

of the Internal Revenue Code disallows a deduction for that type of payment or expenditure (e.g., an illegal bribe described in section 162(c)).

(2) *Costs incurred for non-long-term contract activities.* If a taxpayer performs a non-long-term contract activity, as defined in §1.460-1(d)(2), that is incident to or necessary for the manufacture, building, installation, or construction of the subject matter of one or more of the taxpayer's long-term contracts, the taxpayer must allocate the costs attributable to that activity to such contract(s).

(g) *Method of accounting.* A taxpayer that adopts or elects a cost allocation method of accounting (or changes to another cost allocation method of accounting with the Commissioner's consent) must apply that method consistently for all similarly classified contracts, until the taxpayer obtains the Commissioner's consent under section 446(e) to change to another cost allocation method. A taxpayer-initiated change in cost allocation method will be permitted only on a cut-off basis (i.e., for contracts entered into on or after the year of change) and thus, a section 481(a) adjustment will not be permitted or required.

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§ 1.460-6 Look-back method.

(a) *In general*—(1) *Introduction.* With respect to income from any long-term contract reported under the percentage of completion method, a taxpayer is required to pay or is entitled to receive interest under section 460(b) on the amount of tax liability that is deferred or accelerated as a result of overestimating or underestimating total contract price or contract costs. Under this look-back method, taxpayers are required to pay interest for any deferral of tax liability resulting from the underestimation of the total contract price or the overestimation of total contract costs. Conversely, if the total contract price is overestimated or the total contract costs are underestimated, taxpayers are entitled to receive interest for any resulting acceleration of tax liability. The computation of the amount of deferred or accelerated tax liability under the look-back method is hypothetical; applica-

tion of the look-back method does not result in an adjustment to the taxpayer's tax liability as originally reported, as reported on an amended return, or as adjusted on examination. Thus, the look-back method does not correct for differences in tax liability that result from over- or under-estimation of contract price and costs and that are permanent because, for example, tax rates change during the term of the contract.

(2) *Overview.* Paragraph (b) explains which situations require application of the look-back method to income from a long-term contract. Paragraph (c) explains the operation of the three computational steps for applying the look-back method. Paragraph (d) provides guidance concerning the simplified marginal impact method. Paragraph (e) provides an elective method to minimize the number of times the look-back method must be reapplied to a single long-term contract. Paragraph (f) describes the reporting requirements for the look-back method and the tax treatment of look-back interest. Paragraph (g) provides rules for applying the look-back method when there is a transaction that changes the taxpayer that reports income from a long-term contract prior to the completion of a contract. Paragraph (h) provides examples illustrating the three computational steps for applying the look-back method. Paragraph (j) of this section provides guidance concerning the election not to apply the look-back method in de minimis cases.

(b) *Scope of look-back method*—(1) *In general.* The look-back method applies to any income from a long-term contract within the meaning of section 460(f) that is required to be reported under the percentage of completion method (as modified by section 460) for regular income tax purposes or for alternative minimum tax purposes. If a taxpayer uses the percentage of completion-capitalized cost method for long-term contracts, the look-back method applies for regular tax purposes only to the portion (40, 70, or 90 percent, whichever applies) of the income from the contract that is reported under the percentage of completion

method. To the extent that the percentage-of-completion method is required to be used under § 1.460-1(g) with respect to income and expenses that are attributable to activities that benefit a related party's long-term contract, the look-back method also applies to these amounts, even if those activities are not performed under a contract entered into directly by the taxpayer.

(2) *Exceptions from section 460.* The look-back method generally does not apply to the regular taxable income from any long-term construction contract within the meaning of section 460(e)(4) that:

(i) Is a home construction contract within the meaning of section 460(e)(1)(A), or

(ii) Is not a home construction contract but is estimated to be completed within a 2-year period by a taxpayer whose average annual gross receipts for the 3 tax years preceding the tax year the contract is entered into do not exceed \$10,000,000 (as provided in section 460(e)(1)(B)). These contracts are not subject to the look-back method for regular tax purposes, even if the taxpayer uses a version of the percentage of completion method permitted under § 1.451-3, unless the taxpayer has properly changed its method of accounting for these contracts to the percentage of completion method as modified by section 460(b). The look-back method, however, applies to the alternative minimum taxable income from a contract of this type, unless it is exempt from the required use of the percentage of completion method under section 56(a)(3).

(3) *De minimis exception.* Notwithstanding that the percentage of completion method is otherwise required to be used, the look-back method does not apply to any long-term contract that:

(i) Is completed within 2 years of the contract commencement date, and

(ii) Has a gross contract price (as of the completion of the contract) that does not exceed the lesser of \$1,000,000 or 1 percent of the average annual gross receipts of the taxpayer for the 3 tax years preceding the tax year in which the contract is completed.

This de minimis exception is mandatory and, therefore, precludes applica-

tion of the look-back method to any contract that meets the requirements of the exception. The de minimis exception applies for purposes of computing both regular taxable income and alternative minimum taxable income. Solely for this purpose, the determination of whether a long-term contract meets the gross receipts test for both alternative minimum tax and regular tax purposes is made based only on the taxpayer's regular taxable income.

(4) *Alternative minimum tax.* For purposes of computing alternative minimum taxable income, section 56(a)(3) generally requires long-term contracts within the meaning of section 460(f) (generally without regard to the exceptions in section 460(e)) to be accounted for using only the percentage of completion method as defined in section 460(b), including the look-back method of section 460(b), with respect to tax years beginning after December 31, 1986. However, section 56(a)(3) (and thus the look-back method) does not apply to any long-term contract entered into after June 20, 1988, and before the beginning of the first tax year that begins after September 30, 1990, that meets the conditions of both section 460(e)(1)(A) and clauses (i) and (ii) of section 460(e)(1)(B), and does not apply to any long-term contract entered into in a tax year that begins after September 30, 1990, that meets the conditions of section 460(e)(1)(A). A taxpayer that applies the percentage of completion method (and thus the look-back method) to income from a long-term contract only for purposes of determining alternative minimum taxable income, and not regular taxable income, must apply the look-back method to the alternative minimum taxable income in the year of contract completion and other filing years whether or not the taxpayer was liable for the alternative minimum tax for the filing year or for any prior year. Interest is computed under the look-back method to the extent that the taxpayer's total tax liability (including the alternative minimum tax liability) would have differed if the percentage of completion method had been applied using actual, rather than estimated, contract price and contract costs.

(5) *Effective date.* The look-back method, including the de minimis exception, applies to long-term contracts entered into after February 28, 1986. With respect to activities that are subject to section 460 solely because they benefit a long-term contract of a related party, the look-back method generally applies only if the related party's long-term contract was entered into after June 20, 1988, unless a principal purpose of the related-party arrangement is to avoid the requirements of section 460.

(c) *Operation of the look-back method—*

(1) *Overview—(i) In general.* The amount of interest charged or credited to a taxpayer under the look-back method is computed in three steps. This paragraph (c) describes the three steps for applying the look-back method. These steps are illustrated by the examples in paragraph (h). The first step is to hypothetically reapply the percentage of completion method to all long-term contracts that are completed or adjusted in the current year (the “filing year”), using the actual, rather than estimated, total contract price and contract costs. Based on this reapplication, the taxpayer determines the amount of taxable income (and alternative minimum taxable income) that would have been reported for each year prior to the filing year that is affected by contracts completed or adjusted in the filing year if the actual, rather than estimated, total contract price and costs had been used in applying the percentage of completion method to these contracts, and to any other contracts completed or adjusted in a year preceding the filing year. If the percentage of completion method only applies to alternative minimum taxable income for contracts completed or adjusted in the filing year, only alternative minimum taxable income is re-computed in the first step. The second step is to compare what the tax liability would have been under the percentage of completion method (as reapplied in the first step) for each tax year for which the tax liability is affected by income from contracts completed or adjusted in the filing year (a “redetermination year”) with the most recent determination of tax liability for that year to produce a hypothetical under-

payments or overpayment of tax. The third step is to apply the rate of interest on overpayments designated under section 6621 of the Code, compounded daily, to the hypothetical underpayment or overpayment of tax for each redetermination year to compute interest that runs, generally, from the due date (determined without regard to extensions) of the return for the redetermination year to the due date (determined without regard to extensions) of the return for the filing year. The net amount of interest computed under the third step is paid by or credited to the taxpayer for the filing year. Paragraph (d) provides a simplified marginal impact method that simplifies the second step—the computation of hypothetical underpayments or overpayments of tax liability for redetermination years—and, in some cases, the third step—the determination of the time period for computing interest.

(ii) *Post-completion revenue and expenses—(A) In general.* Except as otherwise provided in section 460(b)(6) (see § 1.460-6(j) for method of electing) or § 1.460-6(e), a taxpayer must apply the look-back method to a long-term contract in the completion year and in any post-completion year for which the taxpayer must adjust total contract price or total allocable contract costs, or both, under the PCM. Any year in which the look-back method must be reapplied is treated as a filing year. See Example 3 of paragraph (h)(4) for an illustration of how the look-back method is applied to post-completion adjustments.

(B) *Completion.* A contract is considered to be completed for purposes of the look-back method in the year in which final completion and acceptance within the meaning of § 1.460-1(c)(3) have occurred.

(C) *Discounting of contract price and contract cost adjustments subsequent to completion; election not to discount—(1) General rule.* The amount of any post-completion adjustment to the total contract price or contract costs is discounted, solely for purposes of applying the look-back method, from its value at the time the amount is taken into account in computing taxable income to its value at the completion of the contract. The discount rate for this

purpose is the Federal mid-term rate under section 1274(d) in effect at the time the amount is properly taken into account. For purposes of applying the look-back method for the completion year, no amounts are discounted, even if they are received after the completion year.

(2) *Election not to discount.* Notwithstanding the general requirement to discount post-completion adjustments, a taxpayer may elect not to discount contract price and contract cost adjustments with respect to any contract. The election not to discount is to be made on a contract-by-contract basis and is binding with respect to all post-completion adjustments that arise with respect to a contract for which an election has been made. An election not to discount with respect to any contract is made by stating that an election is being made on the taxpayer's timely filed Federal income tax return (determined with regard to extensions) for the first tax year after completion in which the taxpayer takes into account (i.e., includes in income or deducts) any adjustment to the contract price or contract costs. See § 301.9100-8 of this chapter.

(3) *Year-end discounting convention.* In the absence of an election not to discount, any revisions to the contract price and contract costs must be discounted to their value as of the completion of the contract in reapplying the look-back method. For this purpose, the period of discounting is the period between the completion date of the contract and the date that any adjustment is taken into account in computing taxable income. Although taxpayers may use the period between the months in which these two events actually occur, in many cases, these dates may not be readily identifiable. Therefore, for administrative convenience, taxpayers are permitted to use the period between the end of the tax years in which these events occur as the period of discounting provided that the convention is used consistently with respect to all post-completion adjustments for all contracts of the taxpayer the adjustments to which are discounted. In that case, the taxpayer must use as the discount rate the Federal mid-term rate under section

1274(d) as of the end of the tax year in which any revision is taken into account in computing taxable income.

