The following comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These comments were prepared by individual members of the Committee on Tax Accounting of the Section of Taxation. Principal responsibility was exercised by Susan Minasian. Substantive contributions were made by Patricia Anderson and Carol Conjura. The comments were reviewed by Helen Hubbard of the Section’s Committee on Government Submissions and by David L. Raish, Council Director for the Committee on Tax Accounting.

Although many of the members of the Section of Taxation who participated in preparing these comments have clients who would be affected by the federal tax principles addressed by these comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

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Date: April 27, 2000
Executive Summary

Section 460 generally requires taxpayers to determine income from a long-term contract using the percentage of completion method based on a cost-to-cost comparison. While the proposed regulations incorporate some provisions of prior guidance, the proposed regulations also modify and amplify the prior guidance. The regulations will apply to any contract entered into on or after the final regulations are published in the Federal Register.

These comments principally address the issues set forth below.

- The proposed regulations would allow a taxpayer to sever a contract to clearly reflect income only if the contract would not be entirely subject to the percentage of completion method. This rule is a departure from the apparent policy in Notice 89-15, which permitted the Commissioner or the taxpayer to sever or aggregate contracts to ensure a clear reflection of income. We suggest that the final regulations retain a rule similar to the rule in Notice 89-15.

- The "customized item" safe harbor exception to the definition of a "unique item" under section 460(f)(2) provides a significant potential for simplification. Specifically, section 1.460-2(b)(2)(ii) of the proposed regulations states that an item is not unique if the total allocable contract costs attributable to customizing activities (such as research, development, design, engineering, etc.) that are incident to or necessary for the production of the item do not exceed five percent of the estimated total allocable contract costs allocable to the item. We suggest that the threshold be increased to fifteen percent to provide more simplification of this highly factual and controversial issue.

- Section 460(f)(2)(B) provides that a manufacturing contract that spans the end of a tax year is a long-term contract if it involves the manufacture of any item that normally requires more than twelve calendar months to complete (without regard to the period of the contract). The proposed regulations provide that the determination of the twelve-month period is based on the production period as defined in the interest capitalization regulations under section 263A. We suggest use of an actual physical fabrication period standard.

- The proposed regulations provide a new exception from the requirement that certain related parties use the percentage of completion method. The exception applies to subassemblies and components regularly carried in finished goods inventory if eighty percent or more of the gross receipts from the sale of these items are from sales to unrelated parties. We suggest a broader exception for subassemblies and components for which the primary source (i.e., more than fifty percent) of gross receipts is sales to unrelated parties.

- The proposed regulations provide that a taxpayer changing its long-term contract accounting method for future long-term contracts will not receive audit protection for its existing long-term contracts. We suggest that the regulations also provide a taxpayer with the additional, alternative opportunity to change its method for long-term contracts entered into before finalization of the regulations and to obtain audit protection.
COMMENTS CONCERNING THE PROPOSED SECTION 460 LONG-TERM CONTRACT REGULATIONS
(REG-208156-91)

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Introduction

Section 460 generally requires the income from a long-term contract to be determined using the percentage of completion method ("PCM") based on a cost-to-cost comparison. However, the income from certain exempt construction contracts still may be determined using the completed contract method, the exempt-contract PCM, or any other permissible method.

Section 1.451-3 of the regulations, which preceded the enactment of section 460, provides guidance concerning long-term contract accounting. In addition, the Internal Revenue Service (the "Service") and the Treasury Department provided guidance on section 460 in Notice 89-15, 1989-1 C.B. 634, and in Notice 87-61, 1987-2 C.B. 370. While the proposed regulations generally incorporate some provisions of section 1.451-3 and the notices issued under section 460, the proposed regulations also modify and amplify the prior guidance. The regulations will apply to any contract entered into on or after the day the final regulations are published in the Federal Register.

The proposed regulations under section 460 provide useful guidance concerning a variety of long-term contract issues and include helpful clarifications and simplifications to the present rules. However, there are several issues that we suggest warrant further consideration as discussed in the comments below.

