APPEALS INDUSTRY SPECIALIZATION PROGRAM

SETTLEMENT GUIDELINES

INDUSTRY: Construction/Real Estate

ISSUE: Percentage of Completion
Timing of Cost Recognition

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APPEALS SETTLEMENT GUIDELINES

CONSTRUCTION/REAL ESTATE INDUSTRY

PERCENTAGE OF COMPLETION METHOD

TIMING OF COST RECOGNITION

ISSUES

1. Whether, when computing a long-term contract's "completion factor" under Treas. Reg. §1.460-4(b)(5), contractors may postpone the recognition of costs they incur for the work of their subcontractors by arguing that construction contracts represent contracts for property that are not "accepted" until substantially complete, and thus postpone income.

    (a) Whether, under the economic performance rules of I.R.C. § 461(h) and the regulations thereunder, construction contracts of the type described herein usually represent contracts for several items, including services, property (raw materials), and the use of property (rental equipment).

    (b) Whether property (raw materials) provided by subcontractors are deemed accepted, within the meaning of Treas. Reg. § 1.461-4(d)(6)(iii), only upon substantial completion of the subcontract.

2. Whether, under I.R.C. § 446(e) and Treas. Reg. § 1.446-1(e)(2)(i), contractors are prohibited from changing their method of accounting for subcontractor expenses without advance consent.

EXAMINATION DIVISION'S POSITION

FACTS

The Examination Coordinated Issue paper provides a typical scenario in the industry to illustrate the issues. The Taxpayer (contractor) contracted with a land owner (owner) for the construction of an office building. The contractor engaged a subcontractor to aid in the construction. The subcontractor provided raw materials as well as construction services.

The contractor (a calendar year taxpayer) uses the accrual method and must report its income from long-term contracts (such as the instant contract) under the Percentage of Completion Method (PCM).

While contractual arrangements may vary, standard contract forms used in the construction

industry always refer to work to be performed. The term "work" means the construction and services required by the contract documents, whether completed or partially complete, and includes labor, materials, equipment, and services provided or to be provided by the contractor to fulfill the contractor's obligations.

The subcontractor's practice was to order materials and to perform construction services and then to send periodic bills to the contractor for the materials it had purchased and the work it had performed. After checking the bills for accuracy and verifying performance, the contractor added a 15 percent profit margin and requested payment from the owner. The owner, on rare occasions, adjusted downward the amount requested for inadequate services or materials. After the contractor received payment from the owner, the contractor would pay the subcontractor's bill.

Before 199x, the contractor would, upon receipt of a bill from the subcontractor, treat this liability as incurred for tax purposes. Therefore, the receipt of the subcontractor's bill before year-end would: (1) generate a tax deduction for that year, and (2) require the inclusion of additional income for that year under the cost-to-cost completion factor used for computing gross receipts under the PCM (discussed below).

For 199x, in order to defer income, the contractor began delaying the recognition of expenses for subcontractor bills until the time that the contractor actually paid these bills, regardless of when the subcontractor's bill was received. The underlying facts of the contractual arrangements between the subcontractors and contractor remained unchanged. In effect, the contractor switched from the accrual to the cash method with respect to the subcontractor's bills, without filing a request on Form 3115 for permission to change its method of accounting.

Excluding a subcontractor’s bill from the numerator of a contract’s completion factor until paid by the contractor (when that payment occurs after year end) reduces the contractor’s gross receipts and gross income from that contract and, thus, reduces the contractor’s taxable income for the tax year. Of course, in utilizing this improper method of accounting, the contractor will not be able to “deduct” the subcontractor’s bill for federal income tax purposes until the following tax year. Therefore, the net effect of the contractor’s unauthorized change in method of accounting is to defer the recognition of the profit attributable to the subcontractor’s work on the contractor’s job.

Under the contractor's new method of accounting, when the subcontractor's bill was received prior to year-end and payment on the bill was made after year-end, the contractor's recognition of income under the cost-based PCM formula was deferred. However, the contractor's new method also deferred the recognition of the underlying expenses as well. Therefore, the contractor's new method served to defer the contractor's profit margin on the subcontractor's work.

