Authority: 49 U.S.C. 106(g), 40113, 44701.

§ 39.13 [Amended]

2. Section 39.13 is amended by adding the following new airworthiness directive:

Cessna Aircraft Company: Docket 2002–NM–332–AD.

Applicability: Model 650 airplanes, serial numbers 0001 through 0171 inclusive, 0173 through 0241 inclusive, 7001 through 7094 inclusive, and 7096 through 7119 inclusive; certificated in any category.

Compliance: Required as indicated, unless accomplished previously.

To prevent uncommanded movement of the horizontal stabilizer, which could result in reduced controllability of the airplane, accomplish the following:

Replacement

(a) Within 18 months after the effective date of this AD, replace the horizontal stabilizer primary trim actuator (HSTA) assembly part number 9914056–3 or 9914056–4, with a repaired assembly, part number 9914056–3 or 9914056–4; in accordance with Cessna Service Bulletin SB650–27–50, dated June 12, 2002. Repeat the replacement thereafter at intervals not to exceed 18 months.

Note 1: Having the letter ''B'' following the part serial number (for example, SER. NO. 13B) identifies a repaired HSTA assembly, part number 9914056–3 or 9914056–4.

Parts Installation

(b) As of the effective date of this AD, no person shall install an HSTA, part number 9914056–3 or 9914056–4, on any airplane, unless that HSTA has been repaired and reidentified with the letter ''B'' following the part serial number.

Alternative Methods of Compliance

(c) In accordance with 14 CFR 39.19, the Manager, Wichita Aircraft Certification Office, FAA, is authorized to approve alternative methods of compliance for this AD.

Issued in Renton, Washington, on July 31, 2003.

Ali Bahrami,

Acting Manager, Transport Airplane Directorate, Aircraft Certification Service.

[FR Doc. 03–19984 Filed 8–5–03; 8:45 am]

BILLING CODE 4910–13–P

COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 1

Investment of Customer Funds

AGENCY: Commodity Futures Trading Commission.

ACTION: Reopening comment period.

SUMMARY: The Commodity Futures Trading Commission (Commission) is reopening the comment period for the proposed amendments to Regulation 1.25. These amendments would, among other things, allow futures commission merchants and derivatives clearing organizations (DCO) to engage in repurchase agreements with securities deposited by customers subject to certain conditions and modify the portfolio time-to-maturity requirements for securities deposited in connection with certain collateral management programs of DCOs pursuant to certain conditions. The new deadline for submitting public comments is September 5, 2003.

DATES: Written comments must be received on or before September 5, 2003.

ADDRESSES: Comments on proposed amendments to Regulation 1.25 should be sent to Jean A. Webb, Secretary, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581. Comments may be sent by facsimile transmission to (202) 418–5528 or by e-mail to *secretary@cftc.gov.* Reference should be made to ''Proposed Amendments to Regulation 1.25.''

FOR FURTHER INFORMATION CONTACT: John C. Lawton, Deputy Director and Chief Counsel, or Lois Gregory, Special Counsel, Division of Clearing and Intermediary Oversight, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington DC 20581. Telephone: (202) 418–5450.

SUPPLEMENTARY INFORMATION: On June 30, 2003, the Commission published a notice of proposed rulemaking which sought comment on proposed amendments to Regulation 1.25.[1] The amendments would allow futures commission merchants and derivatives clearing organizations (DCO) to engage in repurchase agreement with securities deposited by customers subject to certain conditions and modify the portfolio time-to-maturity requirements for securities deposited in connection with certain collateral management programs of DCOs pursuant to certain conditions. The Commission also requested comments concerning whether the portfolio time-to-maturity requirement should be modified for portfolios consisting exclusively of Treasury securities; whether the restriction on embedded derivatives should be modified, whether the list of permitted benchmarks for variable rate securities should be expanded, and whether the concentration limits on reverse repurchase agreements should be changed. The Commission established a 30-day period for submitting public comment, ending July 30, 2003.

[1] 68 FR 38654.

