NEW DEVELOPMENTS IN TAX ASPECTS OF
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EDITED BY T. MILTON KUPFER, CPA, & DANIEL F. KRUGER, CPA

Long-term contract Regulations: Endless complexity and planning opportunities

by LESLIE J. SCHNEIDER and MICHAEL F. SOLOMON

Newly issued Regulations implement restrictions on the operation of the completed contract method of accounting for long-term contracts and apparently will serve as the model for the recently proposed uniform capitalization rules. The authors analyze the implications for contractors, manufacturers and those subject to the uniform rules.

ON 1/6/86, the Service issued final Regulations under Section 451, dealing with accounting for long-term contracts. These Regulations implement the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), P.L. 97-248, 9/3/82, to restrict the operation of the completed contract method of accounting for long-term contracts. Perhaps even more significantly, these Regulations would provide the model for the uniform capitalization rules for all activities involving the production or manufacture of real or personal property under Sections 904 and 905 of the House-passed version of the 1985 tax bill ("H.R. 3838") and for all such production or manufacturing activities and for wholesalers and retailers under the tax proposals considered by the Senate Finance Committee in March and April 1986.[1] Thus, these Regulations are particularly significant, even if the completed contract method of accounting is repealed for most long-term contracts as has been proposed in H.R. 3838 (but not in the proposals considered by the Senate Finance Committee).

The changes embodied in these Regulations are highly complex. Moreover, in many instances, the rules will be applicable to taxpayers who have extended period long-term contracts but do not use one of the special long-term contract methods of accounting (*i.e.*, the completed contract method or the percentage of completion method).

The new long-term contract Regulations make changes in three principal areas: (1) the severing and aggregating of long-term contracts; (2) determining the time of completion of a long-term contract; and (3) the costing of and applicability of inventory accounting rules to long-term contracts.

Severing, aggregating contracts

One of the more interesting and complex aspects of the Regulations is their attempt to deal with the determination of the scope of a long-term contract. The Regulations deal with this question by using the concept of severing and aggregating long-term contracts which is applied at several different levels of analysis. Thus, the Regulations both continue and expand upon the prior Regulations' provisions that require certain long-term contracts to be either severed into multiple contracts or aggregated into a single contract based on principles of substance over form. These provisions are embodied in Reg. 1.451-3(e).

Formal severing and aggregating rules. As noted above, the Regulations continue the rule of prior Regulations that in order to clearly reflect income, it may be necessary to treat one contract as several agreements or several contracts as one agreement. However, in a departure from prior Regulations, the new Regulations make clear that only the Service can initiate the severing and aggregating rules.[2] The Regulations also note that the use of the severing and aggregating rules is not limited to cases in which a long-term contract method is used. Thus, for example, the Service may apply these rules to taxpayers using the accrual-shipment or accrual-acceptance method of accounting. However, in light of the contemporaneous amendment to Reg. 1.451-5(b), which provides that an accrual-basis taxpayer must accrue gross profit as each unit under a contract is shipped or accepted, it is difficult to envision situations under the accrual method where it will be in the Service's interest to sever a single long-term contract. In contrast, the possible aggregation of several single unit contracts may be of concern to accrual-basis taxpayers where the sale of the earlier units will produce a loss.

With respect to the severing of a single contract into two or more contracts, Reg. 1.451-3(e)(1)(ii) states that factors to be taken into account include: (1) whether the contract contemplates separate deliveries or acceptances of units under the contract; (2) whether there is a business purpose for entering into a single contract rather than multiple contracts; (3) whether the units under the contract are independently priced; (4) the customary commercial practice for the type of contract involved; (5) the dealings between the parties to the contract; (6) the nature of the subject matter; (7) the number of units contracted for; and (8) the contemplated time between the completion of each unit. Furthermore, the addition of units by a change order or by the exercise of an option typically is considered to be a separate contract from the original agreement.

The Regulations contain several examples of when a single long-term contract should be severed. Unfortunately, it is difficult to distill many general principles from these examples. Under Example 1 in the Regulations, a taxpayer constructs under a single contract three different houses in three different locations for the same developer; the houses will be placed in service in three different years. The taxpayer is treated as having entered into three separate contracts. In contrast, in Example 4, a contract to build a ten-story office building that is completed in two phases, three floors in one year and seven floors the next year, is not severed into two separate contracts for three floors and seven floors, respectively.

One might conclude from these examples that severance will not occur unless, at a minimum, there is a multi-unit contract. However, this inference is quickly dispelled by Example 5, where the contract in Example 4 is modified by a later agreement to postpone completion of the remaining seven floors of the building for at least two years. In this case, the single contract is severed into two contracts: (1) the original contract for ten floors up to the time of the agreement to postpone completion of the remaining seven floors and (2) the separate agreement to con

plete the remaining seven floors. In light of the wording of the example, presumably all of the costs incurred prior to the amendment of the contract would be allocable to the first contract even though they relate to construction of the last seven floors. This is in contrast to the severance of the contract in Example 1, where severance occurs from the inception of the contract and creates a need to allocate costs among the three contracts from the beginning.

An analysis of these examples does not suggest that a single multi-unit contract will ordinarily be severed where the units under the contract are equally priced. However, H.R. 3838, which would require the use of the percentage of completion method for most long-term contracts, takes a conflicting view,[3] and would require most taxpayers to account for long-term contracts (*i.e.*, manufacturing or construction contracts that take more than one year to complete) under the percentage of completion method, rather than under either the completed contract method or the accrual method.

The remaining examples on severance illustrate two additional principles: (1) change orders or options normally create a new, separate contract; and (2) a contract with two subject matters may be severed. The latter principle is somewhat confusing because, as discussed separately below, there are special time-of-completion rules for contracts with multiple subject matters that presume that the formal severance rules are inapplicable.