In support of its method change, the contractor argued: (1) that, under the Economic Performance Rules (EPR), the subcontractor's bill should represent a bill for the sale of

property (and that any construction services were merely incidental and could be ignored under Treas. Reg. § 1.461-4(d)(6)(iv)); (2) that, under the EPR, liabilities for purchases of property are deemed incurred when the property is provided; (3) that Treas. Reg. § 1.461-4(d)(6)(iii) permits a contractor to treat property as provided to the contractor when the property is "accepted;" and (4) that the subcontractor's work was not "accepted" by the contractor until the subcontract was substantially complete.

As noted above, the contractor did not obtain the Commissioner's permission before changing its method of accounting for subcontractor bills. Instead, the contractor simply noted its accounting change on its corporate tax return. As authority for the accounting change, the contractor cited Treas. Reg. § 1.461-4(m)(2) (discussed below).

CONCLUSIONS

1. Contractors may not postpone the recognition of costs they incur for the work of their subcontractors in order to reduce a contract's completion factor and, thus, reduce their gross receipts and gross income under the PCM.

    (a) Construction contracts of the type as described herein usually represent contracts for several items, including services, property (raw materials), and the use of property (rental equipment).

    (b) Property (raw materials) provided by subcontractors is deemed accepted based upon contractual terms between the parties.

2. Contractors are prohibited from changing their method of accounting for subcontractor expenses without advance consent.

DISCUSSION

Section 460 requires most long-term contracts to be accounted for under the PCM. The PCM requires income from the contract to be reported over the life of the contract and requires contract expenses to be deducted in the year that they are incurred.

Under the PCM, the first year's contract income is computed by multiplying the contract price by the ratio of first year contract costs to estimated total contract costs ("completion factor"). A similar formula is used in future years, taking into account the amounts of costs and income that have already been recognized in prior years.

Because the recognition of income under the PCM formula is based on the amount of costs incurred to date, deferring costs will also delay the recognition of income. Given this potential benefit, contractors (such as the contractor described above) have been

attempting to postpone the time that certain costs are deemed incurred under the economic performance rules.

Generally speaking, most taxpayers wish to take deductions as soon as possible (the reverse of the situation presented here). The Internal Revenue Code protects against abuse in this regard by providing that an accrual basis Taxpayer cannot treat the amount of any liability as incurred until the all events test is met. See, e.g., Section 461(h)(4). The all events test is met with respect to an item if all events have occurred which determine the fact of the liability and the amount of the liability can be determined with reasonable accuracy. Id. See also United States v. General Dynamics Corp., 481 U.S. 239 (1987); United States v. Hughes Properties, Inc., 476 U.S. 593 (1986). Section 461(h)(1), however, provides an additional requirement for the accrual of deductions. It provides that, for purposes of determining whether an accrual basis taxpayer can treat a liability as incurred, the all events test is not treated as met any earlier than the taxable year in which economic performance occurs with respect to the liability. See also Treas. Reg. § 1.461-4(a)(1).

Section 461(h)(2) provides the time when economic performance is deemed to occur for various types of liabilities. With respect to liabilities for services and property provided to the taxpayer, Section 461(h)(2)(A) provides that economic performance occurs as the taxpayer is provided with the services or property. See also Treas. Reg. § 1.461-4(d)(2)(i).

As discussed above, contractors have been postponing the recognition of costs by arguing that the costs of paying their subcontractors should not be deemed incurred until actual payment. The contractors' argument is based upon their assertion that the subcontracts represent contracts for the provision of property and that the property should not be deemed provided until the landowner finally accepts the property. The contractors cite Treas. Reg. § 1.461-4(d)(6)(iii), which provides that a contractor is permitted to treat property as provided to the contractor when the property is delivered or accepted, or when title to the property passes. The contractors assert that the property should not be treated as "accepted" until the landowner accepts the subcontractor's work. Apparently citing industry practice, the contractors assert that the landowner does not accept the subcontractor's work until the time when the subcontractor's work is substantially complete.