By letter dated July 24, 2003, an association of futures industry participants requested an extension of the original comment period until September 5, 2003, so that additional parties who could not meet the original July 30 deadline could submit comments letters.

In response to this request and in order to ensure that an adequate opportunity is provided for submission of meaningful comments, the Commission has determined to reopen the comment period for the notice of proposed rulemaking to September 5, 2003.

Issued in Washington, DC, on July 30, 2003, by the Commission.

Jean A. Webb,

Secretary of the Commission.

[FR Doc. 03–19949 Filed 8–5–03; 8:45 am]

BILLING CODE 6351–01–M

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–128203–02]

RIN 1545–BA81

Partnership Transactions Involving Long-Term Contracts

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

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

DATES: Written and electronic comments and requests for a public hearing must be received by November 4, 2003.

ADDRESSES: Send submissions to: CC:PA:RU (REG–128203–02), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m.

to: CC:PA:RU (REG–128203–02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the internet directly to the IRS Internet site at *http://www.irs.gov/regs*.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Richard Probst, (202) 622–3060; concerning submissions, Guy Traynor, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION

Background

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

A long-term contract or a portion of a long-term contract that is exempt from the PCM may be accounted for under any permissible method, including the completed contract method (CCM). Under the CCM, a taxpayer does not take into account the gross contract price and allocable contract costs until the contract is complete, even though progress payments are received in years prior to completion.

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

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

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

In a constructive completion transaction, the taxpayer that originally accounted for the long-term contract (old taxpayer) must recognize income from the contract as of the time of the transaction. The contract price used to determine the amount of income recognized by the taxpayer is the amount realized from the transaction, reduced by any amounts paid by the old taxpayer to the taxpayer subsequently accounting for the long-term contract (new taxpayer) that are allocable to the contract. Similarly, the new taxpayer in a constructive completion transaction is treated as though it entered into a new contract as of the date of the transaction. The new taxpayer's contract price is the amount that the new taxpayer reasonably expects to receive under the contract, reduced by the price paid by the new taxpayer for the contract, and increased by any amounts paid by the old taxpayer to the new taxpayer that are allocable to the contract. In contrast, in a step-in-the-shoes transaction, the old taxpayer's obligation to account for the contract terminates on the date of the transaction and is assumed by the new taxpayer. The new taxpayer must assume the old taxpayer's methods of accounting for the contract, with both the contract price and allocable contract costs based on amounts taken into account by both parties.

The final section 460 regulations provide that a contribution to a partnership in a transaction described in section 721(a), a transfer of a partnership interest, and a distribution by a partnership to which section 731 applies (other than a distribution of a contract accounted for under a long-term contract method of accounting) are step-in-the-shoes transactions. In a notice issued concurrently with the final regulations, Notice 2002–37 (2002–23 I.R.B. 1095), Treasury and the IRS announced their intention to publish regulations setting forth the special rules that apply to these partnership transactions and described many of these rules. The notice further provided that these regulations would apply to contributions, transfers, and distributions occurring on or after May 15, 2002. The IRS requested comments as to the appropriate scope and substance of the regulations. No comments were received.

Explanation and Summary of Contents

1. Contribution of a Contract to a Partnership

The final section 460 regulations provide that a contribution of a contract accounted for under a long-term contract method of accounting in a transaction described in section 721(a) is a step-in-the-shoes transaction. Under section 722, the partner's basis in the partnership interest is increased by the adjusted basis of the contributed contract (including the uncompleted property, if applicable). Under section 723, the partnership's basis in the contributed contract (including the uncompleted property, if applicable) equals the partner's basis in the contributed contract (including the uncompleted property, if applicable).

