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TY:

LEGEND:

Taxpayer =

Company =

Subsidiary =

Business =

Contract =

Products =

Area =

Completed Project =

Project =

Date 1 =

Date 2 =

Month 1 =

Year 1 =

A =

B =

C =

D =

E =

Dear \_\_\_\_\_ :

This responds to a letter ruling request dated December 4, 2019, submitted on behalf of Taxpayer. Taxpayer requests a letter ruling that (i) the Contract is a long-term manufacturing contract under section 460(f)(2) of the Internal Revenue Code and section 1.460-2 of the Income Tax Regulations subject to the percentage of completion method of accounting under section 460(a) and (ii) Taxpayer is required to treat the prepayments made to Subsidiary in Year 1 as contract costs incurred in the contracting year for purposes of computing the completion factor under the percentage of completion method of accounting.

#### FACTS

Taxpayer is in the Business. Taxpayer entered into a Contract with Company on Date 1 for the design, manufacture, construction, and installation of A Products in an Area.

The Contract requires Taxpayer to provide a Completed Project, consisting of Products that are composed of raw materials, parts, and components. Under the terms of the Contract, Taxpayer is responsible for procuring raw materials and parts, manufacturing the components and subcomponents, delivering the components to the project site, installing the Products, and commissioning the Products. As currently planned, the Contract is expected to take approximately B months to complete from signing of the Contract on Date 1 to customer takeover of the Project in Month 1.

To complete the contract, Taxpayer must procure raw materials and parts necessary to manufacture the components and subcomponents comprising the Products months in advance of the start of physical production to ensure an adequate supply of the raw materials and parts is available to fulfill Taxpayer's obligations under the Contract. To fulfill these obligations, Taxpayer entered into a subcontract with Subsidiary, a related party, to procure or manufacture most of the raw materials, parts, and components for the Products required under the Contract. Subsidiary, in turn, procures from or subcontracts for raw materials and parts with subsuppliers. Under the subcontract, Taxpayer is required to make prepayments to Subsidiary, and Subsidiary then prepays

its subsuppliers to ensure that Taxpayer has an adequate supply of the raw materials and parts needed to fulfill its obligations under the Contract. Taxpayer made prepayments of approximately \$C million to Subsidiary on Date 2. Subsidiary then made payments a few days later to subsuppliers to procure the necessary raw materials and parts in preparation for the manufacturing process.

The time to complete the design, manufacture, construction, and installation of the first Product from the procurement of raw materials, parts, and components comprising more than five-percent (5%) of the total allocable contract costs under the Contract is expected to be approximately D months. The time to complete the design, manufacture, construction, and installation of the last Product from the procurement of raw materials, parts, and components comprising more than five-percent (5%) of the total allocable contract costs under the Contract is expected to be approximately E months.

#### LAW

Section 460(a) requires that the taxable income from a long-term contract be determined under the percentage of completion method.

Section 460(f)(1) and section 1.460-1(b)(1) generally define a long-term contract as any contract for the manufacture, building, installation, or construction of property if such contract is not completed within the tax year in which such contract is entered into.

Section 1.460-1(b)(2)(i) provides that a contract is a contract for the manufacture, building, installation, or construction of property if the manufacture, building, installation, or construction of property is necessary for the taxpayer's contractual obligations to be fulfilled and if the manufacture, building, installation, or construction of that property has not been completed when the parties enter into the contract.

Section 460(f)(2) and section 1.460-2(a) provide that a contract for the manufacture of property is treated as a long-term contract if such contract involves the manufacture of (1) any unique item of a type which is not normally included in the finished goods inventory of the taxpayer or (2) any item which normally requires more than twelve calendar months to complete (regardless of the duration of the contract or the time to complete a deliverable quantity of the item).

