



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

October 9, 2001

Number: **200202045**
Release Date: 1/11/2002
CC:ITA:B5
TL-N-398-01
UILC: 460.00-00
460.05-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR WILLIAM A. MCCARTHY
LMSB ATTORNEY, SEATTLE CC:LM:CTM:SEA

FROM: J. Charles Strickland
Senior Technician Reviewer CC:ITA:B5

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated July 10, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =

X =

Y =

Year 1 =

Year 2 =

Period 1 =

Location 1 =

Amount 1 =

Amount 2 =

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Amount 3 =

Amount 4 =

Amount 5 =

ISSUES

The issue presented is whether Taxpayer's contract for soil remediation is a long-term contract subject to Internal Revenue Code section 460 so that Taxpayer is required to use the percentage of completion method (PCM) to report its income from the contract.

CONCLUSIONS

Because the contract requires the manufacture of an item that is unique and that normally requires more than 12 months to produce, the contract is subject to Code section 460. However, costs and income attributable to the performance of soil remediation services must be segregated from other contract costs and income and accounted for under a proper, nonlong-term contract method.

FACTS

In Year 1, Taxpayer, a member of X's affiliated group, entered into an agreement with Y to erect a soil remediation facility at Location 1 and to treat contaminated soil there. The total contract price was approximately Amount 1. Of that amount, approximately Amount 2 was allocated by Taxpayer to the design, manufacture and installation of the facility, and approximately Amount 3 was allocated to operation of the facility, including its "demobilization/salvage."¹ The time required to design, manufacture and install the facility was approximately Period 1.

Taxpayer received progress payments while performing the contract. For Federal income tax purposes, Taxpayer apparently reported contract income as it was received. Contract costs were capitalized and recovered as contaminated soil was treated.

¹Taxpayer made the foregoing allocation in an estimation of contract costs. The total contract price was subsequently reduced to approximately Amount 4, because of an early termination of the contract in Year 2. Also in that year, Taxpayer disposed of the facility at auction for Amount 5.

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LAW AND ANALYSIS

Code section 460(f)(1) defines a long-term contract as “any contract for the manufacture, building, installation, or construction of property if such contract is not completed within the taxable year in which such contract is entered into.” In the case of a manufacturing contract, however, long-term contract treatment does not apply “unless such contract involves the manufacture of any unique item of a type which is not normally included in the finished goods inventory of the taxpayer, or any item which normally requires more than 12 calendar months to complete (without regard to the period of the contract).” I.R.C §460(f)(2).

Construction contract

As the statute indicates, both construction contracts and manufacturing contracts can be long-term contracts. We do not view the contract as a construction contract. It was entered into prior to the effective date of the recently-promulgated regulations interpreting Code section 460. Thus, former section 1.451-3 of the Income Tax Regulations provides the relevant guidance. In pertinent part, the regulation defines a construction contract as follows:

[T]he term "construction contract" means any contract for the building, construction, or erection of, or the installation of any integral component to, improvements to real property. For purposes of the preceding sentence, construction includes reconstruction and rehabilitation. An improvement to real property includes buildings or other structures intended to be permanently affixed to real property, roadways, dams, or bridges, but does not include such items as vessels or offshore drilling platforms.

Treas. Reg. §1.451-3(b)(3)(ii)(Emphasis supplied.).

One possibility is that the contract is a construction contract because it requires the erection of the soil remediation facility. But the regulation requires an improvement to real property and defines an improvement as a structure intended to be permanently affixed to real property. The facility is not intended to be permanent, rather it is a machine that is disassembled when the soil remediation is completed. Another possibility is that the soil remediation itself is construction, but as stated, the regulation requires a structure. Although some land treatment, such as grading, that is preliminary to erecting structures would be considered construction activity, there is no suggestion here that the soil remediation is preliminary to construction of some permanent structure.

Manufacturing contract

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We do, however, view the contract as a manufacturing contract subject to Code section 460. The facts indicate a fairly lengthy and expensive process for design of the soil remediation facility. These facts support characterizing the facility as unique. The facts also support characterizing the facility as an item normally requiring more than 12 calendar months to complete.

Taxpayer contends that the contract is not a manufacturing contract because the facility will not be delivered to the customer. But the facts indicate that the facility is being constructed for this one customer and that following performance of the contract the facility has only a relatively small, salvage value. Notice 89-15, Q&A4, 1989-1 C.B. 634, indicates that whether a contract is a manufacturing contract depends on whether the Taxpayer must manufacture an item in order to fulfill its contract obligations. Here, that is clearly the case.

However, not all contract costs and income should be accounted for under PCM. While the contract fairly can be characterized as a manufacturing contract, the fact remains that it also requires soil remediation services. The former regulation provides as follows:

The percentage of completion method and the completed contract method apply only to the accounting for income and expenses attributable to long-term contracts. The term "expenses attributable to long term contracts" means all direct labor costs and direct material costs (within the meaning of paragraph (d)(5)(i) or (6)(i) of this section), and all indirect costs except those described in paragraph (d)(5)(iii) or, in the case of extended period long-term contracts, paragraph (d)(6)(iii). Other income and expense items, such as investment income, expenses not attributable to such contracts, and costs incurred with respect to any guarantee, warranty, maintenance, or other service agreement relating to the subject matter of such contracts, shall be accounted for under a proper method of accounting. See section 446(c) and §1.446-1(c).

Treas. Reg. §1.451-3(a)(3)(Emphasis supplied.).

Taxpayer's soil remediation services do not contribute towards the completion of the facility. In fact, they occur after the facility has become operational. Under the circumstances, an allocation of costs and income should be made so that only those items attributable to the manufacturing activity are accounted for under PCM.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS





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Please call if you have any further questions.

By: Associate Chief Counsel
Income Tax & Accounting
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