There are many flaws in this argument.

1. Subcontractor bills of the type described above represent bills for various items, including construction services and raw materials. These bills cannot be classified, under Treas. Reg. § 1.461-4(d)(6)(iv), as solely bills for property as the contractors suggest. Therefore, economic performance is not governed solely by acceptance. Economic performance with respect to construction services occurs as the construction services are rendered.

2. With respect to liabilities for property (i.e., raw materials), acceptance by the owner may be irrelevant. Under the facts as presented, neither the substance nor

form of the contract between the landowner and contractor required such acceptance. The subcontractor appears to be working only for the contractor and, if this were the case, acceptance by the contractor would trigger economic performance with respect to this portion of the liability.

3. Acceptance of property is generally governed by contract. It may occur, for example, as the raw materials are (a) delivered to the job site; (b) billed; and (c) the bill is accepted as correct by the contractor. There may be a reasonable time for inspection provided in the contract. Further, acceptance usually occurs in stages, as periodic subcontractor bills are accepted by the contractor. It is not dependent on the subcontractor's substantial completion of the project, which could take years.

4. Treas. Reg. § 1.461-4(d)(2)(ii) provides that, with respect to long-term contract expenses incurred after 1991, economic performance occurs as the services or property is provided or, if earlier, as the taxpayer makes payment.

5. Treas. Reg. § 1.461-4(d)(6)(iii) provides that the method used by the contractor to determine when property is provided is a method of accounting that must comply with the rules of Treas. Reg. § 1.446-1(e). Therefore, the method of determining when property is provided must be used consistently from year to year, and cannot be changed without the consent of the Commissioner.

These points are discussed, as necessary, in more detail below.

Subcontracts Are Usually Contracts for Services, Property, and the Use of Property

Treas. Reg. § 1.461-4(d)(6)(iv) illustrates how to treat contracts that require different services or items of property. It provides as follows:

> **If different services or items of property are required to be provided to a contractor under a single contract or agreement, economic performance generally occurs over the time each service is provided and as each item of property is provided.** However, if a service or item of property to be provided to the contractor is incidental to other services or property to be provided under a contract or agreement, the contractor is not required to allocate any portion of the total contract price to the incidental service or property. For purposes of this paragraph, services or property is treated as incidental only if--
>
> > (A) The cost of the services or property is treated on the contractor's books and records as part of the cost of the other services or property provided under the contract; and
> >
> > (B) The aggregate cost of the services or property does not exceed 10

percent of the total contract price.

(Emphasis added). As the bolded language above illustrates, contractors are required to differentiate between property and services provided to them by each subcontractor and to recognize income and expenses accordingly. This requirement is relaxed only where the cost of the contracted property or services (the "item") is incidental. In order to be incidental, the item must effectively be ignored on the contractor's books, and the aggregate cost of the item may not exceed 10 percent of the total contract price.

The examples in the regulations help to illustrate how costs for services, property, and the use of property are to be differentiated. See, e.g., Treas. Reg. § 1.461-4(d)(7), Example 3. In Example 3, W is a calendar year accrual method contractor that manufactures tool equipment. In 1992, W pays Z $50,000 to lease equipment to be used in fulfilling the contract. The one-year lease period begins on January 1, 1993. Also, in November 1992, W pays Y $100,000 for certain parts necessary to manufacture the equipment for X. The parts are provided to W in 1993. Finally, in 1993 W's employees provide W with services necessary to manufacture the equipment for X. During 1993, W pays its employees $150,000 for their services.

Even though W's contract with X was for delivery of equipment (i.e., property), Example 3 states that W incurred $50,000 for the use of property, $100,000 in costs for property, and $150,000 for services. Also, Example 3 states that the costs for property should be recognized in 1992, while the costs for services and the use of property are not recognized until 1993. Thus, for purposes of computing the completion factor, these costs are considered separately in determining when economic performance results.