The new long-term contract Regulations also contain rules for determining when two or more long-term contracts should be aggregated. Separate contracts will not be aggregated unless there is no business purpose for entering into separate contracts, rather than one contract. Evidence that two contracts should be aggregated is that one would not have been entered into on the terms agreed upon but for the other. However, the mere *expectation* that another agreement will be entered into does not cause the two agreements to be aggregated, according to Reg. 1.451-3(e)(1)(vii).

The impression one gets from reviewing these rules and the accompanying examples is that the IRS is concerned that taxpayers are creating a loss on units that have a front-end learning curve which will be offset by profits earned on later units produced as part of the same basic activity. Business factors generally make this an unrealistic concern and, as a result, the aggregation rules seem far less important to taxpayers than do the severance rules.

Multiple activities. The long-term contract Regulations have always provided that only income and expenses *from long-term contracts* may be reported on a long-term contract method. However, it was not until these new Regulations that there was an express requirement to allocate income and expenses within a single long-term contract between long-term contract and non-long-term contract activities.[4] This provision operates as a form of severance that operates independently of the severance rules discussed earlier. Moreover, this provision is contrary to the way most taxpayers previously accounted for these non-long-term contract activities embodied in a single long-term contract where such activities were incident to and necessary for the long-term contract manufacturing or construction activities.

The Regulations do not provide any guidance on when multiple activities within a single long-term contract should be allocated between qualifying activities and nonqualifying activities. Instead, these provisions appear to be an outgrowth of Revenue Rulings and published letter rulings dealing with what kinds of activities qualify for long-term contract treatment.[5] The Rulings are premised on the requirement in the Regulations that a taxpayer be engaged in construction, installation, or manufacturing activities in order to be eligible to use a long-term contract method. These Rulings have interpreted the definition of a long-term contract as precluding long-term contract treatment for engineering, design and other types of service contracts that do not involve construction or manufacturing effort. However, even though nonconstruction service contracts are ineligible for long-term contract reporting, there is still the issue of whether such services become eligible for long-term contract reporting if they are included as an integral part of construction or manufacturing activities. For example, if a research and design contract for a new product does not qualify as a long-term contract because the contractor does not actually manufacture the product, do research and design services provided incident to a single long-term contract that calls for the production of products qualify for long-term contract reporting?

Unless the formal severance rules applied under the prior Regulations, nonconstruction services rendered incident to construction or manufacturing activities in a long-term contract were eligible for long-term contract reporting. Thus, for example, while the Service ruled in *Rev. Rul.* 84-32, 1984-1 CB 29, that a painting contract would not qualify for long-term contract treatment, there can be little doubt that painting services provided by a general contractor (either directly or through a subcontractor) in connection with a long-term contract to construct an office building would qualify for long-term contract reporting. In fairness, however, it was not clear whether the Service agreed with such a premise in all circumstances.[6] In any event, under the new Regulations, the Service appears to have a stronger basis for segregating non-construction activities within an otherwise qualifying long-term contract. Nevertheless, it would seem unrealistic and impractical to segregate essential services that are incident to construction or manufacturing activities merely because the services themselves do not entail construction or manufacturing. Unfortunately, it is not clear what standards the Service will apply in implementing this form of severance under the new Regulations.

Time of completion

The new Regulations continue to follow the standard that a long-term contract is not considered completed until the contract is finally completed and is accepted by the customer. However, a new section has been added to the Regulations detailing the factors to be taken in account in determining the time of completion. According to Reg. 1.451-3(b)(2)(i)(B), such factors include: (1) the manner in which the parties to the contract deal with each other; (2) how the parties deal with the contract subject matter; (3) the condition and state of readiness of the subject matter; (4) the nature of any remaining work to be done under the contract; and (5) the extent of the use of the contract subject matter (except for use for testing purposes).

In addition, one contingency that will not postpone contract completion is a contract term requiring supervision of installation or assembly, where it is the customer's responsibility to install or assemble the contract subject matter and

[Leslie J. Schneider and Michael F. Solomon, of the D.C. Bar, are members of the Washington, D.C. law firm of Ivins, Phillips & Barker, Chartered. Mr. Schneider is the author of Federal Income Taxation of Inventories *(three volumes, Matthew Bender). Mr. Solomon is also an adjunct professor of Federal Income Tax Accounting at Georgetown University Law Center.]*

under contract law the subject matter may be accepted prior to installation or assembly. The Regulations also provide that contract completion will be determined without regard to the fact that contingent compensation will be earned in the future if the subject matter performs in accordance with certain standards.

A review of the examples contained in the Regulations suggests that usage of the contract subject matter by the customer, apart from testing, is fairly conclusive that the contract is considered completed. This conclusion does not appear to be altered by the contractor's need to make minor repairs, an unfulfilled requirement to obtain a certificate of completion or the requirement to obtain a governmental certification of completion which has not yet been obtained.

While most of the examples appear to be based on the principles contained in the substantive provisions of the Regulations, Example 4 of Reg. 1.451-3(b)(2)(i)(C) seems difficult to explain without relying on a "substantial completion" standard that has long been rejected in the long-term contract Regulations. In this example, a contract to construct a shopping center and an adjoining parking lot is considered to be completed when the shopping center and three-quarters of the parking lot are open to the public. It is clear from the facts in the example that the parking lot is not finished and, therefore, the contract had not been finally completed and accepted. Moreover, there is no suggestion in the example that the parking lot is a separate subject matter from the shopping center. Accordingly, if use or occupancy of a portion of the contract subject matter by the customer causes the contract to be considered completed, this example has rather far-reaching implications.

