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§ 1.460-1 Long-term contracts.

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

interest owed on any hypothetical underpayment of tax, or earned on any hypothetical overpayment of tax, attributable to accounting for the long-term contract under the PCM.

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

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

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

for the building, installation, or construction of real property is a *construction contract*.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(A) Use of the subject matter of the contract by the customer for its intended purpose (other than for testing)

and at least 95 percent of the total allocable contract costs attributable to the subject matter have been incurred by the taxpayer; or

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

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

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

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

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

accounted for using the PCM, see § 1.460-6(c)(1)(ii) and (2)(vi).

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

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

(d) *Allocation among activities—*(1) *In general.* Long-term contract methods of accounting apply only to the gross receipts and costs attributable to long-term contract activities. Gross receipts and costs attributable to long-term contract activities means amounts included in total contract price or gross contract price, whichever is applicable, as determined under § 1.460-4, and costs allocable to the contract, as determined under § 1.460-5. Gross receipts and costs attributable to non-long-term contract activities (as defined in paragraph (d)(2) of this section) generally must be taken into account using a permissible method of accounting other than a long-term contract method. See section 446(c) and § 1.446-1(c). However, if the performance of a non-long-term contract activity is incident to or necessary for the manufacture, building, installation, or construction of the subject matter of one or more of the taxpayer's long-term contracts, the gross receipts and costs attributable to that activity must be allocated to the long-term contract(s) benefitted as provided in §§ 1.460-4(b)(4)(i) and 1.460-5(f)(2), respectively. Similarly, if a single long-term contract requires a taxpayer to perform a non-long-term contract activity that is

not incident to or necessary for the manufacture, building, installation, or construction of the subject matter of the long-term contract, the gross receipts and costs attributable to that non-long-term contract activity must be separated from the contract and accounted for using a permissible method of accounting other than a long-term contract method. But see paragraph (g) of this section for related party rules.

(2) *Non-long-term contract activity.* *Non-long-term contract activity* means the performance of an activity other than manufacturing, building, installation, or construction, such as the provision of architectural, design, engineering, and construction management services, and the development or implementation of computer software. In addition, performance under a guaranty, warranty, or maintenance agreement is a non-long-term contract activity that is never incident to or necessary for the manufacture or construction of property under a long-term contract.

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

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

(i) *Pricing.* Independent pricing of items in an agreement is necessary for the agreement to be severed into two or more contracts. In the case of an agreement for similar items, if the price to be paid for the items is deter-

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

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

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

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

(ii) *Options and change orders.* Except as provided in paragraph (e)(3)(i) of this section, a taxpayer must sever an

agreement that increases the number of units to be supplied to the customer, such as through the exercise of an option or the acceptance of a change order, if the agreement provides for separate delivery or separate acceptance of the additional units.

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

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

(ii) The taxpayer's name; and

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

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

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

(ii) *Elections.* A taxpayer makes an election under this paragraph (f)(2) by

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

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

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

time. A taxpayer's estimate of completion time will not be considered unreasonable if a contract is not completed within the estimated time primarily because of unforeseeable factors not within the taxpayer's control, such as third-party litigation, extreme weather conditions, strikes, or delays in securing permits or licenses.

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

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

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

(2) *Total contract price.* If a taxpayer is required to use the PCM under paragraph (g)(1)(i) of this section, the total contract price (as defined in § 1.460-

4(b)(4)(i)) is the fair market value of the taxpayer's activity that is incident to or necessary for the performance of the related party's long-term contract. The related party also must use the fair market value of the taxpayer's activity as the cost it incurs for the activity. The fair market value of the taxpayer's activity may or may not be the same as the amount the related party pays the taxpayer for that activity.

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

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

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

that wants to change its exempt-contract method of accounting is not granted the consent of the Commissioner under this paragraph (h)(2) and must file a Form 3115, "Application for Change in Accounting Method," to obtain consent. See Rev. Proc. 97-27 (1997-1 C.B. 680) (see §601.601(d)(2) of this chapter).