(D) *Revenue acceleration rule.* Section 460(b)(1) imposes a special rule that requires a taxpayer to include in gross income, for the tax year immediately following the year of completion, any previously unreported portion of the total contract price (including amounts that the taxpayer expects to receive in the future) determined as of that year, even if the percentage of completion ratio is less than 100 percent because the taxpayer expects to incur additional allocable contract costs in a later year. At the time any remaining portion of the contract price is includible in income under this rule, no offset against this income is permitted for estimated future contract costs. To achieve the requirement to report all remaining contract revenue without regard to additional estimated costs, a taxpayer must include only costs actually incurred through the end of the tax year in the denominator of the percentage of completion ratio in applying the percentage of completion method for any tax years after the year of completion. The look-back method also must be reapplied for the year immediately following the year of completion if any portion of the contract price is includible in income in that year by reason of section 460(b)(1). For purposes of reapplying the look-back method as a result of this inclusion in income, the taxpayer must only include in the denominator of the percentage of completion ratio the actual contract costs incurred as of the end of the year, even if the taxpayer reasonably expects to incur additional allocable contract costs. To the extent that costs are incurred in a subsequent tax year, the look-back method is reapplied in that year (or a later year if the delayed reapplication method is used), and the taxpayer is entitled to receive interest for the post-completion adjustment to contract costs. Because this reapplication occurs subsequent to the completion year, only the cumulative costs incurred as of the end of the reapplication year are includible in the denominator of the percentage of completion ratio.

(2) *Look-back Step One*—(i) *Hypothetical reallocation of income among prior tax years.* For each filing year, a taxpayer must allocate total contract income among prior tax years, by hypothetically applying the percentage of completion method to all contracts that are completed or adjusted in the filing year using the rules of this paragraph (c)(2). The taxpayer must reallocate income from those contracts among all years preceding the filing year that are affected by those contracts using the total contract price and contract costs, as determined as of the end of the filing year (“actual contract price and costs”), rather than the estimated contract price and contract costs. The taxpayer then must determine the amount of taxable income and the amount of alternative minimum taxable income that would have been reported for each affected tax year preceding the filing year if the percentage of completion method had been applied on the basis of actual contract price and contract costs in reporting income from all contracts completed or adjusted in the filing year and in any preceding year. If the percentage of completion method only applies to alternative minimum taxable income from the contract, only alternative minimum taxable income is recomputed in the first step. For purposes of reallocating income (and costs if the 10-percent year changes for a taxpayer using the 10-percent method of section 460(b)(5)) under the look-back method, the method of computing the percentage of completion ratio is the same method used to report income from the contract on the taxpayer’s return. (Thus, an election to use the 10-percent method or the simplified cost-to-cost method is taken into account). See Example 1 of paragraph (h)(2) for an illustration of Step One.

(ii) *Treatment of estimated future costs in year of completion.* If a taxpayer reasonably expects to incur additional allocable contract costs in a tax year subsequent to the year in which the contract is completed, the taxpayer includes the actual costs incurred as of the end of the completion year plus the additional allocable contract costs that are reasonably expected to be incurred (to the extent includible under

the taxpayer’s percentage of completion method) in the denominator of the percentage of completion ratio. The completion year is the only filing year for which the taxpayer may include additional estimated costs in the denominator of the percentage of completion ratio in applying the look-back method. If the look-back method is re-applied in any year after the completion year, only the cumulative costs incurred as of the end of the year of re-application are includible in the denominator of the percentage of completion ratio in reapplying the look-back method.

(iii) *Interim reestimates not considered.* The look-back method cannot be applied to a contract before it is completed. Accordingly, for purposes of applying Step One, the actual total contract price and contract costs are substituted for the previous estimates of total contract price and contract costs only with respect to contracts that have been completed in the filing year and in a tax year preceding the filing year. No adjustments are made under Step One for contracts that have not been completed prior to the end of the current filing year, even if, as of the end of this year, the estimated total contract price or contract costs for these uncompleted contracts is different from the estimated amount that was used during any tax year for which taxable income is recomputed with respect to completed contracts under the look-back method for the current filing year.

(iv) *Tax years in which income is affected.* In general, because income under the percentage of completion method is generally reported as costs are incurred, the taxable income and alternative minimum taxable income are recomputed only for each year in which allocable contract costs were incurred. However, there will be exceptions to this general rule. For example, a taxpayer may be required to cumulatively adjust the income from a contract in a year in which no allocable contract costs are incurred if the estimated total contract price or contract costs was revised in that year. However, in applying the look-back method, no contract income is allocated to

that year. Thus, there may be a difference between the amount of contract income originally reported for that year and the amount of contract income as reallocated. Similarly, because of the revenue acceleration rule of section 460(b)(1), income may be reported in the year immediately following the completion year even though no costs were incurred during that year and, in applying the look-back method in that year or another year, if additional costs are incurred or the contract price is adjusted in a later year, no income is allocated to the year immediately following the completion year.

(v) *Costs incurred prior to contract execution; 10-percent method*—(A) *General rule.* The look-back method does not require allocation of contract income to tax years before the contract was entered into. Costs incurred prior to the year a contract is entered into are first taken into account in the numerator of the percentage of completion ratio in the year the contract is entered into. A taxpayer using the 10-percent method must also use the 10-percent method in applying the look-back method, using actual total contract costs to determine the 10-percent year. Thus, contract income is never reallocated to a year before the 10-percent year as determined on the basis of actual contract costs. If the 10-percent year is earlier as a result of applying Step One of the look-back method, contract costs incurred up to and including the new 10-percent year (as determined based on actual contract costs), are reallocated from the original 10-percent year to the new 10-percent, and costs incurred in later years but before the old 10-percent year are reallocated to those years. If the 10-percent year is later as a result of applying Step One of the look-back method, contract costs incurred up to and including the new 10-percent year are reallocated from all prior years to the new 10-percent year. This is the only case in which costs are reallocated under the look-back method.

(B) *Example.* The application of the look-back method by a taxpayer using the 10-percent method is illustrated by the following example:

Example. Z elected to use the 10-percent method of section 460(b)(5) for reporting income under the percentage of completion method. Z entered into a contract in 1990 for a fixed price of \$1,000x. During 1990, Z incurred allocable contract costs of \$80x and estimated that it would incur a total of \$900x for the entire contract. Since \$80x is less than 10 percent of total estimated contract costs, Z reported no revenue from the contract in 1990 and deferred the \$80x of costs incurred. In 1991, Z incurred an additional \$620x of contract costs, and completed the contract. Accordingly, in its 1991 return, Z reported the entire contract price of \$1,000x, and deducted the \$620x of costs incurred in 1991 and the \$80x of costs incurred in 1990.

Under section 460(b)(5), the 10-percent method applies both for reporting contract income and the look-back method. Under the look-back method, since the costs incurred in 1990 (\$80x) exceed 10 percent of the actual total contract costs (\$700x), Z is required to allocate \$114x of contract revenue ($\$80x/\$700x \times \$1,000x$) and the \$80x of costs incurred to 1990. Thus, application of the look-back method results in a net increase in taxable income for 1990 of \$34x, solely for purposes of the look-back method.

(vi) *Amount treated as contract price*—(A) *General rule.* The amount that is treated as total contract price for purposes of applying the percentage of completion method and reapplying the percentage of completion method under the look-back method under Step One includes all amounts that the taxpayer expects to receive from the customer. Thus, amounts are treated as part of the contract price as soon as it is reasonably estimated that they will be received, even if the all-events test has not yet been met.

(B) *Contingencies.* Any amounts related to contingent rights or obligations, such as incentive fees or amounts in dispute, are not separated from the contract and accounted for under a non-long-term contract method of accounting, notwithstanding any provision in § 1.460-4(b)(4)(i), to the contrary. Instead, those amounts are treated as part of the total contract price in applying the look-back method. For example, if an incentive fee under a contract to manufacture a satellite is payable to the taxpayer after a specified period of successful performance, the incentive fee is includible in the total contract price at the time and to the extent that it can reasonably be predicted that the performance

objectives will be met. . A portion of the contract price that is in dispute is included in the total contract price at the time and to the extent that the taxpayer can reasonably expect the dispute will be resolved in the taxpayer's favor (without regard to when the taxpayer receives payment for the amount in dispute or when the dispute is finally resolved).

(C) *Change orders.* In applying the look-back method, a change order with respect to a contract is not treated as a separate contract unless the change order would be treated as a separate contract under the rules for severing and aggregating contracts provided in §1.460-1(e). Thus, if a change order is not treated as a separate contract, the contract price and contract costs attributable to the change order must be taken into account in allocating contract income to all tax years affected by the underlying contract.

(3) *Look-back Step Two: Computation of hypothetical overpayment or underpayment of tax—(i) In general.* Step Two involves the computation of a hypothetical overpayment or underpayment of tax for each year in which the tax liability is affected by income from contracts that are completed or adjusted in the filing year (a “redetermination year”). The application of Step Two depends on whether the taxpayer uses the simplified marginal impact method contained in paragraph (d) or the actual method described in this paragraph (c)(3). The remainder of this paragraph (c)(3) does not apply if a taxpayer uses the simplified marginal impact method.

(ii) *Redetermination of tax liability.* Under the method described in this paragraph (c)(3) (the “actual method”), a taxpayer, first, must determine what its regular and alternative minimum tax liability would have been for each redetermination year if the amounts of contract income allocated in Step One for all contracts completed or adjusted in the filing year and in any prior year were substituted for the amounts of contract income reported under the percentage of completion method on the taxpayer's original return (or as subsequently adjusted on examination, or by amended return). See Example 2

of paragraph (h)(3) for an illustration of Step Two.

(iii) *Hypothetical underpayment or overpayment.* After redetermining the income tax liability for each tax year affected by the reallocation of contract income, the taxpayer then determines the amount, if any, of the hypothetical underpayment or overpayment of tax for each of these redetermination years. The hypothetical underpayment or overpayment for each affected year is the difference between the tax liability as redetermined under the look-back method for that year and the amount of tax liability determined as of the latest of the following:

(A) The original return date;

(B) The date of a subsequently amended or adjusted return (if, however, the amended return is due to a carryback described in section 6611(f), see paragraph (c)(4)(iii)); or,

(C) The last previous application of the look-back method (in which case, the previous hypothetical tax liability is used).

(iv) *Cumulative determination of tax liability.* The redetermination of tax liability resulting from previous applications of the look-back method is cumulative. Thus, for example, in computing the amount of a hypothetical overpayment or underpayment of tax for a redetermination year, the current hypothetical tax liability is compared to the hypothetical tax liability for that year determined as of the last previous application of the look-back method.

