263A?

a. rent and utilities for a warehouse located ten blocks from the store?

**§1.263A-3(c)(5) - capitalizable storage cost, assuming is not on-site (5)(ii)**

b. rent and utilities for warehouse located in same parking lot as the store?

**off-site or on-site? is it physically attached to, and an integral part of, a retail sales facility - an essential and indispensable part of the retail sales facility? if yes, is deductible on-site storage**

c. lease payments for a lot where manufactured homes are stored so that independent salespersons can show them to potential customers (90% of the sales are then for custom manufactured homes)?

**Off-site because not "on-site." "An on-site storage facility is defined in the regulations as a storage facility that is physically attached to and that is an integral part of a "retail sales facility". Sec. 1.263A-3(c)(5)(ii)(A), Income Tax Regs.**

**A ‘retail sales facility’ is further defined as the location at which merchandise is sold ‘exclusively to retail customers in on-site sales’. Sec. 1.263A-3(c)(5)(ii)(B)(1), Income Tax Regs.**

**With an exception not here relevant, a retail customer is defined as the final purchaser of merchandise and does not include a person who resells the merchandise to others. Sec. 1.263A-3(c)(5)(ii)(E)(1), Income Tax Regs.**

**If a storage facility does not meet the above definition of an on-site storage facility, it is considered an ‘off-site storage facility,’ and storage costs relating to property held for resale are to be included in the taxpayer's inventory. Sec. 1.263A-3(c)(5)(ii)(F), Income Tax Regs.”**

**The court did not find that the lease payments were marketing, selling or distribution costs either. Thus, the costs had to be included in inventory. [*Load, Inc.,* TC Memo 2007-51]**

d. purchasing agent's salary and benefits?

**capitalize - §1.263A-3(c)(3)**

e. salary and benefits of purchasing agent's clerk who spends 80% of his time in the purchasing department and 20% in the advertising office?

**§1.263A-3(c)(3)(ii) - 1/3-2/3 rule IF elected would treat all as purchasing cost because spends more than 2/3 of her activities in purchasing dept.**

f. costs to operate forklift in the warehouse?

**assuming off-site storage - is a handling cost - transportation - §1.263A-3(c)(4)(v)**

15. How does a taxpayer's §263A calculations affect its AMT calculations? Must a corporation compute separate COGS for AMT and ACE?

- **see §1.56(g)-1(r) (T.D. 8340 3/91, amended by T.D. 8352 6/91 and T.D. 8454 12/92) and as modified by final §263A regulations**
- **Blue Book to TRA'86 (page 438) - "... for minimum tax purposes it was intended that ... section 263A ... apply with regard to minimum tax depreciation deductions ..."**

**Current Issue: Notice 2007-29, 2007-14 IRB ___ - “**The Internal Revenue Service and Treasury Department are studying the appropriateness of the use of negative amounts in computing additional costs for purposes of the simplified methods of accounting under §263A of the Internal Revenue Code. This notice invites public comment on changes to the simplified production method under §1.263A-2(b) and the simplified resale method under §1.263A-3(d) of the Income Tax Regulations. This notice also provides interim guidance pending the publication of future guidance.” A negative amount might occur when book depreciation is greater than tax depreciation.

“The Service and Treasury Department are aware of this viewpoint but are concerned that including negative amounts in additional §263A costs may result in significant distortions in some situations. Including negative amounts in additional §263A costs may undercapitalize amounts because the simplified production method formula may remove more of the cost from ending inventory than was actually remaining in ending inventory. Generally, this distortion is caused by the use of a different formula for removing the cost from ending inventory than the formula by which the cost was originally capitalized under §471. The inclusion of raw materials in the simplified production method formula also may cause distortions. For example, including a negative amount for book depreciation greater than tax depreciation (excess depreciation) in the simplified production method formula may reduce ending inventory by more than the amount of excess depreciation actually remaining in ending inventory. In some circumstances this distortion may be a reversal of the overcapitalization of excess tax depreciation over book depreciation in prior years, and thus, may not be a cause for concern. However, the inclusion can cause significant,

lasting distortion in situations in which the taxpayer has a tax basis much lower than book basis in depreciable property."