Section 1.460-2(c)(1) provides that the amount of time normally required to complete an item is the item's reasonably expected production period as described in section 1.263A-12, determined at the end of the contracting year. Thus, in general, the expected production period for an item begins when a taxpayer incurs at least five percent of the costs that would be allocable to the item under section 1.460-5 and ends when the item is ready to be held for sale and all reasonably expected production activities are complete. In the case of components that are assembled or reassembled into an item or unit at the customer's facility by the taxpayer's employees or agents, the production period ends when the components are assembled or reassembled into an

operable unit or item. To the extent that several distinct activities related to the production of an item are expected to occur simultaneously, the period during which these activities occur is not counted more than once. Moreover, the time normally required to design and manufacture the first unit of an item for which the taxpayer intends to produce multiple units generally does not indicate the normal time to complete the item.

Section 1.460-1(b)(3) provides that allocable contract costs are costs that are allocable to a long-term contract under section 1.460-5.

Section 1.460-5(b)(1) provides in part that a taxpayer must allocate costs to each long-term contract subject to the percentage of completion method in the same manner that direct and indirect costs are capitalized to property produced by a taxpayer under section 1.263A-1(e) through (h). Thus, a taxpayer must allocate to each long-term contract subject to the percentage of completion method all direct costs and certain indirect costs properly allocable to the long-term contract (i.e., all costs that directly benefit or are incurred by reason of the performance of the long-term contract).

Section 1.460-5(b)(2)(i) provides that the costs of direct materials must be allocated to a long-term contract when dedicated to the contract under principles similar to those in section 1.263A-11(b)(2). Thus, a taxpayer dedicates direct materials by associating them with a specific contract, including by purchase order, entry on books and records, or shipping instructions. A taxpayer maintaining inventories under section 1.471-1 must determine allocable contract costs attributable to direct materials using its method of accounting for those inventories (e.g., FIFO, LIFO, or specific identification).

Section 1.460-5(b)(2)(ii) provides that the costs of a component or subassembly (component) produced by the taxpayer must be allocated to a long-term contract as the taxpayer incurs costs to produce the component if the taxpayer reasonably expects to incorporate the component into the subject matter of the contract. Similarly, the cost of a purchased component (including a component purchased from a related party) must be allocated to a long-term contract as the taxpayer incurs the cost to purchase the component if the taxpayer reasonably expects to incorporate the component into the subject matter of the contract. In all other cases, the cost of a component must be allocated to a long-term contract when the component is dedicated, under principles similar to those in section 1.263A-11(b)(2). A taxpayer maintaining inventories under section 1.471-1 must determine allocable contract costs attributable to components using its method of accounting for those inventories (e.g., FIFO, LIFO, or specific identification).

Section 1.460-4(b)(1) provides that under the percentage of completion method, a taxpayer includes in income the portion of the total contract price that corresponds to the percentage of the entire contract that the taxpayer has completed during the taxable year. The percentage of completion must be determined by comparing allocable contract costs incurred with estimated total allocable contract costs. Thus, the taxpayer

includes a portion of the total contract price in gross income as the taxpayer incurs allocable contract costs.

Section 1.460-4(b)(2) provides that a taxpayer determines the income from a long-term contract by (i) computing the completion factor for the contract, which is the ratio of the cumulative allocable contract costs that the taxpayer has incurred through the end of the taxable year to the estimated total allocable contract costs that the taxpayer reasonably expects to incur under the contract; (ii) computing the amount of cumulative gross receipts from the contract by multiplying the completion factor by the total contract price; (iii) computing the amount of current-year gross receipts, which is the difference between the amount of cumulative gross receipts for the current taxable year and the amount of cumulative gross receipts for the immediately preceding taxable year (the difference can be positive or negative); and (iv) taking both current year gross receipts and the allocable contract costs incurred during the current year into account in computing taxable income.

Section 1.460-4(b)(5)(ii) provides that a taxpayer must take into account the cumulative allocable contract costs that have been incurred, as defined in section 1.460-1(b)(8), to determine a contract's completion factor.

