Long-Term Contracts

§11.01 GENERALLY

In general, the rules under Sections 451 and 461 of the Code are superseded by the “long-term contract” rules of Section 460. A “long-term contract” is any contract for the manufacture, building, installation, or construction of property, if the contract is not completed in the taxable year in which it was formed. At one time the taxpayer had the option of selecting the rules under Sections 451 and 461 and several permissible methods to account for long-term contracts. Along with many other changes made by the Tax Reform Act of 1986 came changes made to long-term contracts. Subsequent legislation made further changes so that, except for small construction contracts, taxpayers in most cases must use the percentage of completion method to account for long-term contracts.

§11.02 MANUFACTURING CONTRACTS

A manufacturing contract is a long-term contract if and only if the contract involves the manufacture of:

- Any unique item of a type that is not normally carried in the finished goods inventory of the taxpayer, or
- Any item that normally requires more than 12 calendar months to complete (without regard to the period of the contract).¹

A contract that meets one or both of these criteria is subject to long-term contract rules.

§11.02(a) More Than 12 Months To Complete

To qualify its contract as a long-term manufacturing contract, a manufactured item normally requires more than 12 calendar months to complete. A manufactured item normally requires more than 12 months to complete if its production period is reasonably expected to exceed 12 months. An item’s production period begins when a taxpayer incurs at least five percent of the estimated total allocable costs to that item, and the period ends when the item is ready for shipment to the purchaser and all reasonably expected production activities are completed.²

§11.03 CONSTRUCTION CONTRACTS

§11.03(a) Generally

A contract for the production or installation of real property or any improvements to real property is considered to be a contract for building, installation, or construction and is subject to the long-term contract rules of Section 460. Included as well are contracts for the rehabilitation

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¹ Section 460(f)(2).
² Reg. §1.460-2(c)(1).
of real property, installation of integral components to real property, and improvement of real property.3

On the other hand, a contract for the provision of personal services such as architectural services, engineering, or construction management is not a long-term contract when the sole subject matter is the service itself.4

§11.03(b) De Minimis Construction Activities

A contract is not a construction contract if it includes the provision of land by the taxpayer and the estimated total allocable contract costs attributable to the taxpayer’s construction activities are less than 10 percent of the contract’s total contract price.5

§11.04 COMPLETED CONTRACT METHOD (CCM)

Prior to the Revenue Reconciliation Act of 1989, the completed contract method of accounting was the method used by contractors to account for long-term contracts. The Revenue Reconciliation Act of 1989 limited the application of the completed contract method. Now it can be used only by small construction companies and for home and other residential construction contracts. For contracts entered into after February 28, 1986, the completed contract method can be used only for construction expected to be completed within two years by taxpayers with average annual gross receipts of $10 million ("small contractor exception") or less and for “home construction” contracts entered into on or after June 21, 1988.

The completed contract method is an exception to the annual accounting concept.6 This exception allows for the deferral of tax on profitable contracts until the completion of the contracts. When there are loss contracts, however, or when the use of the completed contract method creates wide swings in taxable income, and therefore in tax rates applicable to the contract profits, this method may not be advantageous.

Under the completed contract method, gross income derived from long-term contracts must be reported by including the gross contract price of each contract in gross income for the taxable year in which that contract is completed. Costs properly allocable to a long-term contract must be deducted from gross income for that taxable year in which the contract is completed. Account must be taken of any material and supplies charged to the contract but remaining on hand at the time of completion.

§11.04(a) Home Construction Contracts

A “home construction” contract is a construction contract in which 80 percent or more of the estimated total costs (as of the close of the year the contract was entered into) are reasonably expected to be attributable to building, construction, reconstruction, or rehabilitation of, or the installation of any integral component to, or improvements of, real property with respect to (1) “dwelling units” contained in buildings containing four or fewer dwelling units and (2)

3 Reg. §1.460-3(a).
5 See §11.06, below.
6 Reg. §1.460-3(b)(3).
improvements to real property directly related to the dwelling units and located on the site of the dwelling units. A “dwelling unit” is a house or apartment used to provide living accommodations in a building or structure, but not a unit in a hotel, motel, or other establishment more than half of the units of which are used on a transient basis. Home construction contracts that do not meet the small contractor exception are subject to the uniform capitalization rules of Section 263A (see Chapter 9) and the interest capitalization rules of Section 460.

