

**Office of Chief Counsel  
Internal Revenue Service  
Memorandum**

Release Number: **20205301F**  
Release Date: 12/31/2020

CC:LB:2:WAS:1R:GHSCHOEN  
POSTF-117188-20

UILC: 59.06-00

date: September 28, 2020

to:  
Revenue Agent (Team 1132)  
(Large Business & International)

from: GWEN H. SCHOEN  
Attorney (Richmond)  
(Large Business & International)

CATHY FUNG  
Associate Area Counsel (Washington)  
(Large Business & International)

---

subject: Internal Revenue Code section 59(e) election<sup>1</sup>

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

**LEGEND**

Taxpayer =  
Year 1 =  
Year 2 =  
Industry =  
Contract 1 =  
X =  
\$a =  
\$b =

---

<sup>1</sup> Unless otherwise noted, subsequent section references are to the Internal Revenue Code of 1986, as amended and in effect during the tax year in issue and to the Treasury regulations promulgated thereunder.

\$c =  
 \$d =  
 \$e =  
 \$f =  
 \$g =  
 \$h =  
 \$i =  
 \$j =

### ISSUES

1. Was Taxpayer permitted to make a section 59(e) election for research and experimental (“R&E”) expenditures allocated to long-term contracts under section 460?
2. Did Taxpayer properly implement its section 59(e) election?
3. Can Exam permit Taxpayer to revoke its section 59(e) election?

### CONCLUSIONS

1. Yes. Taxpayer is permitted to elect under section 59(e) to capitalize and amortize over 10 years any portion of R&E expenditures that met the requirements of section 174(a) and the regulations thereunder. This memorandum does not address whether Taxpayer’s reported R&E expenditures satisfied the requirements of section 174(a) and the regulations thereunder.
2. No. Taxpayer amortized revenue from the long-term contracts in addition to amortizing R&E expenditures. Neither section 59(e) nor the section 460 long-term contract rules permit Taxpayer to amortize a portion of revenue from long-term contracts over the same 10-year period as it amortizes qualified expenditures under a section 59(e) election.
3. No. Taxpayer did not submit a letter ruling request or demonstrate rare and unusual circumstances as required to revoke a section 59(e) election.

### FACTS

Taxpayer is an Industry company whose largest customer is . For Year 1, Taxpayer filed a Form 1120 (U.S. Corporation Income Tax Return) on a consolidated basis on behalf of itself and its subsidiaries.

Taxpayer entered into numerous long-term manufacturing contracts, including cost-plus long-term contracts . Taxpayer reported that it incurred R&E expenditures meeting the definition of section 174(a) that were allocable to its long-term contracts. Whether the expenditures that Taxpayer reported as R&E expenditures met the definition under section 174(a) is a separate matter, outside the

scope of the memorandum. For the purposes of this memorandum, we assume that at least some of Taxpayer's reported R&E expenditures satisfied the definition of section 174(a) and the regulations thereunder.

Taxpayer's Year 1 Form 1120 included an election under section 59(e) to capitalize and deduct ratably over a 10-year period \$a of R&E expenditures allocable to long-term contracts. Taxpayer also deferred a proportionate amount of revenue from its long-term contracts.

Taxpayer provided a spreadsheet in response to an Information Document Request showing how Taxpayer implemented the section 59(e) election. For example, for its long-term contract identified as Contract 1, Taxpayer elected under section 59(e) to ratably deduct over 10 years \$b of claimed R&E expenditures allocated to the Contract 1 contract. Taxpayer deducted one-tenth of claimed R&E expenditures in the amount of \$c in Year 1. And Taxpayer capitalized the remaining amount of \$d.

The spreadsheet also shows how Taxpayer calculated deferred revenue. Continuing with the example above relating to the Contract 1 contract, Taxpayer estimated a profit rate of X by comparing estimates of the total contract price with estimated total contract costs. Taxpayer multiplied the amount of R&E expenditures subject to its section 59(e) election, \$b, by the profit rate to calculate Year 1 R&E revenue in the amount of \$e. Citing section 59(e), Taxpayer reported one-tenth of the R&E revenue, \$f, as revenue in Year 1 and deferred the remaining \$g of the R&E revenue.

On its Year 1 Schedules M-3 (Net Income (Loss) Reconciliation for Corporations with Total Assets of \$10 Million or More), Taxpayer reported an increase in taxable income over book income in the amount of \$h as a result of the deferred deduction for R&E expenditures pursuant to its section 59(e) election. Taxpayer reported a decrease in taxable income in the amount of \$i from the revenue deferred in reliance on its section 59(e) election. Taxpayer reported the net effect of its section 59(e) election as the deferral of taxable income in the amount of \$j.

Taxpayer filed a Schedule UTP (Uncertain Tax Position Statement) with its Year 2 Form 1120. Taxpayer identified its section 59(e) election as a prior year uncertain tax position. The accompanying UTP statement acknowledged that "there is some uncertainty on the application of the [section 59(e)] election to the taxpayer's section 460 contracts."