A. Severing and Aggregating of Contracts

I.

Section 460(f)(3) of the Internal Revenue Code of 1986, as amended (the "Code"), states "under regulations prescribed by the Secretary . . . 2 or more contracts which are interdependent (by reason of pricing or otherwise) may be treated as 1 contract, and . . . a contract which is properly treated as an aggregation of separate contracts may be so treated." Section 1.451-3(a)(4) of the regulations provides that the Commissioner, for the purpose of clearly reflecting income, may find it necessary "to treat one agreement as several contracts or to treat several agreements as one contract." Section 1.451-3(e)(1)(i)(C) further provides that in general only the Commissioner (and not the taxpayer) may sever or aggregate contracts. In Q&A 38 of Notice 89-15, the Service changed this position and indicated that section 460 permits a taxpayer, as well as the Commissioner, to sever and aggregate contracts when appropriate. Specifically, Q&A 38 states:

"Under § 460(f)(3), a taxpayer is permitted and required to sever and aggregate contracts, notwithstanding the statement to the contrary in §1.451-3(e)(1)(i)(C) of the regulations, which does not apply to contracts subject to §460 and this notice. Forthcoming regulations may require any taxpayer that severs or aggregates contracts under this Q&A-38 to attach a statement to its Federal income tax return for the first year in which it has entered into two or more agreements that are properly treated as a single contract, or a single agreement that is properly treated as more than one contract. If required, such a statement would describe the criteria used by the taxpayer in determining to sever or aggregate the agreements."

However, the proposed regulations would allow a taxpayer to sever a contract to clearly reflect income only if the contract would not be entirely subject to the PCM. The proposed regulations

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1 1989-1 C.B. at 643.
2 Prop. Reg. § 1.460-1(e)(1) and (3)(i).
The proposed regulation precluding a taxpayer from severing PCM contracts is a departure from the apparent policy in Notice 89-15, which permitted both the Commissioner and taxpayers to sever or aggregate contracts to ensure uniformity and a clear reflection of income. The proposed regulation appears to be a narrow interpretation of section 460(f)(3), which contains no limitations on the ability of a taxpayer to aggregate or sever contracts. We suggest that the final regulations retain a rule similar to Q&A 38 and allow both the Commissioner and the taxpayer to sever or aggregate contracts, if necessary, to clearly reflect income attributable to a long-term contract in accordance with the standards set forth in the proposed regulations. Further, the final regulations should make clear that severing or aggregating may be necessary to avoid the premature recognition of income or the deferral of loss, as well as the deferral of income or premature recognition of loss.

Due to the tension between parties to a contract, taxpayers often do not have the ability to negotiate contracts so as to avoid the need to sever or aggregate contracts for federal income tax purposes. Accordingly, the regulations should permit a taxpayer to sever or aggregate contracts to clearly reflect income without seeking the Commissioner’s consent. From a policy perspective, this seems preferable to forcing a taxpayer to report income in a manner that does not clearly reflect income and putting the burden of identifying situations requiring severance or aggregation on the Commissioner. Further, forbidding severance or aggregation by taxpayers would subject taxpayers to potential interest expense if the Service severed or aggregated contracts on examination. Allowing taxpayers to sever or aggregate contracts as we suggest would encourage uniform application of the law and voluntary compliance by helping to ensure that all taxpayers may report taxable income in a consistent manner that promotes a clear reflection of income.

II.

The proposed regulations state “whether an agreement should be severed, or two or more agreements should be aggregated, depends on the following [four] factors:” independent pricing, interdependent pricing, separate delivery or acceptance, and, for aggregation, whether “a reasonable businessperson would not have entered into one of the agreements for the terms agreed upon without also entering into the other agreement(s).” The example provided in proposed regulation section 1.451-3(e)(2)(iv) to illustrate the reasonable businessperson test for aggregation states:

[A] single agreement to manufacture a prototype of an item, which would result in a substantial loss, and ten additional units of the item, which would result in a substantial gain, may not be severed into one contract for the prototype and another contract for the ten additional units under this paragraph (e)(2)(iv) because a reasonable businessperson would not have entered into a separate contract to manufacture the prototype. For purposes of this paragraph (e)(2)(iv), a taxpayer’s expectation that the parties would enter into another agreement, when agreeing to the terms contained in the first agreement, is irrelevant.