Severance by subject matter. The Regulations contain a new section designed to prevent long-term contracts from being held open indefinitely by attaching collateral or subsidiary obligations to a basic construction or manufacturing contract. The Regulations accomplish this result by adopting the approach of dividing a single contract into separate subject matters. If, after applying the severance rules in Reg. 1.451-3(e), a contract is treated as a single contract but the contract calls for the construction or production of one or more units that are the primary subject matter of the contract and other items that are not the primary subject matter, failure to complete the latter items does not prevent the primary subject matter from being considered completed.[7] There is an illustration of the application of this rule with a contract that calls for the production of an aircraft, as well as for the production of spare parts or a training manual. In this case, the contract for the production of the aircraft will not be held open merely because the spare parts or training manual are not completed.

It is important to distinguish between these rules and both the formal severance rules and the rules for allocating income among qualifying and nonqualifying activities. This distinction is important because the accounting treatment under each approach varies considerably. If a contract is formally severed into two or more contracts under Reg. 1.451-3(e), each severed contract must qualify on its own as a long-term contract. If either or both severed contracts fail to qualify as a long-term contract, such contract may not be accounted for under a long-term contract method *ab initio*. Similarly, if a contract is not severed, but an allocation is required among qualifying and nonqualifying activities, the nonqualifying activities may not be accounted for under a long-term contract method *ab initio*.

In contrast, if the primary subject matter rules apply, they do not prevent the non-primary subject matter from being accounted for under a long-term contract method until the point when the primary subject matter is completed. At that point in time, if the non-primary subject matter is not completed, an allocable portion of the contract revenues and costs must be separated from the qualifying portion and must be accounted for under a non-long-term contract method. If units of the non-primary subject matter have already been shipped, an immediate income recognition would be required. However, the primary subject matter rules (as they apply to the non-primary subject matter of a long-term contract) appear to be more advantageous to taxpayers than either the formal severance rules or the activity allocation rules because no income recognition would be required until the primary subject matter is completed. This is not true under the other severance rules. The Regulations suggest that in some circumstances the entire contract price may be allocated to the primary subject matter of the contract. In such a case, this subject matter rule might postpone the deduction of certain costs attributable to the non-primary subject matter while requiring all revenues to be reported when the primary subject matter is completed. This result would appear difficult to sustain if no revenues were to be allocated to this non-primary subject matter of the contract.

One of the more ambiguous aspects of the Regulations is the determination of whether the primary subject matter rules apply, rather than any of the other severance rules. The reason this determination is so difficult to make is that the Regulations provide absolutely no guidance in distinguishing between the primary and non-primary subject matter of a long-term contract. For example, with reference tc the various examples in the Regulations discussed above, can multiple units undeı a single contract be considered separate subject matters? Are a parking lot and a shopping center separate subject matters? Are the design phase and the constructior phase of a single contract considered to be separate subject matters?

The Regulations do not answer these questions. They merely provide that the inability to determine which of two subject matters is the primary subject matte would be considered evidence that the contract should be severed under Reg 1.451-3(e) because there is no busines purpose for entering into a single contract However, the example in the Regulation which illustrates these principles results i the severance of a multi-unit machine an spare parts contract into two separat contracts on facts remarkably similar t the example in the Regulations which il lustrates the application of the primar subject matter rules.[8] Since these cor clusions are mutually exclusive, it is sig nificant that the only discernible differ ence between the two examples is that i the severance example it is stated that th portion of the contract price allocable t the spare parts is not insubstantial. Never theless, the primary subject matter rule do not indicate that such a fact woul preclude application of such rules. Thu it is unclear which set of rules woul prevail. Moreover, further heightening th uncertainty, the rules requiring the alloca tion of income among activities in Reg 1.451-3(a)(3) have potential application i each of these situations, but this poss bility is also not addressed in the Regul tions. In view of these uncertainties, ther is likely to be considerable audit cor troversy and litigation over these que tions in the years to come.

New costing rules

The new Regulations have their mo significant impact in the area of identif ing which costs are attributable to lon term contracts and allocating such costs

particular long-term contracts. Specifically, they: (1) impose new cost allocation rules for taxpayers entering into extended period long-term contracts; (2) require these new cost allocation rules to be used by certain taxpayers accounting for extended period long-term contracts under an accrual method of accounting with inventories; and (3) establish specific rules (applicable to both extended period and non-extended period long-term contracts) for identifying the particular cost of an item which is attributable to a long-term contract.

Allocation of costs to extended period and non-extended period long-term contracts. The Regulations differentiate between two classes of long-term contracts—extended period long-term contracts and non-extended period long-term contracts. This differentiation is important since two rather disparate sets of cost allocation rules are found in the Regulations and the application of each set depends upon whether or not a contract is an extended period long-term contract.

An extended period long-term contract is generally defined as any long-term contract (*i.e.*, a building, installation, construction or manufacturing contract which is not completed within the taxable year in which it is entered into) that the taxpayer estimates at the time the contract is entered into will not be completed within two years from the date (defined as the "contract commencement date") the taxpayer first incurs any costs (other than bidding or negotiating costs) allocable to such contract.[9] If a taxpayer estimates that a contract will be completed within the applicable two-year period, such contract will not be reclassified as an extended period long-term contract if the contract takes longer than the two-year period to complete and the taxpayer could reasonably have expected the contract to be completed within the two-year period. A taxpayer's estimate will not be considered to be unreasonable if the contract is not completed within the time period *primarily* because of unforeseeable factors (defined as abnormal factors that could not reasonably be anticipated) not within the control of the taxpayer. A taxpayer is required to maintain records which support the reasonableness of the estimate, and the Regulations give special weight to contractual provisions specifying a completion date where *bona fide* penalties are imposed if such date is not met. This estimation procedure and the determination of what delaying factors should reasonably be anticipated at the commencement of a contract will undoubtedly spawn numerous audit disputes. However, the estimation rule is certainly beneficial to taxpayers, since a purely objective two-year "look-back" rule would allow no contracts completed after the applicable two-year period to escape the extended period costing rules.