Under the final section 460 regulations, the basis of a long-term contract (including the uncompleted property, if applicable) is determined by reference to the allocable contract costs incurred by the taxpayer but not taken into account in computing taxable income. Thus, if the contract is accounted for under the PCM, then the taxpayer's basis in the contract is $0, even though the taxpayer has incurred costs and recognized income under the contract. If, on the other hand, the contract is accounted for under the CCM, then the taxpayer's basis in the contract is equal to the costs incurred by the taxpayer, unreduced by any progress

payments that the taxpayer has received but not taken into income with respect to the contract. Under these rules, a partner accounting for a long-term contract under the CCM that incurs $400 of allocable contract costs, receives $500 of progress payments with respect to the contract, and the contributes the contract, but not the progress payments, to a partnership would be able to claim a $400 basis in the partnership interest received. Without any adjustments, such an analysis would give rise to erroneous results.

For this reason, these proposed regulations, like the rules in the final section 460 regulations applicable to corporate step-in-the-shoes transactions, such as transactions described in section 351(a), require a partner that contributes a contract accounted for under a long-term contract method of accounting to a partnership to adjust the basis of the partnership interest received. Specifically, the proposed regulations require the partner to increase the basis of the partnership interest by the amount of gross receipts that the partner has recognized under the contract, and reduce the basis of the partnership interest by the amount of gross receipts the partner has received or reasonably expects to receive under the contract. If the decrease exceeds the partner's basis in the partnership interest, then the partner must recognize income equal to the excess. To ensure that the partnership is not taxed again on any income taken into account by the partner under this rule, the proposed regulations require the partnership to reduce its total contract price (or gross contract price) by the amount of income recognized by the contributing partner.

2. Built-In Income and Loss

Section 704(c) generally provides that income, gain, loss, or deduction attributable to property that is contributed to a partnership must be allocated to the contributing partner. The purpose of section 704(c) is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss. These proposed regulations provide that the principles of section 704(c) and § 1.704–3 apply to allocations of income or loss with respect to a contract accounted for under a long-term contract method of accounting that is contributed to a partnership (or that is revalued by a partnership under § 1.704–1(b)(2)(iv)(f)). The proposed regulations provide that the partnership must apply section 704(c) to such income or loss in a manner that reasonably accounts for the section 704(c) income or loss over the remaining term of the contract.

Under the proposed regulations, the amount of built-in income or built-in loss attributable to a contributed contract that is subject to section 704(c) is determined as follows. First, the contributing partner must take into account any income or loss required under the step-in-the-shoes rules for the period ending on the date of the contribution. Second, the partnership determines 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 the step-in-the-shoes rules, 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.

3. Transfer of a Partnership Interest

The transfer of an interest in a partnership engaged in a contract accounted for under a long-term contract method of accounting is a step-in-the-shoes transaction. Section 741 provides that gain or loss recognized on the sale or exchange of an interest in a partnership is considered as gain or loss from a capital asset, except as provided in section 751. Section 751(a) provides that the amount of any money, or the fair market value of any property, received by a transferor partner in exchange for all or any part of the partner's interest in the partnership attributable to unrealized receivables (as defined in section 751(c)) or inventory items (as defined in section 751(d)) of the partnership shall be considered as an amount realized from the sale or exchange of property other than a capital asset. In Rev. Rul. 79–51 (1979–1 C.B. 225), the IRS addressed a transaction in which a partner sold the partner's entire interest in a partnership holding partially completed contracts, the income from which was being accounted for under the CCM. The IRS ruled that the value of the contracts at the time of sale are unrealized receivables for purposes of section 751(c).

Consistent with Rev. Rul. 79–51, the proposed regulations provide that contracts accounted for under a long-term contract method of accounting are unrealized receivables within the meaning of section 751(c). The amount of ordinary income or loss attributable to a contract is the amount of income or loss that the partnership would take into account under the constructive completion rules if, at the time of a transfer of a partnership interest, the partnership disposed of the contract for its fair market value in a constructive completion transaction.

4. Adjustments to the Basis of Partnership Property

Section 743(b) allows a partnership to adjust the basis of partnership property in the case of a transfer of an interest in the partnership by sale or exchange or on the death of a partner. If all or part of a basis adjustment under section 743(b) is allocated to a contract accounted for under a long-term contract method of accounting, the proposed regulations provide that the adjustment shall reduce or increase, as the case may be, the transferee partner's distributive share of 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 the 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. Similar rules apply if all or part of an adjustment to the basis of partnership property under section 734(b) is allocated to a contract accounted for under a long-term contract method of accounting.

