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

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

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

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

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

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

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

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

[T.D. 8929, 66 FR 2231, Jan. 11, 2001]

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

§ 1.460–3(c). Permissible exempt contract methods include the PCM, the EPCM described in paragraph (c)(2) of this section, the CCM described in paragraph (d) of this section, or any other permissible method. See section 446.

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

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

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

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

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

(4) *Contracts with disputed claims*—(i) *In general.* The special rules in this paragraph (d)(4) apply to a long-term contract accounted for using the CCM

with a dispute caused by a customer's requesting a reduction of the gross contract price or the performance of additional work under the contract or by a taxpayer's requesting an increase in gross contract price, or both, on or after the date a taxpayer has tendered the subject matter of the contract to the customer.

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

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

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

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

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

(2) *Election to use regular completion factors.* Under this paragraph (f)(2), a taxpayer may elect for AMTI purposes to determine the completion factors of all of its long-term contracts using the methods of accounting and allocable contract costs used for regular federal income tax purposes. A taxpayer makes this election by using regular

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

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

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

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

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

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

	Taxable Year		
	2001	2002	2003
(A) Cumulative incurred costs	$200,000	$600,000	$750,000
(B) Estimated total costs	800,000	900,000	750,000
(C) Completion factor: (A) ÷ (B)	25.00%	66.67%	100.00%
(D) Total contract price	1,000,000	1,000,000	1,000,000
(E) Cumulative gross receipts: (C) × (D)	250,000	666,667	1,000,000
(F) Cumulative gross receipts (prior year)	(0)	(250,000)	(666,667)
(G) Current-year gross receipts	250,000	416,667	333,333
(H) Cumulative incurred costs	200,000	600,000	750,000

	Taxable Year		
	2001	2002	2003
(I) Cumulative incurred costs (prior year)	(0)	(200,000)	(600,000)
(J) Current-year costs	200,000	400,000	150,000
(K) Gross income: (G) − (J)	$50,000	$16,667	$183,333

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

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

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

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

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

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

*Unless (C) <10 percent.

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

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

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

Example 8. CCM—contracts with disputes from taxpayer and customer claims. C, whose taxable year ends December 31, uses the CCM to account for exempt construction contracts. C constructs a factory for B pursuant to a long-term contract. Under the terms of the contract, B agrees to pay C a total of

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

(i) [Reserved]

(j) *Consolidated groups and controlled groups*—(1) *Intercompany transactions*—(i) *In general.* Section 1.1502–13 does not apply to the income, gain, deduction, or loss from an intercompany transaction between members of a consolidated group, and section 267(f) does not apply to these items from an intercompany sale between members of a controlled group, to the extent—

(A) The transaction or sale directly or indirectly benefits, or is intended to benefit, another member's long-term contract with a nonmember;

(B) The selling member is required under section 460 to determine any part of its gross income from the transaction or sale under the percentage-of-completion method (PCM); and

(C) The member with the long-term contract is required under section 460 to determine any part of its gross income from the long-term contract under the PCM.

(ii) *Definitions and nomenclature.* The definitions and nomenclature under §1.1502–13 and §1.267(f)–1 apply for purposes of this paragraph (j).

(2) *Example.* The following example illustrates the principles of paragraph (j)(1) of this section.

Example. Corporations P, S, and B file consolidated returns on a calendar-year basis. In 1996, B enters into a long-term contract with X, a nonmember, to manufacture 5 airplanes for $500 million, with delivery scheduled for 1999. Section 460 requires B to determine the gross income from its contract with X under the PCM. S enters into a contract with B to manufacture for $50 million the engines that B will install on X's airplanes. Section 460 requires S to determine the gross income from its contract with B under the PCM. S estimates that it will incur $40 million of total contract costs during 1997 and 1998 to manufacture the engines. S incurs $10 million of contract costs in 1997 and $30 million in 1998. Under paragraph (j) of this section, S determines its gross income from the long-term contract under the PCM rather than taking its income or loss into account under section 267(f) or §1.1502–13. Thus, S includes $12.5 million of gross receipts and $10 million of contract costs in gross income in 1997 and includes $37.5 million of gross receipts and $30 million of contract costs in gross income in 1998.

(3) *Effective dates*—(i) *In general.* This paragraph (j) applies with respect to transactions and sales occurring pursuant to contracts entered into in years beginning on or after July 12, 1995.

(ii) *Prior law.* For transactions and sales occurring pursuant to contracts entered into in years beginning before July 12, 1995, see the applicable regulations issued under sections 267(f) and 1502, including §§1.267(f)–1T, 1.267(f)–2T, and 1.1502–13(n) (as contained in the 26 CFR part 1 edition revised as of April 1, 1995).

(4) *Consent to change method of accounting.* For transactions and sales to which this paragraph (j) applies, the Commissioner's consent under section 446(e) is hereby granted to the extent any changes in method of accounting are necessary solely to comply with this section, provided the changes are made in the first taxable year of the taxpayer to which the rules of this paragraph (j) apply. Changes in method of accounting for these transactions are to be effected on a cut-off basis.

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

[T.D. 8597, 60 FR 36684, July 18, 1995, as amended by T.D. 8929, 66 FR 2232, Jan. 11, 2001; 66 FR 18191, Apr. 6, 2001]