Internal Revenue Service

Number: **200938020**
Release Date: 9/18/2009

Index Number: 460.00-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

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Refer Reply To:
CC:ITA:B04
PLR-153795-08

Date:
June 17, 2009

Taxpayer =
Sub 1 =
Date1 =
B =
C1 =
C2 =
D =
Date2 =
Date3 =
Date4 =
E =
F =
Date4 =
Date5 =
Date6 =

Dear :

This responds to your request for a ruling that in applying the terminated contract rules of § 1.460-4(b)(7) of the Income Tax Regulations, Taxpayer shall exclude research and experimental costs described in § 174 of the Internal Revenue Code from the cumulative allocable contract costs under the contract that are reversed in the taxable year of termination.

FACTS

Taxpayer, a diversified company that conducts business in the aerospace and industrial distribution markets in the United States and abroad, is a member of an affiliated group of corporations, as defined in § 1504. Taxpayer has filed consolidated federal income tax returns for all relevant tax years using an accrual method of accounting with the percentage-of-completion method (PCM) for long-term contracts. Taxpayer has elected

to treat research and experimental expenditures as expenses not chargeable to capital account and deducted them in the year paid or incurred under § 174(a) and § 1.174-3.

On Date1, Sub1 entered into a fixed price contract (Contract) with B, for Sub1 to design, test, and fabricate C1. Sub1 consistently treated Contract as a long-term manufacturing contract and determined its taxable income under the PCM. The C1 were to include D that Sub1 was responsible for developing and testing. By Date2, the production of the C1 was essentially complete except for D. Sub1 encountered significant technical difficulties in developing D, which caused Sub1 to suffer significant time delays and cost overruns.

By Date3, B had taken delivery of and provisionally accepted C2 without D. B's use of the C2 was limited to testing and training, which continued into Date4. During this time, B raised E that resulted in F. By Date4, Taxpayer had not resolved E, and B had identified further requirements that the C1 would have to meet for B to accept them. During Date5, B initiated Contract's dispute resolution process. On Date6, Sub1 and B signed a settlement deed to terminate Contract. Sub1 has not treated Contract as complete under § 460, including for purposes of the look-back method.

LAW AND ANALYSIS

Section 174(a) provides that a taxpayer may treat research or experimental expenditures that he pays or incurs during the taxable year in connection with his trade or business as expenses that are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction.

Section 263A(c)(2) and § 1.263A-1(e)(iii)(B) provide that § 263A, relating to capitalization and inclusion inventory costs of certain expenses, does not apply to any amount allowable as a deduction under § 174. *See also* § 1.263A-1(e)(3)(ii)(P).

Section 460(a) provides that, in the case of any long-term contract, the taxable income from the contract is determined under the PCM. Section 460(b)(1) provides that the percentage of completion is determined by comparing costs allocated to the contract and incurred before the close of the taxable year with the estimated total contract costs.

Section 460(c)(1) provides that, in the case of a long-term contract, all costs (including research and experimental costs) that directly benefit, or are incurred by reason of, the long-term contract activities of the taxpayer are allocated to the contract in the same manner as costs are allocated to extended period long-term contracts under § 451 and the regulations thereunder.

Section 1.460-1(c)(3)(i) provides that a taxpayer's contract is completed upon the earlier of (A) use of the subject matter of the contract by the customer for its intended purpose (other than for testing) and at least 95 percent of the total allocable contract costs

attributable to the subject matter have been incurred by the taxpayer or (B) final completion and acceptance of the subject matter of the contract.

Section 1.460-4(b)(7)(ii) provides that, if a long-term contract is terminated before completion, and as a result, the taxpayer retains ownership of the property that is the subject matter of that contract, the taxpayer must reverse the transaction in the taxable year of termination. To reverse the transaction, the taxpayer reports a loss (or gain) equal to the cumulative allocable contract costs reported under the contract in all prior taxable years less the cumulative gross receipts reported under the contract in all prior taxable years.