5. Closing of the Books

Generally, under the step-in-the-shoes rules, an old taxpayer's obligation to account for the contract terminates on the date of the transaction and is assumed by the new taxpayer. 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. This rule differs from § 1.706–1(c)(2)(ii), which provides that, if a partner's interest in the partnership terminates during the taxable year, the partnership may determine the partner's distributive share of partnership items either by closing the partnership's books as of the termination date or by prorating the partnership's income for the entire year between the pre- and post-termination periods.

Consistent with § 1.706–1(c)(2)(ii), these regulations generally provide that upon the transfer or liquidation of an interest in a partnership holding a contract accounted for under a long-term contract method of accounting, the step-in-the-shoes rules apply to a

contract accounted for under a long-term contract method of accounting only if the partnership's books are properly closed with respect to that contract under section 706. If the partnership's books are not closed with respect to the contract, the partnership shall compute its income or loss from each contract accounted for under a long-term contract method of accounting for the period that includes the date of the transfer or liquidation as though no change in taxpayer had occurred with respect to that contract, and may pro rate income from the contract under a reasonable method complying with section 706. Similar rules are provided for distributions of property (other than a contract accounted for under a long-term contract method of accounting) from a partnership holding a long-term contract, and for contributions of property (other than a contract accounted for under a long-term contract method of accounting) to a partnership holding a contract accounted for under a long-term contract method of accounting.

Comments are requested regarding whether similar rules should be provided with respect to transfers of stock in an S corporation holding a contract accounted for under a long-term contract method of accounting. See section 1377(a)(1) and § 1.1377–1(a) (providing that each shareholder's pro rata share of any S corporation item for any taxable year is generally the sum of the amounts determined with respect to the shareholder by assigning an equal portion of the item to each day of the S corporation's taxable year, and then dividing that portion pro rata among the shares outstanding on that day); and section 1377(a)(2) and § 1.1377–1(b) (providing that an S corporation may elect to close its books if a shareholder's entire interest in an S corporation is terminated during the S corporation's taxable year, and the corporation and all affected shareholders agree).

6. Look-Back Method

The final section 460 regulations generally require any old taxpayer that accounted for income from a long-term contract under the PCM, and that transfers the contract to a new taxpayer in a step-in-the-shoes transaction, to provide the information described in § 1.460–6(g)(3)(ii)(D) to the new taxpayer. The proposed regulations provide that, if the step-in-the-shoes transaction is a contribution of property (other than a contract accounted for under a long-term contract method of accounting) to a partnership, the distribution of property (other than a contract accounted for under a long-term contract method of accounting) by a partnership, or a transfer of a partnership interest, the old taxpayer is not required to provide this information, because information necessary for the new taxpayer to apply the look-back method is provided by the partnership. A similar exception is provided if the step-in-the-shoes transaction is a transfer of stock in an S corporation, or a conversion to or from an S corporation.

7. Distribution of a Contract by a Partnership

The distribution of a contract accounted for under a long-term contract method of accounting by a partnership to a partner is a constructive completion transaction. The proposed regulations provide that, in determining the partnership's income on the constructive completion transaction, the fair market value of the contract is treated as the amount realized from the transaction. The proposed regulations also clarify that, 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 partnership as though the partnership closed its books on the date of the distribution.

Section 732 determines the basis of property (other than money) distributed by a partnership to a partner. Section 734(b) provides for an adjustment to the basis of partnership property as a result of certain distributions from partnerships that have a section 754 election in effect. The proposed regulations provide that, if a contract accounted for under a long-term contract method of accounting is distributed to a partner, then, for purposes of determining the partner'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 the partnership's allocable contract costs (including transaction costs), 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 decreased by the amounts that the partnership has received or reasonably expects to receive under the contract.