(v) *Years affected by look-back only.* A redetermination of income tax liability under Step Two is required for every tax year for which the tax liability would have been affected by a change in the amount of income or loss for any other year for which a redetermination is required. For example, if the allocation of contract income under Step One changed the amount of a net operating loss that was carried back to a year preceding the year the taxpayer entered into the contract, the tax liability for the earlier year must be redetermined.

(vi) *Definition of tax liability.* For purposes of Step Two, the income tax liability must be redetermined by taking into account all applicable additions to tax, credits, and net operating loss

carrybacks and carryovers. Thus, the tax, if any, imposed under section 55 (relating to alternative minimum tax) must be taken into account. For example, if the taxpayer did not pay alternative minimum tax, but would have paid alternative minimum tax for that year if actual rather than estimated contract price and costs had been used in determining contract income for the year, the amount of any hypothetical overpayment or underpayment of tax must be determined by comparing the hypothetical total tax liability (including hypothetical alternative minimum tax liability) with the actual tax liability for that year. The effect of taking these items into account in applying the look-back method is illustrated in Examples (4) through (7) of paragraphs (h)(5) through (h)(8) below.

(4) *Look-back Step Three: Calculation of interest on underpayment or overpayment*—(i) *In general.* After determining a hypothetical underpayment or overpayment of tax for each redetermination year, the taxpayer must determine the interest charged or credited on each of these amounts. Interest on the amount determined under Step Two is determined by applying the overpayment rate designated under section 6621, compounded daily. In general, the time period over which interest is charged on hypothetical underpayments or credited on hypothetical overpayments begins at the due date (not including extensions) of the return for the redetermination year for which the hypothetical underpayment or overpayment determined in Step Two is computed. This time period generally ends on the earlier of:

(A) The due date (not including extensions) of the return for the filing year, and

(B) The date both

(1) The income tax return for the filing year is filed, and

(2) The tax for that year has been paid in full. If a taxpayer uses the simplified marginal impact method contained in paragraph (d), the remainder of this paragraph (c)(4) does not apply.

(ii) *Changes in the amount of a loss or credit carryback or carryover.* The time period for determining interest may be different in cases involving loss or credit carrybacks or carryovers in

order to properly reflect the time period during which the taxpayer (in the case of an underpayment) or the Government (in the case of an overpayment) had the use of the amount determined to be a hypothetical underpayment or overpayment. Thus, if a reallocation of contract income under Step One results in an increase or decrease to a net operating loss carryback (but not a carryforward), the interest due or to be refunded must be computed on the increase or decrease in tax attributable to the change to the carryback only from the due date (not including extensions) of the return for the redetermination year that generated the carryback and not from the due date of the return for the redetermination year in which the carryback was absorbed. In the case of a change in the amount of a carryover as a result of applying the lookback method, interest is computed from the due date of the return for the year in which the carryover was absorbed. See Examples (8) and (9) of paragraph (h)(9) for an illustration of these rules.

(iii) *Changes in the amount of tax liability that generated a subsequent refund.* If the amount of tax liability for a redetermination year (as reported on the taxpayer's original return, as subsequently adjusted on examination, as adjusted by amended return, or as redetermined by the last previous application of the look-back method) is decreased by the application of the look-back method, and any portion of the redetermination year tax liability was absorbed by a loss or credit carryback arising in a year subsequent to the redetermination year, the look-back method applies as follows to properly reflect the time period of the use of the tax overpayment. To the extent the amount of tax absorbed because of the carryback exceeds the total hypothetical tax liability for the year (as redetermined under the look-back method) the taxpayer is entitled to receive interest only until the due date (not including extensions) of the return for the year in which the carryback arose.

Example. Upon the completion of a long-term contract in 1990, the taxpayer redetermines its tax liability for 1988 under the

look-back method. This redetermination results in a hypothetical reduction of tax liability from \$1,500x (actual liability originally reported) to \$1,200x (hypothetical liability). In addition, the taxpayer had already received a refund of some or all of the actual 1988 tax by carrying back a net operating loss (NOL) that arose in 1989. The time period over which interest would be computed on the hypothetical overpayment of \$300x for 1988 would depend on the amount of the refund generated by the carryback, as illustrated by the following three alternative situations:

(A) If the amount refunded because of the NOL is \$1,500x: interest is credited to the taxpayer on the entire hypothetical overpayment of \$300x from the due date of the 1988 return, when the hypothetical overpayment occurred, until the due date of the 1989 return, when the taxpayer received a refund for the entire amount of the 1988 tax, including the hypothetical overpayment.

(B) If the amount refunded because of the NOL is \$1,000x: interest is credited to the taxpayer on the entire amount of the hypothetical overpayment of \$300x from the due date of the 1988 return, when the hypothetical overpayment occurred, until the due date of the 1990 return. In this situation interest is credited until the due date of the return for the completion year of the contract, rather than the due date of the return for the year in which the carryback arose, because the amount refunded was less than the redetermined tax liability. Therefore, no portion of the hypothetical overpayment is treated as having been refunded to the taxpayer before the filing year.

(C) If the amount refunded because of the NOL is \$1,300x: interest is credited to the taxpayer on \$100x (\$1,300x - \$1,200x) from the due date of the 1988 return until the due date of the 1989 return because only this portion of the total hypothetical overpayment is treated as having been refunded to the taxpayer before the filing year. However, the taxpayer did not receive a refund for the remaining \$200x of the overpayment at that time and, therefore, is credited with interest on \$200x through the due date of the tax return for 1990, the filing year. See Examples (10) and (11) of paragraph (h)(9) for a further illustration of this rule.

(d) *Simplified marginal impact method*—

(1) *Introduction.* This paragraph (d) provides a simplified method for calculating look-back interest. Any taxpayer may elect this simplified marginal impact method, except that pass-through entities described in paragraph (d)(4) of this section are required to apply the simplified marginal impact method at the entity level with respect to domestic contracts and the owners

of those entities do not apply the look-back method to those contracts. Under the simplified marginal impact method, a taxpayer calculates the hypothetical underpayments or overpayments of tax for a prior year based on an assumed marginal tax rate. A taxpayer electing to use the simplified marginal impact method must use the method for each long-term contract for which it reports income (except with respect to domestic contracts if the taxpayer is an owner in a widely held pass-through entity that is required to use the simplified marginal impact method at the entity level for those contracts).

(2) *Operation*—(i) *In general.* Under the simplified marginal impact method, income from those contracts that are completed or adjusted in the filing year is first reallocated in accordance with the procedures of Step One contained in paragraph (c)(2) of this section. Step Two is modified in the following manner. The hypothetical underpayment or overpayment of tax for each year of the contract (a “redetermination year”) is determined by multiplying the applicable regular tax rate (as defined in paragraph (d)(2)(iii)) by the increase or decrease in regular taxable income (or, if it produces a greater amount, by multiplying the applicable alternative minimum tax rate by the increase or decrease in alternative minimum taxable income, whether or not the taxpayer would have been subject to the alternative minimum tax) that results from reallocating income to the tax year under Step One. Generally, the product of the alternative minimum tax rate and the increase or decrease in alternative minimum taxable income will be the greater of the two amounts described in the preceding sentence only with respect to contracts for which a taxpayer uses the full percentage of completion method only for alternative minimum tax purposes and uses the completed contract method, or the percentage of completion-capitalized cost method, for regular tax purposes. Step Three is then applied. Interest is credited to the taxpayer on the net overpayment and is charged to the taxpayer on the net underpayment for each redetermination year from the due date (determined without regard to

extensions) of the return for the redetermination year until the earlier of

(A) The due date (determined without regard to extensions) of the return for the filing year, and

(B) The first date by which both the return is filed and the tax is fully paid.

(ii) *Applicable tax rate.* For purposes of determining hypothetical underpayments or overpayments of tax under the simplified marginal impact method, the applicable regular tax rate is the highest rate of tax in effect for the redetermination year under section 1 in the case of an individual and under section 11 in the case of a corporation. The applicable alternative minimum tax rate is the rate of tax in effect for the taxpayer under section 55(b)(1). The highest rate is determined without regard to the taxpayer's actual rate bracket and without regard to any additional surtax imposed for the purpose of phasing out multiple tax brackets or exemptions.

(iii) *Overpayment ceiling.* The net hypothetical overpayment of tax for any redetermination year is limited to the taxpayer's total federal income tax liability for the redetermination year reduced by the cumulative amount of net hypothetical overpayments of tax for that redetermination year resulting from earlier applications of the look-back method. If the reallocation of contract income results in a net overpayment of tax and this amount exceeds the actual tax liability (as of the filing year) for the redetermination year, as adjusted for past applications of the look-back method and taking into account net operating loss, capital loss, or credit carryovers and carrybacks to that year, the actual tax so adjusted is treated as the overpayment for the redetermination year. This overpayment ceiling does not apply when the simplified marginal impact method is applied at the entity level by a widely held pass-through entity in accordance with paragraph (d)(4) of this section.

(iv) *Example.* The application of the simplified marginal impact method is illustrated by the following example:

Example. Corporation X, a calendar-year taxpayer, reports income from long-term contracts and elected the simplified marginal impact method when it filed its income

tax return for 1989. X uses only the percentage of completion method for both regular taxable income and alternative minimum taxable income. X completed contracts A, B, and C in 1989 and, therefore, was required to apply the look-back method in 1989. Income was actually reported for these contracts in 1987, 1988, and 1989. X's applicable tax rate, as determined under section 11, for the redetermination years 1987 and 1988 was 40 percent and 34 percent, respectively. The amount of contract income originally reported and reallocated for contracts A, B, and C, and the net overpayments and underpayments for the redetermination years are as follows:

	1987	1988
Contract A:		
Originally reported	\$5,000x	\$4,000x
Reallocated	3,000x	5,000x
Increase/(Decrease)	(2,000x)	1,000x
Contract B:		
Originally reported	6,000x	2,000x
Reallocated	7,000x	1,500x
Increase/(Decrease)	1,000x	(500x)
Contract C:		
Originally reported	8,000x	5,000x
Reallocated	4,000x	7,000x
Increase/(Decrease)	(4,000x)	2,000x
Net Increase/(Decrease)	(5,000x)	2,500x
Tentative (Underpayment)/Overpayment:		
@ .40	2,000x	.....
@ .34 .....	.....	(850x)
Ceiling:		
Actual Tax Liability (After Carryovers and Carrybacks)	1,500x	500x
Final (Underpayment)/Overpayment	1,500x	(850x)

Under the simplified marginal impact method, X determined a tentative hypothetical net overpayment for 1987 and a net underpayment for 1988. X determined these amounts by first aggregating the difference for contracts A, B, and C between the amount of contract price originally reported and the amount of contract price as reallocated and, then, applying the highest regular tax rate to the aggregate decrease in income for 1987 and the aggregate increase in income for 1988.

However, X's overpayment for 1987 is subject to a ceiling based on X's total tax liability. Because the tentative net overpayment of tax for 1987 exceeds the actual tax liability for that year after taking into account carryovers and carrybacks to that year, the final overpayment under the simplified marginal impact method is the amount of tax liability paid instead of the tentative net overpayment. Since application of the look-back method for 1988 results in a tentative underpayment of tax, it is not subject to a ceiling. If the look-back method is applied in 1991, the ceiling amount for 1987 will be zero and the ceiling amount for 1988 will be \$1,350.