"The Service and Treasury Department are considering amending the regulations under §263A to prohibit the use of some or all negative amounts in computing additional §263A costs under the existing simplified methods and to provide a new alternative simplified method of cost allocation under §263A."

16. What is the general rule for when a taxpayer must capitalize interest expense per §263A(f)?

**Required when taxpayer has:**

**1) property:**

**- subject to §263A**

**- self-produced real or tangible personal property with either, a long useful life (real property or personal property with class life ≥ 20 years), <u>or</u> estimated production period > 2 years, <u>or</u> estimated production period > 1 year & cost > $1,000,.000**

**[referred to as "designated property" in final regulations at §1.263A-8(b)]**

**and**

**2) interest paid or incurred during the production period**

**• In TAM 9327007, the IRS ruled that the time that wine was aging in the bottle was considered part of the production period such that if it took over 2 years, interest capitalization would be required.**

17. Law firm X, a personal service corporation, borrowed $100,000 to install leasehold improvements in its new office for which it entered a 20-year lease. Could §263A(f) apply to X?

**YES - self-produced real property - need to capitalize interest on traced debt during production period and if accumulated production costs > traced debt, check for other eligible debt for which interest may need to be capitalized under the avoided cost rule.**

18. What is the theory behind the requirement to capitalize interest expense on avoided cost debt when production expenditures exceed traced debt? Reg. §1.263A-9(a).

**"any interest that the taxpayer theoretically would have avoided if accumulated production expenditures had been used to repay or reduce the taxpayer's outstanding debt" - such interest expense could have been avoided if production payments had instead been used to pay down outstanding debt. Similar in theory to FAS #34.**

19. Would accounts payable that do not bear interest be considered eligible debt under?

**Notice 88-99 - yes (but superseded by final regulations)**

**Final reg. §1.263A-9(a)(4)(ii) - no unless bears interest**

What difference does it make if non-interest bearing debt is included in eligible debt?

**If non-interest bearing debt is included, total capitalized interest is lowered.**

20. For which of the following debts might a partnership or its partners need to capitalize interest if partnership production costs exceed traced and avoided cost debt?

    a. a partner's qualified residence loan?

    **not eligible debt per §1.263A-9(a)(4)(v)**

    b. the partnership's debt secured by tax-exempt bonds?

    **not eligible debt per §1.263A-9(a)(4)(i)**

21. Corporation X is constructing a new warehouse for itself. It is using a forklift it owns in the construction activity. However, 20% of the time, the forklift is used in its manufacturing plant. How does this forklift affect the computation of X's accumulated production expenditures? See Reg. §1.263A-11(d)

    **Include 80% of the adjusted basis in the production expenditures for purposes of determining how much interest needs to be capitalized**

    TAM 199913030—A public utility acquired land on which to construct a facility in the future. Under the rate setting rules, T is allowed to include in the land in its rate calculation. Once construction began, T only included construction costs in its accumulated production costs for purposes of determining how much interest to capitalize during the production period per §263A(f). The Service ruled that the land must also be included in the accumulated production costs despite the fact that T began to earn income with respect to the land prior to the production period. The land was purchased solely for the production activity and must be factored in when computing capitalized interest expense.

22. Z Corporation is planning on building a new retail store and acquired the land on 1/1/98. It does not plan to start building until 9/1/98. On 5/1/98, the fire department made Z clear the brush from the land. Which date is considered the beginning of Z's production period? Reg. §1.263A-12(c)(2) & (e).

    **Per regulations, 5/1/98 probably constitutes the start of the production period. Note per §1.263A-12(g), if production ceases for at least 120 days after 5/1/98, the production period would be suspended.**

    **Production for other §263A purposes may have started earlier. See *Reichel* and *Von Lusk.***

23. When Z Corporation's production period ends for the building it is constructing for itself, what should it do with the capitalized interest? How should it treat the interest expense incurred after the production period ends?

    **add it to the basis of the property**

24. Reseller Y incurred $50,000 of interest expense in 1998 on working capital loans used to acquire inventory. Must Y capitalize this interest expense?