The proposed regulations provide that, if a contract accounted for under a long-term contract method of accounting is distributed to a partner, then, in computing the total contract price (or gross contract price) for the new contract, the partner'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 partner 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.

Section 751(b)(1) provides that, to the extent a partner receives in a distribution partnership property which is unrealized receivables or inventory items which have appreciated substantially in value, in exchange for all or a part of the partner's interest in other partnership property (including money), the transaction is considered a sale or exchange of the property between the distributee partner and the partnership. The same treatment applies if a partner receives in a distribution partnership property (including money) other than unrealized receivables and substantially appreciated inventory in exchange for the partner's interest in the partnership's unrealized receivables or substantially appreciated inventory. 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. Therefore, the proposed regulations provide an ordering rule under which a partnership that distributes a contract accounted for under a long-term contract method of accounting to apply the constructive completion rules before applying the rules of section 751(b) to the distribution.

8. Treatment of Progress Payments Under Section 752

In Rev. Rul. 73–301 (1973–2 C.B. 215), the IRS addressed whether unrestricted progress payments received by a partnership reporting its income under the CCM constitute a partnership liability under section 752. In that revenue ruling, the partnership performed all of the services required 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. The IRS ruled that the progress payments described in the ruling did not constitute a liability

within the meaning of section 752. See also Rev. Rul. 81–241 (1981–2 C.B. 146) (citing and following Rev. Rul. 73–301). Treasury and the IRS request comments regarding whether there are circumstances under which the receipt of progress payments under a contract accounted for under a long-term contract method of accounting could give rise to a liability under section 752, and, if so, how the regulations would need to be revised to account for such liabilities.

Proposed Effective Date

As indicated in Notice 2002–37, the regulations are proposed to apply to contributions, transfers, and distributions that occur on or after May 15, 2002.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight copies) that are submitted timely to the IRS. Alternatively, taxpayers may submit comments electronically directly to the IRS Internet site at *http://www.irs.gov/regs.* Treasury and the IRS request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing may be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the **Federal Register**.

Drafting Information

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

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.460–0 is amended as follows:

1. Revising the entry for paragraph 1.460–4(k)(2)(iv).
2. Adding entries for § 1.460–4(k)(2)(iv)(A) through (E).
3. Revising the entry for § 1.460–4(k)(3)(iv).
4. Revising the entry for § 1.460–4(k)(3)(iv)(A)(*2*) and adding an entry for §1.460–4(k)(3)(iv)(c).
5. Revising the entry for § 1.460–4(k)(3)(v).
6. Adding entries for § 1.460–4(k)(3)(v)(A) through (D).
7. Adding entries for § 1.460–6(g)(3)(ii)(D)(*1*) and (*2*).

The revisions and additions read as follows:

§ 1.460–0 Outline of regulations under section 460.

* * * * *

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

* * * * *

(k) * * *

(2) * * *

(iv) Special rules relating to distributions of certain contracts by a partnership.

(A) In general.

(B) Old taxpayer.

(C) New taxpayer.

(D) Basis rules.

(E) Section 751.

(*1*) In general.

(*2*) Ordering rules.

(3) * * *

(iv) Special rules related to certain corporate and partnership transactions.

(A) * * *

(*2*) Basis adjustment in excess of stock or partnership interest basis.

* * * * *

(C) Definition of old taxpayer and new taxpayer for certain partnership transactions.

(v) Special rules relating to certain partnership transactions.

(A) Section 704(c).

(*1*) Contributions of contracts.

(*2*) Revaluations of partnership property.

(*3*) Allocation methods.

(B) Basis adjustments under sections 743(b) and 734(b).

(C) Cross reference.

(D) Exceptions to step-in-the-shoes rules.

* * * * *

§ 1.460–6 Look-back method.

* * * * *

(g) * * *

(3) * * *

(ii) * * *

(D) * * *

(*1*) In general.

(*2*) Special rules for certain pass-through entity transactions.