Although Example 3 is not directly on point since it involves three separate subcontractors (instead of one), it is clear that subcontractors frequently perform several functions and that each function must be separately considered under the economic performance rules, Treas. Reg. § 1.461-4(d)(6)(iv) (quoted above). In considering just how to allocate the value of a subcontractor's bill between, for example, raw materials provided and services rendered, all facts and circumstances should be considered.

Based on the above, it is unlikely that many contractors will be able to classify their subcontractors' work as entirely for the provision of property in order to postpone income under the method described above.

Timing of Acceptance of Property Component of Subcontracts

Although contractors will seldom be able to successfully argue that construction contracts represent contracts solely for property, most subcontracts will contain a component for raw materials. Therefore, the timing of acceptance is relevant for this limited purpose.

It is important to note here that subcontractor’s bill for raw materials (as well as for

construction services) periodically. Therefore, acceptance occurs periodically and costs are incurred and accrued periodically. Thus, contractors cannot wait until substantial completion to accrue costs.

The meaning of acceptance is not defined in the regulations or in the Internal Revenue Code. Whether raw materials have been accepted is a question to be governed by the form and substance of the contract between the contractor and the subcontractor.

One question to be answered in this context is whether acceptance of the subcontractor's raw materials by the contractor is sufficient even if the owner ultimately rejects the subcontractor's raw materials. If, under the arrangement between the contractor and the subcontractor, the contractor is still liable for payment to the subcontractor, acceptance has occurred. On the other hand, if the contractor's liability to the subcontractor were conditioned upon the owner's acceptance, this would likely govern.

Where the facts and circumstances establish that the contractor's acceptance triggers economic performance, liabilities for the raw materials should be accrued at the time the contractor accepts, as correct, each of the subcontractor's periodic bills for the raw materials. Under the facts presented above, the contractor reviews and accepts the subcontractor bills before adding a 15 percent profit margin and requesting payment from the owner. At the point of contractor review and acceptance, the fact and amount of the liability are certain and economic performance has occurred. Thus, the all events test is met, even though payment has not yet been made.

Unauthorized Change in Method of Accounting

Contractors have been asserting that Treas. Reg. § 1.461-4(m)(2) authorizes them to change their accounting method for subcontractor expenses. That section states in part:

> For the first taxable year beginning after December 31, 1991, a contractor is granted the consent of the Commissioner to change its method of accounting for long-term contract liabilities described in paragraph (d)(2)(ii) of this section and payment liabilities described in paragraph (g) of this section...to comply with the provisions of this section.

Treas. Reg. § 1.461-4(m)(2)(i). This regulation gives automatic consent only in limited situations and only to change a contractor's method of accounting for the purpose of complying with I.R.C. § 461 and the regulations promulgated thereunder. As discussed in detail above, the method changes at issue are not in compliance with Section 461. Accordingly, contractors must request advance consent under the normal procedures. See Treas. Reg. § 1.446-1(e)(2)(i).

SETTLEMENT GUIDELINES

ISSUES

1. Whether, when computing a long-term contract's "completion factor" under Treas. Reg. §1.460-4(b)(5), contractors may postpone the recognition of costs they incur for the work of their subcontractors by arguing that construction contracts represent contracts for property that are not "accepted" until substantially complete, and thus postpone income.

    (a) Whether, under the economic performance rules of I.R.C. § 461(h) and the regulations thereunder, construction contracts of the type described herein usually represent contracts for several items, including services, property (raw materials), and the use of property (rental equipment).

    (b) Whether property (raw materials) provided by subcontractors are deemed accepted, within the meaning of Treas. Reg. § 1.461-4(d)(6)(iii), only upon substantial completion of the subcontract.

2. Whether, under I.R.C. § 446(e) and Treas. Reg. § 1.446-1(e)(2)(i), contractors are prohibited from changing their method of accounting for subcontractor expenses without advance consent.

