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Department of the Treasury
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Date:
February 26, 2010

DO: TY:

Legend

Taxpayer =
Parent =
Division 1 =
Division 2 =
Trade 1 =

Trade 2 =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Agency =
Ship F =
State =
Contract A =
Contract B =
Contract Modification A-1 =
w percent =
x percent =
y percent =
z percent =

Dear :

In a letter dated August 28, 2009, you requested a private letter ruling on behalf of Taxpayer under Revenue Procedure 2009-1. On February 17, 2010, you submitted additional information. With respect to Contract A and Contract B, which Taxpayer entered into on Date 1 and on Date 3 respectively, you requested the following rulings:

1. That, under section 1.460-1(e) of the Income Tax Regulations, Contract A and Contract B are not aggregated so as to be treated as a single contract;

2. That, under section 708(c)(3) of the American Jobs Creation Act of 2004, Pub. L. 108-357 (JOBS Act), the construction commencement date of Contract B did not occur before Date 3, when Taxpayer entered into Contract B;

3. That Contract B is a qualified naval ship contract under section 708(c)(1) of the JOBS Act;

4. That, for five taxable years beginning with Year 4, the proper method for Taxpayer to determine the taxable income from Contract B is the percentage-of-completion/capitalized-cost method (PCCM) with 40 percent of contract income determined under the percentage-of-completion method (PCM) and with the remaining 60 percent of contract income determined under the completed contract method (CCM); and

5. That, in the event the Service makes the requested rulings on the four issues above, it will not constitute a change in accounting method for Taxpayer to file an amended return for Year 4 to implement those rulings.

FACTS

Taxpayer, wholly owned by Parent, is a member of an affiliated group of corporations with Parent as its common parent that files consolidated Federal income tax returns.

Taxpayer's business is conducted through two separate operating divisions, namely, Division 1 and Division 2. Division 1 is engaged in Trade 1. Division 2 is engaged in Trade 2. Prior to the close of Year 4, Taxpayer was engaged in only one trade or business, that of Division 1.

Prior to the enactment of section 460 of the Internal Revenue Code in 1986, Taxpayer, then unaffiliated with Parent, used the CCM to account for all items of income and expenses from its long-term contracts. For long-term contracts entered into after the effective date of section 460 as originally enacted, Taxpayer used the PCCM as then

required under section 460. In Year 1, for the first time, Taxpayer entered into commercial shipbuilding contracts that it expected to complete within 5 years. For Year 1 and subsequent taxable years, Taxpayer used the PCCM to determine the taxable income from those commercial shipbuilding contracts, with 40 percent of contract income determined under PCM and with the remaining 60 percent of contract income determined under CCM.

In Year 2, Parent acquired all of Taxpayer's outstanding stock and began including Taxpayer in its consolidated Federal income tax returns.

In Year 3, Taxpayer entered into Contract A with Agency. Agency is an acquisition arm of the United States Navy. Under Contract A, Taxpayer was required to perform design work, long lead time materials procurement, advance construction of components and engineering services, all relating to a ship, Ship F. Contract A also provided options, exercisable by Agency, for additional work in the same categories. Contract A neither required the construction of Ship F, nor obligated either party to enter into such a contract. As of Date 1, Congress had not appropriated the funds necessary for construction and delivery of a complete ship.

Contract A was a cost-reimbursement-type contract with a fixed-fee structure, in which the amount of the fixed fee was calculated as a percentage of allowable costs with the fee percentage rate varying according to the category of work. The fixed fee percentages ranged between w percent and x percent. In addition, Contract A provided for various incentive fee arrangements and fee reduction possibilities linked to Taxpayer’s performance.

Between Date 1 and Date 3, Contract A underwent numerous modifications, most of which reflected Agency's exercise of the options provided in that contract. In Contract Modification A-1 dated Date 2, the parties added a new category of advance construction work. In subsequent modifications that occurred between Date 2 and Date 3, Taxpayer and Agency increased the funding for the advance construction category and agreed that the increased funding and any costs incurred against it would be transferred to the ship construction contract, "when and if awarded."