X is entitled to receive interest on the hypothetical overpayment from March 15, 1988,

to March 15, 1990. X is required to pay interest on the underpayment from March 15, 1989, to March 15, 1990.

(3) *Anti-abuse rule.* If the simplified marginal impact method is used with respect to any long-term contract (including a contract of a widely held pass-through entity), the district director may recompute interest for the contract (including domestic contracts of widely held pass-through entities) under the look-back method using the actual method (and without regard to the simplified marginal impact method). The district director may make such a recomputation only if the amount of income originally reported with respect to the contract for any redetermination year exceeds the amount of income reallocated under the look-back method with respect to that contract for that year (using actual contract price and contract costs) by the lesser of \$1,000,000 or 20 percent of the amount of income as reallocated (*i.e.*, based on actual contract price and contract costs) under the look-back method with respect to that contract for that year. In determining whether to exercise this authority upon examination of the Form 8697, the district director may take into account whether the taxpayer overreported income for a purpose of receiving interest under the look-back method on a hypothetical overpayment determined at the applicable tax rate. The district director also may take into account whether the taxpayer underreported income for the year in question with respect to other contracts. Notwithstanding the look-back method, the district director may require an adjustment to the tax liability for any open tax year if the taxpayer did not apply the percentage of completion method properly on its original return.

(4) *Application—(i) Required use by certain pass-through entities—(A) General rule.* The simplified marginal impact method is required to be used with respect to income reported from domestic contracts by a pass-through entity that is either a partnership, an S corporation, or a trust, and that is not closely held. With respect to contracts described in the preceding sentence, the simplified marginal impact method is applied by the pass-through entity at

the entity level. For determining the amount of any hypothetical underpayment or overpayment, the applicable regular and alternative minimum tax rates, respectively, are generally the highest rates of tax in effect for corporations under section 11 and section 55 (b)(1). However, the applicable regular and alternative minimum tax rates are the highest rates of tax imposed on individuals under section 1 and section 55 (b)(1) if, at all times during the redetermination year involved (*i.e.*, the year in which the hypothetical increase or decrease in income arises), more than 50 percent of the interests in the entity were held by individuals directly or through 1 or more pass-through entities.

(B) *Closely held.* A pass-through entity is closely held if, at any time during any redetermination year, 50 percent of more (by value) of the beneficial interests in that entity are held (directly or indirectly) by or for 5 or fewer persons. For this purpose, the term “person” has the same meaning as in section 7701(a)(1), except that a pass-through entity is not treated as a person. In addition, the constructive ownership rules of section 1563(e) apply by substituting the term “beneficial interest” for the term “stock” and by substituting the term “pass-through entity” for the term, “corporation” used in that section, as appropriate, for purposes of determining whether a beneficial interest in a pass-through entity is indirectly owned by any person.

(C) *Examples.* The following examples illustrate the application of the rules of paragraph (d)(4)(i):

Example 1. P, a partnership, began a long-term contract on March 1, 1986, and completed this contract in its tax year ending December 31, 1989. P used the percentage of completion method for all contract income. Substantially all of the income from the contract arose from U.S. sources. At all times during all of the years for which income was required to be reported under the contract, exactly 25 percent of the value of P’s interests was owned by Corporation M. The remaining 75 percent of the value of P’s interests was owned in equal shares by 15 unrelated individuals, who are also unrelated to Corporation M. M’s ownership of P represents less than 50 percent of the value of the beneficial interests in P, and, therefore, viewed alone, is insufficient to make P a

closely held partnership. In addition, because no 4 of the individual owners together own 25 percent or more of the remaining value of P's beneficial interests, there is no group of 5 owners that together own, directly or indirectly, 50 percent or more by value of the beneficial interests in P. Therefore, P is not closely held pass-through entity.

Because P is not a closely held pass-through entity, and because P completed the contract after the effective date of section 460(b)(4), P is required to use the simplified marginal impact method. Any interest computed under the look-back method will be paid to, or collected from, P, rather than its partners, and must be reported to each of the partners on Form 1065 as interest income or expense. Further, assume that, for the redetermination years, Corporation M is subject to alternative minimum tax at the rate of 20 percent and 3 of the individuals who own interests in P are subject to the highest marginal tax rate of 33 percent in 1988. Regardless of the actual marginal tax rates of its partners, P is required to determine the underpayment or overpayment of tax for each redetermination year at the entity level by applying a single rate to the increase or decrease in income resulting from the reallocation of contract income under the look-back method. Because more than 50 percent of the interests in P are held by individuals, P must use the highest rate specified in section 1 for each redetermination year. Thus, the rate applied by P is 50 percent for 1986, 38.5 percent for 1987, and 28 percent for 1988.

Example 2. Assume the same facts as in Example 1, except that one of the individuals, Individual I, who directly owns 5 percent of the value of the interests of P, also owns 100 percent of the stock of Corporation M. Section 1563(e)(4) of the Code provides that stock owned directly or indirectly by or for a corporation is considered to be owned by any person who owns 5 percent or more in value of its stock in that proportion which the value of the stock which that person so owns bears to the value of all the stock in that corporation. Because section 460(b)(4)(C)(iii) and this paragraph (d)(4) provide that rules similar to the constructive ownership rules of section 1563(e) apply in determining whether a pass-through entity is closely held, all of M's interest in P is attributed to I because I owns 100 percent of the value of the stock in M. Accordingly, because I's direct 5 percent and constructive 25 percent ownership of P, plus the interests owned by any 4 other individual partners, equals 50 percent or more of the value of the beneficial interests of P, P is a closely held pass-through entity within the meaning of section 460(b)(4)(C)(iii). Therefore, P cannot use the simplified marginal impact method at the entity level. Accordingly, each of the partners of P must separately apply the look-back method to their respective inter-

ests in the income and expenses attributable to the contract, but each partner may elect to use the simplified marginal impact method with respect to the partner's share of income from the contract.

(D) *Domestic contracts—(1) General rule.* A domestic contract is any contract substantially all of the income of which is from sources in the United States. For this purpose, “substantially all” of the income from a long-term contract is considered to be from United States sources if 95 percent or more of the gross income from the contract is from sources within the United States as determined under the rules in sections 861 through 865.

(2) *Portion of contract income sourced.* In determining whether substantially all of the gross income from a long-term contract is from United States sources, taxpayers must apply the allocation and apportionment principles of sections 861 through 865 only to the portion of the contract accounted for under the percentage of completion method. Under the percentage of completion method, gross income from a long-term contract includes all payments to be received under the contract (*i.e.*, any amounts treated as contract price). Similarly, all costs taken into account in the computation of taxable income under the percentage of completion method are deducted from gross income rather than added to a cost of goods sold account that reduces gross income. Therefore, allocable contract costs are not considered in determining whether a long-term contract is a domestic contract or a foreign contract, even if, under the taxpayer's facts, the allocation of contract costs to any portion of a contract not accounted for under the percentage of completion method would affect the relative percentages of United States and foreign source gross income from the entire contract if this portion of the contract were taken into account in applying the 95-percent test.

(E) *Application to foreign contracts.* If a widely held pass-through entity has some foreign contracts and some domestic contracts, the owners of the pass-through entity each apply the look-back method (using, if they elect,

the simplified marginal impact method) to their respective share of the income and expense from foreign contracts. Moreover, in applying the look-back method to foreign contracts at the owner level, the owners do not take into account their share of increases or decreases in contract income resulting from the application of the simplified marginal impact method with respect to domestic contracts at the entity level.

(F) *Effective date.* The simplified marginal impact method must be applied to pass-through entities described in paragraph (d)(4)(i) of this section with respect to domestic contracts completed or adjusted in tax years for which the due date of the return (determined with regard to extensions) of the pass-through entity is after November 9, 1988.

(ii) *Elective use—(A) General rule.* As provided in paragraph (d)(4)(i) of this section, the simplified marginal impact method must be used by certain pass-through entities with respect to domestic contracts. C corporations, individuals, and owners of closely held pass-through entities may elect the simplified marginal impact method. Owners of other pass-through entities may also elect the simplified marginal impact method with respect to all contracts other than those for which the simplified marginal impact method is required to be applied at the entity level. This rule applies to foreign contracts of widely held pass-through entities. In the case of an electing owner in a pass-through entity, the simplified marginal impact method is applied at the owner level, instead of at the entity level, with respect to the owner's share of the long-term contract income and expense reported by the pass-through entity.

(B) *Election requirements.* A taxpayer elects the simplified marginal impact method by stating that the election is being made on a timely filed income tax return (determined with regard to extensions) for the first tax year the election is to apply. An election to use the simplified marginal impact method applies to all applications of the look-back method to all eligible long-term contracts for the tax year for which the election is made and for any subse-

quent tax year. The election may not be revoked without the consent of the Commissioner.

(C) *Consolidated group consistency rule.* In the case of a consolidated group of corporations as defined in §1.1502-1(h), an election to use the simplified marginal impact method is made by the common parent of the group. The election is binding on all other affected members of the group (including members that join the group after the election is made with respect to all applications of the look-back method after joining). If a member subsequently leaves the group, the election remains binding as to that member unless the Commissioner consents to a revocation of the election. If a corporation using the simplified marginal impact method joins a group that does not use the method, the election is automatically revoked with respect to all applications of the look-back method after it joins the group.

(e) *Delayed reapplication method—(1) In general.* For purposes of reapplying the look-back method after the year of contract completion, a taxpayer may elect the delayed reapplication method to minimize the number of required reapplications of the look-back method. Under this method, the look-back method is reapplied after the year of completion of a contract (or after a subsequent application of the look-back method) only when the first one of the following conditions is met with respect to the contract:

(i) The net undiscounted value of increases or decreases in the contract price occurring since the time of the last application of the look-back method exceeds the lesser of \$1,000,000 or 10 percent of the total contract price as of that time,

(ii) The net undiscounted value of increases or decreases in the contract costs occurring since the time of the last application of the look-back method exceeds the lesser of \$1,000,000 or 10 percent of the total contract price as of that time,

(iii) The taxpayer goes out of existence,

(iv) The taxpayer reasonably believes the contract is finally settled and closed, or

(v) Neither condition (e)(1) (i), (ii), (iii), nor (iv) above is met by the end of the fifth tax year that begins after the last previous application of the look-back method.