## LAW AND ANALYSIS

A taxpayer must compute its taxable income under the same method of accounting used to compute book income except for deviations permitted or required by methods of accounting for special items such as depreciation or R&E expenditures. Treas. Reg. § 1.446-1(a)(1); see also I.R.C. § 451. Section 460 provides special rules for computing taxable income from long-term contracts.

Generally, a taxpayer must determine its taxable income from a long-term contract under the percentage of completion method (“PCM”). I.R.C. § 460(a). Under the PCM, a taxpayer compares the allocable contract costs incurred with an estimate of total allocable contract costs. I.R.C. § 460(b)(1)(A); Treas. Reg. § 1.460-4(b)(1). Therefore, to determine taxable income from a long-term contract, a taxpayer must determine both which costs are incurred in the taxable year and which incurred costs are allocable to a long-term contract.

Regardless of its method of accounting, a taxpayer incurs a cost for the purpose of section 460 when the cost would properly be taken into account under the accrual method of accounting. Treas. Reg. § 1.460-1(b)(8). Under the accrual method of accounting, a taxpayer incurs a liability (i.e., a cost or expense) in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. Treas. Reg. §§ 1.446-1(c)(1)(ii)(A); 1.461-1(a)(2)(i). Economic performance with respect to a taxpayer’s liability that arises from the provision of services or property to the taxpayer and that is an expense attributable to a long-term contract subject to the PCM occurs as the services or property is provided or if earlier, as the taxpayer makes payment. Treas. Reg. § 1.461-4(d)(2)(ii).

A taxpayer generally determines which costs are allocable to each long-term contract in the same manner that it determines direct and indirect costs that must be capitalized to property produced by the taxpayer under section 1.263A-1(e) through (h). Treas. Reg. § 1.460-5(b)(1). Even though not required under the section 263A regulations, a taxpayer must allocate R&E expenditures to its long-term contracts. Treas. Reg. § 1.460-5(b)(2)(vi).

The determination of incurred and allocable long-term contract costs is just one step in determining taxable income to recognize for a long-term contract. I.R.C. § 460(a). Under the PCM, a taxpayer then compares allocable contract costs incurred through the end of the taxable year with its estimated total allocable contract costs to calculate its completion factor. Treas. Reg. § 1.460-4(b)(2)(i). A taxpayer multiplies the completion factor by the total contract price to determine cumulative gross receipts from the contract. Treas. Reg. § 1.460-4(b)(2)(ii). Next, a taxpayer calculates its current year gross receipts by subtracting the prior year’s cumulative gross receipts from the current year’s cumulative gross receipts. Treas. Reg. § 1.460-4(b)(2)(iii). A taxpayer “takes both the current-year gross receipts and the allocable contract costs incurred during the current year into account in computing taxable income.” Treas. Reg. § 1.460-4(b)(2)(iv).

A taxpayer takes a deduction in the taxable year that is the proper taxable year under the method of accounting used to compute taxable income. I.R.C. § 461. As explained above, a taxpayer must use the accrual method of accounting to determine when a cost allocable to a long-term contract is treated as incurred. Treas. Reg. § 1.460-1(b)(8). Therefore, a taxpayer using the PCM generally deducts an expenditure allocable to a long-term contract in the same year that it treats the expenditure as incurred in order to determine income from the long-term contract.

A taxpayer may elect to capitalize and deduct ratably over a specified period any qualified expenditures beginning in the year that the expenditures were paid or incurred. I.R.C. § 59(e)(1); Treas. Reg. § 1.59-1(b)(2). Qualified expenditures include amounts which, if not for the section 59(e) election, would be deductible in the taxable year incurred under sections 173, 174(a), 263(c), 616(a), and 617(a). I.R.C. § 59(e)(2). In the case of qualified expenditures under section 174(a) (R&E expenditures), the specified period is a 10-year period beginning with the taxable year in which such expenditures were made. See also I.R.C. § 174(f)(2).<sup>2</sup> A taxpayer may make the election for any portion of a qualified expenditure. I.R.C. § 59(e)(4)(A).

If a taxpayer elects to deduct qualified expenditures ratably over 10 years, it cannot deduct the expenditures under any other section of the Code. I.R.C. § 59(e)(3). The amount elected under section 59(e) is properly chargeable to a capital account under section 1016(a)(20). Treas. Reg. § 1.59-1(b)(2).

A taxpayer can revoke an election under section 59(e) only with the consent of the Commissioner. I.R.C. § 59(e)(4)(B); Treas. Reg. § 1.59-1(c)(1). The Commissioner will grant consent only in rare and unusual circumstances. Id. A taxpayer must submit a letter ruling request to the Service to apply for a consent to revoke a section 59(e) election. Treas. Reg. § 1.59-1(c)(2). The taxpayer's request must include all information necessary to demonstrate the rare and unusual circumstances that would justify granting revocation. Treas. Reg. § 1.59-1(c)(3).

