not unique items and do not normally require more than 12 months to produce. C must classify its second contract with B as a non-long term contract, notwithstanding that it classified the previous contract with B for a similar item as a long-term contract, because the determination of whether a contract is a long-term contract is made on a contract-by-contract basis. A change in classification is not a change in method of accounting because the change in classification results from a change in underlying facts.

Example 2. 12-month rule—related party. C manufactures cranes. C purchases one of the crane's components from R, a related party under §1.460–1(b)(4). Less than 50 percent of R's gross receipts attributable to the sale of this component comes from sales to unrelated parties; thus, the exception for components and subassemblies under §1.460–1(g)(1)(ii) is not satisfied. Consequently, C must consider the activities of R as R incurs costs and performs the activities rather than as C incurs a liability to R. The normal time period between the time that both C and R incur five percent of the costs allocable to the crane and the time that R completes the component is five months. C normally requires an additional eight months to complete production of the crane after receiving the integral component from R. C's crane is an item of a type that normally requires more than 12 months to complete under paragraph (c) of this section because the production period from the time that both C and R incur five percent of the costs allocable to the crane until the time that production of the crane is complete is normally 13 months.

Example 3. 12-month rule—duration of contract. The facts are the same as in *Example 2,* except that C enters into a sales contract with B on December 31, 2001 (the last day of C's taxable year), and delivers a completed crane to B on February 1, 2002. C's contract with B is a long-term contract under paragraph (a)(2) of this section because the contract is not completed in the contracting year, 2001, and the crane is an item that normally requires more than 12 calendar months to complete (regardless of the duration of the contract).

Example 4. 12-month rule—normal time to complete. The facts are the same as in *Example 2,* except that C (and R) actually complete B's crane in only 10 calendar months. The contract is a long-term contract because the normal time to complete a crane, not the actual time to complete a crane, is the relevant criterion for determining whether an item is subject to paragraph (a)(2) of this section.

Example 5. Normal time to complete. C enters into a multi-unit contract to produce four units of an item. C does not anticipate producing any additional units of the item. C expects to perform the research, design, and development that are directly allocable to the particular item and to produce the first unit in the first 24 months. C reasonably expects the production period for each of the three remaining units will be 3 months. This contract is not a contract that involves the manufacture of an item that normally requires more than 12 months to complete because the normal time to complete the item is 3 months. However, the contract does not satisfy the 90-day safe harbor for unique items because the normal time to complete the first unit of this item exceeds 90 days. Thus, the contract might involve the manufacture of a unique item depending on the facts and circumstances.

[T.D. 8929, 66 FR 2230, Jan. 11, 2001; 66 FR 18191, Apr. 6, 2001]

§1.460–3 Long-term construction contracts.

(a) *In general.* Section 460 generally requires a taxpayer to determine the income from a long-term construction 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 construction contract if it involves the building, construction, reconstruction, or rehabilitation of real property; the installation of an integral component to real property; or the improvement of real property (collectively referred to as construction). *Real property* means land, buildings, and *inherently permanent structures,* as defined in §1.263A–8(c)(3), such as roadways, dams, and bridges. Real property does not include vessels, offshore drilling platforms, or unsevered natural products of land. An *integral component to real property* includes property not produced at the site of the real property but intended to be permanently affixed to the real property, such as elevators and central heating and cooling systems. Thus, for example, a contract to install an elevator in a building is a construction contract because a building is real property, but a contract to install an elevator in a ship is not a construction contract because a ship is not real property.

(b) *Exempt construction contracts*—(1) *In general.* The general requirement to use the PCM and the cost allocation rules described in §1.460–5(b) or (c) does not apply to any long-term construction contract described in this paragraph (b) (exempt construction contract). *Exempt construction contract* means any—

(i) Home construction contract; and

(ii) Other construction contract that a taxpayer estimates (when entering into the contract) will be completed within 2 years of the contract commencement date, provided the taxpayer satisfies the $10,000,000 gross receipts test described in paragraph (b)(3) of this section.

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

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

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

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

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

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

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

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

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

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

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