There are two exceptions to the definition of an extended period long-term contract discussed above. Both of these exceptions are applicable only to contracts involving building, construction, erection or installation of improvements to real property.[10] The first exception applies to construction contracts that the taxpayer reasonably estimates will be completed within a three-year (rather than two-year) period.[11] The second exception is one provided for "small taxpayers" having average annual gross receipts over the three taxable years preceding the taxpayer year the contract is entered into of $25 million or less. For purposes of this gross receipts test, all gross receipts of trades or businesses under common control of the taxpayer are aggregated, and a taxpayer is attributed construction gross receipts from persons owning a 5% or greater interest in the taxpayer or from persons in which the taxpayer owns a 5% or greater interest.[12]

Once it is determined whether a contract is an extended period long-term contract or a non-extended period long-term contract, the Regulations then provide detailed rules as to which costs must be allocated to each such contract and which costs may be deducted as period costs. Non-extended period long-term contracts continue to be governed by the allocation rules contained in the prior long-term contract Regulations, consistent with the legislative history of TEFRA which precludes changes in the period cost rules with respect to non-extended period contracts. However, three "clarifying" changes are made in these provisions. First, the amount of depreciation, amortization and cost recovery allowances which must be allocated to a non-extended period long-term contract is the amount reported for financial purposes, but not in excess of the amount allowed for tax purposes. There was no such express limitation in the prior Regulations, although presumably the same rule applied. Sec-

[1] H.R. 3838, 99th Cong., 1st Sess. (1985). Joint Committee on Taxation, *Tax Reform Proposals in Connection with Committee on Finance Markup* (JCS-8-86), 3/18/86.

[2] Reg. 1.451-3(e)(1)(i)(C). See, however, the last two sentences of Reg. 1.451-3(e)(3)(iii) for the one instance in which the taxpayer is allowed to sever a single long-term contract.

[3] See H. Rep't, No. 99-426, 99th Cong., 1st Sess. 630 (1985).

[4] Reg. 1.451-3(a)(3).

[5] See *Rev. Ruls.* 70-67, 1970-1 CB 117; 80-18, 1980-1 CB 103; and 82-134, 1982-2 CB 88.

[6] For example, in *Ltr. Rul.* 8546002, the Service ruled that architectural and design services rendered by a subsidiary to its parent incident to a construction contract between the parent and a customer did not qualify for the completed contract method.

[7] Reg. 1.451-3(b)(2)(ii)(A).

[8] *Cf.* Reg. 1.451-3(e)(2) Example (7), with the example in Reg. 1.451-3(b)(2)(ii)(B).

[9] The Regulations require that the taxpayer use the extended period cost allocation rules to determine when a cost is first incurred for determining the contract commencement date. Presumably, if a contract is estimated to be completed within the two-year period, the extended period cost allocation rules are then ignored for all other purposes. Additionally, if the date costs are first incurred is not determinable, the date the contract is entered into is deemed to be the contract commencement date, unless the taxpayer establishes a later date to the satisfaction of the district director, or unless the taxpayer delayed entering into the contract principally to avoid the extended period contract rules. See Reg. 1.451-3(b)(3)(i). A special rule to determine when costs are first incurred is provided for subassemblies or components produced by the taxpayer, and in a Proposed Regulation, for subassemblies or components produced by an affiliate of the taxpayer (where intercompany profit is deferred). See Reg. 1.451-3(b)(3)(v) and Prop. Reg. 1.451-3(b)(3)(v).

[10] The preamble states that construction contracts which qualify for this exception must be related to real property. However, a contract involving the construction of a ship may still qualify as a long-term contract if the contract is not completed within the taxable year it is entered into.

[11] A special rule is provided where a taxpayer both manufactures an item (such as an elevator) and installs the item as an improvement to real property. If the manufacturing and installation activities are estimated to take longer than three years to complete, the entire contract is an extended period long-term contract. If such activities are estimated to take less than two years, no portion of the contract is an extended period long-term contract. If completion is estimated at between two and three years, the manufacturing portion of the contract is treated as an extended period long-term contract even if the manufacturing activities (but not installation) are estimated to be completed within two years; and the installation portion of the contract is not treated as an extended period long-term contract. See Reg. 1.451-3(b)(3)(ii). To avoid this anomaly, taxpayers are given the choice of severing a single manufacturing and installation contract, but only if all such contracts are consistently severed and there is an appropriate allocation of gross contract price between manufacturing and installation. Presumably, taxpayers are well advised to allocate the contract price in the underlying agreement.

[12] Trades or businesses under common control means any group of trades or businesses that is either a "parent-subsidiary group under common control" as defined in Reg. 1.52-1(c), a "brother-sister group under common control" as defined in Reg. 1.52-1(d), or a "combined group under common control" as defined under Reg. 1.52-1(1). See Reg. 1.451-3(b)(3)(iii)(B). Detailed constructive ownership rules to be used in determining whether a 5% or greater interest is owned in or by the taxpayer are set forth in Regs. 1.451-3(b)(3)(iii)(c)(3) and (c)(4). These gross receipt rules also provide: (1) that intra- and intercompany transactions are to be eliminated, thus preventing double counting for trades or businesses under common control; and (2) that gross receipts do not include the cost of direct materials supplied by the party for whom the contract is being performed unless the contractual arrangement resulting in the cost of direct materials not being represented in the gross contract price is entered into for the principal purpose of reducing the contractor's gross receipts. Reg. 1.451-3(b)(3)(iii)(A).

ond, a definition is provided for equipment and facilities which are temporarily idle. 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 not en route to or not located at a job-site. Third, the provision dealing with those employee benefit expenses which are treated as period costs has been rewritten to clarify the application of certain recent legislative changes (particularly the enactment of Section 404A).

