

within 2 years of the contract commencement date, provided the taxpayer satisfies the \$10,000,000 gross receipts test described in paragraph (b)(3) of this section.

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

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

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

(i) *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.

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

(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 in-

come. 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
(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

§ 1.460-4

26 CFR Ch. I (4-1-10 Edition)

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 intercom-

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

(2) *Constructive completion transactions—*(i) *Scope.* The constructive completion rules in this paragraph (k)(2) apply to transactions (constructive completion transactions) that result in a change in the taxpayer re-

sponsible for reporting income from a contract and that are not described in paragraph (k)(3)(i) of this section. Constructive completion transactions generally include, for example, taxable sales under section 1001 and deemed asset sales under section 338.

(ii) *Old taxpayer.* The old taxpayer is treated as completing the contract on the date of the transaction. The total contract price (or, gross contract price in the case of a long-term contract accounted for under the CCM) for the old taxpayer is the sum of any amounts realized from the transaction that are allocable to the contract and any amounts the old taxpayer has received or reasonably expects to receive under the contract. Total contract price (or gross contract price) is reduced by any amount paid by the old taxpayer to the new taxpayer, and by any transaction costs, that are allocable to the contract. Thus, the old taxpayer's allocable contract costs determined under paragraph (b)(5) of this section do not include any consideration paid, or costs incurred, as a result of the transaction that are allocable to the contract. In the case of a transaction subject to section 338 or 1060, the amount realized from the transaction allocable to the contract is determined by using the residual method under §§ 1.338-6 and 1.338-7.

(iii) *New taxpayer.* The new taxpayer is treated as entering into a new contract on the date of the transaction. The new taxpayer must evaluate whether the new contract should be classified as a long-term contract within the meaning of § 1.460-1(b) and account for the contract under a permissible method of accounting. For a new taxpayer who accounts for a contract using the PCM, the total contract price is any amount the new taxpayer reasonably expects to receive under the contract consistent with paragraph (b)(4) of this section. Total contract price is reduced by the amount of any consideration paid by the new taxpayer as a result of the transaction, and by any transaction costs, that are allocable to the contract and is increased by the amount of any consideration received by the new taxpayer as a result of the transaction that is allocable to

the contract. Similarly, the gross contract price for a contract accounted for using the CCM is all amounts the new taxpayer is entitled by law or contract to receive consistent with paragraph (d)(3) of this section, adjusted for any consideration paid (or received) by the new taxpayer as a result of the transaction, and for any transaction costs, that are allocable to the contract. Thus, the new taxpayer's allocable contract costs determined under paragraph (b)(5) of this section do not include any consideration paid, or costs incurred, as a result of the transaction that are allocable to the contract. In the case of a transaction subject to sections 338 or 1060, the amount of consideration paid that is allocable to the contract is determined by using the residual method under §§ 1.338-6 and 1.338-7.

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

poses of the constructive completion rules, and the partnership must apply paragraph (k)(2) of this section immediately prior to the transaction or transactions resulting in the termination of the partnership.

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

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

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

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

(2) Increased (or decreased) by the amount of cumulative taxable income (or loss) recognized by the partnership

on the contract through the date of the distribution (including amounts recognized as a result of the constructive completion); and

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

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

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

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

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

(B) Transfers to which section 361 applies if the transfer is in connection with a reorganization described in sec-

tion 368(a)(1)(D) or (G), provided the requirements of section 354(b)(1)(A) and (B) are met;

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

(D) Transfers described in section 351;

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

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

(G) Conversion to or from an S corporation;

(H) Members joining or leaving a consolidated group;

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

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

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

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

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

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

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

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

sioner to begin using such other method.

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

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

(iv) *Special rules related to certain corporate and partnership transactions—(A) Old taxpayer—basis adjustment—(1) In general.* Except as provided in paragraph (k)(3)(iv)(A)(2) of this section, in the case of a transaction described in paragraph (k)(3)(i)(D), (E), or (I) of this section, the old taxpayer must adjust its basis in the stock or partnership interest of the new taxpayer by—

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

(ii) Reducing such basis by the amount of gross receipts the old taxpayer has received or reasonably expects to receive under the contract (except to the extent such gross receipts give rise to a liability other than a liability described in section 357(c)(3)).