* * * * *

Par. 3. Section 1.460–4 is amended as follows:

1. Revising the sixth sentence in paragraph (k)(1).
2. Revising paragraph (k)(2)(iv).
3. Removing the first word ‘‘The’’ in paragraph (k)(3)(i) and adding in its place: ‘‘Except as otherwise provided in paragraph (k)(3)(v)(D) of this section, the’’
4. Revising paragraph (k)(3)(i)(I).
5. Redesignating paragraphs (k)(3)(i)(J), (K) and (L) as paragraphs (k)(3)(i)(K), (L) and (M), respectively.
6. Adding a new paragraph (k)(3)(i)(J).
7. Revising paragraph (k)(3)(iv).
8. Adding text to paragraph (k)(3)(v).
9. Adding to paragraph (k)(5) *Example 9* through *Example 13*.

The additions and revisions read as follows.

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

* * * * *

(k) * * *

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

(2) * * *

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

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

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

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

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

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

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

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

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

* * * * *

(3) * * *

(i) * * *

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

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

* * * * *

(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.

(*2*) *Basis adjustment in excess of stock or partnership interest basis.* If the old and new taxpayer do not join in the filing of a consolidated Federal income tax return, the old taxpayer may not adjust its basis in the stock or partnership interest of the new taxpayer under paragraph (k)(3)(iv)(A)(*1*) of this section below zero and the old taxpayer must recognize ordinary income to the extent the basis in the stock or partnership interest of the new taxpayer otherwise would be adjusted below zero. If the old and new taxpayer join in the filing of a consolidated Federal income tax return, the old taxpayer must create an (or increase an existing) excess loss account to the extent the basis in the stock of the new taxpayer otherwise would be adjusted below zero under paragraph (k)(3)(iv)(A)(*1*) of this section. See §§ 1.1502–19 and 1.1502–32(a)(3)(ii).

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

(B) *New Taxpayer*—(*1*) *Contract price adjustment.* Generally, payments between the old taxpayer and the new taxpayer with respect to the contract in connection with the transaction do not affect the contract price. Notwithstanding the preceding sentence and paragraph (k)(3)(iii)(B) of this section, however, in the case of transactions described in paragraph (k)(3)(i)(B), (D), (E), or (I) of this section, the total contract price (or gross contract price) must be reduced to the extent of any amount recognized by the old taxpayer with respect to the contract in connection with the transaction (*e.g.*, any amount recognized under section 351(b) or section 357 that is attributable to the contract and any income recognized by the old taxpayer pursuant

to the basis adjustment rule of paragraph (k)(3)(iv)(A) of this section).

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

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

(v) *Special rules relating to certain partnership transactions*—(A) *Section 704(c)*—(*1*) *Contributions of contracts.* The principles of sections 704(c) and § 1.704–3 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) 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, immediately before the revaluation, the contract were disposed of for its fair market value in a constructive completion transaction.

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

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

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

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

* * * * *

(5) * * *

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

(ii) *Tax consequences to PRS.* For Year 1, PRS reports receipts of $750,000 (the completion factor multiplied by total contract

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

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

(iv) *Section 734(b).* Because X's basis in the contract (including the uncompleted property) immediately after the distribution, $150,000, is equal to PRS's basis in the contract (including the uncompleted property) immediately prior to the distribution, a basis adjustment under section 734(b) is not required.

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 x $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 ×x $1,000,000), $762,500, decreased by receipts already reported, $750,000) and costs of $10,000, for a profit of $2,500. Under section 722, X's initial basis in its interest in PRS is $125,000. Pursuant to paragraph (k)(3)(iv)(A)(*1*) of this section, X must increase its basis in its interest in PRS by the amount of gross receipts X recognized under the contract, $762,500, and reduce its basis by the amount of gross receipts X received under the contract, the $650,000 in progress payments. Accordingly, X's basis in its interest in PRS is $237,500.