(i) [Reserved]

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

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

Example 2. De minimis construction activity. C, a master developer whose taxable year ends December 31, owns 5,000 acres of undeveloped land with a cost basis of \$5,000,000 and a fair market value of \$50,000,000. To obtain permission from the local county government to improve this land, a service road must be constructed on this land to benefit all 5,000 acres. In 2001, C enters into a contract to sell a 1,000-acre parcel of undeveloped land to B, a residential developer, for its fair market value, \$10,000,000. In this contract, C agrees to construct a service road running through the land that C is selling to B and through the 4,000 adjacent acres of undeveloped land that C has sold or will sell to other residential developers for its fair market value, \$40,000,000. C reasonably estimates that it will incur allocable contract costs of \$50,000 (excluding the cost of the land) to construct this service road, which will be owned and maintained by the county. C must reasonably allocate the cost of the service road among the benefitted parcels. The portion of the estimated total allocable contract costs that C allocates to the 1,000-acre parcel being sold to B (based upon its fair market value) is \$10,000 ($\$50,000 \times (\$10,000,000 \div \$50,000,000)$). Construction of the service road is finished in 2002. Because the estimated total allocable contract costs attributable to C's construction activities, \$10,000, are less than 10 percent of the contract's

total contract price, \$10,000,000, C's contract with B is not a construction contract under paragraph (b)(2)(ii) of this section. Thus, C's contract with B is not a long-term contract under paragraph (b)(2)(i) of this section, notwithstanding that construction of the service road is not completed in 2001.

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

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

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

Example 6. Non-long-term contract activity. On January 1, 2001, C, whose taxable year ends December 31, enters into a single long-

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

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

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

Example 9. Severance. C, a large construction contractor whose taxable year ends December 31, accounts for its construction contracts using the PCM and has elected to use the 10-percent method described in § 1.460-4(b)(6). In September 2001, C enters into an agreement to construct four buildings in four different cities. The buildings are independently priced and the contract provides a reasonable profit for each of the buildings. In addition, the agreement requires C to complete one building per year in 2002, 2003, 2004, and 2005. As of December 31, 2001, C has in-

curring 25 percent of the estimated total allocable contract costs attributable to one of the buildings, but only five percent of the estimated total allocable contract costs attributable to all four buildings included in the agreement. C does not request the Commissioner's consent to sever this contract. Using the 10-percent method, C does not take into account any portion of the total contract price or any incurred allocable contract costs attributable to this agreement in 2001. Upon examination of C's 2001 tax return, the Commissioner determines that C entered into one agreement for four buildings rather than four separate agreements each for one building solely to take advantage of the deferral obtained under the 10-percent method. Consequently, to clearly reflect the taxpayer's income, the Commissioner may require C to sever the agreement into four separate contracts under paragraph (e)(2) of this section because the buildings are independently priced, the agreement provides for separate delivery and acceptance of the buildings, and a reasonable businessperson would have entered into separate agreements for these buildings.

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

Example 11. Aggregation. In 2001, C, a manufacturer of aircraft and related equipment, agrees to manufacture 10 military aircraft for foreign government B and to deliver the aircraft by the end of 2003. When entering into the agreement, C anticipates that it might receive production orders from B over the next 20 years for as many as 300 more of these aircraft. The negotiated contract price reflects C's and B's consideration of the expected total cost of manufacturing the 10 aircraft, the risks and opportunities associated with the agreement, and the additional factors the parties considered relevant. The negotiated price provides a profit on the sale of the 10 aircraft even if C does not receive any additional production orders from B. It

is unlikely, however, that C actually would have wanted to manufacture the 10 aircraft but for the expectation that it would receive additional production orders from B. In 2003, B accepts delivery of the 10 aircraft. At that time, B orders an additional 20 aircraft of the same type for delivery in 2007. When negotiating the price for the additional 20 aircraft, C and B consider the fact that the expected unit cost for this production run of 20 aircraft will be lower than the unit cost of the 10 aircraft completed and accepted in 2003, but substantially higher than the expected unit cost of future production runs. Based upon these facts, aggregation is not permitted under paragraph (e)(2) of this section. Because the parties negotiated the prices of both agreements considering only the expected production costs and risks for each agreement standing alone, the terms and conditions agreed upon for the first agreement are independent of the terms and conditions agreed upon for the second agreement. The fact that the agreement to manufacture 10 aircraft provides a profit for C indicates that a reasonable businessperson would have entered into that agreement without entering into the agreement to manufacture the additional 20 aircraft.

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

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§ 1.460-2 Long-term manufacturing contracts.

(a) *In general.* Section 460 generally requires a taxpayer to determine the

income from a long-term manufacturing contract using the percentage-of-completion method described in § 1.460-4(b) (PCM). A contract not completed in the contracting year is a long-term manufacturing contract if it involves the manufacture of personal property that is—

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

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

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

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

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

(ii) *Customized item.* An item is not unique if the total allocable contract