    **No requirement exists for Y to capitalize interest - see §263A(f).**

25. A bank has some of its facility and maintenance employees assisting with the opening and remodeling of a few bank stores. These employees oversee leasing, maintenance and repairs, configuration of space, remodeling projects and construction of new facilities. Should the bank include the indirect costs of these employees' salaries, pensions and employee benefit expenses as a capitalized amount of the new and remodeled facilities, or does the *Wells Fargo* case (224 F.3d 874 (8th Cir. 2000)) that allowed the salaries of employees assisting with a merger be expensed because that is the usual treatment of employee salaries? [CCA 200917031]

**These indirect costs must be capitalized to the property produced because they were incurred because of the production activities. Reg. §1.263A-1(e)(3)(i)**

Excerpts from CCA 200917031 which includes a helpful explanation of why §263A was enacted in 1986:

"Section 1.263A-1(a)(3)(i)(A) provides taxpayers must capitalize all direct costs and certain indirect costs properly allocable to real property and tangible personal property produced by the taxpayer.

Section 1.263A-1(d)(1) provides that self-constructed assets are assets produced by a taxpayer for use by the taxpayer in its trade or business. Self-constructed assets are subject to § 263A.

Section 1.263A-1(e)(1) provides that, in general, taxpayers subject to § 263A must capitalize all direct costs and certain indirect costs properly allocable to property produced.

Section 1.263A-1(e)(3)(i) provides that indirect costs are defined as all costs other than direct material costs and direct labor costs in the case of property produced. Taxpayers subject to § 263A must capitalize all indirect costs properly allocable to property produced. Indirect costs are properly allocable to property produced when the costs directly benefit or are incurred by reason of the performance of production activities.

Section 1.263A-1(e)(3)(ii) provides examples of indirect costs required to be capitalized to property produced. These examples include, but are not limited to, indirect labor costs, officers' compensation, pension and other related costs, and employee benefit expenses.

Like the transportation property in Commissioner v. Idaho Power Co., 418 U.S. 1, 94 S. Ct. 2757, 41 L. Ed. 2d 535 (1974) (discussed below), the indirect costs at issue — salaries, pensions and other related costs, and employee benefit expenses — are costs that directly benefit or are incurred by reason the construction of self-constructed assets. Moreover, these indirect costs are explicitly identified by the regulations as categories of indirect costs that are required to be capitalized under § 263A. See § 1.263A-1(e)(3)(ii). Accordingly, Taxpayer must capitalize these indirect costs to the property produced as a result of h's construction and remodeling activities.

For its part, Taxpayer believes that the indirect costs at issue should be analyzed under Wells Fargo & Co. v. Commissioner, 224 F.3d 874 (8th Cir. 2000). As explained below, Wells Fargo is irrelevant to the issue of whether these costs must be capitalized to real and tangible personal property under §263A.

In Wells Fargo, corporate officers of a subsidiary spent part of their time negotiating a merger transaction with the taxpayer. The subsidiary paid the officers the same compensation that it was paying them to perform their day-to-day operational duties. After completion of the merger, the taxpayer, which became the 100 percent owner of the subsidiary, deducted the portion of the salaries paid to these corporate officers that was attributable to services performed in merging the companies.

The Wells Fargo Court analyzed whether the indirect costs at issue (salaries paid to corporate officers) were "ordinary" under §162(a) and thus fully deductible in the taxable year, or whether these costs were capital expenditures under §263(a).[1] In applying the origin of the claim doctrine, the Wells Fargo Court concluded "that if an expense is directly related to the capital transaction (and therefore, the long term benefit), then it should be capitalized."[2] In reversing the Tax Court, the Wells Fargo Court held that the salaries at issue were currently deductible because "there is only an indirect relationship

between the salaries (which originate from the employment relationship) and the acquisition (which provides the long term benefit [])." [3]

Wells Fargo simply does not apply here. The Wells Fargo Court addressed whether the costs to create an intangible asset must be capitalized under § 263(a). Accordingly, we disagree with Taxpayer's argument that the "direct relationship" test in Wells Fargo should be used in determining whether the costs at issue constitute indirect costs under § 1.263A-1(e)(3)(i) because, in Taxpayer's case, the examining agent is arguing that the indirect costs at issue must be capitalized to real property and tangible personal property produced as a result of the h's construction and remodeling activities.