(2) *Time and manner of making election.* An election to use the delayed reapplication method may be made for any filing year for which the due date of the return (determined with regard to extensions) is after June 12, 1990. The election is made by a statement to that effect on the taxpayer's timely filed Federal income tax return (determined with regard to extensions) for the first tax year the election is to be effective. An election to use the delayed reapplication method is binding with respect to all long-term contracts for which the look-back method would be reapplied without regard to the election in the year of election and any subsequent year unless the Commissioner consents to a revocation of the election. In the case of a consolidated group of corporations as defined in § 1.1502-1(h), an election to use the delayed reapplication method is made by the common parent of the group. The election is binding on all other affected members of the group (including members that join the group after the election is made with respect to contracts adjusted after joining). If a member subsequently leaves the group, the election remains binding as to that member unless the Commissioner consents to a revocation of the election. If a corporation that has made the election joins a consolidated group that has not made the election, the election is treated as revoked with respect to contracts adjusted after joining.

(3) *Examples.* The operation of this delayed reapplication method is illustrated by the following examples:

Example 1. X completes a contract in 1987, and applies the look-back method when its return for 1987 is filed. X properly uses \$600,000 as the actual contract price in applying the look-back method. In 1990, as a result of the settlement of a dispute with its customer, X redetermines total contract price to be \$640,000, and includes \$40,000 in gross income. On its return for 1990, X states it is electing the delayed reapplication method. X is not required to reapply the look-back method at that time, because \$40,000 does not exceed the lesser of \$1,000,000 or 10 percent of the unadjusted contract price of \$600,000, and

5 years have not passed since the last application of the look-back method.

Example 2. Assume the same facts as in Example 1, except that at the end of 1992, the fifth year after completion of the contract, no other adjustments to contract price or contract costs have occurred. X is required to reapply the look-back method in 1992 and, accordingly, redetermine its tax liability for each redetermination year. After redetermining the underpayment of tax for those years, X must compute the amount of interest charged on the underpayments. Although 1992 is the filing year, interest is due on the amount of each underpayment resulting from the adjustment only from the due date of the return for each redetermination year to the due date of the return for 1990 because the tax liability for the adjustment was fully paid in 1990. However, from the due of the 1990 return until the due date of the 1992 return, when the look-back method is reapplied for the adjustment, interest is due on the amount of interest attributable to the underpayments.

(f) *Look-back reporting—(1) Procedure.* The amount of any interest due from, or payable to, a taxpayer as a result of applying the look-back method is computed on Form 8697 for any filing year. In general, the look-back method is applied by the taxpayer that reports income from a long-term contract. See paragraph (g) of this section to determine who is responsible for applying the look-back method when, prior to the completion of a long-term contract, there is a transaction that changes the taxpayer that reports income from the contract.

(2) *Treatment of interest on return—(i) General rule.* The amount of interest required to be paid by a taxpayer is treated as an income tax under subtitle A, but only for purposes of subtitle F of the Code (other than sections 6654 and 6655), which addresses tax procedures and administration. Thus, a taxpayer that fails to pay the amount of interest due is subject to any applicable penalties under subtitle F, including, for example, an underpayment penalty under section 6651, and the taxpayer also is liable for underpayment interest under section 6601. However, interest required to be paid under the look-back method is treated as interest expense for purposes of computing taxable income under subtitle A, even though it is treated as income tax liability for subtitle F purposes. Interest received under the look-back method is treated

as taxable interest income for all purposes, and is not treated as a reduction in tax liability or a tax refund. The determination of whether or not interest computed under the look-back method is treated as tax is determined on a “net” basis for each filing year. Thus, if a taxpayer computes for the current filing year both hypothetical overpayments and hypothetical underpayments for prior years, the taxpayer has an increase in tax only if the interest computed on the underpayments for all those prior years exceeds the interest computed on the overpayments for all those prior years, for all contracts completed or adjusted for the year.

(ii) *Timing of look-back interest.* For purposes of determining taxable income under subtitle A of the Code, any amount of interest payable to the taxpayer under the look-back method is includible in gross income as interest income in the tax year it is properly taken into account under the taxpayer’s method of accounting for interest income. Any amount of interest required to be paid is taken into account as interest expense arising from an underpayment of income tax in the tax year it is properly taken into account under the taxpayer’s method of accounting for interest expense. Thus, look-back interest required to be paid by an individual, or by a pass-through entity on behalf of an individual owner (or beneficiary) under the simplified marginal impact method, is personal interest and, therefore, is disallowed in accordance with §1.163-9T(b)(2). Interest determined at the entity level under the simplified marginal impact method is allocated among the owners (or beneficiaries) for reporting purposes in the same manner that interest income and interest expense are allocated to owners (or beneficiaries) and subject to the requirements of section 704 and any other applicable rules.

(3) *Statute of limitations and compounding of interest on look-back interest.* For guidance on the statute of limitations applicable to the assessment and collection of look-back interest owed by a taxpayer, see sections 6501 and 6502. A taxpayer’s claim for credit or refund of look-back interest previously paid by or collected from a taxpayer is a claim for credit or refund

of an overpayment of tax and is subject to the statute of limitations provided in section 6511. A taxpayer’s claim for look-back interest (or interest payable on look-back interest) that is not attributable to an amount previously paid by or collected from a taxpayer is a general, non-tax claim against the federal government. For guidance on the statute of limitations that applies to general, non-tax claims against the federal government, see 28 U.S.C. sections 2401 and 2501. For guidance applicable to the compounding of interest when the look-back interest is not paid, see sections 6601 to 6622.

(g) *Mid-contract change in taxpayer—*

(1) *In general.* The rules in this paragraph (g) apply if, as described in §1.460-4(k), prior to the completion of a long-term contract accounted for using the PCM or the PCCM by a taxpayer (old taxpayer), there is a transaction that makes another taxpayer (new taxpayer) responsible for accounting for income from the same contract. The rules governing constructive completion transactions are provided in paragraph (g)(2) of this section, while the rules governing step-in-the-shoes transactions are provided in paragraph (g)(3) of this section. For purposes of this paragraph, pre-transaction years are all taxable years of the old taxpayer in which the old taxpayer accounted for (or should have accounted for) gross receipts from the contract, and post-transaction years are all taxable years of the new taxpayer in which the new taxpayer accounted for (or should have accounted for) gross receipts from the contract.

(2) *Constructive completion transactions.* In the case of a transaction described in §1.460-4(k)(2)(i) (constructive completion transaction), the look-back method is applied by the old taxpayer with respect to pre-transaction years upon the date of the transaction and, if the new taxpayer uses the PCM or the PCCM to account for the contract, by the new taxpayer with respect to post-transaction years upon completion of the contract. The contract price and allocable contract costs to be taken into account by the old taxpayer or the new taxpayer in applying the look-back method are described in §1.460-4(k)(2).

(3) *Step-in-the-shoes transactions*—(i) *General rules.* In the case of a transaction described in § 1.460-4(k)(3)(i) (step-in-the-shoes transaction), the look-back method is not applied at the time of the transaction, but is instead applied for the first time when the contract is completed by the new taxpayer. Upon completion of the contract, the look-back method is applied by the new taxpayer with respect to both pre-transaction years and post-transaction years, taking into account all amounts reasonably expected to be received by either the old or new taxpayer and all allocable contract costs incurred during both periods as described in § 1.460-4(k)(3). The new taxpayer is liable for filing the Form 8697 and for interest computed on hypothetical underpayments of tax, and is entitled to receive interest with respect to hypothetical overpayments of tax, for both pre- and post-transaction years. The old taxpayer will be secondarily liable for any interest required to be paid with respect to pre-transaction years reduced by any interest on pre-transaction overpayments.

(ii) *Application of look-back method to pre-transaction period*—(A) *Contract price.* The actual contract price for pre-transaction taxable years must be determined by the new taxpayer without regard to any contract price adjustment described in paragraph (k)(3)(iv)(B)(1) of this section.

(B) *Method.* The new taxpayer may apply the look-back method to each pre-transaction taxable year that is a redetermination year using the simplified marginal impact method described in paragraph (d) of this section (regardless of whether or not the old taxpayer would have actually used that method and without regard to the tax liability ceiling). But see paragraph (d)(4) of this section, which requires use of the simplified marginal impact method by certain pass-through entities.

(C) *Interest accrual period.* With respect to any hypothetical underpayment or overpayment of tax for a pre-transaction taxable year, interest accrues from the due date of the old taxpayer's tax return (not including extensions) for the taxable year of the underpayment or overpayment until

the due date of the new taxpayer's return (not including extensions) for the completion year or the year of a post-completion adjustment, whichever is applicable.

(D) *Information old taxpayer must provide*—(1) *In general.* Except as provided in paragraph (g)(3)(ii)(D)(2) of this section, in order to help the new taxpayer to apply the look-back method with respect to pre-transaction taxable years, any old taxpayer that accounted for income from a long-term contract under the PCM or PCCM for either regular or alternative minimum tax purposes is required to provide the information described in this paragraph to the new taxpayer by the due date (not including extensions) of the old taxpayer's income tax return for the first taxable year ending on or after a step-in-the-shoes transaction described in § 1.460-4(k)(3)(i). The required information is as follows—

(i) The portion of the contract reported by the old taxpayer under PCM for regular and alternative minimum tax purposes (*i.e.*, whether the old taxpayer used PCM, the 40/60 PCCM method, or the 70/30 PCCM method);

(ii) Any submethods used in the application of PCM (*e.g.*, the simplified cost-to-cost method or the 10-percent method);

(iii) The amount of total contract price reported by year;

(iv) The numerator and the denominator of the completion factor by year;

(v) The due date (not including extensions) of the old taxpayer's income tax returns for each taxable year in which income was required to be reported;

(vi) Whether the old taxpayer was a corporate or a noncorporate taxpayer by year; and

(vii) Any other information required by the Commissioner by administrative pronouncement.

(2) *Special rules for certain pass-through entity transactions.* For purposes of paragraph (g)(3)(ii)(D)(1) of this section, in the case of a transaction described in § 1.460-4(k)(3)(i)(I), the contributing partner is treated as the old taxpayer, and the partnership is treated as the new taxpayer. In the case of transactions described in § 1.460-4(k)(3)(i)(F), (G), (J), (K), or (L), the old taxpayer is not required to provide the

information described in paragraph (g)(3)(ii)(D)(1) of this section, because information necessary for the new taxpayer to apply the look-back method is provided by the pass-through entity. This paragraph (g)(3)(ii)(D) is applicable for transactions on or after August 6, 2003.

(iii) *Application of look-back method to post-transaction years.* With respect to post-transaction taxable years, the new taxpayer must use the same look-back method it uses for other contacts (i.e., the simplified marginal impact method or the actual method) to determine the amount of any hypothetical overpayment or underpayment of tax and the time period for computing interest on these amounts.

(iv) *S corporation elections.* Following the conversion of a C corporation into an S corporation, the look-back method is applied at the entity level with respect to contracts entered into prior to the conversion, notwithstanding section 460(b)(4)(B)(i).

(4) *Effective date.* Except as provided in paragraph (g)(3)(ii)(D) of this section, this paragraph (g) is applicable for transactions on or after May 15, 2002.

