

(\$150,000 value allocable to the contract + \$650,000 progress payments)—\$600,000 costs incurred but not recognized). The gain realized on the transfer of the unrelated capital asset to Z is \$125,000. The amount of gain X must recognize due to the receipt of \$100,000 of cash in the exchange is \$100,000, of which \$54,545 is allocated to the contract (\$150,000 value of the contract/\$275,000 total value of property transferred to Z×\$100,000) and is treated as ordinary income, and \$45,455 is allocated to the unrelated capital asset (\$125,000 value of capital asset/\$275,000 total value of property transferred to Z×\$100,000). Under section 358(a), X's basis in the Z stock is \$600,000 (\$600,000 basis in the contract and unrelated capital asset transferred—\$100,000 cash received + \$100,000 gain recognized). Pursuant to paragraph (k)(3)(iv)(A)(1) of this section, X must reduce its basis in the stock of Z by \$650,000, the progress payments received under the contract. However, X may not reduce its basis in the Z stock below zero pursuant to paragraph (k)(3)(iv)(A)(2) of this section. Accordingly, X's basis in the Z stock is reduced by \$600,000 to zero and X must recognize income of \$50,000.

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

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

[T.D. 8597, 60 FR 36684, July 18, 1995, as amended by T.D. 8929, 66 FR 2232, Jan. 11, 2001; 66 FR 18191, Apr. 6, 2001; T.D. 8995, 67 FR 34605, May 15, 2002]

#### § 1.460-5 Cost allocation rules.

(a) *Overview.* This section prescribes methods of allocating costs to long-term contracts accounted for using the percentage-of-completion method described in § 1.460-4(b) (PCM), the completed-contract method described in § 1.460-4(d) (CCM), or the percentage-of-completion/capitalized-cost method de-

scribed in § 1.460-4(e) (PCCM). Exempt construction contracts described in § 1.460-3(b) accounted for using a method other than the PCM or CCM are not subject to the cost allocation rules of this section (other than the requirement to allocate production-period interest under paragraph (b)(2)(v) of this section). Paragraph (b) of this section describes the regular cost allocation methods for contracts subject to the PCM. Paragraph (c) of this section describes an elective simplified cost allocation method for contracts subject to the PCM. Paragraph (d) of this section describes the cost allocation methods for exempt construction contracts reported using the CCM. Paragraph (e) of this section describes the cost allocation rules for contracts subject to the PCCM. Paragraph (f) of this section describes additional rules applicable to the cost allocation methods described in this section. Paragraph (g) of this section provides rules concerning consistency in method of allocating costs to long-term contracts.

(b) *Cost allocation method for contracts subject to PCM—(1) In general.* Except as otherwise provided in paragraph (b)(2) of this section, a taxpayer must allocate costs to each long-term contract subject to the PCM in the same manner that direct and indirect costs are capitalized to property produced by a taxpayer under § 1.263A-1(e) through (h). Thus, a taxpayer must allocate to each long-term contract subject to the PCM all direct costs and certain indirect costs properly allocable to the long-term contract (*i.e.*, all costs that directly benefit or are incurred by reason of the performance of the long-term contract). However, see paragraph (c) of this section concerning an election to allocate contract costs using the simplified cost-to-cost method. As in section 263A, the use of the practical capacity concept is not permitted. See § 1.263A-2(a)(4).

(2) *Special rules—(i) Direct material costs.* The costs of direct materials must be allocated to a long-term contract when dedicated to the contract under principles similar to those in § 1.263A-11(b)(2). Thus, a taxpayer dedicates direct materials by associating them with a specific contract, including by purchase order, entry on books

and records, or shipping instructions. A taxpayer maintaining inventories under § 1.471-1 must determine allocable contract costs attributable to direct materials using its method of accounting for those inventories (e.g., FIFO, LIFO, specific identification).

(ii) *Components and subassemblies.* The costs of a component or subassembly (component) produced by the taxpayer must be allocated to a long-term contract as the taxpayer incurs costs to produce the component if the taxpayer reasonably expects to incorporate the component into the subject matter of the contract. Similarly, the cost of a purchased component (including a component purchased from a related party) must be allocated to a long-term contract as the taxpayer incurs the cost to purchase the component if the taxpayer reasonably expects to incorporate the component into the subject matter of the contract. In all other cases, the cost of a component must be allocated to a long-term contract when the component is dedicated, under principles similar to those in § 1.263A-11(b)(2). A taxpayer maintaining inventories under § 1.471-1 must determine allocable contract costs attributable to components using its method of accounting for those inventories (e.g., FIFO, LIFO, specific identification).