In contrast, for extended period long-term contracts, a completely new set of cost allocation rules is presented in the Regulations. Direct material and direct labor costs which must be allocated to extended period contracts are the same as the direct costs which must be allocated to non-extended period contracts. The indirect costing rules are substantially different, however. In addition to all of the indirect costs required to be allocated to non-extended period contracts, the following costs must also be allocated to extended period long-term contracts to the extent attributable to the performance of extended period long-term contracts:

1. Depreciation, amortization and cost recovery allowances on equipment and facilities used in the performance of extended period long-term contracts to the extent allowed for tax purposes (even if in excess of the comparable allowances for financial purposes).

2. Depletion (whether or not in excess of cost).[13]

3. Direct and indirect costs incurred by any administrative, service, or support function or department (as discussed in detail below).

4. Compensation paid to officers attributable to services performed on particular extended period long-term contracts (not including selling), presumably even if such services are incidental or occasional since there is no exception for incidental or occasional services of this type as is provided for non-extended period contracts.

5. All employee benefits other than contributions to or under a pension or annuity plan allowable as a deduction under Section 404 (or 404A) to the extent such contributions represent past service costs.[14]

6. Research and experimental expenses directly attributable to an extended period long-term contract already entered into or incurred under an agreement to perform research and experimentation.[15]

7. Rework labor, scrap and spoilage to the extent incurred in the performance of extended period long-term contracts.

8. Bidding expenses incurred in the solicitation of particular extended period long-term contracts ultimately awarded to the taxpayer.

Two particular comments concerning these additional costs are in order. First, all bidding expenses paid or incurred in soliciting an extended period long-term contract must be deferred and either assigned as an indirect cost of the contract if the contract is awarded to the taxpayer or deducted in the year the contract is awarded to another person. Special rules are provided for abandoning bids and partial awards. Of particular concern, however, is the fact that at the time a taxpayer incurs bidding expenses, it may not know whether the ultimate contract will be an extended period or non-extended period contract. If the contract is not an extended period contract, the bidding expenses are deducted as incurred. If, however, the contract is an extended period contract, the costs are not deducted until the contract is awarded (assuming it is awarded to another). Should a taxpayer defer all bidding expenses until it is clear whether the underlying contract is an extended period or non-extended period contract? Alternatively, should the taxpayer's judgment be subject to a reasonableness standard at the time any such bidding expenses are incurred? No answers to these questions are provided.

Second, curiously absent from the list of allocated extended period contract costs are product development costs not otherwise described in Section 174. There is perhaps more justification for allocating these costs to extended period contracts than research and experimental costs generally. Accordingly, such costs will likely be allocated to particular extended period contracts under the general rule that costs not listed in either Reg. 1.451-3(d)(6)(ii) or (iii) should be classified on the basis of the classification afforded the most similar type of cost.

The most dramatic departure from prior accounting practice is the inordinately complicated set of rules contained in Reg. 1.451-3(d)(9), which provide guidance in allocating administrative, service and support costs to extended period contracts. Previously, tax accounting principles generally required only those costs associated with a function or department which was directly related to the acquisition or construction of an asset to be capitalized in the cost of such asset.[16] The Service, however, stepped back from this direct relationship in at least one pub lished Ruling, *Rev. Rul.* 73-580, 1973-2 C 86, which held that a portion of the ir direct costs of in-house legal and profe sional staff personnel must be allocated t the capitalized cost of certain mergers an acquisitions which were consummate with the help of such legal and profe sional staff. The Ruling apparently r quired only the allocation of employe salaries, although its basic premise is ve close to the policy underlying the rule Reg. 1.451-3(a)(9), *i.e.*, allocate all costs t revenue producing and production a tivities or asset acquisition accounts. Th new Regulations adopt the Service's a proach in *Rev. Rul.* 73-580 and take it or step further by requiring a portion of all the costs incurred by administrative an support services (both direct—*i.e* labor—and indirect costs—*i.e.*, ove head—of such services) to be allocated extended period long-term contracts. I satisfying this new requirement, three ca egories of administrative and support ser ice costs are effectively established: (those costs which must be wholly all cated to extended period contracts; (those costs which are not allocated to e tended period contracts; and (3) tho costs which must be apportioned betwe extended period contracts and other pr duction activities of a taxpayer.

The Regulations start out by allocati the entire cost of a function or departme of a taxpayer to particular extended p riod long-term contracts to the extent th such function or department incurs co that directly relate to or are incurr solely by reason of the extended peri long-term contract activities of a ta payer.[17] Both the direct costs of such fun tion or department and the indirect co of such function or department (includi compensation, travel, materials and su plies, rent, depreciation, utilities, a other departmental overhead) are alloc ble to the extended period contracts tributable to such function or departme It is unclear the extent to which this pa ticular rule is a departure from prior t accounting principles. Under *Coors*, 60 T 368 (1973), and *Rev. Rul.* 73-580, th types of costs, at least the direct costs the particular department, were deem directly attributable to a particular act ity so that these direct costs would within the category of administrative co previously allocated to a long-term co tract. However, even if these direct costs a particular department may, in the pa have properly been allocated to long-te contracts, there was no apparent rule

quiring the indirect costs of such department to be cross-allocated to the department and then to the long-term contracts. This latter category of costs must, under the new Regulations, be allocated to departments and functions of a taxpayer and then deferred to the extent attributed to functions directly related to long-term contracts.