(h) *Examples—(1) Overview.* This paragraph provides computational examples of the rules of this section. Except as otherwise noted, the examples involve calendar-year taxpayers and involve long-term contracts subject to section 460 that are accounted for using the percentage of completion method, rather than the percentage of completion-capitalized cost method. If the percentage of completion-capitalized cost method were used by a taxpayer described in the examples, the amounts of contract income and expenses shown in the examples would be reduced, for purposes of determining regular taxable income, to the appropriate fraction (40, 70, or 90 percent) of contract items accounted for under the percentage of completion method. Tens of thousands of dollars (\$ 00,000's) are omitted from the figures in the examples. The contracts described in the examples are assumed to be the taxpayers' only contracts that are subject to the look-back method of section 460. Except as otherwise stated, the examples assume that the taxpayer has no

adjustments and preferences for purposes of section 55, so that alternative minimum taxable income is the same as taxable income, and no alternative minimum tax is imposed for the years involved. The examples assume that the taxpayer does not elect the 10-percent method, the simplified marginal impact method, or the delayed re-application method.

(2) *Step One.* The following example illustrates the application of paragraph (c)(2):

Example 1. In 1989, W completes three long-term contracts, A, B, and C, entered into on January 1 of 1986, 1987, and 1988, respectively. For Contract A, W used the completed contract method of accounting. For Contract B, W used the percentage of completion-capitalized cost method of accounting, taking into account 60 percent of contract income under W's normal method of accounting, which was the completed contract method. For Contract C, W used the percentage of completion method of accounting. The total price for each contract was \$1,000. In computing alternative minimum taxable income, W is required to use the percentage of completion method for Contracts B and C. W used regular tax costs for purposes of determining the degree of contract completion under the alternative minimum tax.

Contract A is not taken into account for purposes of applying the look-back method, because it is subject to neither section 460 nor section 56(a)(3). Thus, even if W had used the percentage of completion method as permitted under §1.451-3, instead of the completed contract method, the look-back method would not be applicable because the Contract A was entered into before the effective date of section 460.

The actual costs allocated to Contracts B and C under section 460(c) and incurred in each year of the contract were as follows:

Contract	1987	1988	1989	Total
B	\$200	\$400	\$200	\$800
C	100	300	400	800

In applying the look-back method, the first step is to allocate the contract price among tax years preceding and including the completion year. That allocation would produce the following amounts of gross income for purposes of the regular tax. Note that no income from Contract C is allocated to 1987, the year before the contract was entered into, even though contract costs were incurred in 1987:

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Contract	1987	1988	1989
B	\$100 (40%X\$200/\$800X\$1000)	\$200 ((40%X\$600/\$800X\$1000)-\$100)	\$700
C	0	500 (\$400/\$800X\$1000)	500

Because the percentage of completion-capitalized cost method may not be used for alternative minimum tax purposes, the allocation of contract income would produce the

following amounts of gross income for purposes of computing alternative minimum taxable income:

Contract	1987	1988	1989
B	\$250 (\$200/\$800X\$1000)	\$500 ((\$600/\$800X\$1000)-\$250)	\$250
C	0	500	500

(3) *Step Two.* The following example illustrates the application of paragraph (c)(3):

Example 2. (i) X enters into two long-term contracts (D and E) in 1988. X determines its tax liability for 1988 as follows:

e=estimate
a=amount originally reported (actual)
h=hypothetical

	1988		Total
	D	E	
1988 contract costs	\$3,000a	\$2,000a	.....
Total contract costs	8,000e	8,000e	.....
Total contract price	10,000e	10,000e	.....
1988 completion %	37.5e	25e	.....
1988 gross income	3,750a	2,500a	.....
Less, 1988 costs	(3,000a)	(2,000a)	.....
1988 net contract income	750a	500a	\$1,250a
Other 1988 net income (loss) .....	.....	.....	(2,000a)
Taxable income (NOL) .....	.....	.....	(750a)
Tax .....	.....	.....	0a
Refund from NOL carryback fully absorbed in 1985, at 46% .....	.....	.....	345a

(ii) X completes Contract D during 1989. X determines its taxable income for 1989 as follows:

	1989		Total
	D	E	
1989 contract costs	\$3,000a	0a	.....
Total contract costs	6,000a	\$9,000e	.....
Total contract price	10,000a	10,000e	.....
1989 completion %	100a	22.2e	.....
1989 gross income/(loss)	6,250a	(278a)	.....
Less, 1989 costs	(3,000a)	0a	.....
1989 net contract income	3,250a	(278a)	\$2,972a
Other 1989 net income (loss)	0a
Taxable income (NOL)	2,972a
Tax at 34%	1,011a

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(iii) For purposes of the look-back method, X must reallocate the actual total contract D price between 1988 and 1989 based on the actual total contract D costs. This results in the following hypothetical underpayment of tax for 1988 for purposes of the look-back method. Note that X does not reallocate the

contract E price in applying the look-back method in 1989 because contract E has not been completed, even though X's estimate of contract E costs has changed. The following computation is only for purposes of applying the look-back method, and does not result in the assessment of a tax deficiency.

	1988		Total
	D	E	
1988 contract costs	\$3,000a	\$2,000a	.....
Total contract costs	6,000a	8,000e	.....
Total contract price	10,000a	10,000e	.....
1988 completion %	50a	25e	.....
1988 gross income	5,000h	2,500a	.....
Less, 1988 costs	(3,000a)	(2,000a)	.....
1988 net contract income	2,000h	500a	\$2,500h
Other 1988 net income (loss) .....	.....	.....	(2,000a)
Taxable income (NOL) .....	.....	.....	500h
Tax at 34% .....	.....	.....	170h
Less, previously computed tax .....	.....	.....	- 0a
Underpayment of 1988 tax .....	.....	.....	170h
Underpayment of 1985 tax from NOL carryback refund in 1988 .....	.....	.....	345h
Total underpayment of tax .....	.....	.....	515h

For purposes of any subsequent application of the look-back method for which 1989 is a redetermination year, because the reallocation of contract income and redetermination of tax liability are cumulative, X will use for 1989 the amount of contract D income and the amount of tax liability that would have been reported in 1989 if X had used actual

contract costs instead of the amounts that were originally reported using the estimate of \$8,000. Assuming no subsequent revisions (due to, for example, adjustments to contract D price and costs determined after the end of 1989), this amount would be determined as follows:

	1989		Total
	D	E	
1989 contract costs	\$3,000a	0a	.....
Total contract costs	6,000a	\$9,000e	.....
Total contract price	10,000a	10,000e	.....
1989 completion %	100a	22.2e	.....
1989 gross income	5,000h	(278a)	.....
Less, 1989 costs	(3,000a)	0a	.....
1989 net contract income	2,000h	(278a)	\$1,722h
Other 1989 net income (loss) .....	.....	.....	0a
Taxable income (NOL) .....	.....	.....	1,722h
Tax at 34% .....	.....	.....	585h

(iv) X completes contract E during 1990. X determines its taxable income for 1990 as follows:

	1990		Total
	D	E	
1990 contract costs	\$7,000a	.....
Total contract costs	9,000a	.....
Total contract price	10,000a
1990 completion %	100a
1990 gross income	7,778a

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	1990		Total
	D	E	
Less, 1990 costs		(7,000a)	
1990 net contract income		778a	\$778a
Other 1990 net income (loss)			0a
Taxable income (NOL)			778a
Tax at 34%			265a

(v) For purposes of the look-back method, X must reallocate the actual total contract E price between the 1988, 1989, and 1990, based on the actual total contract E costs.

This results in the following hypothetical overpayment of tax for 1988. Note that X uses the amount of income for contract D determined in the last previous application of the look-back method, and not the amount of income actually reported:

	1988		Total
	D	E	
1988 contract costs	\$3,000a	\$2,000a	
Total contract costs	\$6,000a	\$9,000a	
Total contract price	\$10,000a	\$10,000a	
1988 completion (%)	50a	22.2a	
1988 gross income	\$5,000h	\$2,222h	
Less, 1988 costs	(\$3,000a)	(\$2,000a)	
1988 net contract income	\$2,000h	\$222h	\$2,222h
Other 1988 net income (loss)			(\$2,000a)
Taxable income (NOL)			\$222h
Tax at 34%			\$75h
Less, previously computed tax (based on most recent application of the look-back method)			\$170h
Overpayment of 1988 tax			(\$95h)

In applying the look-back method to 1989, X again uses the amounts substituted as of the last previous application of the look-

back method with respect to contract D. Thus, X computes its hypothetical underpayment for 1989 as follows:

	1989		Total
	D	E	
1989 contract costs	\$3,000a	0a	
Total contract costs	\$6,000a	\$9,000a	
Total contract price	\$10,000a	\$10,000a	
1989 completion (%)	100a	22.2a	
1989 gross income	\$5,000h	\$0h	
Less, 1989 costs	(\$3,000a)	(\$0a)	
1989 net contract income	\$2,000h	0a	\$2,000h
Other 1989 net income (loss)			(\$0a)
Taxable income (NOL)			\$2,000h
Tax at 34%			\$680h
Less, previously computed tax			\$585h
Underpayment of 1989 tax			\$95h

For purposes of any subsequent application of the look-back method for which 1990 is a redetermination year, X will use for 1990 the amount of Contract E income, and the

amount of tax liability, that was originally reported in 1990 because X's estimate of the total contract costs from \$8,000 to \$9,000 did not change after 1989. Without regard to any

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subsequent revisions, these amounts are the same as in the table in paragraph (h)(3)(iv) above.

(4) *Post-completion adjustments.* The following example illustrates the application of paragraph (c)(1)(ii):

Example 3. The facts are the same as in Example 2. In 1991, X settles a lawsuit against its customer in Contract E. The customer pays X an additional \$3,000, without interest, in 1991. Applying the Federal mid-term rate then in effect, this \$3,000 has a discounted value at the time of contract completion in 1990 of \$2,700. X is required to apply the look-back method for 1991 even though no contract was completed in 1991. X must include the full \$3,000 adjustment (which was not previously includible in total contract price)

in gross income for 1991. X does not elect not to discount adjustments to the contract price or costs. Thus, X adjusts the contract price by the discounted amount of the adjustment and, therefore, uses \$12,700 (not \$13,000) for total Contract E price, rather than \$10,000, which was used when the look-back method was first applied with respect to Contract E.

For purposes of the look-back method, X must allocate the revised total Contract E price of \$12,700 between 1988, 1989 and 1990 based on the actual total Contract E costs, and compare the resulting revised tax liability with the tax liability determined for the last previous application of the look-back method involving those years. This results in the following hypothetical underpayments of tax for purposes of the look-back method:
r=revised

	1988		Total
	D	E	
1988 contract costs	\$3,000a	\$2,000a	.....
Total contract costs	\$6,000a	\$9,000a	.....
Total contract price	\$10,000a	\$12,700r	.....
1988 completion (%)	50a	22.2a	.....
1988 gross income	\$5,000h	\$2,822rh	.....
Less, 1988 costs	(\$3,000a)	(\$2,000a)	.....
1988 net contract income	\$2,000h	822rh	\$2,222rh
Other 1988 net income (loss)			(\$2,000a)
Taxable income			\$822rh
Tax at 34%			\$279rh
Less, previously computed tax			\$75h
Underpayment of 1988 tax			\$204rh

No Contract E costs were incurred in 1989, and there is no hypothetical underpayment for 1989.