(2) *Basis adjustment in excess of stock or partnership interest basis.* If the old and new taxpayer do not join in the filing of a consolidated Federal income tax return, the old taxpayer may not adjust its basis in the stock or partnership interest of the new taxpayer under paragraph (k)(3)(iv)(A)(1) of this section below zero and the old taxpayer

must recognize ordinary income to the extent the basis in the stock or partnership interest of the new taxpayer otherwise would be adjusted below zero. If the old and new taxpayer join in the filing of a consolidated Federal income tax return, the old taxpayer must create an (or increase an existing) excess loss account to the extent the basis in the stock of the new taxpayer otherwise would be adjusted below zero under paragraph (k)(3)(iv)(A)(I) of this section. See § 1.1502-19 and 1.1502-32(a)(3)(ii).

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

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

or section 357 that is attributable to the contract and any income recognized by the old taxpayer pursuant to the basis adjustment rule of paragraph (k)(3)(iv)(A) of this section).

(2) *Basis in contract.* The new taxpayer's basis in a contract (including the uncompleted property, if applicable) acquired in a transaction described in paragraphs (k)(3)(i)(A) through (E) or paragraph (k)(3)(i)(I) of this section will be computed under section 362, section 334, or section 723, as applicable. Upon a new taxpayer's completion (actual or constructive) of a CCM or a PCM contract acquired in a transaction described in paragraphs (k)(3)(i)(A) through (E) or paragraph (k)(3)(i)(I) of this section, the new taxpayer's basis in the contract (including the uncompleted property, if applicable) is reduced to zero. The new taxpayer is not entitled to a deduction or loss in connection with any basis reduction pursuant to this paragraph (k)(3)(iv)(B)(2).

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

(D) *Exceptions to step-in-the-shoes rules for S corporations.* Upon a transfer described in paragraph (k)(3)(i)(F) of this section or a conversion described in paragraph (k)(3)(i)(G) of this section, paragraphs (k)(3)(ii) and (iii) of this section apply to a contract accounted for under a long-term contract method of accounting only if the S corporation's books are closed under section 1362(e)(3), section 1362(e)(6)(C), section 1362(e)(6)(D), section 1377(a)(2), or § 1.1502-76 on the date of the transfer or conversion. In these cases, the corporation is treated as both the old taxpayer and the new taxpayer for purposes of paragraphs (k)(3)(ii) and (iii) of this section. In all other cases involving these transfers, the corporation shall compute its income or loss from each contract accounted for under a long-term contract method of accounting

for the period that includes the date of the transaction as though no change in taxpayer had occurred with respect to the contract, and must allocate the income or loss from the contract for that period in accordance with the rules generally applicable to transfers of S corporation stock and conversions to or from S corporation status. This paragraph (k)(3)(iv)(D) is applicable for transactions on or after July 16, 2004. In addition, this paragraph (k)(3)(iv)(D) may be relied upon for transactions on or after May 15, 2002.

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

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

fair market value in a constructive completion transaction.

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

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

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

for under a long-term contract method of accounting.

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

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

(5) *Examples.* The following examples illustrate the rules of this paragraph (k). For purposes of these examples, it is assumed that the contract is a long-term construction contract accounted

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

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

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

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

\$120,000 (total contract price minus receipts already reported (\$200,000 - \$80,000)) and costs of \$75,000, for a profit of \$45,000.

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

(ii) *Old taxpayer.* X does not report any income or costs from the contract in Year 1. In Year 2, the contract is deemed complete for X, and X reports its gross contract price of \$800,000 (the sum of the amounts received under the contract and the amount realized in the sale (\$650,000 + \$150,000)) and its total allocable contract costs of \$600,000 (the sum of the costs incurred in Year 1 and Year 2 (\$200,000 + \$400,000)) in that year, for a profit of \$200,000.