Consistent with the rule governing functions or departments which perform activities solely for extended period contracts, the Regulations also provide that if a function or department performs only overall management or policy guidance functions for the taxpayer, the costs incurred by such function or department are not allocable to any extended period long-term contracts. The Regulations list nine categories of functions which generally are policy functions which are not related to extended period contracts.[18] Certainly, these functions indirectly affect the construction activities of a taxpayer and the costs of such functions must be recovered by sales revenues. Nevertheless, the Regulations do not require any allocation of these costs to extended period contracts. The implication, however, is that costs incurred by other departments or functions not specifically enumerated will be allocated, at least partially, to extended period contracts. This overall policy category is of limited practical help to taxpayers because few taxpayers will have isolated such "no allocation" functions in a separate department. Thus, the costs of overall policy functions will undoubtedly have to be derived by allocation of costs from a larger department or function by most taxpayers.

The final category of administrative and support costs encompasses those costs which must be allocated to the production activities of a taxpayer and then apportioned between extended period contracts and the other activities of a taxpayer. Reg. 1.451-3(d)(9)(iii) provides three methods of allocating service costs to the production activities of a taxpayer. The first method allocates the total costs of all service departments to production, even if a portion of the service costs relates to general policy functions of the taxpayer or to functions the cost of which is treated as a period cost (*i.e.*, marketing or personnel policy). Presumably, a service function which benefits only general policy activities of a taxpayer would not be allocated to production under this rule despite the lack of a limitation in Reg. 1.451-3(d)(9)(iii)(A).

The second method is much more detailed and complicated than the first, but has the advantage of not allocating to production activities the portion of service costs attributable to policy functions and functions the cost of which are treated as a period cost. Under this method, the costs incurred by each service department are allocated to other service departments and to production based on the particular function involved. For example, the cost of security services might be allocated partly to the production plant and partly to the data processing department. The costs of the data processing department (including the allocated portion of the security services) would then be allocated to the functions benefited by such department. Ultimately, a portion of the costs of each service department (other than those wholly benefiting overall management and general policy) would be allocated to production.[19] Under this method, any service costs allocated to service departments which directly benefit extended period long-term contracts would be wholly allocated to such contracts and those costs allocated to general policy departments would not be allocated to extended period contracts at all. The costs of the remaining departments would be allocated to production departments and then apportioned between extended period contract production activities and non-extended period contract production activities.

The third method allowed is any other method authorized by cost accounting principles. Presumably, any such method must approximate either of the other two methods in order to be acceptable.

The Regulations require the costs of functions or departments which indirectly relate to production but which are operated from a parent or affiliated corporation or from a separate division to be subject to the allocation rules outlined above. Thus, a reasonable arm's-length price must be charged for these services, and this charge would be allocated to production activities under one of the three methods listed above. To the extent payment for such services is made to an affiliate, the income would be subject to the intercompany profit deferral rules of Reg. 1.1502-13 if the service fee is apportioned

[13] Since depletion is accrued only at the time the minerals are sold, depletion allocated to an extended period long-term contract will be effectively deducted in the same year it is accrued for tax purposes assuming completion is contemporaneous with sale.

[14] Past service costs are credits toward retirement benefits earned by employees in years prior to the current year. This definition does not necessarily correspond to the definition of past service costs for purposes of meeting minimum standards under ERISA. See H. Rep't No. 99-426, *supra* note 3.

[15] The language "incurred under an agreement to perform research or experimentation" is curious since such agreements are not long-term contracts. Presumably, this language is designed to capture research and experimentation costs associated with certain extended period contracts where the research is independent of the contract subject matter but not severable under the applicable severing rule. So-called "R&D" costs incurred on Federal Government contracts may come within this provision if the Service is otherwise unsuccessful in severing such activities.

[16] See, *e.g.*, *Coors*, 60 TC 368 (1973). Compare *Fort Howard Paper Co.*, 49 TC 275 (1967).

[17] This rule is essentially the same rule enunciated by the Tax Court in *Coors*, *supra*.

[18] These functions are: (1) overall management and overall policy; (2) general business planning; (3) financial accounting; (4) general financial planning; (5) general economic analysis and forecasting; (6) internal audit; (7) shareholder, public and industrial relations; (8) tax department; and (9) other departments responsible for setting policy. See Reg. 1.451-3(d)(9)(vii).

[19] The Regulations require these allocations to be made from those service departments benefitting the most other service departments to those benefitting the least. Thus, the form of allocation is like a spider web with the center representing the production function and the service departments encircling this function with the outside of the web representing those service functions benefitting most other service functions. As one moves inward to the center, the allocable costs of each department or function are attributed to service departments "nearer" the production function until an allocation is made directly to production. The mathematical and administrative complexity of this system is obvious.

[20] The Regulations provide guidance on the allocation and apportionment requirements (allowing allocation bases such as the relative output of the service department or the relative size of the extended period contract activities of a taxpayer—using, for example, the number of direct labor employees or hours) and expressly provide that allocation methods prescribed in Regulations of the Cost Accounting Standards Board, 4 C.F.R. Chapter III, Subchapter G, as well as other allocation methods consistent with the principles of paragraph (d)(9) of Reg. 1.451-3, are acceptable allocation methods, provided that the taxpayer applies such methods consistently.

[21] The Regulations provide an insignificant deviation rule for methods used by a taxpayer in allocating service costs to extended period contracts. The taxpayer's method must not differ significantly from the method provided for in the Regulations, and the taxpayer's method must not disproportionately allocate expenses to contracts which complete in the near future. This rule, while possibly helpful for small deviations, is purely subjective in the determination of what is significant and also is tested against the method required under the Regulations. Thus, a taxpayer must maintain records to perform the necessary allocations under the method established in the Regulations, even if such method is not actually used.

[22] The Service's position is set forth in *Rev. Rul.* 59-329, 1959-2 CB 138, which holds that a taxpayer who reports income on the completed contract method may not consider as inventory the cost of materials, labor, supplies, depreciation, and taxes accumulated with respect to such contracts.