	1990		
	D	E	Total
1990 contract costs		\$7,000a	.....
Total contract costs		\$9,000a	.....
Total contract price		\$12,700r	.....
1990 completion (%)		100a	.....
1990 gross income		\$9,878rh	.....
Less 1990 costs		(\$7,000a)	.....
1990 net contract income		\$2,878rh	\$2,878rh
Other 1990 net income (loss)			0a
Taxable income (NOL)			\$2,878rh
Tax at 34%			\$978rh
Less, previously computed tax			\$265h
Underpayment of 1990 tax			\$713rh

In 1992, X incurs an additional cost of \$1,000 allocable to the contract, which was not previously includible in total contract costs. Applying the Federal mid-term rate then in

effect, the \$1,000 has a discounted value at the time of contract completion of \$800. X deducts this additional \$1,000 in expenses in 1992. Based on this increase to contract

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costs, X reapplies the look-back method, and determines the following hypothetical un-

derpayments for 1988, 1989 and 1990 for purposes of the look-back method:

	1988		Total
	D	E	
1988 contract costs	\$3,000a	\$2,000a	.....
Total contract costs	\$6,000a	\$9,800r	.....
Total contract price	\$10,000a	\$12,700r	.....
1988 completion (%)	50a	20.4r	.....
1988 gross income	\$5,000h	\$2,592rh	.....
Less, 1988 costs	(\$3,000a)	(\$2,000a)	.....
1988 net contract income	\$2,000h	592rh	\$2,592rh
Other 1988 net income (loss)			(\$2,000a)
Taxable income (NOL)			\$592rh
Tax at 34%			\$201rh
Less, previously computed tax			\$279rh
Overpayment of 1988 tax			(\$78rh)

No Contract E costs were incurred in 1989, and there is no hypothetical underpayment for 1989.

	1990		Total
	D	E	
1990 contract costs			\$7,000a
Total contract costs		9,800r	.....
Total contract price		12,700r	.....
1990 completion (%)		92a	.....
1990 gross income		9,071rh	.....
Less, 1990 costs		(7,000a)	.....
1990 Net contract income		2,071rh	\$2,071rh
Other 1990 net income (loss)			0a
Taxable income (NOL)			2,071rh
Tax at 34%			704rh
Less, previously computed tax			978rh
Overpayment of 1990 tax			(274rh)

(5) *Alternative minimum tax.* The operation of the look-back method in the case of a taxpayer liable for the alternative minimum tax as provided in paragraph (c)(3)(vi) is illustrated by the following examples:

Example 4. Y enters into a long-term contract in 1988 that is completed in 1989. Y used regular tax costs for purposes of determining the degree of contract completion under the alternative minimum tax.

(i) Y determines its tax liability for 1988 as follows:

1988 contract costs	\$4,000a
Total contract costs	\$8,000e
Total contract price	\$20,000e
1988 completion (%)	50e
1988 gross income	\$10,000a
Less, 1988 contract costs	(\$4,000a)
1988 net contract income	\$6,000a

Other 1988 net income/(loss)	(\$3,400a)
Taxable income	\$2,600a
Regular tax at 34%	884a
Adjustments and preferences to produce alternative minimum taxable income	\$600a
Alternative minimum taxable income	\$3,200a
Tentative minimum tax at 20%	640a
Tax liability	\$884a

In 1989, Y determines the following amounts:

1989 contract costs	\$6,000a
Total contract costs	\$10,000a
Total contract price	\$20,000a

(ii) For purposes of applying the look-back method, Y redetermines its tax liability for 1988, which results in a hypothetical overpayment of tax. This hypothetical overpayment is determined by comparing Y's original regular tax liability for 1988 with the hypothetical total tax liability (including alternative minimum tax liability) for that

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year because Y would have paid the alternative minimum tax if Y had used its actual contract costs to report income:

1988 contract costs	\$4,000a
Total contract costs	\$10,000a
Total contract price	\$20,000a
1988 completion(%)	40a
1988 gross income	\$8,000h
less, 1988 contract costs	(\$4,000a)
1988 net contract income	\$4,000h
Other 1988 net income/(loss)	(\$3,400a)
Taxable income	\$600h
Regular tax at 34%	\$204h
Adjustments and preferences to produce alternative minimum taxable income	\$600a
Alternative minimum taxable income	\$1,200h
Tentative minimum tax at 20%	240h
Alternative minimum tax	\$36h
Total tax liability	\$240h
Less, previously computed tax	\$884a
Underpayment/(overpayment)	(\$644h)

(6) *Credit carryovers.* The operation of the look-back method in the case of credit carryovers as provided in paragraph (c)(3)(v) is illustrated by the following example:

Example 5. Z enters into a contract in 1986 that is completed in 1987. Z determines its tax liability for 1986 as follows:

1986 contract costs	\$400a
Total contract costs	\$1,000e
Total contract price	\$2,000e
1986 completion (%)	40e
1986 gross income	\$800a
Less, 1986 costs	(\$400a)
1986 net contract income	\$400a
Other 1986 net income	\$0a
Taxable income	\$400a
Tax at 46%	\$184a
Unused tax credits carried forward from 1985 allowable in 1986	\$350a
Net tax due	\$0a

Z determines the following amounts for 1987:

1987 contract costs	\$400a
Total contract price	\$2,000a
Total contract costs	\$800a

If Z had used actual rather than estimated contract costs in determining gross income for 1986, Z would have reported tax liability of \$276 (46%x\$600) rather than \$184. However, Z would have paid no additional tax for 1986 because its unused tax credits carried forward from 1985 would have been sufficient to offset this increased tax liability. Therefore, there is no hypothetical underpayment for 1986 for purposes of the look-back method. However, this hypothetical earlier use of the credit may increase the hypothetical tax liability for 1987 (or another subsequent year) for purposes of subsequent applications of the look-back method.

(7) *Net operating losses.* The operation of the look-back method in the case of net operating loss ("NOL") carryovers as provided in paragraph (c)(3)(v) is illustrated by the following example:

Example 6. A entered into a long-term contract in 1986, which was completed in 1987. A determined its tax liability for 1986 as follows:

1986 contract costs	\$400a
Total contract costs	\$1,000e
Total contract price	\$2,000e
1986 completion (%)	40e
1986 gross income	\$800a
Less, 1986 costs	(\$400a)
1986 net contract income	\$400a
Other 1986 net income/(loss)	(\$1,000a)
Taxable income/(NOL)	(\$600a)
Tax	\$0a

A elected to carry this loss forward to 1987 pursuant to section 172(b)(3)(C).

For 1987, A determined the following amounts:

1987 contract costs	\$400a
Total contract costs	\$800a
Total contract price	\$2,000a

If actual rather than estimated contract costs had been used in determining gross income for 1986, A would have reported \$1,000 of gross income from the contract rather than \$800, and thus would have reported a loss of \$400 rather than \$600. However, since A would have paid no tax for 1986 regardless of whether actual or estimated contract costs had been used, A does not have an underpayment for 1986 for purposes of the look-back method. If A had, instead, carried back the 1986 NOL, and this NOL had been absorbed in the tax years 1983 through 1985, it would have resulted in refunds of tax for those years in 1986. When A applies the look-back method, a hypothetical underpayment of tax would have resulted for those years due to a hypothetical reduction in the amount that would have been refunded if income had been reported on the basis of actual contract costs. See Example 2(iii).

(8) *Alternative minimum tax credit.* The following example illustrates the application of the look-back method if affected by the alternative minimum tax credit as provided in paragraph (c)(3)(vi):

(i) Example 4, above illustrates that the reallocation of contract income under the look-back method can result in a hypothetical underpayment or overpayment determined using the alternative minimum tax rate, even though the taxpayer actually paid only the regular tax for that year. However, application of the look-back method had no effect on the difference between the amount of alternative minimum taxable income and the amount of regular taxable income taken into account in that year because the taxpayer was

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required to use the percentage of completion method for both regular and alternative minimum tax purposes and used the same version of the percentage of completion method for both regular and alternative minimum tax purposes (*i.e.*, the taxpayer had made an election to use regular tax costs in determining the percentage of completion for purposes of computing alternative minimum taxable income).

(ii) The following example illustrates the application of the look-back method in the case of a taxpayer that does not use the percentage of completion method of accounting for long-term contracts in computing taxable income for regular tax purposes and thus must make an adjustment to taxable income to determine alternative minimum taxable income. The example also shows how interest is computed under the look-back method when the taxpayer is entitled to a credit under section 53 for minimum tax paid because of this adjustment.

Example 7. X is a taxpayer engaged in the construction of real property under contracts that are completed within a 24-month period and whose average annual gross receipts do not exceed \$10,000,000. As permitted by section 460(e)(1)(B), X uses the completed contract method (“CCM”) for regular tax purposes. However, X is engaged in the construction of commercial real property and, therefore, is required to use the percentage of completion method (“PCM”) for alternative minimum tax (“AMT”) purposes.

Assume that for 1988, 1989, and 1990, X has only one long-term contract, which is entered into in 1988 and completed in 1990. Assume further that X estimates gross income from the contract to be \$2,000, total contract costs to be \$1,000, and that the contract is 25 percent complete in 1988 and 75 percent complete in 1989. In 1990, the year of completion, the percentage of completion does not change but, upon completion, gross income from the contract is actually \$3,000, instead of \$2,000, and costs are actually \$1,000.

For 1988, 1989, and 1990, X’s income and tax liability using estimated contract price and costs are as follows:

Estimates	1988	1989	1990
Regular tax:			
Long-term:			
Contract-CCM	0	0	\$2,000
Other Income	0	\$5,000	0
Total Income	0	\$5,000	\$2,000
Tax @ 34%	0	\$1,700	\$680
AMT			
Gross Income	\$500	\$1,000	\$1,500
Deductions	\$(250)	\$(500)	\$(250)
Total long-term:			
Contract-PCM	\$250	\$500	\$1,250
Other Income	0	\$5,000	0
Total Income	\$250	\$5,500	\$1,250
Tax @ 20%	\$50	\$1,100	\$250
Tentative Minimum Tax	\$50	\$1,100	\$250
Regular Tax	0	\$1,700	\$680
Minimum Tax Credit	0	\$(50)	0
Net Tax Liability	\$50	\$1,650	\$680

When X files its tax return for 1990, X applies the look-back method to the contract. For 1988, 1989, and 1990, X’s income and tax

liability using actual contract price and costs are as follows:

Actual	1988	1989	1990
Regular tax:			
Long-term:			
Contract-CCM	0	0	\$2,000
Other Income	0	\$5,000	0
Total Income	0	\$5,000	\$2,000
Tax @ 34%	0	\$1,700	\$680
AMT			
Gross Income	\$750	\$1,500	\$750
Deductions	\$(250)	\$(500)	\$(250)
Total long-term:			
Contract-PCM	\$500	\$1,000	\$500
Other Income	0	\$5,000	0

Actual	1988	1989	1990
Total Income	\$500	\$6,000	\$500
Tax @ 20%	\$100	\$1,200	\$100
Tentative Minimum Tax	\$100	\$1,200	\$100
Regular Tax	0	\$1,700	\$680
Minimum Tax Credit	0	\$(100)	0
Net Tax Liability	\$100	\$1,600	\$680
Underpayment	\$50		
Overpayment		\$50	

As shown above, application of the look-back method results in a hypothetical underpayment of \$50 for 1988 because X was subject to the alternative minimum tax for that year. Interest is charged to X on this \$50 underpayment from the due date of X's 1988 return until the due date of X's 1990 return.