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

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

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

(iii) *New taxpayer.* Because the mid-contract change in taxpayer results from a step-in-the-shoes transaction, Y must account for the contract using the same methods of accounting used by X prior to the transaction. Total contract price is the sum of any amounts that X and Y have received or reasonably expect to receive under the contract, and total allocable contract costs are the allocable contract costs of X and Y. Thus, the estimated total allocable contract costs at the end of Year 2 are \$725,000 (the cumulative allocable contract costs of X and the estimated total allocable contract costs of Y (\$200,000 + \$400,000 + \$50,000 + \$75,000)). In

Year 2, Y reports receipts of \$146,552 (the completion factor multiplied by the total contract price minus receipts reported by the old taxpayer $[(\$650,000/\$725,000) \times \$1,000,000] - \$750,000$) and costs of \$50,000, for a profit of \$96,552. For Year 3, Y reports receipts of \$103,448 (the total contract price minus prior year receipts (\$1,000,000-\$896,552)) and costs of \$75,000, for a profit of \$28,448.

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

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

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

Example 5. Step in the shoes—PCM—basis adjustment. The facts are the same as in Example 3, except that X transfers the contract (including the uncompleted property) with a basis of \$0 and \$125,000 of cash to a new corporation, Z, in exchange for all of the stock of Z in a section 351 transaction. Thus, under section 358(a), X's basis in the Z stock is \$125,000.

Pursuant to paragraph (k)(3)(iv)(A)(I) of this section, X must increase its basis in the Z stock by the amount of gross receipts X recognized under the contract, \$750,000 (\$250,000 receipts in Year 1 + \$500,000 receipts in Year 2), and reduce its basis by the amount of gross receipts X received under the contract, the \$650,000 in progress payments. Accordingly, X's basis in the Z stock is \$225,000. All other results are the same.

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

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

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

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

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

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

lative gross receipts—\$750,000 cumulative gross receipts reported by the old taxpayer) and costs of \$50,000, for a profit of \$69,655. In Year 3, Z reports gross receipts of \$100,345 ($\$970,000 - \$869,655$) and costs of \$75,000, for a profit of \$25,345.

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

(ii) *Old taxpayer.* X reports no income or costs under the contract in Years 1, 2, or 3. Under paragraph (k)(3)(ii)(B), X determines that the gain realized on the transfer of the contract to Z under the constructive completion rules of paragraph (k)(2)(ii) of this section is \$200,000 ($\$800,000$ total contract price (\$150,000 value allocable to the contract + \$650,000 progress payments)—\$600,000 costs incurred but not recognized). The gain realized on the transfer of the unrelated capital asset to Z is \$125,000. The amount of gain X must recognize due to the receipt of \$100,000 of cash in the exchange is \$100,000, of which \$54,545 is allocated to the contract ($\$150,000$ value of the contract/\$275,000 total value of property transferred to Z \times \$100,000) and is treated as ordinary income, and \$45,455 is allocated to the unrelated capital asset ($\$125,000$ value of capital asset/\$275,000 total value of property transferred to Z \times \$100,000). Under section 358(a), X's basis in the Z stock is \$600,000 ($\$600,000$ basis in the contract and unrelated capital asset transferred—\$100,000 cash received + \$100,000 gain recognized). Pursuant to paragraph (k)(3)(iv)(A)(1) of this section, X must reduce its basis in the stock of Z by \$650,000, the progress payments received under the contract. However, X may not reduce its basis in the Z stock below zero pursuant to paragraph (k)(3)(iv)(A)(2) of this section. Accordingly, X's basis in the Z stock is reduced by \$600,000 to zero and X must recognize income of \$50,000.