(iii) *Tax consequences to PRS.* Because the mid-contract change in taxpayer results from a step-in-the-shoes transaction, PRS must account for the contract using the same methods of accounting used by X prior to the transaction. The total contract price is the sum of any amounts that X and PRS have received or reasonably expect to receive under the contract, and total allocable contract costs are the allocable contract costs of X and PRS. For Year 2, PRS reports receipts of $134,052 (the completion factor multiplied by the total contract price

[($650,000/$725,000) × $1,000,000], $896,552, decreased by receipts reported by X, $762,500) and costs of $40,000, for a profit of $94,052. For Year 3, PRS reports receipts of $103,448 (the total contract price minus prior year receipts ($1,000,000 − $896,552)) and costs of $75,000, for a profit of $28,448.

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

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

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

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

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

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

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

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

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

(v) *Tax Consequences to T.* T's adjusted basis for its interest in PRS is $150,000. Under § 1.743–1(d)(2), the amount of income that would be allocated to T if the contract were disposed of for its fair market value (adjusted to account for income from the contract for the portion of PRS's taxable year that ends on the date of the transfer) is $11,875. Under § 1.743–1(b), the amount of T's basis adjustment under section 743(b) is

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

* * * * *

Par. 4. Section 1.460–6 is amended as follows:

1. Paragraph (g)(3)(ii)(D) is revised.
2. Paragraph (g)(4) is revised.

The revisions read as follows:

§ 1.460–6 Look-back method.

* * * * *

(g) * * *

(3) * * *

(ii) * * *

(D) *Information old taxpayer must provide*—(1) *In general.* Except as provided in paragraph (g)(3)(ii)(D)(2) of this section, in order to help the new taxpayer to apply the look-back method with respect to pre-transaction taxable years, any old taxpayer that accounted for income from a long-term contract under the PCM or PCCM for either regular or alternative minimum tax purposes is required to provide the information described in this paragraph to the new taxpayer by the due date (not including extensions) of the old taxpayer's income tax return for the first taxable year ending on or after a step-in-the-shoes transaction described in § 1.460–4(k)(3)(i). The required information is as follows—

(*i*) The portion of the contract reported by the old taxpayer under PCM for regular and alternative minimum tax purposes (*i.e.*, whether the old taxpayer used PCM, the 40/60 PCCM method, or the 70/30 PCCM method);

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

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

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

(*v*) The due date (not including extensions) of the old taxpayer's income tax returns for each taxable year in which income was required to be reported;

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

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

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

* * * * *

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

* * * * *

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

§ 1.704–3 Contributed property.

(a) * * *

(3) * * *

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

* * * * *

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

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

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

* * * * *

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

§ 1.723–1 Basis of property contributed to partnership.

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

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

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

* * * * *

(c) * * *

(1) * * *

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

* * * * *

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

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

* * * * *

(b) * * *

(i) * * *

(ii) * * *

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

* * * * *

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

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

The additions read as follows:

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

* * * * *

(d) * * *

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

* * * * *

(j) * * *

(2) * * * See § 1.460–4(k)(3)(v)(B) for rules relating to the effect of a basis adjustment under section 743(b) that is allocated to a contract accounted for under a long-term contract method of accounting in determining the

transferee's distributive share of income or loss from the contract.

* * * * *

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

§ 1.751–1 Unrealized receivables and inventory items.

(a) * * *

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

* * * * *

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

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

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

3. New paragraph (c)(5) is added.

The additions read as follows:

§ 1.755–1 Rules for allocation of basis.

* * * * *

(b) * * *

(1) * * *

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

* * * * *

(c) * * *

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

* * * * *

Dale F. Hart,

Acting Deputy Commissioner for Services and Enforcement.

[FR Doc. 03–18484 Filed 8–5–03; 8:45 am]

BILLING CODE 4830–01–P

DEPARTMENT OF DEFENSE

Office of the Secretary

32 CFR Part 199

RIN 0720–AA78

TRICARE; Individual Case Management Program; Program for Persons with Disabilities; Extended Benefits for Disabled Family Members of Active Duty Service Members; Custodial Care

AGENCY: Office of the Secretary, DoD.

ACTION: Proposed rule.