A brief history of § 263A may be helpful at this point. Prior to enactment of § 263A, the issue of whether a taxpayer must capitalize the cost of constructing real property and tangible personal property was addressed on a case-by-case basis and yielded different results for different industries. In Idaho Power, the Supreme Court held that § 263(a)(1) of the 1954 Code bars depreciation deductions on transportation equipment, including passenger cars, trucks, power-operated equipment, and trailers, that a taxpayer owned and used in the construction of the taxpayer's capital facilities. The Idaho Power Court reasoned that the depreciation on the transportation equipment is similar to "wages paid in connection with the construction or acquisition of the capital asset," which "must be capitalized and are then entitled to be amortized over the life of the capital asset so acquired." [4]

In 1986, Congress, unsatisfied with this "case-by-case" approach, effectively codified and extended the Idaho Power result to production activities of all industries by enacting §263A. See §§263A(a)(1)(B), (a)(2), and (b)(1). Section 263A and the regulations thereunder require a taxpayer who produces real property and tangible personal property to capitalize the property's properly allocable share of indirect costs to the property produced, regardless of whether the property is sold or is used in the taxpayer's trade or business. See § 263A and § 1.263A-1(a)(3)(ii). These statutory and regulatory rules are intended to provide uniform rules regarding capitalization of direct and indirect costs of producing real property and tangible personal property, regardless of the industry involved or the type of real property and tangible personal property produced.

Accordingly, the issue, properly stated, is whether the h's costs, consisting of salaries, pensions and other related costs, and employee benefit expenses, are properly allocable to property produced as a result of the h's construction and remodeling activities. See § 1.263A-1(e)(3)(i). The criteria for analyzing and determining whether those costs are properly allocable under § 263A to the real property and tangible personal property produced by the taxpayer are found in § 1.263A-1(e)(3). The analysis of the Wells Fargo Court to determine whether costs are allocable or capitalizable to intangible property under § 263(a) is simply irrelevant. Moreover, reliance on that judicial analysis of §263(a) would be a reversion to the state of affairs that Congress sought to remedy by enacting §263A."

[1] Wells Fargo, 224 F.3d at 880 (citing INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 112 S. Ct. 1039, 117 L. Ed. 2d 226 (1992) (holding that, while "the mere presence of a future benefit may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether" the expense should be deducted or capitalized); Commissioner v. Lincoln Savings and Loan Assoc., 403 U.S. 345, 29 L. Ed. 519, 91 S.Ct. 1893 (1971) (holding that a taxpayer must capitalize an amount p aid to create or enhance a separate and distinct asset)).

[2] Id. at 887 (citing INDOPCO, 503 U.S. 79) (emphasis in original).

[3] Id. (emphasis in original).

[4] Idaho Power Co., 418 U.S. at 13 (citing Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775, 781 (2 nd Cir. 1973); Perlmutter v. Commissioner, 44 T.C. 382, 404 (1965), aff'd, 373 F.2d 45 (10 th Cir. 1967); Jaffa v. United States, 198 F.Supp. 234, 236 (ND Ohio 1961); § 1.266-1 (e)).

# §460

25. What is the purpose of §460?

Excerpt from the *General Explanation of the Tax Reform Act of 1986*, prepared by the Staff of the Joint Committee on Taxation (page 527)

"Reasons for Change

The Congress believed that the completed contract method of accounting for long-term contracts permitted an unwarranted deferral of the income from those contracts. The Congress noted that the Study of 1983 Effective Tax Rates on Selected Large U.S. Corporations by the Joint Committee on Taxation indicated that some corporations had large deferred taxes and low effective tax rates as a result of their use of the completed contract method for tax purposes. Annual reports for certain large defense contractors reflected negative tax rates due to net operating loss carryforwards generated through use of the completed contract method in prior years.

The Congress believed it was appropriate to limit the tax deferral obtainable through use of the completed contract method by requiring that a portion of the income from long-term contracts be reported on a percentage of completion method. However, the Congress recognized that use of the percentage of completion method may produce harsh results for taxpayers in some cases, for example, where an overall loss is experienced on the contract, or where actual profits are significantly less than projected. The method was also subject to manipulation by taxpayer. In order to address these deficiencies in the percentage of completion method under prior law, the Congress adopted a modified version of the method, applicable whether the taxpayer uses the percentage of completion method for all or only a portion of a long-term contract. Under this modified percentage of completion method, variances between the estimated and the actual completion during each year of the contract are accounted for at the end of the contract through an interest charge or credit to the taxpayer.