[23] There is an issue as to how the LIFO cost of such direct material is to be determined. LIFO does not identify costs with particular units, and a number of alternative approaches seem plausible. A with-and-without-LIFO calculation has been suggested by the Service in an analogous case (see *Ltr. Rul.* 8331003); an approach which shares any LIFO reserve recapture (if there is a liquidation of layers) proportionately with all units sold is plausible; an approach which assumes such direct material comes out of current-year purchases is also not inconsistent with LIFO in general; etc. There is no affirmative guidance on this point.

[24] Reg. 1.451-3(d)(6)(iv).

to extended period contracts which are not completed in the taxable year.

It would seem that the first alternative allocation procedure is the simplest to implement. Unfortunately, the price of simplicity could be quite high due to the overallocation of indirect costs to production activities that results under this approach. While the second (or third) alternative should be preferable from the viewpoint of allocating the fewest indirect service department costs to production activities, the taxpayer must weigh any cost savings against the higher degree of complexity required under these approaches.

Once the service costs are allocated to production activities, they must be apportioned between the extended period contract activities of a taxpayer and the other production activities of that taxpayer.[20] Under the Regulations, only the service department costs apportioned to an extended period long-term contract of a taxpayer need to be deferred as part of the cost of such contract. The non-allocated service department costs remain deductible period costs.[21]

Additional costing rules

Inventory taxpayers. Taxpayers using a method of accounting that employs inventories (*i.e.*, a non-long-term contract method) must use the cost allocation rules discussed above for any extended period long-term contract unless the taxpayer reasonably expects at the time the contract is entered into that the taxpayer will recognize gross income from the contract of at least 40%, 70% and 100% by the end of the first, second and third year, respectively, after the taxable year in which the contract is entered into. This rule is fairly harsh and will probably not exempt from the more extensive costing rules many contracts of accrual-method taxpayers that are being reported on a more accelerated basis than under the completed contract method.

For LIFO taxpayers, the operation of the more inclusive costing rules is inordinately complex. While additional indirect costs will need to be treated as inventoriable costs of extended period contracts, the effect on the taxpayer will vary depending on whether the taxpayer experiences an increment or liquidation in its LIFO pool. All current year production costs (including the additional costs under the extended period costing rules) will be immediately deductible in the year incurred under LIFO if there is not an increment in the LIFO pool. In contrast, if there is an increment in the pool, a portion of the additional costs allocated to inventory under the extended period costing rules would be captured in the increment. The precise calculation of the increment and the applicable price index are not addressed in the Regulations. However, adjustments such as the adoption of a new base-year seem appropriate to avoid distortions in the LIFO calculations occasioned by differences in the categories of costs included in the base-year cost of items in the pool and the categories of cost included in the current-year cost of such items.

An additional uncertainty is the calculation of the percentage exception if the taxpayer uses LIFO. This uncertainty is caused by the fact that the exception is measured by reference to levels of gross income and the LIFO method does not provide a mechanism for attributing gross income to the sale of particular products out of a LIFO pool. It is unclear how gross income is to be measured by a LIFO taxpayer in applying this exception if sales out of such pool are of items from both extended period and non-extended period contracts.

Cost identification. The cost identification rules are set forth in Reg. 1.451-3(d)(8), and they generally affirm the Service's long-standing view that costs attributable to long-term contracts and accounted for on the completed contract method should be identified with such contracts in the year incurred.[22] Thus, the Regulations reject the analysis of *Peninsula Steel Products Co.*, 78 TC 1029 (1982), which allowed the identification of costs attributable to a particular contract under the completed contract method to be postponed until the year the contract was completed using the LIFO method. There are two substantive issues raised by the identification rules of the new Regulations. First, Reg. 1.451-3(d)(8)(i) provides that any change in a taxpayer's method of accounting for costs attributable to long-term contracts required by the Regulations is a change subject to the requirements of Section 446(e) and the Regulations and procedures thereunder. Thus, Section 481 is applicable to the change and the procedural requirements of *Rev. Proc.* 84-74, 1984-2 CB 736, apply. Taxpayers who do not currently identify costs under the method set forth in the Regulations apparently cannot change their method prior to requesting permission, yet the transition rule for direct material cost allocation in Reg. 1.451-3(d)(8)(iii)(B) suggests that a taxpayer may use a special rule for interim years (post-1982 and pre-1986) without consent. It is unclear whether such a taxpayer may change for prior years unilaterally or whether the district director is to make such changes. Also, if a taxpayer requests permission to change prospectively, will this request protect past years from audit exposure, as is normally the case where a taxpayer voluntarily requests permission to change under the procedures of *Rev. Proc.* 84-74?

Second, the Regulations state that the cost of direct materials will be determined in the year of dedication using the taxpayer's method of accounting for inventories (FIFO, LIFO, etc.). Thus, the LIFO cost of a direct material is attributed to a long-term contract by a LIFO taxpayer in the year such direct material is dedicated to a long-term contract. The item is not maintained in the taxpayer's ending LIFO inventory in the year of dedication, but is included as part of the long-term contract.[23] The Regulations also provide that the cost identification rule applies whether or not the item is purchased specifically for a long-term contract (and thus dedicated immediately) or taken out of a general inventory of such items. Thus, for LIFO taxpayers, purchases which are immediately dedicated nevertheless affect the taxpayer's current year index calculation under LIFO.

The rule for the identification of the cost of direct materials (and other costs) applies to both extended period long-term contracts and non-extended period contracts. Thus, the same cost is identified for purchased direct materials under either set of long-term contract rules. However, there is an interesting issue for components or subassemblies produced by the taxpayer. The preamble suggests that these items are direct materials, the cost of which is determined on dedication. Accordingly, a LIFO taxpayer would get a LIFO benefit on the cost (including labor and overhead) of produced components or subassemblies prior to dedication. This is apparently true even if such items are incorporated into an extended period contract. The Regulations would require that more indirect costs be allocated to a component or subassembly that is incorporated into an extended period contract than into a non-extended period contract,[24] but the allocated cost would be determined in the year of dedication and not in the year the taxpayer began constructing such component or subassembly. Reg. 1.451-3(d)(6)(iv) only requires the cost of components or subassemblies to be "super" absorbed if reasonably expecte

to be incorporated into an extended period contract. Reg. 1.451-3(d)(8)(iii) identifies the "super" fully absorbed cost in the year of dedication. This cost may be quite different from the actual material, labor and overhead costs that were incurred in producing the component or subassembly. This is a point that will undoubtedly require clarification.