1. Taxpayer is permitted to make an election under section 59(e) for R&E expenditures allocable to a long-term contract.

A taxpayer is permitted to elect to capitalize and amortize incurred section 174(a) expenditures over a 10-year period under section 59(e) whether or not the section 174(a) expenditures were allocable to a long-term contract. Section 460 addresses recognition of long-term contract income. Section 460 does not govern the timing of a taxpayer's deduction for incurred allocable long-term contract costs.

To make an election under section 59(e), a taxpayer must have R&E expenditures it would otherwise deduct in the current year under section 174(a)(1). Only incurred expenditures are deductible. Treas. Reg. § 1.461-1(a)(2)(i). Any expenditure incurred must be included in the calculation of income under the PCM for long-term contracts. Treas. Reg. § 1.460-4(b)(2)(i). Because section 59(e) relates only to the year of the deduction or amortization of expenses, a section 59(e) election does not alter the income calculation required under section 460.

Taxpayer used the PCM to recognize gross income from long-term contracts. Taxpayer allocated direct and indirect incurred costs, including R&E expenditures, to its long-term

---

<sup>2</sup> A taxpayer may treat R&E expenditures incurred during that taxable year as a deduction in the taxable year incurred. I.R.C. § 174(a)(1). A taxpayer could alternatively elect to defer and amortize certain R&E expenditures incurred during a taxable year and deduct the expenses ratably. I.R.C. § 174(b)(1).

contracts. Taxpayer's section 460 calculations do not reflect any impact or adjustment from its section 59(e) election.

Absent a section 59(e) election Taxpayer would have deducted the R&E expenditures in the taxable year incurred. The section 59(e) election permits Taxpayer to capitalize and deduct ratably over 10 years R&E expenditures allocable to a long-term contract.

2. Taxpayer improperly implemented the section 59(e) election.

Section 59(e) permits Taxpayer to elect to defer the deduction for section 174(a) expenditures over 10 years. It does not permit Taxpayer to defer revenue, regardless whether the revenue is generated by the section 174(a) expenditures.

If the R&E expenditures are expenditures which, if not for an election under section 59(e), would be deductible in the taxable year incurred under sections 174(a), Taxpayer properly deducted one-tenth of the R&E expenditures and capitalized the remaining nine-tenths of the R&E expenditures subject to its section 59(e) election. Taxpayer must continue to deduct one-tenth of the R&E expenditures each year through 2026.

Taxpayer multiplied the amount of R&E expenditures subject to the section 59(e) election, \$b, by the estimated long-term contract profit rate to calculate Year 1 R&E revenue in the amount of \$e. Citing section 59(e), Taxpayer reported one-tenth of the R&E revenue, \$f, as revenue in Year 1 and deferred the remaining \$g of R&E revenue.

Section 59(e) does not permit Taxpayer to defer any portion of its revenue from long-term contracts or from any other source. Exam has stated that Taxpayer relied on section 59(e)(3) to support its revenue deferral. Under section 59(e)(3), a taxpayer that elects to deduct qualified expenditures ratably over 10 years may not deduct those same expenditures under any other provision of the Code. Code sections permitting a deduction do not apply to section 59(e) election expenditures. Section 460, as a revenue recognition provision, is not a provision to which section 59(e)(3) applies.

3. Exam cannot permit Taxpayer to revoke its section 59(e) election.

A taxpayer must submit a letter ruling request to request consent from the Commissioner to revoke its section 59(e) election due to rare and unusual circumstances. Treas. Reg. § 1.59-1(c)(2). Taxpayer has not submitted a letter ruling request or demonstrated rare or unusual circumstances as required by section 1.59-1(c).

In conclusion, Taxpayer properly elected to deduct a portion of its R&E expenditures ratably over 10 years. We advise you to adjust the amount of Taxpayer's deferred deductions only if you determine that the R&E expenditures do not qualify as section 174(a) expenditures as defined by section 174(a) and the regulations thereunder. If the expenditures are not section 174(a) expenditures, they are not qualified expenditures

under section 59(e), and Taxpayer cannot elect to capitalize and amortize such expenditures.

Taxpayer improperly relied on section 59(e) to defer recognition of revenue from its long-term contracts. We further advise you to disallow Taxpayer's revenue deferral because Taxpayer must recognize in Year 1 the amount of income from its long-term contracts as determined under section 460. Taxpayer's section 59(e) election to capitalize and amortize section 174(a) expenditures has no impact on the amount of income from long-term contracts that Taxpayer is required to recognize in Year 1 under section 460.

Finally, we advise you not to permit Taxpayer to revoke its section 59(e) election. Taxpayer must request the permission of the Commissioner by submitting a letter ruling request detailing the rare and unusual circumstances that justify a revocation. Exam may not revoke Taxpayer's section 59(e) election either unilaterally or at the request of Taxpayer.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call Gwen Schoen at (804) 916-3941 if you have any further questions.

Cathy Fung  
Associate Area Counsel (Washington)  
(Large Business & International)

By: \_\_\_\_\_  
GWEN HELEN SCHOEN  
Attorney (Richmond)  
(Large Business & International)