We suggest that this example be clarified to indicate that if some or all production phase units are not subject to section 460, the long-term contract accounting rules do not apply to such units. Specifically, some or all of the production phase units may qualify for exclusion from the long-term contract accounting rules based on one or more of the safe harbors of section 1.460-2(b)(2).

3 Prop. Reg. § 1.460-1(e)(1).
4 Prop. Reg. § 1.460-1(e)(2). The preamble to the proposed regulations indicates that independent and interdependent pricing of items is regarded as one criterion. Accordingly, the proposed rules technically provide three criteria for determining whether severance or aggregation is required.
of the proposed regulations, a facts and circumstances determination that the units are not unique, or a determination that the units require twelve months or less to complete.

B. The Unique Item Definition and Safe-Harbor Rules

I.

Section 460(f)(2) provides that “[a] contract for the manufacture of property shall not be treated as a long-term contract unless such contract involves the manufacture of . . . any unique item of a type which is not normally included in the finished goods inventory of the taxpayer.” Neither the Code nor section 1.451-3(b)(1) of the regulations defines the term “unique.” However, section 1.451-3(b)(1)(ii) provides that a contract to manufacture a unit of industrial machinery specifically designed for the needs of a customer and not normally carried in the taxpayer’s inventory is a long-term contract.

Section 1.460-2(b)(1) of the proposed regulations states that the term “unique” in the context of a manufactured item means “designed for the needs of a specific customer.” To ascertain whether an item is unique, the proposed regulations provide that a taxpayer should consider the extent to which research, development, design, engineering, retooling, and similar activities are required to produce the item and whether the same item can be sold to other customers, with or without minor modifications. Accordingly, as under the present regulatory guidance, the determination of whether an item is unique remains highly factual (unless the “safe harbors,” discussed further below apply).

In the context of this facts and circumstances analysis, the preamble to the proposed regulations states that the Service intends to incorporate the Tax Court’s criterion from *Sierracin Corp. v. Commissioner* regarding design, but not the criterion regarding unpredictable manufacturing risk because that criterion was developed primarily to justify the taxpayer’s use of the completed contract method. In *Sierracin*, the Tax Court held that items produced in certain divisions of a manufacturer using the completed contract method were unique within the meaning of section 1.451-3(b)(1)(ii) of the regulations. In reaching this conclusion, the court placed particular emphasis on two factors: (1) the degree to which the taxpayer’s products are designed for the use of specific customers; and (2) the degree to which the contracts are subject to unpredictable risks that make it difficult to account for ultimate profit or loss on an interim basis. The Tax Court’s discussion of whether the items were sufficiently customized to be unique was limited to the following:

> The items produced by [the divisions] are custom designed. The products of each division satisfied the highly specialized needs of specific customers. Each transparency produced by [the first division] is limited in use to a specific opening in a particular model of aircraft. Each glazing produced by [the second division] can only be installed in a specific opening in a specific building. Many of the machines produced by [the third division] are “one of a kind.” These products are not suitable for functions or customers other than those for which they were designed.

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5 Reg. § 1.451-3(b)(1)(ii).
7 In AOD CC-1990-016, responding to the *Sierracin* case, the Service stated its position that the presence of unpredictable risk is not a prerequisite to a finding that a manufactured item is unique.
8 90 T.C. at 366.
The relative brevity of this portion of the *Sierracin* decision, as well as inconsistencies by both the Service and taxpayers in interpreting the published acquiescence to *Sierracin*, have fostered numerous controversies concerning what constitutes a unique item.\(^9\)

The Service has proposed three safe harbors.\(^10\) Satisfaction of any safe harbor avoids the facts and circumstances determination of uniqueness otherwise required under the standards set forth in section 1.460-2(b)(1). In general, we believe the use of appropriate safe harbors will provide welcome simplification by reducing the number of situations requiring a highly factual analysis of the unique item issue and, correlatively, reducing the potential for related disputes.