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

Example 9. Constructive completion—PCM—distribution of contract by partnership. (i) *Facts.* In Year 1, W, X, Y, and Z each contribute \$100,000 to form equal partnership PRS. In Year 1, PRS enters into a contract. The total contract price is \$1,000,000 and the estimated total allocable contract costs are \$800,000. In Year 1, PRS incurs costs of \$600,000 and receives \$650,000 in progress payments under the contract. Under the contract, PRS performed all of the services required in order to be entitled to receive the progress payments, and there was no obligation to return the payments or perform any additional services in order to retain the payments. PRS properly accounts for the contract under the PCM. In Year 2, PRS distributes the contract to X in liquidation of X's interest. PRS incurs no costs and receives no progress payments in Year 2 prior to the distribution. At the time of the distribution, PRS's only asset other than the long-term contract and the partially constructed property is \$450,000 cash (\$400,000 initially contributed and \$50,000 in excess progress payments). The fair market value of the contract is \$150,000. Pursuant to the distribution, X assumes PRS's contract obligations and rights. In Year 2, X incurs additional allocable contract costs of \$50,000. X correctly estimates at the end of Year 2 that X will have to incur an additional \$75,000 of allocable contract costs in Year 3 to complete the contract (rather than \$150,000 as originally estimated by PRS). Assume that X properly accounts for the contract under the PCM, that PRS has no income or loss other than income or loss from the contract, and that PRS has an election under section 754 in effect in Year 2.

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

cordingly, each partner's distributive share of this income is \$12,500.

(iii) *Tax consequences to X.* X's basis in its interest in PRS immediately prior to the distribution is \$150,000 (X's \$100,000 initial contribution, increased by \$37,500, X's distributive share of Year 1 income, and \$12,500, X's distributive share of Year 2 income). Under paragraph (k)(2)(iv)(D) of this section, PRS's basis in the contract (including the uncompleted property, if applicable) immediately prior to the distribution is equal to \$150,000 (the partnership's allocable contract costs, \$600,000, increased by the amount of income recognized by PRS on the contract through the date of the distribution (including amounts recognized as a result of the constructive completion), \$200,000, decreased by the amounts that the partnership has received or reasonably expects to receive under the contract, \$650,000). Under section 732, X's basis in the contract (including the uncompleted property) after the distribution is \$150,000. Under paragraph (k)(2)(iv)(C) of this section, X's basis in the contract (including the uncompleted property) is treated as consideration paid by X that is allocable to the contract. X's total contract price is \$200,000 (the amount remaining to be paid under the terms of the contract less the consideration allocable to the contract $(\$350,000 - \$150,000)$). For Year 2, X reports receipts of \$80,000 (the completion factor multiplied by the total contract price $(\$50,000/\$125,000 \times \$200,000)$) and costs of \$50,000 (the costs incurred after the distribution of the contract), for a profit of \$30,000. For Year 3, X reports receipts of \$120,000 (the total contract price minus receipts already reported $(\$200,000 - \$80,000)$) and costs of \$75,000, for a profit of \$45,000.

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

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

(ii) *Tax consequences to PRS.* PRS reports no income or costs from the contract in Year 1. Immediately prior to the distribution of the contract to X in Year 2, the contract is deemed completed. Under paragraph (k)(2)(iv)(B) of this section, the fair market value of the contract (\$150,000) is treated as the amount realized from the transaction. For purposes of applying the CCM in Year 2, the gross contract price is \$800,000 (the sum of the amounts received under the contract and the amount treated as realized from the transaction $(\$650,000 + \$150,000)$) and the total allocable contract costs are \$600,000. Thus, in

Year 2 PRS reports profits of \$200,000 (\$800,000 - \$600,000). This profit must be allocated among W, X, Y, and Z as though the partnership closed its books on the date of the distribution. Accordingly, each partner's distributive share of this income is \$50,000.

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

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

Example 11. Step-in-the-shoes—PCM—contribution of contract to partnership. (i) *Facts.* In Year 1, X enters into a contract that X properly accounts for under the PCM. The total contract price is \$1,000,000 and the estimated total allocable contract costs are \$800,000. In Year 1, X incurs costs of \$600,000 and receives \$650,000 in progress payments under the contract. Under the contract, X performed all of the services required in order to be entitled to receive the progress payments, and there was no obligation to return the payments or perform any additional services in order to retain the payments. In Year 2, X contributes the contract (including the uncompleted property) with a basis of \$0 and \$125,000 of cash to partnership PRS in exchange for a one-fourth partnership interest. X incurs costs of \$10,000, and receives no progress payments in Year 2 prior to the contribution of the contract. X and the other three partners of PRS share equally in its capital, profits, and losses. The parties determine that, at the time of the contribution, the fair market value of the contract is

\$160,000. Following the contribution in Year 2, PRS incurs additional allocable contract costs of \$40,000. PRS correctly estimates at the end of Year 2 that it will have to incur an additional \$75,000 of allocable contract costs in Year 3 to complete the contract (rather than \$150,000 as originally estimated by PRS).