The Congress also believed that, with respect to the portion of a long-term contract reported under the completed contract method (or an inventory method of accounting), income would be more clearly reflected if certain costs reimbursed under a contract, but not treated as contract costs under prior law, were subject to capitalization.

Finally, the Congress believed it was desirable to resolve (retroactively as well as prospectively) a controversy between taxpayers and the Internal Revenue Service concerning the treatment of independent research and development costs."

The change to the percentage of completion method was gradually achieved starting with changes by TRA'86. Changes were made to IRC §460 by tax acts subsequent to TRA'86.

| Tax Act | % completion | normal | Effective for contracts entered into after: |
|---|---|---|---|
| TRA'86 | 40% | 60% | 2/28/86 |
| RA'87 | 70 | 30 | 10/13/87 |
| TAMRA'88 | 90 | 10 | 6/20/88 |
| RA'89 | 100 | 0 | 7/10/89 |

23. Under §460, must a taxpayer use the percentage of completion method assuming no exception applies, or is §460 elective?

24. Which of the following are long-term contracts?

a. architect agrees to provide blueprints and consultation during construction of high-rise building. Begins in 2/06 and finishes 6/08.

b. calendar year taxpayer agrees to construct a small building for a customer. Contract entered into 11/1/07 and completed 2/1/08.

c. contract to manufacture 15,000 folding chairs, will take over 12 months to complete.

d. DX Company is constructing roads for a new housing tract. [See §460(e) and Prop. Regs REG-120844-07 (8/4/08)]

**More on "unique"**

**Molds in Auto Industry Are Unique–**TAM 199925002—T manufactures metal molds, wood molds, and fixtures to produce plastic parts for the auto industry. Each mold is to produce a part used on a particular model or car-body configuration. It takes about 10 months for T to design, fabricate and assemble a complete mold for a customer. T was granted permission via Form 3115 to change its accounting method for long-term contracts from an impermissible hybrid method to the accrual-shipment method. Upon audit, the IRS engineer determined that the molds were unique items and the Agent proposed that T change from the accrual-shipment method to the percentage-of-completion method under §460.

The Service relied on the *Sierracin* case (90 T.C. 341 (1988), acq. 1990-2 C.B. 1), to find that the molds were unique and that T was required to apply §460. The Service's 4-part analysis included:

1. Custom Design—While the process of creating molds is similar for each customer, the actual molds are made to meet each customer's particular needs.

2. Pre-Production Costs—Pre-production costs, including R&D, engineering, and retooling, run about 10% of total costs.

3. Nature of Manufacturing Operation—While the manufacturing process is becoming more automated, a substantial amount of manual labor is required.

4. Length of Production Period—The mean production period was 10 months.

**Note**: Also see FSA 1999-1122 and regulations under §460 which define "unique." In the FSA, the Service noted that "risk is not a necessary prerequisite to a finding of uniqueness. ... [M]anufacturing risk is irrelevant under the percentage-of-completion method of accounting of section 460. Section 460 requires the taxpayer to use reasonable estimates adjusted annually to determine the portion of expected contract revenue which must be recognized each year; it also requires the taxpayer to "look back" at the actual contact costs and revenues at the completion of the contract and make adjustments for estimating errors."

Also see TAM 8941003 and cases cited therein – but also see final §460 regulations.

**More on manufacturing:**

**Systems Installation Contracts Are Not Manufacturing–**In FSA 1999-1108, the Service held that contracts to install computer systems were not long-term under §1.451-3(b)(1). Taxpayer was in the business of selling, installing and designing computer systems. T used the percentage of completion method for financial reporting purposes and the completed contract method for tax purposes. The FSA makes no mention of §460 and thus, likely predates the addition of that provision to the Code in 1986. The Revenue Agent took the position that although the contracts took over 12 months to complete, T's activities did not constitute manufacturing. The Service agreed with the Agent based on its revenue rulings holding that contracts for architectural, engineering, construction management and painting services are not long-term contracts (see Rev. Ruls. 84-32, 82-134, and 70-67). One of the rationales behind the rulings is that the taxpayers were not subject to risks of price changes and losses as a general contractor would be. "Where the taxpayer is not subject to such risks, the completed contract method of accounting is generally not appropriate." The Service also cited PLR 8545007, which held that agreements to provide data processing services were not long-term contracts. This ruling also held that the words, "building, installation, and construction," added to the regulations in 1922, are "in pari materia and, as such, should be construed together to effect the drafter's intent." Thus, "installation" of software is not the type of "installation" contemplated by the regulations.