Two of the safe harbors appear relatively straight-forward: (1) the “short production period” safe harbor, under which an item is not unique if it normally requires ninety days or less to complete the item; and (2) the “inventoried item” safe harbor, under which an item ceases to be unique no later than when the taxpayer normally carries similar items in its finished goods inventory.\(^11\)

While taxpayers and the Service could debate aspects of the bright-line standards (e.g., the length of the production period in the first safe harbor) in the context of specific taxpayers or types of manufacturers that may be affected, we believe that the tests provide an opportunity for simplification in some cases.

Given experience involving a significant number of controversies concerning the nature and extent of customization,\(^12\) we anticipate that the “customized item” safe harbor in section 1.460-2(b)(2)(ii) of the proposed regulations provides the greatest potential for simplification. The proposed regulations state:

> [a]n item is not unique if the total allocable contract costs attributable to customizing (such as research, development, design, engineering, retooling, and similar activities) that are incident to or necessary for the production of the item do not exceed five percent of the estimated total allocable contract costs allocable to the item.

However, we believe the five percent threshold in this safe harbor is too low to provide a truly meaningful simplification of this highly factual and controversial area. We suggest that the Service increase the threshold to fifteen percent. In our experience, taxpayers rarely characterize a noninventoried item as unique if customization costs are less than five percent of total contract costs.\(^13\) As a result, the proposed standard would not significantly reduce the future potential for disputes. We believe this type of safe harbor has the most likelihood of easing the burdens for the Service and taxpayers in applying the uniqueness standard if a higher threshold is adopted.

II.

In TAM 8941003 (July 30, 1989), issued after the *Sierracin* decision but before the Service’s acquiescence, the National Office of the Service addressed the unique item issue in the context

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\(^9\) As discussed further herein, the National Office issued TAM 8941003 (June 30, 1989), which set forth four factors that were considered relevant to the determination of uniqueness. The four factors also were cited in the 1990 AOD. It is our experience that the National Office adhered to these factors in processing Forms 3115, Applications for Change in Accounting Method, as late as the mid-1990s. Also, certain examining agents applied the factors to varying degrees, while others appeared to rely on both the customization and unpredictable risk standards of *Sierracin*.


\(^11\) *Id.* A recommendation concerning the standard for measurement of the time required to “complete” an item is set forth below.

\(^12\) Such controversies typically have involved situations in which the manufactured items require relatively lengthy production periods and are not inventoried.

\(^13\) In some cases, taxpayers were challenged on the unique item issue without any inquiry from the examining agents concerning the proportion of customization costs to total contract costs.
of a manufacturer using sophisticated technology and metal-working processes. In describing the criteria applied to determine whether the manufactured items were sufficiently customized to constitute unique items, the Service stated:

Items that are custom designed to fulfill the particular needs of a buyer are usually unique items. In contrast, items that would be of use to a number of potential buyers and that share a basic design with items that, at the time the contract is entered into, have been produced previously by the taxpayer, generally are shelf items. Items that have these characteristics may be shelf items even if they are manufactured to the particular specifications of a buyer, if these specifications do not involve the basic design of the items, and instead, for example, involve their size and weight.\footnote{Emphasis added. The other three criteria applied in TAM 8941003 were: (1) whether performance of a contract to produce the item required extensive research, development, design, engineering, retooling, or similar activities; (2) whether the item was produced in a non-automated manufacturing operation or, alternatively in a specialized manufacturing operation (the latter being consistent with a unique item, as opposed to a shelf item); and (3) the relative length of the production period (the longer the period, the greater likelihood of a unique item).}

Example 1 in section 1.460-2(e) of the proposed regulations expressly refers to the “basic design” concept. The example involves a contract for the design and manufacture of a new type of industrial equipment that requires an eight month production period. The taxpayer determines that the item is unique under this initial contract based on the substantial amount of research, design, and engineering costs required to produce the item. Upon entering into a subsequent contract for five additional units of industrial equipment involving the same “basic design” as the first contract, the taxpayer concludes that the items are not unique because the five percent safe harbor of section 1.460-2(b)(2)(ii) of the proposed regulations is satisfied. Although this example refers to the concept of a shared basic design, the significance of this concept is unclear. We believe that either the reference to the shared basic design should be deleted or the significance of a shared basic design should be discussed in the regulations. As presently drafted, the example creates the potential for confusion.