(ii) *Tax consequences to X.* For Year 1, X reports receipts of \$750,000 (the completion factor multiplied by the total contract price (\$600,000/\$800,000 × \$1,000,000)) and costs of \$600,000, for a profit of \$150,000. Because the mid-contract change in taxpayer results from a transaction described in paragraph (k)(3)(i)(I) of this section, X is not treated as completing the contract in Year 2. Under paragraph (k)(3)(ii)(A) of this section, for Year 2, X reports receipts of \$12,500 (the completion factor multiplied by the total contract price (\$610,000/\$800,000 × \$1,000,000, or \$762,500), decreased by receipts already reported, \$750,000) and costs of \$10,000, for a profit of \$2,500. Under section 722, X's initial basis in its interest in PRS is \$125,000. Pursuant to paragraph (k)(3)(iv)(A)(1) of this section, X must increase its basis in its interest in PRS by the amount of gross receipts X recognized under the contract, \$762,500, and reduce its basis by the amount of gross receipts X received under the contract, the \$650,000 in progress payments. Accordingly, X's basis in its interest in PRS is \$237,500.

(iii) *Tax consequences to PRS.* Because the mid-contract change in taxpayer results from a step-in-the-shoes transaction, PRS must account for the contract using the same methods of accounting used by X prior to the transaction. The total contract price is the sum of any amounts that X and PRS have received or reasonably expect to receive under the contract, and total allocable contract costs are the allocable contract costs of X and PRS. For Year 2, PRS reports receipts of \$134,052 (the completion factor multiplied by the total contract price [(\$650,000/\$725,000) - \$1,000,000], \$896,552, decreased by receipts reported by X, \$762,500) and costs of \$40,000, for a profit of \$94,052. For Year 3, PRS reports receipts of \$103,448 (the total contract price minus prior year receipts (\$1,000,000 × \$896,552)) and costs of \$75,000, for a profit of \$28,448.

(iv) *Section 704(c).* The principles of section 704(c) and § 1.704-3 apply to allocations of income or loss with respect to the contract contributed by X. In this case, the amount of built-in income that is subject to section 704(c) is the amount of income or loss that the contributing partner would take into account if the contract were disposed of for its fair market value in a constructive completion transaction. This calculation is treated as occurring immediately after the partner has applied paragraph (k)(3)(ii)(A) of this section, but before the contribution to the partnership. In a constructive completion

transaction, the total contract price would be \$810,000 (the sum of the amounts received under the contract and the amount realized in the deemed sale (\$650,000 + \$160,000)). X would report receipts of \$47,500 (total contract price minus receipts already reported (\$810,000 - \$762,500)) and costs of \$0, for a profit of \$47,500. Thus, the amount of built-in income that is subject to section 704(c) is \$47,500. The partnership must apply section 704(c) to this income in a manner that reasonably accounts for the income over the remaining term of the contract. For example, in Year 2, PRS could allocate \$26,810 to X under section 704(c) (the amount of built-in income, \$47,500, multiplied by a fraction, the numerator of which is the completion factor for the year, \$650,000/725,000, less the completion factor for the prior year, \$610,000/\$800,000, and the denominator of which is 100 percent reduced by the completion factor for the taxable year preceding the event creating the section 704(c) income or loss, \$610,000/\$800,000). The remaining \$67,242 would be allocated equally among all of the partners. In Year 3, the completion year, PRS could allocate \$20,690 to X under section 704(c) ($\$47,500 \times [(\$725,000/\$725,000 - \$650,000/\$725,000) / (100 \text{ percent} - \$610,000/\$800,000)]$). The remaining \$7,758 would be allocated equally among all the partners.

