

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/reg>.

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