The FSA also attempts to define the term "manufacturing," relying on a Supreme Court definition from *Anheuser-Busch Brewing Assoc. v. U.S.*, 207 U.S. 556 (1908): "Manufacture implies a change, but every change is not manufacture, and yet every change in an article is the result of treatment, labor, and manipulation. But something more is necessary .... There must be transformation; a new and different article must emerge, 'having a distinctive name, character, or use.' ... a person who makes only minor alterations to a product, which do not affect the basic nature of the product, is not engaged in manufacturing." As T did not cause the computer hardware to be transformed into a new and different item or make it suitable for a different use, T was not engaged in manufacturing.

The Service also did not find that design, development and loading of software constituted manufacturing. It relied on a state decision—*First Data Corp.*, 357 N.E.2d 933 (MA 1976). First

Data operated a commercial, online computer time-sharing system. The court held that the transmission or manipulation of knowledge or intelligence did not constitute manufacturing.

25. On 12/20/07, calendar year taxpayer G Corporation entered a long-term contract where the total contract price was $4,000,000 with estimated costs of $3,500,000. On 12/30/07, in order to secure a better price on materials needed for the contract, G prepaid a supplier $1,000,000 for materials to be delivered on 2/1/08. What is the tax effect, if any, to G in 1907? Also see §1.461-4(d)(2)(ii). Would your answer change if the materials purchased on 12/30/07 only cost $300,000? Explain.

26. Would a 50 unit apartment building being built by a partnership with gross receipts under $10,000,000 meet the exception at §460(e)? Why or why not?

27. **Facts:** • corporate taxpayer W, calendar year, accrual method

- enters into contract to construct waste treatment facility for city of San Jose
- estimated construction costs = $9,000,000
- estimated construction period - contract entered into 2/1/96 and completion date set at 7/1/98
- contract price = $10,500,000 + $250,000 to be paid after satisfactory operation of the facility for 4 months (W actually collects the entire amount by 11/1/98)
- actual construction costs each year are (direct & indirect costs, other than interest expense):

| | |
|---|---|
| 1996 | $4,000,000 |
| 1997 | $4,000,000 |
| 1998 | $1,600,000 |

- W also had to borrow $1,000,000 on 3/1/97 for this project which it repaid (principal and interest) on 1/1/98. W incurred $100,000 of interest expense on this loan (not included in above numbers).

TO DO:

1) compute how much revenue and expense W must report under §460 with respect to this long-term contract for 1996, 1997 and 1998 (assume no simplified method is used by W).

2) apply the lookback method by completing Form 8697 to determine how much interest W either owes or will receive in 1998

References:

§460 & 1.460-6
Form 8697

**Solution:**

(TCR x PC) - I = contract revenue for current year

| Year | Computation | | | |
|---|---|---|---|---|
| 1996 | (10,750,000 x 4,000,000 / 9,000,000) | - 0 | = | $ 4,777,777 |
| 1997 | (10,750,000 x 8,100,000 / 9,100,000) | - 4,777,777 | = | $ 4,790,904 |
| 1998 | (10,750,000 x 1) | - $9,568,681 | = | $ 1,181,319 |
| | | | | $10,750,000 |

Lookback:

| Year | Computation | | | | Differences 8697 line 2 |
|---|---|---|---|---|---|
| 1996 | (10,750,000 x 4,000,000 / 9,700,000) | - 0 | = | $ 4,432,990 | (344,787) |
| 1997 | (10,750,000 x 8,100,000 / 9,700,000) | - 4,432,990 | = | $ 4,543,814 | (247,090) |
| 1998 | (10,750,000 x 1) | - $8,976,804 | = | $ 1,773,196 | 591,877 |
| | | | | $10,750,000 | |
| | | | | | $ -0- |

**NOTE – For more background on §460, see the excerpt from the regulations at the end of this chapter.**

## Application of §263A to a Producer

Note: §471 costs are defined at §1.263A-1(d)(2) and §1.471-11.