CONCLUSIONS

1. Contractors may not postpone expense recognition by arguing that construction contracts represent contracts for property that are not "accepted" until substantially complete. This argument is contrary to Treas. Reg. § 1.461-4(d)(6)(iv), which provides that when a contract or agreement requires different services or items of property to be provided, economic performance occurs as each service or item of property is provided.

    a. Yes. Generally, due to the nature of construction projects, the work product of most subcontractors involves the provision of both property (raw materials) and services.

    b. No. In the case of a long-term contract, acceptance of property is generally governed by terms of the contract. For example, the contract may specify that acceptance occurs as raw materials are (a) delivered to the job site; (b) billed; or (c) when the bill is accepted as correct by the contractor. Any of these methods would be acceptable, if, in the opinion of the Commissioner, it clearly reflects income and is used consistently. See Treas. Reg. § 1.446-1(c)(1)(ii)(C). Where the contract provides for the provision of both services

and materials, economic performance generally occurs as each service or item of property is provided (unless such service or materials meet the "incidental" exception). Treas. Reg. § 1.461-4(d)(6)(iv).

2. Treas. Reg. § 1.461-4(m)(2)(i) gives automatic consent only in limited situations and only to change a contractor's method of accounting for the purpose of complying with I.R.C. § 461 and the regulations promulgated thereunder. Since the method changes at issue are not in compliance with I.R.C. § 461 contractors must request advance consent under the normal procedures. See Treas. Reg. § 1.446-1(e)(2)(i).

DISCUSSION

Issue 1 and 1(b)

Under the PCM, a taxpayer/contractor determines the current year's gross receipts from a long-term contract by multiplying the "total contract price" by the contract's "completion factor" for the current year ("cumulative gross receipts") and by subtracting from this amount the cumulative gross receipts for the immediately preceding year. The completion factor, which shows the percentage of completion, is the ratio of (1) the amount of allocable contract costs incurred by the end of the current year (the numerator) to (2) the estimated total contract costs (denominator). At issue in this paper is when subcontractor expenses are incurred within the meaning of § 461, and thus, must be included in the numerator of the completion factor. Contract costs generally are treated as incurred in the taxable year in which the "all events" test of § 461 is met.

IRC § 461(a) provides that the amount of any deduction or credit shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

IRC § 461(h) and Treas. Reg. § 1.461-1(a)(2) provide that, under an accrual method of accounting, a liability {as defined in § 1.446-1(c)(1)(ii)(B)} is incurred, and generally is taken into account for federal income tax purposes, in the taxable year in which

1) all the events have occurred that establish the fact of the liability,
2) the amount of the liability can be determined with reasonable accuracy, and
3) economic performance has occurred with respect to the liability.

The first two requirements are referred to as the all events test. See IRC § 461(h)(4).

While this paper focuses principally on the "economic performance" aspect, Appeals Officers are cautioned to also carefully consider the first two requirements (the "all events" test) in determining when expenses are incurred within the meaning of IRC § 461.

Regarding the first requirement of the "all events" test, if all the events that determine the fact of liability do not occur until a taxable year after economic performance is met, a liability is not incurred under IRC § 461 until both of these requirements, as well as the reasonable accuracy requirement, are met.

With respect to the "reasonable accuracy" requirement, it is possible that the amount of the liability may not be determinable with reasonable accuracy where there is a legitimate dispute concerning the amount.

> For example, A renders services for which he charges $10,000. B admits a liability to A for $6,000 but contests the remainder. B may take into account only $6,000 as an expense for the year in which the services were rendered. See Treas. Reg. §1.461-1(a)(2)(ii).

Where a taxpayer's obligations are set forth in a written agreement, the specific terms of the agreement are relevant in determining the events that fix the taxpayer's liability. See Decision, Inc. v. Commissioner, 47 T.C. 58 (1966), acq. 1967-2 C.B. 2. In order to fully analyze when a liability is incurred, the specific contractual provisions should be provided and analyzed. In Shepherd Construction Co., Inc. v. Commissioner, 51 T.C. 890 (1969), acq. 1969-2 C.B. 25, the court looked to specific terms of the contracts relating to acceptance in determining whether an accrual basis general contractor had incurred a liability for retainages withheld from its subcontractors prior to final acceptance and approval of the work performed. Relevant contractual provisions would include:

1. whether the contract is for the provision of property, services, or both property and services;
2. the billing arrangements;
3. acceptance provisions;
4. retainage provisions; and
5. conditions relating to progress or periodic payments.