In 1989, although X was required to compute alternative minimum taxable income using the percentage of completion method, X was not required to pay alternative minimum tax. Nevertheless, the look-back method must be applied to 1989 because use of actual rather than estimated contract price in computing alternative minimum taxable income for 1988 would have changed the amount of the alternative minimum tax credit carried to 1989. Interest is paid to X on the resulting \$50 overpayment from the due date of X's 1989 return until the due date of X's 1990 return.

(9) *Period for interest.* The following Examples (8) through (11) illustrate how to determine the period for computing interest as provided in paragraph (c)(4):

Example 8. The facts are the same as in Example 6, except that the contract is completed in 1988, and A determined the following amounts for 1987 and 1988:

For 1987:	
1987 contract costs	0
Total contract costs	\$1,000e
Total contract price	\$2,000e
1987 completion (%)	\$40e
1987 gross income	0a
Less, 1987 costs	0a
Other 1987 net income	\$600a
Net operating loss carryforward from 1986 ..	\$(600a)
Taxable income	0a
Tax	0a
For 1988:	
1988 contract costs	\$400a
Total contract costs	\$800a
Total contract price	\$2,000a

If actual rather than estimated contract costs had been used in determining gross income for 1986, A would have reported \$1,000 of gross income from the contract for 1986 rather than \$800, and would have reported a net operating loss carryforward to 1987 of \$400 rather than \$600. Therefore, A would have reported taxable income of \$200, and would have paid tax of \$80 (i.e., \$200×40%) for 1987. The due date for filing A's Federal income

tax return for its 1988 taxable year is March 15. A obtains an extension and files its 1988 return on September 15, 1989. Under the look-back method, A is required to pay interest on the amount of this hypothetical underpayment (\$80) computed from the due date (determined without regard to extensions) for A's return for 1987 (not 1986, even though 1986 was the year in which the net operating loss arose) until March 15 (not September 15), the due date (without regard to extensions) of A's return for 1988. A is required to pay additional interest from March 15 until September 15 on the amount of interest outstanding as of March 15 with respect to the hypothetical underpayment of \$80.

Example 9. The facts are the same as in Example 6, except that A carries the net operating loss of \$600 back to 1983 rather than forward to 1987, and receives a refund of \$276 (\$600 reduction in 1983 taxable income × 46% rate in effect in 1983). As in Example 6, if actual contract costs had been used, A would have reported a loss for 1986 of \$400 rather than \$600. Thus, A would have received a refund of 1983 tax of \$184 (\$400×46%) rather than \$276. Under the look-back method A is required to pay interest on the difference in these two amounts (\$92) computed from the due date (determined without regard to extensions) of A's return for 1986 (the year in which the carryback arose rather than 1983, the year in which it was used) until the due date of A's return for 1988.

Example 10. B enters into a long-term contract in 1986 that is completed in 1988. B determines its 1986 tax liability as follows:

1986 contract costs	\$400a
Total contract costs	\$1,000e
Total contract price	\$2,000e
1986 completion (%)	40e
1986 gross income	\$800a
Less, 1986 costs	(\$400a)
1986 net contract income	\$400a
Other 1986 net income	\$2,000a
Taxable income	\$2,400a
Tax at 46%	\$1,104a
B determines its tax liability for 1987 as follows:	
1987 contract costs	\$400a
Total contract costs	\$1,600e
Total contract price	\$2,000e
1987 completion (%)	50e
1987 gross income	\$200a
(=50%×\$2,000) - \$800 previously reported) less,	
1987 costs	(\$400a)
1987 net contract income	(\$200a)
Other 1987 net income/(loss)	(\$2,200a)
Taxable income (NOL)	(\$2,400a)

Tax 0a

Assume that B had no taxable income in either 1984 or 1985, so that the entire amount of the \$2,400 net operating loss is carried back to 1986, and B receives a refund, with interest from the due date of B's 1987 return, of the entire \$1,104 in tax that it paid for 1986.

In 1988, B determines the following amounts:

1988 contract costs	\$800a
Total contract costs	\$1,600a
Total contract price	\$2,000a

If B had used actual contract costs rather than estimated costs in determining its gross income for 1986, B would have had gross income from the contract of \$500 rather than \$800, and thus would have had taxable income of \$2,100 rather than \$2,400, and would have paid tax of \$966 rather than \$1,104. B is entitled to receive interest on the difference between these two amounts, the hypothetical overpayment of tax of \$138. Interest is computed from the due date (without regard to extensions) of B's return for 1986 until the due date for B's return for 1987. Interest stops running at this date, because B's hypothetical overpayment of tax ended when B filed its original 1987 return and received a refund for the carryback to 1986, and interest on this refund began to run only from the due date of B's 1987 return. See section 6611(f).

Example 11. C enters into a long-term contract in 1986, its first year in business, which is completed in 1988. C determines its tax liability for 1986 as follows:

1986 contract costs	\$400a
Total contract costs	\$1,000e
Total contract price	\$2,000e
1986 completion (%)	40e
1986 gross income	\$800a
less, 1986 costs	(\$400a)
1986 net contract income	\$400a
Other 1986 net income	\$2,000a
Taxable income (NOL)	\$2,400a
Tax at 46%	\$1,104a

C determines its tax liability for 1987 as follows:

1987 contract costs	\$400a
Total contract costs	\$1,066e
Total contract price	\$2,000e
1987 completion (%)	75e
1987 gross income	\$700a
Less, 1987 costs	(\$400a)
1987 net contract income	\$300a
Other 1987 net income	(\$2,450a)
Taxable income (NOL)	(\$2,150a)
Tax	\$10a

C carries back the net operating loss to 1986, and files an amended return for 1986, showing taxable income of \$250, and receives a refund of \$989 (46%×\$2,150). Interest on this refund begins to run only as of the due date of C's 1987 return. See section 6611(f).

In 1988, when the contract is completed, C determines the following amounts:

1988 contract costs	\$800a
Total contract costs	\$1,600a
Total contract price	\$2,000a

If C had used actual contract price and contract costs in determining gross income for 1986, it would have reported gross income from the contract of \$500 rather than \$800, taxable income of \$2,100 rather than \$2,400, and tax liability of \$966 rather than \$1,104.

If C had used actual contract price and contract costs in determining gross income for 1987, it would have reported gross income from the contract of \$500 rather than \$700, and would have reported a net operating loss of \$2,350, rather than \$2,150, which would have been carried back to 1986.

Under the look-back method, C receives interest with respect to a total 1986 hypothetical overpayment of \$138 (\$1,104 minus \$966). C is credited with interest on \$23 of this amount only from the due date of C's 1986 return until the due date of C's 1987 tax return, because this portion of C's total hypothetical overpayment for 1986 was refunded to C with interest computed from the due date of C's 1987 return and, therefore, was no longer held by the government. However, because the remainder of the total hypothetical overpayment of \$115 was not refunded to C, C is credited with interest on this amount from the due date of C's 1986 return until the due date of C's 1988 tax return.

Under the look-back method, C receives no interest with respect to 1987, because C had no tax liability for 1987 using either estimated or actual contract price and costs.

(i) [Reserved]

(j) *Election not to apply look-back method in de minimis cases.* Section 460(b)(6) provides taxpayers with an election not to apply the look-back method to long-term contracts in de minimis cases, effective for contracts completed in taxable years ending after August 5, 1997. To make an election, a taxpayer must attach a statement to its timely filed original federal income tax return (including extensions) for the taxable year the election is to become effective or to an amended return for that year, provided the amended return is filed on or before March 31, 1998. This statement must have the legend "NOTIFICATION OF ELECTION UNDER SECTION 460(b)(6)"; provide the taxpayer's name and identifying number and the effective date of the election; and identify the trades or businesses that involve long-term contracts. An election applies to all long-term contracts completed during and after the taxable

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year for which the election is effective. An election may not be revoked without the Commissioner's consent. For taxpayers who elected to use the delayed reapplication method under paragraph (e) of this section, an election under this paragraph (j) automatically revokes the election to use the delayed reapplication method for contracts subject to section 460(b)(6). A consolidated group of corporations, as defined in § 1.1502-1(h), is subject to consistency rules analogous to those in paragraph (e)(2) of this section and in paragraph (d)(4)(ii)(C) of this section (concerning election to use simplified marginal impact method).

[T.D. 8315, 55 FR 41670, Oct. 15, 1990, as amended by T.D. 8775, 63 FR 36181, July 2, 1998; T.D. 8929, 66 FR 2240, Jan. 11, 2001; T.D. 8995, 67 FR 34609, May 15, 2002; T.D. 9137, 69 FR 42558, July 16, 2004]

TAXABLE YEAR FOR WHICH DEDUCTIONS TAKEN

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This section lists the captions that appear in the regulations under section 461 of the Internal Revenue Code.

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 - (3) Effect in current taxable year of improperly accounting for a liability in a prior taxable year.
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 - (b) Special rule in case of death.
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 - (2) Special rules.
 - (3) When election may be made.
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 - (5) Apportionment of taxes on real property between seller and purchaser.
 - (6) Examples.
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 - (e) Dividends or interest paid by certain savings institutions on certain deposits or withdrawable accounts.
 - (1) Deduction not allowable.
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§ 1.461-2 Contested liabilities.

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- (1) Taxable year of deduction.
- (2) Exception.
- (3) Refunds includible in gross income.
- (4) Examples.
- (5) Liabilities described in paragraph (g) of § 1.461-4. [Reserved]
 - (b) Contest of asserted liability.
 - (1) Asserted liability.
 - (2) Definition of the term "contest."
 - (3) Example.
 - (c) Transfer to provide for the satisfaction of an asserted liability.
 - (1) In general.
 - (2) Examples.
 - (d) Contest exists after transfer.
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 - (1) In general.
 - (2) Example.
 - (f) Treatment of money or property transferred to an escrowee, trustee, or court and treatment of any income attributable thereto. [Reserved]
 - (g) Effective dates.

§ 1.461-3 Prepaid interest. [Reserved]

§ 1.461-4 Economic performance.

- (a) Introduction.
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 - (d) Liabilities arising out of the provision of services, property, or the use of property.
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