§11.04(b) Small Contractors

The exception for small contractors applies if the following criteria are met:

• The contract must be a construction contract, i.e., a contract for the building, construction, reconstruction, or rehabilitation of real property; the installation of an integral component to real property; or the improvement of real property.
• It must be estimated at the time the contract is entered into that it will be completed within a two-year period beginning on the contract commencement date.
• The contractor’s average annual gross receipts for the three tax years preceding the tax year in which the contract is entered into must be $10 million or less.

§11.05 PERCENTAGE OF COMPLETION METHOD (PCM)

§11.05(a) Application of Method

In general, taxable income from “long-term contracts” must be determined under the percentage of completion method (PCM). Under this method, income is reported proportionally over the life of the contract as contract costs are incurred. Contract-related expenses are deducted in the year they are incurred. Under the percentage of completion method, all income from a long-term contract must be reported by the end of the taxable year following the year that the contract is completed. A taxpayer may elect not to recognize income from or the costs of the contract if less than 10 percent of the estimated total contract costs are incurred by the end of the taxable year. After a contract subject to the PCM is completed, a taxpayer must, in general, apply the “look-back method” to determine the amount of interest owed on any hypothetical underpayment of tax, or earned on any hypothetical overpayment of tax.

A PCM taxpayer must, in general, include 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. The taxpayer includes a

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7 Sec. 460(e)(6)(A).
8 Sec. 168(e)(2)(A)(ii).
9 Reg. §§1.460-1(a)(2) and 1.460-5(b)(2)(v).
10 Section 460.
11 Sec. 460(b)(1); Reg. §1.460-4(b)(1).
12 Reg. §§1.460-4(b)(2)(iv) and 1.460-1(b)(8).
13 Section 460(b).
14 Section 460(b)(5). See §11.06, below (10-Percent Method).
15 See §11.07, below.
portion of the total contract price in gross income as the taxpayer incurs allocable contract costs.  

The long-term contract rules are generally unfavorable to manufacturers because the rules require them to include income as the item is produced as opposed to when it ships or when title passes.

§11.05(b) Exceptions
§11.05(b)(1) Exempt Contracts

The percentage of completion method does not apply to:

- Home construction contracts; or
- Other construction contracts that a taxpayer estimates (when entering into the contract) will be completed within two years of the contract commencement date, as long as the taxpayer satisfies the $10 million gross receipts test.

A taxpayer may determine the income from an exempt construction contract using any accounting method permitted by Reg. §1.460-4(c). For contracts subject to the completed contract method (CCM), the taxpayer may use any cost allocation method permitted by Reg. §1.460-5(d).

Exempt construction contracts not subject to the CCM or PCM are not subject to the cost allocation rules of Reg. §1.460-5, except for the production-period interest rules of Reg. §1.460-5(b)(2)(v). Exempt construction contractors that are large homebuilders described in Reg. §1.460-5(d)(3) must capitalize costs under Section 263A of the Code. All other exempt construction contractors must account for the cost of construction using the appropriate rules contained in other sections of the Internal Revenue Code or in other IRS Regulations.

§11.05(b)(2) Residential Construction Contracts

Taxpayers performing contracts to construct buildings with more than four dwelling units are subject to a more limited exception from Section 460. These are referred to as “residential construction contracts.” Residential construction contracts may be accounted for using either the percentage completion method (PCM) (discussed above) or the 70/30 percentage completion capitalized cost method (PCCM). Under the 70/30 PCCM method, 70 percent of contract-related income and costs are reported under the PCM; 30 percent are reported using either the PCM or one of the alternative methods allowable for exempt construction contracts—the completed contracts method, one of the pre-TRA-86 percentage of completion methods, the accrual method, or if otherwise available, the cash method.

§11.05(c) Computation of Income
§11.05(c)(1) Computational Steps

To determine the income from a long-term contract, a taxpayer must follow four steps.

16 Reg. §1.460-4(b)(1).
17 Reg. §1.460-3(b)(3).
18 See §11.04, above.
19 Reg. §1.460-4(e).