It should also be noted that recognition of contract costs under the PCM may not be delayed by postponing payment. In determining whether an expense has been incurred, the all events test shall not be treated as met any earlier than when economic performance occurs with respect to such item. See IRC §461(h)(1). In the case of any liability of a taxpayer that is an expense attributable to a long-term contract, subject to the PCM, economic performance occurs:

a) as the services or property are provided; or, if earlier,

b) when payment is made to the person providing the services or property.

Treas. Reg. §1.461-4(d)(2)(ii).

Accordingly, while payment made prior to the provision of services or property may accelerate economic performance, payment is not a prerequisite for economic performance and thus cannot delay economic performance or recognition of contract costs under the PCM.

Similarly, **contractors may not postpone expense recognition by arguing that construction contracts represent contracts for property that are not "accepted" until substantially complete**. See discussion at Issue 1(b) below. This argument is contrary to Treas. Reg. § 1.461-4(d)(6)(iv), which provides that when a contract or agreement requires different services or items of property to be provided, economic performance occurs as each service or item of property is provided. As a cautionary note however, specific contract terms conditioning acceptance on specific events could affect the timing of economic performance. Accordingly, careful review of contract terms is essential, particularly those terms affecting when property or raw materials are deemed accepted.

As the Examination Coordinated Issue paper points out, the taxpayer's assertion that property (raw materials) provided by subcontractors are deemed accepted, within the meaning of Treas. Reg. § 1.461-4(d)(6)(iii) only upon substantial completion of the subcontract, is clearly contrary to other applicable Treasury Regulations as well as to industry practice:

1. Where the subcontract provides for the provision of both services and materials, economic performance generally occurs as each service or item of property is provided, unless such service or materials meet the "incidental" exception of Treas. Reg. § 1.461-4(d)(6)(iv).

2. Property may be treated as "provided" when the property is delivered or accepted, or when title to the property passes. The method used to determine when property is provided is a method of accounting that must comply with the rules of §1.446-1(e). Thus, the method of determining when property is provided must be used consistently from year to year, and cannot be changed without the consent of the Commissioner. See Treas. Reg. § 1.461-4(d)(6)(iii).

Note: A sale does not necessarily occur exactly when title passes. The determinative factor is when the parties intend the sale to be effective (see Item 3 below). Thus, for example, the fact that the seller retains title as

security will not prevent a completed sale.

3. In the case of a long-term contract, acceptance of property is generally governed by contract. For example, the contract may specify that acceptance occurs as raw materials are (a) delivered to the job site; (b) billed; or (c) when the bill is accepted as correct by the contractor. Any of these methods would be acceptable, if, in the opinion of the Commissioner, it clearly reflects income and is used consistently. See Treas. Reg. § 1.446-1(c)(1)(ii)(C).

4. Treas. Reg. § 1.461-4(d)(2)(ii) provides that, with respect to long-term contract expenses incurred after 1991, economic performance occurs as the services or property is provided or, if earlier, as the taxpayer makes payment.

Summary

The appropriate timing for the recognition of contract expenses is governed by the "all events" test as outlined in Treas. Reg. § 1.461-1(a)(2)(i) and IRC § 461(h). Whether a subcontractor expense has satisfied the "all events" test and should therefore be recognized as an incurred contract cost in computing income under the PCM depends upon the facts and circumstances. Contractors may not postpone expense recognition by arguing that construction contracts represent contracts for property that are not "accepted" until substantially complete. In the case of a long-term contract, acceptance of property is generally governed by terms of the specific contract between the contractor and the subcontractor. Furthermore, this argument is contrary to Treas. Reg. § 1.461-4(d)(6)(iv), which provides that when a contract or agreement requires different services or items of property to be provided, economic performance occurs as each service or item of property is provided.