(iii) *Simplified production methods.* A taxpayer may not determine allocable contract costs using the simplified production methods described in § 1.263A-2(b) and (c).

(iv) *Costs identified under cost-plus long-term contracts and federal long-term contracts.* To the extent not otherwise allocated to the contract under this paragraph (b), a taxpayer must allocate any identified costs to a cost-plus long-term contract or federal long-term contract (as defined in section 460(d)). *Identified cost* means any cost, including a charge representing the time-value of money, identified by the taxpayer or related person as being attributable to the taxpayer's cost-plus long-term contract or federal long-term contract under the terms of the contract itself or under federal, state, or local law or regulation.

(v) *Interest—(A) In general.* If property produced under a long-term contract is *designated property*, as defined in

§ 1.263A-8(b) (without regard to the exclusion for long-term contracts under § 1.263A-8(d)(2)(v)), a taxpayer must allocate interest incurred during the production period to the long-term contract in the same manner as interest is allocated to property produced by a taxpayer under section 263A(f). See §§ 1.263A-8 to 1.263A-12 generally.

(B) *Production period.* Notwithstanding § 1.263A-12(c) and (d), for purposes of this paragraph (b)(2)(v), the production period of a long-term contract—

(1) Begins on the later of—

(i) The contract commencement date, as defined in § 1.460-1(b)(7); or

(ii) For a taxpayer using the accrual method of accounting for long-term contracts, the date by which 5 percent or more of the total estimated costs, including design and planning costs, under the contract have been incurred; and

(2) Ends on the date that the contract is completed, as defined in § 1.460-1(c)(3).

(C) *Application of section 263A(f).* For purposes of this paragraph (b)(2)(v), section 263A(f)(1)(B)(iii) (regarding an estimated production period exceeding 1 year and a cost exceeding \$1,000,000) must be applied on a contract-by-contract basis; except that, in the case of a taxpayer using an accrual method of accounting, that section must be applied on a property-by-property basis.

(vi) *Research and experimental expenses.* Notwithstanding § 1.263A-1(e)(3)(ii)(P) and (iii)(B), a taxpayer must allocate research and experimental expenses, other than independent research and development expenses (as defined in § 1.460-1(b)(9)), to its long-term contracts.

(vii) *Service costs—(A) Simplified service cost method—(1) In general.* To use the simplified service cost method under § 1.263A-1(h), a taxpayer must allocate the otherwise capitalizable mixed service costs among its long-term contracts using a reasonable method. For example, otherwise capitalizable mixed service costs may be allocated to each long-term contract based on labor hours or contract costs allocable to the contract. To be considered reasonable, an allocation method must be applied consistently

and must not disproportionately allocate service costs to contracts expected to be completed in the near future.

(2) *Example.* The following example illustrates the rule of this paragraph (b)(2)(vii)(A):

*Example. Simplified service cost method.* During 2001, C, whose taxable year ends December 31, produces electronic equipment for inventory and enters into long-term contracts to manufacture specialized electronic equipment. C's method of allocating mixed service costs to the property it produces is the labor-based, simplified service cost method described in §1.263A-1(h)(4). For 2001, C's total mixed service costs are \$100,000, C's section 263A labor costs are \$500,000, C's section 460 labor costs (*i.e.*, labor costs allocable to C's long-term contracts) are \$250,000, and C's total labor costs are \$1,000,000. To determine the amount of mixed service costs capitalizable under section 263A for 2001, C multiplies its total mixed service costs by its section 263A allocation ratio (section 263A labor costs ÷ total labor costs). Thus, C's capitalizable mixed service costs for 2001 are \$50,000 ( $\$100,000 \times \$500,000 \div \$1,000,000$ ). Thereafter, C allocates its capitalizable mixed service costs to produced property remaining in ending inventory using its 263A allocation method (*e.g.*, burden rate, simplified production). Similarly, to determine the amount of mixed service costs that are allocable to C's long-term contracts for 2001, C multiplies its total mixed service costs by its section 460 allocation ratio (section 460 labor ÷ total labor costs). Thus, C's allocable mixed service contract costs for 2001 are \$25,000 ( $\$100,000 \times \$250,000 \div \$1,000,000$ ). Thereafter, C allocates its allocable mixed service costs to its long-term contracts proportionately based on its section 460 labor costs allocable to each long-term contract.