Section 1.460-4(b)(7)(ii) provides that as a result of reversing the transaction under § 1.460-4(b)(7)(i), a taxpayer will have an adjusted basis in the retained property equal to the cumulative allocable contract costs reported under the contract in all prior taxable years.

Section 1.460-5(b)(vi) provides that, 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, to its long-term contracts.

Taxpayer asserts that the phrase "reverse the transaction" under § 1.460-4(b)(7)(i) means that Taxpayer must reverse the application of § 460 in its entirety to Contract. Taxpayer asserts that reversal out of § 460 is required because § 460 cannot apply if a taxpayer does not have a contract with a customer. Absent § 460, the rules of § 263A would have applied to Taxpayer's transaction with B. With this foundation, Taxpayer asserts that under § 1.460-4(b)(7) the "allocable contract costs" that must be reversed must be limited to those costs — and only those costs — that would **not** have been deductible in the year incurred absent the application of § 460. Conversely, Taxpayer's view is that under § 1.460-4(b)(7), "allocable contract costs" do not include costs that would be currently deductible in the year incurred with or without regard to § 460, such as research and experimental expenditures described in § 174. Thus, the phrase "allocable contract costs" in the second sentence of § 1.460-4(b)(7)(i) is limited by the phrase "reverse the transaction" in the first sentence of that subparagraph.

We disagree. Under § 1.460-1(b)(1) a long-term contract generally is any contract for the manufacture, building, installation, or construction of property if the contract is not completed within the contracting year. Under § 1.460-1(b)(2) a contract is for the manufacture, building, installation, or construction of property if the following two requirements are met—

1. The manufacture, building, installation, or construction of property is necessary for the taxpayer's contractual obligations to be fulfilled; and
2. The manufacture, building, installation, or construction of property of that property has not been completed when the parties *enter into* the contract. [Emphasis added.]

Contract was a long-term under § 1.460-1(b)(1) because (1) it was necessary for Taxpayer to manufacture C1 to fulfill its obligations under Contract and (2) manufacture of the C1 had not been completed when Taxpayer and B entered into Contract. That Taxpayer treated Contract as terminated under § 1.460-4(b)(7) does not mean that Contract is not a long-term contract and that Taxpayer reverses the application of § 460 in its entirety to Contract. Rather, Contract, though treated as terminated by Taxpayer, is still a long-term contract under § 1.460-1(b)(1) and thus is subject to the rules of § 460 and its regulations, which include the cost allocation rules of § 460(c)(1) and § 1.460-5(b). (We also note that if § 460 did not apply to terminated contracts, § 1.460-4(b)(7)(iii), which provides that the look-back method does not apply to terminated contracts would be superfluous.)

Taxpayer treated Contract as terminated under § 460 and § 1.460-4(b)(7). To comply with § 1.460-4(b)(7), Taxpayer must "reverse the transaction" in the taxable year of termination of Contract by reporting a loss (or gain) equal to the cumulative allocable contract costs reported under Contract less the cumulative gross receipts reported under the contract. Under § 460(c)(1) and § 1.460-5(b)(2)(vi) "allocable contract costs" specifically include research and experimental costs described in § 174 that directly benefit or are incurred by reason of performance of the long-term contracts. *See* § 1.460-5(b)(1).

Thus, to comply with the terminated contract rules, Taxpayer must include the § 174 research and experimental costs that directly benefited or were incurred by reason of Contract in "allocable contract costs" to reverse the transaction under section 1.460-4(b)(7)(i).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. Enclosed is a copy of the letter ruling showing the deletions proposed to be made when it is disclosed under § 6110.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling. *See* section 7.05 of Rev. Proc. 2009-1, 2009-1 I.R.B. 1, 28.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

In accordance with the Power of Attorney on file with this office, we are sending a copy of this letter to your authorized representative.

Sincerely,

Michael J. Montemurro
Chief, Branch 4
Office of Associate Chief Counsel
(Income Tax & Accounting)

Enclosure