Section 1.460-1(b)(8) provides that incurred has the meaning given in section 1.461-1(a)(2) (concerning the taxable year a liability is incurred under an accrual method). This section cross references section 1.461-4(d)(2)(ii) for economic performance rules relating to the percentage of completion method.

Section 1.461-4(d)(2)(i) provides that, if the liability of a taxpayer arises out of the providing of services or property to the taxpayer by another person, economic performance occurs as the services or property is provided.

Section 1.461-4(d)(2)(ii) provides that, in the case of any liability of a taxpayer arising out of the providing of services or property to the taxpayer by another person that is an expense attributable to a long-term contract with respect to which the taxpayer uses the percentage of completion method, economic performance occurs as the services or property is provided, or, if earlier, as the taxpayer makes payment (as defined in paragraph (g)(1)(ii) of section 1.461-4) in satisfaction of the liability to the person providing the services or property. See section 1.461-4(d)(7), example 3(iii).

## ANALYSIS

The Contract is a long-term manufacturing contract within the meaning of section 460(f)(2) and section 1.460-2 because the average production period of all A Products is reasonably expected to exceed 12 months based on the production, installation, and turnover dates established in the Contract. The production periods of the Products range from D months for the first product to E months for the last product, both in excess of 12 months. The production period of the Products began on Date 2 when Taxpayer incurred at least five percent of the contract costs by prepaying approximately

\$C million to Subsidiary to ensure an adequate supply of the raw materials, parts, and components necessary to fulfill its contractual obligations under the Contract.

Taxpayer is required under section 460(a) to use the percentage of completion method to account for the Contract because the Contract is a long-term manufacturing contract. Under the percentage of completion method described in section 1.460-4(b)(1), Taxpayer must include in gross income the portion of the total contract price that corresponds to the percentage of the entire contract that Taxpayer has completed during the taxable year. The percentage of completion must be determined by comparing allocable contract costs incurred with estimated total allocable contract costs.

Taxpayer is required to allocate to the Contract all direct costs and indirect costs that directly benefit or are incurred by reason of the performance of the Contract under section 1.460-5(b)(1). The direct material costs of the Contract include the raw materials, parts, and components purchased from Subsidiary because Taxpayer will incorporate the raw materials, parts, and components into the subject matter of the contract. See section 1.460-5(b)(2).

Under section 1.461-4(d)(2)(ii), Taxpayer is treated as incurring the contract costs of the raw materials, parts, and components purchased from Subsidiary the earlier of when (i) Subsidiary provides the raw materials, parts, and components for the Products to Taxpayer under the subcontract between the parties; or (ii) Taxpayer makes payments in satisfaction of the liability to Subsidiary under the subcontract. Taxpayer made prepayments of approximately \$C million to Subsidiary on Date 2 in advance of delivery of any raw materials, parts, and components and is required to treat the prepayment as incurred contract costs for purposes of computing the completion factor under the percentage of completion method.

#### RULING

Based upon our analysis of the facts as represented, we conclude that (a) the Contract is a long-term manufacturing contract within the meaning of section 460(f)(2) and section 1.460-2 subject to the percentage of completion method of accounting under section 460(a) because the Products normally require more than 12 calendar months to complete and (b) Taxpayer is required to treat the approximately \$C million in prepayments made to Subsidiary in Year 1 as contract costs incurred in the contracting year for purposes of computing the completion factor under the percentage of completion method of accounting.

The rulings contained in this letter are based upon information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by appropriate parties. 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.

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. Specifically, we express no opinion regarding Subsidiary's method of accounting for its subcontract with Taxpayer.

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.

A copy of this ruling should be attached to Taxpayer's federal income tax returns for the tax years affected. Alternatively, taxpayers filing returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of this ruling.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representatives. We are also sending a copy of this letter to the appropriate operating division director. Enclosed is a copy of the letter ruling showing the deletions proposed to be made in the letter when it is disclosed under section 6110 of the Code.

Sincerely,

John Aramburu  
Senior Counsel, Branch 5  
(Income Tax & Accounting)