Taxpayer (T) manufactures and sells widgets. It has a factory with two assembly lines, a storage area for raw materials and supplies and another storage area for finished goods. Each storage area is near a loading dock. The factory building also contains office space where inventory control, shipping and receiving and factory personnel matters are handled.

T has a separate building which includes sales personnel, executives, accounting, tax, legal, financial/budgeting, human resources, benefits processing, R & D, and shareholder relations.

Costs incurred in the factory and sales include the following:

Factory:

- salaries of assembly line workers, QA inspectors, purchasing agent and assistant, inventory control clerks, shipping and receiving workers, personnel office workers, receptionist
  - overtime
  - vacation and sick pay
  - employment taxes
  - employee benefits
  - workers' compensation costs
- depreciation on build and equip
- §179 costs
- utilities
- security
- building and equipment repairs
- property taxes
- sales tax on equipment purchases
- warranty repair costs

In July, had to stop assembly line #2 for 3 weeks for retooling.

Administrative Office:

- salaries, overtime, vacation and sick pay, benefits, employment taxes, benefits and workers' comp for:
  - sales staff
  - accounting dept.
  - tax dept.
  - legal dept.
  - financial/budgeting dept.
  - shareholder relations dept.
  - human resources office
  - benefits processing office
  - President
  - Vice-president - operations
  - Vice president - marketing
  - Treasurer/controller
- Sales dept costs:
  - mailings
  - brochures
  - phone
  - demo room
  - bidding costs
- Depreciation on building and equipment
- R & D
- Income taxes
- Property taxes
- Sales tax on equipment

Identify the above costs as:

- DM
- DL
- Indirect
- MSC
- non-§263A

Also, for the MSC costs, identify an appropriate base to be used to allocate between §263A activities and non-§263A activities. §1.263A-1(g)(4)(iii) & (iv). Note that there are various methods available to T for allocating its MSC. Each is a method of accounting so can only be changed with permission of the IRS. See §1.263A-1(g) and (h). Also consider the impact of the de minimis rule of §1.263A-1 (g)(4)(ii) and §1.263A-1(h)(8).

Simplified production method - use of this method requires calculation of "additional §263A costs" and "§471 costs" (so does the simplified resale method). A summary of the §471 rules and how §263A has changed them follows:

| Cost | §471 treatment | §263A treatment | T's amounts |
|---|---|---|---|
| **Category 1: §1.471-11(c)(2)(i)** | | | |
| repairs & maintenance | capitalize | capitalize | 1,000 |
| utilities | capitalize | capitalize | 3,000 |
| rent | capitalize | capitalize | -0- |
| indirect labor and production supervisory wages, including basic compensation, overtime pay, vacation and holiday pay, sick leave pay, shift differential, payroll taxes and contributions to a supplemental unemployment benefit plan | capitalize | capitalize | 20,000 |
| indirect materials and supplies | capitalize | capitalize | 10,000 |
| tools and equipment not capitalized | capitalize | capitalize | -0- |
| quality control and inspection | capitalize | capitalize | 50,000 |
| | | TOTAL | 84,000 |
| **Category 2: §1.471-11(c)(2)(ii)** | | | |
| marketing | expense | expense §1.263A-1(e)(iii)(A) | 60,000 |
| advertising | expense | expense §1.263A-1(e)(iii)(A) | 40,000 |
| selling | expense | expense §1.263A-1(e)(iii)(A) BUT, see special rule on bidding costs at §1.263A-1(e)(3)(ii)(T) & -1(e)(3)(iii)(J) | 90,000 |
| other distribution | expense | expense §1.263A-1(e)(iii)(A) | 10,000 |