Hazards of Litigation

The appropriate timing of cost recognition, within the context of the percentage of completion method, is a factually driven issue. In most circumstances, the issue is resolved by appropriate application of the "all events" test, which ensures that expense recognition is neither premature nor inappropriately deferred. Appropriate application of the "all events" test requires careful analysis of the contract terms between the contractor and the subcontractor, as contract terms negotiated at "arms length" (evidencing the intent of the buyer and seller) generally control for purposes of determining when property or materials are deemed "accepted".

While it is possible that issues may arise requiring a hazards of litigation analysis, it is

anticipated that most issues concerning the appropriate timing for cost recognition should be resolved on a factual basis, following appropriate application of the "all events" test.

Discussion – Issue 1(a)

Under the economic performance rules of I.R.C. §461(h) and the regulations thereunder, do construction contracts of the type described herein usually represent contracts for several items, including services, property (raw materials), and the use of property (rental equipment)?

Yes. Generally, due to the nature of construction projects, the work product of **most** subcontractors involves the provision of both property (raw materials) and services. However, whether a particular contract involves "property only" or a combination of property, services and/or use of property is clearly a factual question that must be resolved on a contract-by-contract basis by analysis of the terms and substance of the particular contract.

The question of whether a contract represents solely the provision of property verses the provision of both property and other items (such as services and/or use of property) is an important distinction since it may affect the timing of when economic performance occurs. Economic performance, as previously discussed, must occur before the "all events" test is satisfied. For example, if a contract represents solely the provision of property, then economic performance may be deemed to occur when the property is provided. Treas. Reg. Section 1.461-4(d)(6)(III). Conversely, if the contract involves the provision of property plus other items such as services and/or use of property, then economic performance occurs over the time each service is provided and as each item of property is provided (unless the service or item of property meets the incidental exception). Treas. Reg. Section 1.461-4(d)(6)(iv). Services or property are treated as incidental only if:

A) The cost of the services or property is treated on the taxpayer's books and records as part of the cost of the other services or property provided under the contract; and

B) The aggregate cost of the services or property does not exceed 10 percent of the total contract price.

Contractors asserting that a particular subcontract is solely for property bears the burden of proving this factual assertion. Additionally, appeals officers are cautioned when presented with a contract that is asserted to represent the provision of "property only" to consider whether such contract actually represents the whole agreement between the contractor and subcontractor. In some cases the property portion and services portion of an agreement may have been bifurcated into two contracts in an attempt to circumvent the rules of Treas.

Reg. section 1.461-4(d)(6)(iv). Two or more contracts which are in substance one agreement should be treated as one contract.

Discussion – Issue 2

A change to the time a taxpayer consistently reports income or deducts expenses is a change to the taxpayer's method of accounting, subject to the provisions of IRC §§ 446 and 481. Thus, a change in the way that subcontractor expenses are reported could potentially be a change in accounting method.

For instance, if the taxpayer has consistently accrued subcontractor expenses as incurred in computing income under the PCM and then changes to a method of deferring recognition of subcontractor expenses until the subcontractor's work is "substantially complete", such change would likely constitute a change of accounting method.

The automatic consent provisions of Treas. Reg. 1.461-4(m)(2) grants automatic consent to taxpayers in certain limited situations for the purpose of changing the taxpayers accounting method to comply with the requirements of section 461. As previously discussed in this paper, an improper change in accounting method (i.e. change from accrual cost recognition to improperly deferring cost recognition under the PCM) is an improper change which does not qualify for the automatic consent provisions of Treas. Reg. § 1.461-4(m)(2). Accordingly, contractors seeking to make such a change must request advance consent under the normal procedures as described in Treas. Reg. § 1.446-1(e)(2).

Any change of accounting method concerns can be addressed when you contact the Appeals ISP Coordinator.