III.

As noted previously, in determining whether an item is designed for the needs of a specific customer, the proposed regulations state that a taxpayer should consider the extent to which research, development, design, engineering, retooling, and similar customization activities are required to produce the item.\footnote{Prop. Reg. § 1.460-2(b)(1).} The final regulations should also clarify that taxpayers should not treat software development and software implementation costs as customization costs for purposes of the customized item safe harbor.\footnote{This position is consistent with LTR 8109015 (Nov. 26, 1980) and LTR 8545007 (July 31, 1985).} Similarly, and consistent with the relevant portions of the definition of a “non-long-term contract” activity in section 1.460(d)(2) of the proposed regulations, guarantee, warranty, and maintenance costs should not be treated as customization costs for determining whether an item is designed for the needs of a specific customer or for purposes of the safe harbor set forth in section 1.460-2(b)(2)(ii) of the proposed regulations.

C. The 12-month “Manufacturing” Period

I.

Section 460(f)(2)(B) provides that a manufacturing contract that spans the end of a tax year is a long-term contract if it involves the manufacture “of any item which normally requires more than
12 calendar months to complete (without regard to the period of the contract)." 17 Section 1.460-2(c) of the proposed regulations states:

> [T]he amount of time normally required to complete an item is the item's reasonably expected production period, as described in §1.263A-12 [pertaining to interest capitalization], determined at the end of the contracting year [i.e. the year in which the contract is entered into]. . . . [T]he expected production period for an item generally would begin when a taxpayer incurs at least five percent of the costs allocable to the item and end when the item is ready to be held for sale and all reasonably expected production activities are complete.

Thus, the proposed regulations indicate that the twelve-month test is determined without regard to the actual manufacturing time required to physically produce a particular, complete deliverable item. Example 2 in section 1.460-2(e) of the proposed regulations involves a crane that is deemed to normally require more than twelve months to complete because a related party completes a component in five months and the primary manufacturer normally requires an additional eight months to complete production of the crane after receiving the component from the related party. 18 Example 4 in section 1.460-2(e) of the proposed regulations states that "the normal time to complete a crane, not the actual time, . . . is the relevant criterion."

We suggest use of an actual physical fabrication period test instead of the definition from the interest capitalization rules. Under the interest capitalization rules, the production period of an item of tangible personal property begins on the first date the taxpayer's accumulated production expenditures, including planning and design expenditures, are at least five percent of the taxpayer's total estimated accumulated production expenditures for the property unit. Thus, this determination is made without regard to the whether physical production activity has commenced. 19 Under the interest capitalization rules, the production period ends on the date the item is ready to be held for sale and all reasonably expected production activities by the taxpayer or a related person are complete.

A principal problem with the proposed reasonably expected production period standard is its focus on the overall time period during which costs are incurred rather than the time when an item undergoes actual physical fabrication. The time period during which a taxpayer incurs costs with respect to a particular item may be influenced by factors that are separate from and unrelated to the taxpayer's physical manufacturing operations, including cost accounting and billing functions of the taxpayer, as well as special rules under the accrual method of accounting that determine the time when costs are deemed incurred (e.g., the recurring item exception and the three and one-half month rule of the economic performance regulations under section 461(h), 20 the timing rules for deferred compensation under section 404, and the matching rules of section 267). Costs may also be incurred before physical fabrication begins for planning and design activities, procurement, warehousing, and transportation. The time when these costs are incurred may vary significantly from taxpayer to taxpayer and, with respect to a single taxpayer, from one contract to another, and even from one item to another within a single contract.