| Cost | §471 treatment | §263A treatment | T's amounts |
| --- | --- | --- | --- |
| interest | expense | depends - §1.263A-1(e)(ii)(V) - see §263A(f) | -0- |
| R & D | expense | expense §1.263A-1(e)(iii)(B) | 80,000 |
| §165 losses | expense | expense §1.263A-1(e)(iii)(D) | -0- |
| percentage depletion in excess of cost depletion | expense | capitalize | -0- |
| depr and amort reported for federal income tax purposes in excess of depreciation reported by taxpayer on books | expense | capitalize<br>NOTES: • §179 deduction - expense per §1.263A-1(e)(3)(iii)(C)<br>• temporarily idle equipment - expense per §1.263A-1(e)(3)(iii)(E) | 10,000 |
| income taxes on income from sale of inventory | expense | expense §1.263A-1(e)(iii)(F) | 40,000 |
| pension contributions to extent they represent past services cost | expense | capitalize | -0- |
| G & A incident to and necessary for t/p's activities as a whole rather than to production or manufacturing operations or processes<br>ASSUME IS A MSC | expense | capitalize - if related to production (MSC to be allocated). §1.263A-1(e)(4)(C)(iii) & (iv); otherwise, expense per §1.263A-1(e)(3)(iii)(K) | 40,000 |
| officer salaries attributable to performance of services incident to and necessary for t/p's activities taken as a whole rather than to production or manufacturing operations or processes | expense | expense (unless "properly allocable" to property produced or acquired for resale) | -0- |
| | | | |
| **Category 3:**<br>**§1.471-11(c)(2)(iii)**<br>**§1.263A-1(d)(2)(iii)** | | | |
| non-income taxes attributable to assets incident to and necessary for production or manufacturing operations or processes | capitalize or expense depending on financial statement treatment | capitalize §1.263A-1(e)(ii)(L) | 10,000 |
| depr and depletion on assets incident to and necessary for production or manufacturing operation or processes | capitalize or expense depending on financial statement treatment | capitalize §1.263A-1(e)(ii)(I) & (J)<br>Note - temporarily idle equipment - expense per §1.263A-1(e)(3)(iii)(E) | 70,000 |

| Cost | §471 treatment | §263A treatment | T's amounts |
|---|---|---|---|
| employee benefits (e.g. §404, workers' comp, profit-sharing, stock option, life and health insurance) incident to and necessary for production or manufacturing labor | capitalize or expense depending on financial statement treatment | capitalize §1.263A-1(e)(3)(ii)(C) & (D) | 100,000 |
| costs attributable to strikes | capitalize or expense depending on financial statement treatment | expense §1.263A-1(e)(3)(iii)(G) | -0- |
| costs attributable to rework labor, scrap and spoilage | capitalize or expense depending on financial statement treatment | capitalize §1.263A-1(e)(3)(ii)(Q) | 8,000 |
| factory administrative expenses | capitalize or expense depending on financial statement treatment | capitalize §1.263A-1(e)(ii)(W) | 6,000 |
| officers' salaries attributable to services performed incident to and necessary for production or manufacturing operations or processes | capitalize or expense depending on financial statement treatment | capitalize §1.263A-1(e)(3)(ii)(B) | 26,000 |
| insurance costs incident to and necessary for production or manufacturing operations or processes such as insurance on production machinery and equipment | capitalize or expense depending on financial statement treatment | capitalize §1.263A-1(e)(3)(ii)(M) | 42,000 |

To do: Apply the simplified production cost and simplified service cost method (using the production cost allocation ratio) to T. Additional information:

T uses FIFO

| | | |
|---|---|---|
| Direct labor costs | $500,000 | |
| Direct material costs | $400,000 | |
| Beginning inventory | $200,000 | ($180,000 §471 costs + $20,000 §263A costs) |
| Ending inventory | ??? | ($220,000 §471 costs + ______ §263A costs) |

If more information is needed, state what it is.

What must T do to elect and use the historic absorption ratio method? Will T need to calculate a §481(a) adjustment? §1.263A-2(b)(4)

# Final Regulations under §460 (T.D. 8929, 1/10/01)

Following is the preamble for T.D. 8929 as well as selected examples from the regulations.

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**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 24096The 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 section 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 section 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 section 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 section 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 section 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 section 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 section 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 section 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 section 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 section 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 section 1.460-6(f)(1) and (2) to clarify the reporting requirements and add new section 1.460- 6(f)(3). New section 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 section 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 section 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.

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**§1.460-1 Long-term contracts.**

(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 section 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 section 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.

…

(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 section 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 section 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 section 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 section 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 section 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 section 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 section 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.

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(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 section 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 section 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.

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

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(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.

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