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

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

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

(iv) *Section 704(c).* In this case, the amount of built-in income that is subject to section 704(c) is the amount of income or loss that the contributing partner would take into ac-

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

Example 13. Step-in-the-shoes—PCM—transfer of a partnership interest. (i) *Facts.* In Year 1, W, X, Y, and Z each contribute \$100,000 to form equal partnership PRS. In Year 1, PRS enters into a contract. The total contract price is \$1,000,000 and the estimated total allocable contract costs are \$800,000. In Year 1, PRS incurs costs of \$600,000 and receives \$650,000 in progress payments under the contract. Under the contract, PRS performed all of the services required in order to be entitled to receive the progress payments, and there was no obligation to return the payment or perform any additional services in order to retain the payments. PRS properly accounts for the contract under the PCM. In Year 2, W transfers W's interest in PRS to T for \$150,000. Assume that \$10,000 of PRS's Year 2 costs are incurred prior to the transfer, \$40,000 are incurred after the transfer; and that PRS receives no progress payments in Year 2. Also assume that the fair market value of the contract on the date of the transfer is \$160,000, that PRS closes its books with respect to the contract under section 706 on the date of the transfer, and that PRS correctly estimates at the end of Year 2 that it will have to incur an additional \$75,000 of allocable contract costs in Year 3 to complete the contract (rather than \$150,000 as originally estimated by PRS).

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

(iii) *Income reporting for period after transfer.* PRS must continue to use the PCM. For the part of Year 2 beginning on the day after the transfer, PRS reports receipts of \$134,052 (the completion factor multiplied by the total contract price decreased by receipts reported by PRS for the period ending on the date of the transfer $[(\$650,000/\$725,000 \times \$1,000,000) - \$762,500]$) and costs of \$40,000, for a profit of \$94,052. This profit is shared equally among T, X, Y, and Z (\$23,513 each). For Year 3, PRS reports receipts of \$103,448 (the total contract price minus prior year receipts $(\$1,000,000 - \$896,552)$) and costs of \$75,000, for a profit of \$28,448. The profit for Year 3 is shared equally among T, X, Y, and Z (\$7,112 each).

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

(v) *Tax Consequences to T.* T's adjusted basis for its interest in PRS is \$150,000. Under § 1.743-1(d)(2), the amount of income that would be allocated to T if the contract were disposed of for its fair market value (adjusted to account for income from the contract for the portion of PRS's taxable year that ends on the date of the transfer) is

\$11,875. Under § 1.743-1(b), the amount of T's basis adjustment under section 743(b) is \$11,875. Under paragraph (k)(3)(v)(B) of this section, the portion of T's basis adjustment that is recovered in Year 2 and Year 3 must be determined by PRS in a manner that reasonably accounts for the adjustment over the remaining term of the contract. For example, PRS could recover \$6,703 of the adjustment in Year 2 (the amount of the basis adjustment, \$11,875, multiplied by a fraction, the numerator of which is the excess of the completion factor for the year, $\$650,000/\$725,000$, less the completion factor for the prior year, $\$610,000/\$800,000$, and the denominator of which is 100 percent reduced by the completion factor for the taxable year preceding the transfer, $\$610,000/\$800,000$). T's distributive share of income in Year 2 from the contract would be adjusted from \$23,513 to \$16,810 as a result of the basis adjustment. In Year 3, the completion year, PRS could recover \$5,172 of the adjustment $(\$11,875 \times [(\$725,000/\$725,000 - \$650,000/\$725,000) / (100 \text{ percent} - \$610,000/\$800,000)])$. T's distributive share of income in Year 3, the completion year, from the contract would be adjusted from \$7,112 to \$1,940 as a result of the basis adjustment.

(6) *Effective date.* Except as provided in paragraph (k)(3)(iv)(D) of this section, this paragraph (k) is applicable for transactions on or after May 15, 2002. Application of the rules of this paragraph (k) to a transaction that occurs on or after May 15, 2002 is not a change in method of accounting.

[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; T.D. 8995, 67 FR 34605, May 15, 2002; T.D. 9137, 69 FR 42553, July 16, 2004]

§ 1.460-5 Cost allocation rules.

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