We believe it is in the best interest of tax compliance and administration to replace the production period standard borrowed from the interest capitalization rules with a rule that determines the "normal time to complete an item" based on the actual manufacturing process. In our view, measuring the completion time of an item by the actual time required to physically produce each complete item would improve the accuracy and uniformity of application of the twelve-month test.

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17 This provision has been referred to as the "12-month test."
18 Presumably, five months is the reasonably expected production period of the related party's component.
19 Reg. § 1.263A-12(c)(3).
In this context, we believe it is appropriate to interpret the term “normal” as excluding the time associated with the nonproduction activities discussed above.

Our recommended formulation of the twelve-month test would also be more consistent with the apparent application of the test under the existing regulations. Specifically, section 1.451-3(b)(1)(ii) of the regulations provides, as an example, that a contract to manufacture 15,000 folding chairs that take three months each to manufacture is not a long-term contract. This example can be interpreted as implying that the time required to complete each item is determined by reference to the item’s physical fabrication activities.\(^{21}\) The inclusion of time attributable to planning and design activities, procurement, and transportation, as well as differences due to when costs are treated as incurred under the relevant tax accounting rules, could result in deemed production periods that differ from the uniform, actual three-month manufacturing period set forth in the cited example.

As discussed above, we suggest that the severing and aggregating rules of section 1.460-1(e) of the proposed regulations be modified to allow taxpayers to sever contracts subject to the PCM. If an agreement is severed into multiple contracts and one or more of the severed contracts provide for the manufacture of items in subsequent years, the taxpayer should be allowed to determine, for each severed contract, whether the subsequently produced items meet the twelve-month test. Such a contract by contract (and item by item) application of the twelve-month test is consistent with the overall goal of the severing rules in accounting for severed contracts independently.

II.

Apart from the specific standard for measuring the time required to “complete” an item, we believe that section 460(f)(2)(B) also could be more effectively administered by allowing taxpayers that have previously manufactured an item to elect to use a historical testing period as a safe harbor. Because manufacturing processes may change rapidly with technology and experience, we believe the appropriate historical testing period to be the most recent one-year period ending with the month in which the taxpayer enters into a contract (including a contract that results from application of the severing and aggregating rules). Contracts subject to the election could be identified in an attachment to the tax return for the contracting year.

D. Related Party Rules

Section 460(h) provides that the Secretary shall prescribe such regulations as may be necessary or appropriate, including regulations to prevent the use of related parties, pass-through entities, intermediaries, options, or other similar arrangements to avoid the application of the long-term contract accounting rules. Notice 89-15 sets forth two related party rules. Q&A 2 provides that “in determining whether a contract is completed in the taxable year in which it is entered into, all activities of the taxpayer and any related parties in connection with the manufacture, building, installation, or construction must be taken into account.” Q&A 8 addresses activities by a related party that are not, standing alone, long-term contract activities but that benefit or are performed by reason of a long-term contract of another (related) taxpayer. Q&A 8 provides that the related party must utilize long-term contract accounting for such activities. These rules are continued in the proposed regulations, accompanied by a newly added exception for subassemblies and

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\(^{21}\) The historical, unpublished National Office ruling policy in processing Forms 3115, Application for Change in Accounting Method, prior to the statutory phase-out of the completed contract method for manufacturers was to apply a “hands-on” manufacturing standard for purposes of administering the 12-month rule. Under such standard, only the time required to physically manufacture a specific item was taken into account. Also, it should be noted that the production period for real property under Reg. § 1.263A-12(c)(2) begins on the first date that “any physical production activity” is performed. Thus, the proposed standard is not without precedent.
components regularly carried in finished goods inventory if eighty percent or more of the gross receipts from the sale of these items are from sales to unrelated parties.\textsuperscript{22} The rule reflects the Service’s goal of not requiring a related party that otherwise would not be subject to section 460 for a given contract to use the PCM, provided no abuse is present.