(B) *Jobsite costs.* If an administrative, service, or support function is performed solely at the jobsite for a specific long-term contract, the taxpayer may allocate all the direct and indirect costs of that administrative, service, or support function to that long-term contract. Similarly, if an administrative, service, or support function is performed at the jobsite solely for the taxpayer's long-term contract activities, the taxpayer may allocate all the direct and indirect costs of that administrative, service, or support function among all the long-term contracts performed at that jobsite. For this purpose, jobsite means a production plant or a construction site.

(C) *Limitation on other reasonable cost allocation methods.* A taxpayer may use any other reasonable method of allocating service costs, as provided in §1.263A-1(f)(4), if, for the taxpayer's long-term contracts considered as a whole, the—

(1) Total amount of service costs allocated to the contracts does not differ significantly from the total amount of service costs that would have been allocated to the contracts under §1.263A-1(f)(2) or (3);

(2) Service costs are not allocated disproportionately to contracts expected to be completed in the near future because of the taxpayer's cost allocation method; and

(3) Taxpayer's cost allocation method is applied consistently.

(c) *Simplified cost-to-cost method for contracts subject to the PCM—(1) In general.* Instead of using the cost allocation method prescribed in paragraph (b) of this section, a taxpayer may elect to use the simplified cost-to-cost method, which is authorized under section 460(b)(3)(A), to allocate costs to a long-term contract subject to the PCM. Under the simplified cost-to-cost method, a taxpayer determines a contract's completion factor based upon only direct material costs; direct labor costs; and depreciation, amortization, and cost recovery allowances on equipment and facilities directly used to manufacture or construct the subject matter of the contract. For this purpose, the costs associated with any manufacturing or construction activities performed by a subcontractor are considered either direct material or direct labor costs, as appropriate, and therefore must be allocated to the contract under the simplified cost-to-cost method. An electing taxpayer must use the simplified cost-to-cost method to apply the look-back method under §1.460-6 and to determine alternative minimum taxable income under §1.460-4(f).

(2) *Election.* A taxpayer makes an election under this paragraph (c) by using the simplified cost-to-cost method for all long-term contracts entered into during the taxable year of the election on its original federal income tax return for the election year. This election is a method of accounting and, thus, applies to all long-term contracts

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entered into during and after the taxable year of the election. This election is not available if a taxpayer does not use the PCM to account for all long-term contracts or if a taxpayer elects to use the 10-percent method described in § 1.460-4(b)(6).

(d) *Cost allocation rules for exempt construction contracts reported using the CCM*—(1) *In general.* For exempt construction contracts reported using the CCM, other than contracts described in paragraph (d)(3) of this section (concerning contracts of homebuilders that do not satisfy the \$10,000,000 gross receipts test described in § 1.460-3(b)(3) or will not be completed within two years of the contract commencement date), a taxpayer must annually allocate the cost of any activity that is incident to or necessary for the taxpayer's performance under a long-term contract. A taxpayer must allocate to each exempt construction contract all direct costs as defined in § 1.263A-1(e)(2)(i) and all indirect costs either as provided in § 1.263A-1(e)(3) or as provided in paragraph (d)(2) of this section.

(2) *Indirect costs*—(i) *Indirect costs allocable to exempt construction contracts.* A taxpayer allocating costs under this paragraph (d)(2) must allocate the following costs to an exempt construction contract, other than a contract described in paragraph (d)(3) of this section, to the extent incurred in the performance of that contract—

- (A) Repair of equipment or facilities;
- (B) Maintenance of equipment or facilities;
- (C) Utilities, such as heat, light, and power, allocable to equipment or facilities;
- (D) Rent of equipment or facilities;
- (E) Indirect labor and contract supervisory wages, including basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d) as it existed prior to its repeal in 1983), shift differential, payroll taxes, and contributions to a supplemental unemployment benefits plan;
- (F) Indirect materials and supplies;
- (G) Noncapitalized tools and equipment;
- (H) Quality control and inspection;

(I) Taxes otherwise allowable as a deduction under section 164, other than state, local, and foreign income taxes, to the extent attributable to labor, materials, supplies, equipment, or facilities;

(J) Depreciation, amortization, and cost-recovery allowances reported for the taxable year for financial purposes on equipment and facilities to the extent allowable as deductions under chapter 1 of the Internal Revenue Code;

(K) Cost depletion;

(L) Administrative costs other than the cost of selling or any return on capital;

(M) Compensation paid to officers other than for incidental or occasional services;

(N) Insurance, such as liability insurance on machinery and equipment; and

(O) Interest, as required under paragraph (b)(2)(v) of this section.