Conclusion

The new long-term contract Regulations are immediately effective and in some cases are retroactive in whole or in part to 1983. Nevertheless, they are highly complex and leave unanswered a whole range of questions. It behooves all taxpayers, including manufacturers and contractors and wholesalers and retailers to study these Regulations because, in addition to their immediate impact for many taxpayers, they apparently will serve as the model for the uniform capitalization rules proposed for *all* taxpayers in H.R. 3838 and the proposals considered by the Senate Finance Committee. ☆

New accounting decisions this month

CAPITAL GAINS

Loss on sale of stock failed to qualify under Section 1244. *(TCM)*

Taxpayer signed an agreement cancelling all indebtedness owed to him by his insolvent corporation in return for the corporation's issuance to him of 25 shares of stock which purported to be Section 1244 stock. Taxpayer then sold his 25 shares of stock to another corporation in return for the corporation's assumption of a bank loan and an option enabling the taxpayer to purchase some property. Taxpayer argued that the loss incurred on the sale of his stock qualified as an ordinary loss under Section 1244. The Service disagreed.

Held: For the Commissioner. The stock was not Section 1244 stock because it was not issued in exchange for the cancellation of indebtedness but instead was an exchange of stock for an equity interest since the advances taxpayer had made to his corporation were an already existing equity interest. *Toney, Sr.*, TCM 1986-69. See also *Flood,* TCM 1986-65 (stock failed to qualify under Section 1244 because the proposed maximum offering price of the shares exceeded $500,000.)

Payments received by former officer was compensation, not consideration for sale of stock. *(TCM)*

On his 1975 and 1976 returns, taxpayer reported payments he received as long-term capital gain, claiming that such payments constituted consideration for redeemed stock. The Service contended the payments were compensation for services and should have been reported as ordinary income.

Held: For the Commissioner. The form and substance of the payments support ordinary income treatment. The payments constituted compensation for the availability to perform consulting services. Taxpayer failed to sustain his burden of proof to show the contrary. *Treister,* TCM 1986-53.

Publication 1212 contains incorrect information. *(Ann.)*

Publication 1212, *List of Original Issue Discount Instruments* (Revised December 1985), contains incorrect information in Section I-B about the publicly traded long-term corporate debt instruments originally issued at a discount after 1984. The corrected information is provided in this announcement and is available from the Service. *Ann.* 86-17, IRB 1986-7.

Rules on information reporting under Sections 1275 and 6049 issued. *(Ann.)*

The Service has issued information reporting rules to provide guidance for compliance with the reporting requirements of Sections 1275 and 6049. Issuers of publicly offered original issue discount debt instruments and middlemen who hold interests in those debt interests as nominees should complete Form 8281 in accordance with these rules. *Ann.* 86-22, IRB 1986-9.

DEPRECIATION

*****No ITC recapture when Section 38 property is distributed to parent corp. and subsequently contributed to partnership.*** *(Rev. Rul.)*

No investment tax credit (ITC) recapture results from the distribution of Section 38 property by wholly owned subsidiaries to their parent in a complete liquidation since Section 381(a) is applicable to a liquidation within Section 332. The recapture provisions are inapplicable to a transaction which is governed by Section 381. Further, no ITC recapture results when the parent subsequently contributed the Section 38 property to a 75%-owned partnership because the requirements of Reg. 1.47-3(f)(1)(ii) are satisfied, in tht (1) the property was retained in the same trade or business; (2) the transferor of the property retained a substantial interest in the trade or business; (3) substantially all of the assets necessary to operate the trade or business were transferred to the transferee to whom the Section 38 property was transferred, and (4) the basis of the Section 38 property in the hands of the transferee was determined in whole or in part by reference to the basis of the Section 38 property in the hands of the transferor. Thus, the transfer constituted a mere change in form which did not trigger ITC recapture. *Rev. Rul.* 86-23, IRB 1986-8.

Customer contracts were permitted to be depreciated over 15-year useful life. *(TCM)*

In a stock purchase and subsequent liquidation of a subsidiary into a parent, the acquired customer contracts were accorded a basis dependent upon their relative fair market value and a 15-year useful life. On its returns, taxpayer-corporation claimed deductions for amortization of the contracts using a useful life of 15 years. The Service contended that no part of the purchase price is amortizable by the taxpayer over any period.

Held: For taxpayer (in part). The location contracts had a value separate and distinct from the franchise value or goodwill. The contracts also had an ascertainable useful life of 15 years but part of the cost attributed to intangibles is reallocated to the going concern value and goodwill. *Business Service Industries, Inc.*, TCM 1986-86.

ACCOUNTING METHODS

Publisher's distribution contracts were on sale-or-return basis. *(TCM)*

Taxpayer, a magazine publisher, sold its magazines to nationwide distributors with the understanding that any unsold magazines would be returned for credit. Maintaining that its sales arrangements were consignment contracts, the taxpayer claimed a deduction for anticipated returns.

Held: For the Commissioner. The intention of the contracting parties was that a consummated sale be effected by the shipment of magazines. The contracts were, therefore, sale-or-return contracts and not consignment contracts. The taxpayer, therefore, must report as income the invoice amount in the year of shipment, and may not take a deduction for anticipated returns, as the all events test is not met