SUMMARY: The Department is publishing this proposed rule to implement requirements enacted by Congress in section 701(g) of the National Defense Authorization Act for Fiscal Year 2002 (NDAA–02), Pub. L. 107–107, which terminates the Individual Case Management Program. The Department withdraws its proposed rule published at 66 FR 39699–39705, August 1, 2001 regarding the Individual Case Management Program. This rule also implements section 701(b) of the NDAA–02 which provides additional benefits for certain eligible active duty dependents by amending the TRICARE regulations at 32 CFR 199.5 governing the Program for Persons with Disabilities. The Program for Persons with Disabilities will now be called the Extended Care Health Option. Other administrative amendments are included to clarify specific policies that relate to the Extended Care Health Option, custodial care, and to update related definitions.

Public comments are invited and will be considered for possible revisions to the Final Rule.

DATES: Written comments received at the address indicated below by October 6, 2003 will be accepted.

ADDRESSES: Because of staff and resource limitation, we cannot accept comments by facsimile (FAX) transmission or electronic mail (e-mail). Mail written comments to the following address ONLY: TRICARE Management Activity, Medical Benefits and Reimbursement Systems, 16401 East Centretech Parkway, Aurora, CO 80011. Please allow sufficient time for mailed comments to be timely received in the event of delivery delays.

FOR FURTHER INFORMATION CONTACT: Michael Kottyan, Medical Benefits and Reimbursement Systems, TRICARE Management Activity, telephone (303) 676–3520. Questions regarding payment of specific claims should be addressed to the appropriate TRICARE contractor.

SUPPLEMENTARY INFORMATION:

I. Background

The Individual Case Management Program (ICMP). Under the provisions of section 704(3) of the NDAA–93 [Pub. L. 102–484], 10 U.S.C. 1079(a)(17) was enacted which allowed the DoD to establish the ICMP, also known as the Individual Case Management Program for Persons with Extraordinary Conditions (ICMP–PEC). This allowed a reasonable deviation from the restrictive statutory coverage of health services for patients who had exceptionally serious, long-range, costly and incapacitating conditions. The ICMP was officially implemented in March 1999 as a waiver program that provided coverage for care and services that were normally restricted from coverage under the Basic Program. Specifically, when a beneficiary was determined to meet the TRICARE definition of custodial care, coverage under the Basic Program was limited to one hour of skilled nursing care per day, twelve physician visits per year related to the custodial condition, durable medical equipment and prescription medications. The Department recognized that the exclusion of coverage when a family member is deemed to be a custodial care patient is both a financial and emotional burden. Consequently, the Department used the ICMP/ICMP–PEC authority to cover medically necessary care and to enable TRICARE case managers to maximize available resources for these beneficiaries.

Repeal of the ICMP. Section 701(g) of the NDAA–02 repealed 10 U.S.C. 1079(a)(17), the statutory authority for the ICMP. However, section 701(d) allows the Department to continue to provide payment for home health care or custodial care services not otherwise authorized under the Basic Program as if the ICMP were still in effect. Payment may occur when a determination is made that discontinuation of payment would result in the provision of services inadequate to meet the needs of the eligible beneficiary and would be unjust to the beneficiary. Eligible beneficiaries are defined in section 701(d)(3) as covered beneficiaries who were regarded as custodial care patients under the ICMP/ICMP–PEC and received medically necessary skilled services for which the Secretary provided payment before December 28, 2001.

Custodial Care. Section 701(c) of the NDAA–02 provides a statutory definition of custodial care that is more consistent with other federal programs. The change also results in the narrowing of the statutory exclusions of custodial care that has the effect of eliminating current program restrictions on paying for certain medically necessary care. **Note:** The statutory definition of custodial care under section 701(c) became effective on December 28, 2001, the effective date of the NDAA–02. Public notice of the substitution of the new statutory definition for the former custodial care definition in 32 CFR 199.2 was provided on June 13, 2002 (67 FR 40597–40606).

The Program for Persons with Disabilities (PFPWD). This program is now renamed the Extended Health Care Option (ECHO). The PFPWD was established by Congress in 1966 and