ID: CCA_2010101516343042 Number: **201111006**
Release Date: 3/18/2011
Office:
UILC: 460.03-00

From:
Sent: Friday, October 15, 2010 4:34:32 PM
To:
Cc:
Subject: RE: Treas. Reg. §1.460-4(b)(5)(iv)

The following is my analysis of the issue:

Background

Taxpayer and its customer entered into "terms agreements" that require taxpayer to design and develop certain . The agreements also set forth terms for sale of the components when the customer has submitted a purchase order. Before the customer has submitted a purchase order, taxpayer is not obligated to provide the customer with any manufactured item.

Issue

The issue presented is whether taxpayer's design and development costs, which include research and experimental costs described in section 174, must be capitalized as "pre-contracting year costs" that become deductible only when taxpayer has become obligated to manufacture and deliver items pursuant to one or more purchase orders.

The relevant provision is § 1.460-4(b)(5)(iv) of the regulations, which provides in part, "If a taxpayer reasonably expects to enter into a long-term contract in a future taxable year, the taxpayer must capitalize all costs incurred prior to entering into the contract that will be allocable to that contract (e.g., bidding and proposal costs). "

Analysis

Taxpayer does not appear to dispute that when it incurred the design and development costs it "reasonably expect[ed]" to enter into a long-term contract. In all likelihood, taxpayer expected that its customer would issue one or more purchase orders that would obligate taxpayer to manufacture and deliver the that were the subject of the design and development costs.

Thus, the issue is whether the design and development costs "will be allocable" to one or more long-term contracts entered into in a future year, so as to require capitalization.

The contracts would be accounted for under the percentage-of-completion method (PCM). Section 460(c)(1) sets forth the general rule for allocating costs to a long-term contract that is accounted for under the PCM:

> In the case of a long-term contract, all costs (including research and experimental costs) which directly benefit, or are incurred by reason of, the long-term contract activities of the taxpayer shall be allocated to such contract in the same manner as costs are allocated to extended period long-term contracts under section 451 and the regulations thereunder.

The design and development costs at issue, including the research and experimental costs, appear to meet this statutory definition of allocable contract costs; at the least, the costs incurred in designing and developing would directly benefit any long-term contract for manufacture and delivery of the .

Taxpayer argues, however, that the design and development costs arise from a "non-long-term contract activity" and cannot be allocable contract costs because the costs of a non-long-term contract activity are allocable contract costs only when they benefit an *existing* long-term contract.

In support of its position, taxpayer cites § 1.460-1(d) of the regulations:

> [I]f the performance of a non-long-term contract activity 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 gross receipts and costs attributable to that activity must be allocated to the long-term contract(s) benefitted as provided in §§ 1.460-4(b)(4)(i) and 1.460-5(f)(2), respectively.

Taxpayer cites as well examples 6 and 7 in § 1.460-1(j) in support of its position.

While the cited provisions can be read to imply that non-long-term contract activity costs, such as those in issue here, are allocable contract costs only if incurred to benefit an existing long-term contract, the section 460 regulations nowhere expressly impose this condition.

Moreover, this interpretation of the regulation is inconsistent with the statutory definition of independent research and development expenses (IRD). As noted, section 460(c)(1) generally makes research and experimental costs allocable to benefitted long-term contracts. However, under section 460(c)(5), "independent research and development expenses" (IRD) are <u>not</u> allocated. The Code defines IRD as follows:

> [T]he term "independent research and development expenses" means any expenses incurred in the performance of research or development, except that such term shall not include--

> (A) any expenses which are directly attributable to a long-term contract in existence when such expenses are incurred, or
>
> (B) any expenses under an agreement to perform research or development.

Thus, the statute sets forth two categories of research and development expenses that are not IRD and that are, therefore, allocable to benefitted long-term contracts. The first category – set forth in section 460(c)(5)(A) – includes only those costs incurred to benefit existing long-term contracts. The second category of allocable research and development costs, however, that set forth in section 460(c)(5)(B), includes costs performed under an agreement, without requiring the contemporaneous existence of a benefitted long-term contract. Taxpayer would require that non-long-term contract activity costs, such as research and development costs, benefit existing long-term contracts in order to be allocable contract costs. But this would nullify section 460(c)(5)(B).

Taxpayer's argument that non-long-term contract activity costs need not be capitalized as pre-contracting year costs also is inconsistent with the regulations' express reference to bidding costs as among those costs required to be capitalized. Preparation of a bid is a non-long-term contract activity. It is a service that entails neither manufacturing nor construction. Yet, bidding costs clearly are subject to capitalization under § 1.460-4(b)(5)(iv).

Even assuming that § 1.460-1(d) contains an implicit requirement that non-long-term contract activity costs benefit an existing long-term contract, the regulation applies only when a taxpayer is compensated for performing the non-long-term contract activity. By its terms, the regulation requires that both the revenue and costs associated with a non-long-term contract activity be allocated to a benefitted long-term contract. This is confirmed by the regulations' cross reference to § 1.460-4(b)(4)(i). That provision requires that the contract price of a long-term contract include the revenue from any non-long-term contract activity that benefits the long-term contract.

In this case, Taxpayer is not separately compensated for designing and developing the . Rather, Taxpayer is looking to one or more future long-term contracts to recover the costs of design and development. When a contract for design and development provides for separate compensation, it might be proper to separately account for income and costs rather than allocate those items to a future long-term contract. Under the circumstances of this case, however, capitalizing design and development costs and deducting them when future long-term contract income is recognized results in a matching of income and associated costs.

Applying the pre-contracting year cost rule to uncompensated costs such as those at issue is supported by those portions of Notice 89-15, 1989-1 C.B. 634, upon which the rule is based. Q&A 36 provides:

> Q-36: When are costs that are allocable to a long term contract, but are incurred prior to the date that the contract is entered into, deductible and taken into account for purposes of determining degree of contract completion?
>
> A-36: Such costs are treated as allocated to the contract and are deductible in the taxable year in which the contract is entered into. These costs might include, for example, bidding and proposal costs allocable to the contract, raw land purchased before a construction contract was entered into, and labor costs incurred in anticipation that a contract will be awarded. See Q&A-29 regarding accounting for income attributable to such costs.

The reference to "labor costs incurred in anticipation that a contract will be awarded" suggests the rule is broad and applies to the costs at issue.

Taxpayer argues that Congress intended for research and experimental costs described in section 174 to be currently deductible under all circumstances, and that the section 460 regulations should be interpreted so as to permit a current deduction. Any other interpretation, Taxpayer argues, would make the regulations invalid.

This argument is inconsistent, however, with the historical treatment of section 174 costs related to long-term contracts. Prior to the enactment of section 460, which made use of PCM mandatory for certain long-term contracts, § 1.451-3(d)(6)(ii)(Q) (now obsolete) required the allocation of "Research and experimental expenses (described in section 174 and the regulations there under) directly attributable to particular extended period long-term contracts in existence at the time such expenses are incurred, or incurred under an agreement to perform research or experimentation." Notably, this rule was published in response to Congress' directive in the Tax Equity and Fiscal Responsibility Act of 1982, P.L. 97-248. Thus, Congress contemplated that taxpayers using the completed-contract method of accounting for certain long-term contracts would capitalize their section 174 costs. At least in certain circumstances, Congress not only permitted but directed the capitalization of section 174 costs associated with long-term contracts.

Conclusion

Taxpayer's design and development costs, which include research and experimental costs described in section 174, must be capitalized as "pre-contracting year costs" that become deductible only when taxpayer has become obligated to manufacture and deliver items pursuant to one or more purchase orders.

[redacted]