We believe the inventory exception is helpful, but we suggest a broader exception. Specifically, we suggest that the inventory exception apply in any case in which more than fifty percent of the gross receipts from sales of such item are from sales to unrelated parties. We do not believe that a fifty percent standard would be subject to abuse by taxpayers.

Also, we see no reason why a related party that meets the fifty percent gross receipts test should be obligated to use the PCM merely because it does not regularly carry the item in finished goods inventory. We are not aware of any policy reason to, for example, require a taxpayer with items regularly on back order and, thus, not physically held in ending inventory, to use the PCM. We believe the emphasis should be on the source of gross receipts for items, whether or not the items (which are not otherwise subject to section 460) are in stock.

E. Effective Date and Transitional Rules

Section 1.460-1(h) of the proposed regulations provides the general rule that the regulations will be effective for contracts entered into on or after the date final regulations are published in the Federal Register. The proposed regulations further provide that a taxpayer that changes its method of accounting for contracts subject to the final regulations must follow the automatic consent procedures in Revenue Procedure 98-60, 1998-51 I.R.B. 16 (which since has been modified and superseded by Revenue Procedure 99-49, 1999-52 I.R.B. 725), except that the scope limitations of section 4.02 will not apply.

The proposed regulations provide that a taxpayer changing its long-term contract accounting method for future long-term contracts will not receive audit protection for its methods of accounting for its existing long-term contracts. We believe that if there is no issue “under consideration” (within the meaning of section 3.09(1) of Revenue Procedure 99-49) concerning the method to be changed, the regulations also should provide a taxpayer with the additional, alternative opportunity to file Form 3115, Application for Change in Accounting Method, to change its method of accounting for long-term contracts entered into before finalization of the regulations and to obtain audit protection. A section 481(a) adjustment, spread over four tax years beginning with the year of change, would apply if a taxpayer elects to file under this alternative, automatic procedure in order to obtain audit protection.

The audit protection alternative is important to certain taxpayers due to the scope of the changes and clarifications provided in the proposed rules. For example, the proposed regulations modify the definition of a unique item, which affects the determination of whether a manufacturing contract is subject to section 460. Given the long-standing, inconsistent interpretations by both the Service and taxpayers in interpreting the published acquiescence to \textit{Sierracin}, as well as the brief discussion of the customization standard addressed in the specific fact pattern of the \textit{Sierracin} case, we believe taxpayers should be given an opportunity to comply with the newly proposed guidelines for contracts entered into before the regulations are finalized. Although a taxpayer presumably could file a Form 3115 under Revenue Procedure 97-27 prior to finalization of the regulations and obtain audit protection under the non-automatic procedure, the taxpayer apparently would not be able to avail itself of the proposed safe harbors. The present unavailability of the still proposed safe harbors could create the need for a possible second change under the final regulations. We believe the possible successive changes in how a unique item is defined could result in unneeded complexity for a taxpayer. Even if the safe harbors were

\textsuperscript{22} Prop. Reg. § 1.460-1(g)(1)(ii).
available through a voluntary change prior to finalization of the proposed regulations, this also would result in the potential for inconsistent treatment of similarly situated taxpayers from an implementation date standpoint.

In contrast to the presently proposed accounting method change rules for long-term contracts, the Service historically has provided audit protection in other contexts involving an automatic change to comply with newly finalized regulations.\textsuperscript{23} The proposed long-term contract method change rules should be consistent in approach.\textsuperscript{24}

\textsuperscript{23} See Rev. Proc. 94-49, 1994-2 C.B. 705 (requiring filing of Form 3115 but providing audit protection if no section 263A issue pending); Rev. Proc. 95-19, 1995-1 C.B. 664 (according audit protection to eligible taxpayers for changes under final section 263A regulations).

\textsuperscript{24} Historically, Notice 89-15, Q&A 13, required taxpayers not in timely compliance with section 460 to amend tax returns in the context of a voluntary accounting method change. This rule was not applied in the context of similarly situated taxpayers changing to correct an erroneous method and thereby comply with sections 263A or 448. Section 14.03 of Revenue Procedure 97-27 superseded this inequitable treatment of long-term contracts.