(ii) *Indirect costs not allocable to exempt construction contracts.* A taxpayer allocating costs under this paragraph (d)(2) is not required to allocate the following costs to an exempt construction contract reported using the CCM—

(A) Marketing and selling expenses, including bidding expenses;

(B) Advertising expenses;

(C) Other distribution expenses;

(D) General and administrative expenses attributable to the performance of services that benefit the taxpayer's activities as a whole (e.g., payroll expenses, legal and accounting expenses);

(E) Research and experimental expenses (described in section 174 and the regulations thereunder);

(F) Losses under section 165 and the regulations thereunder;

(G) Percentage of depletion in excess of cost depletion;

(H) Depreciation, amortization, and cost recovery allowances on equipment and facilities that have been placed in service but are temporarily idle (for this purpose, an asset is not considered to be temporarily idle on non-working days, and an asset used in construction is considered to be idle when it is neither en route to nor located at a job-site), and depreciation, amortization and cost recovery allowances under chapter 1 of the Internal Revenue Code in excess of depreciation, amortization, and cost recovery allowances reported

by the taxpayer in the taxpayer's financial reports;

(I) Income taxes attributable to income received from long-term contracts;

(J) Contributions paid to or under a stock bonus, pension, profit-sharing, or annuity plan or other plan deferring the receipt of compensation whether or not the plan qualifies under section 401(a), and other employee benefit expenses paid or accrued on behalf of labor, to the extent the contributions or expenses are otherwise allowable as deductions under chapter 1 of the Internal Revenue Code. Other employee benefit expenses include (but are not limited to): Worker's compensation; amounts deductible or for whose payment reduction in earnings and profits is allowed under section 404A and the regulations thereunder; payments pursuant to a wage continuation plan under section 105(d) as it existed prior to its repeal in 1983; amounts includible in the gross income of employees under a method or arrangement of employer contributions or compensation which has the effect of a stock bonus, pension, profit-sharing, or annuity plan, or other plan deferring the receipt of compensation or providing deferred benefits; premiums on life and health insurance; and miscellaneous benefits provided for employees such as safety, medical treatment, recreational and eating facilities, membership dues, *etc.*;

(K) Cost attributable to strikes, rework labor, scrap and spoilage; and

(L) Compensation paid to officers attributable to the performance of services that benefit the taxpayer's activities as a whole.

(3) *Large homebuilders.* A taxpayer must capitalize the costs of home construction contracts under section 263A and the regulations thereunder, unless the contract will be completed within two years of the contract commencement date and the taxpayer satisfies the \$10,000,000 gross receipts test described in § 1.460-3(b)(3).

(e) *Cost allocation rules for contracts subject to the PCCM.* A taxpayer must use the cost allocation rules described in paragraph (b) of this section to determine the costs allocable to the entire qualified ship contract or residential construction contract accounted

for using the PCCM and may not use the simplified cost-to-cost method described in paragraph (c) of this section.

(f) *Special rules applicable to costs allocated under this section—(1) Nondeductible costs.* A taxpayer may not allocate any otherwise allocable contract cost to a long-term contract if any section of the Internal Revenue Code disallows a deduction for that type of payment or expenditure (*e.g.*, an illegal bribe described in section 162(c)).

(2) *Costs incurred for non-long-term contract activities.* If a taxpayer performs a non-long-term contract activity, as defined in § 1.460-1(d)(2), that is incident to or necessary for the manufacture, building, installation, or construction of the subject matter of one or more of the taxpayer's long-term contracts, the taxpayer must allocate the costs attributable to that activity to such contract(s).

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

[T.D. 8929, 66 FR 2237, Jan. 11, 2001]

#### § 1.460-6 Look-back method.

(a) *In general—(1) Introduction.* With respect to income from any long-term contract reported under the percentage of completion method, a taxpayer is required to pay or is entitled to receive interest under section 460(b) on the amount of tax liability that is deferred or accelerated as a result of overestimating or underestimating total contract price or contract costs. Under this look-back method, taxpayers are required to pay interest for any deferral of tax liability resulting from the underestimation of the total contract price or the overestimation of total contract costs. Conversely, if the total