In Year 4, Taxpayer entered into Contract B with Agency. Contract B required Taxpayer to construct Ship F and deliver the vessel with on board repair parts to Agency on Date 4. Taxpayer will construct Ship F at its plant located in State. Pursuant to modifications to Contract A and terms of Contract B, certain funding increases and costs incurred under Contract A were transferred to Contract B.

Unlike in Contract A, the pricing structure of Contract B consisted of cost-reimbursement and an incentive fee regime. Upon completion of the contract, if the total actual allowable cost of completing Ship F is less than the target cost, Taxpayer will be entitled to an additional fee. If the total actual allowable cost of completing Ship F is greater than the target cost, Taxpayer's fee will be reduced. In no event may

Taxpayer's fee be greater than y percent of the target cost or less than z percent of the target cost. In addition to the basic incentive fee described, Contract B provides for various incentive fee arrangements for strong performance.

In accordance with the Federal Acquisition Regulations, taxpayer expects that Agency will issue DD Form 250 on Date 4, when Taxpayer delivers the completed Ship F. Taxpayer represents that DD Form 250 constitutes a standard letter of acceptance in delivery and acceptance of hardware produced for the Department of Defense. The DD Form 250 is issued to "provide evidence of Government contract quality assurance at origin or destination [and] to provide evidence of acceptance at origin or destination." 48 C.F.R. Ch. 2, App. F, § F-103(a).

For Year 3 and all relevant taxable years thereafter, Taxpayer used PCM to take into account the portions of Contract A relating to the advance construction of components. Parent filed its consolidated Federal income tax return for Year 4, after Taxpayer submitted the request for a letter ruling. On that consolidated return, Taxpayer used PCM to determine the taxable income from Contract B.

LAW AND ANALYSIS

Ruling Request 1. Applicability of the aggregation rules

Section 460(a) of the Internal Revenue Code generally requires taxpayers to determine the taxable income from long-term contracts under PCM. For purposes of Federal income taxation, "the term 'long-term contract' means any contract for the manufacture, building, installation, or construction of property if such contract is not completed within the taxable year in which such contract is entered into." § 460(f)(1).

Section 1.460-1(e) of the Income Tax Regulations, promulgated under section 460(f)(3) of the Code, provides that, to reflect income clearly, the Commissioner or a taxpayer may treat one agreement as two or more contracts and two or more agreements as one contract. In general, the "taxpayer must determine whether to sever an agreement or to aggregate two or more agreements based on the facts and circumstances known at the end of the contracting year." § 1.460-1(e)(1) of the Income Tax Regs.

Under section 1.460-1(e)(2) of the Income Tax Regulations, whether to aggregate two or more agreements into one contract depends on two factors: pricing and a reasonable businessperson's behavior. Regarding pricing, two or more agreements will not be aggregated into one contract in the absence of interdependent pricing of items in the separate agreements. The regulations further provide that a “single price negotiation for similar items ordered under one or more agreements indicates that the items are interdependently priced.” See § 1.460-1(e)(2)(i) of the Income Tax Regs.

Regarding the expected behavior of a reasonable businessperson, the regulations provide that "Two or more agreements . . . may not be aggregated into one contract, unless 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)." § 1.460-1(e)(2)(iii) of the Income Tax Regs. "Analyzing the reasonable businessperson standard requires an analysis of all facts and circumstances of the business arrangement between the taxpayer and the customer." Id. For purposes of applying the reasonable businessperson factor, the "taxpayer's expectation that the parties would enter into another agreement, when agreeing to the terms contained in the first agreement, is not relevant." Id.

Examples 10 and 11 of section 1.460-1(j) contain applications of the aggregation rule to taxpayers entering into multiple agreements. Example 10 deals with two agreements, each for construction of a submarine, which were the result of a single negotiation. Treated separately, one of the contracts will result in a substantial loss to the taxpayer-contractor, while the other will produce a substantial profit. Because the pricing of the two agreements was interdependent, and because a reasonable businessperson would not have entered into one agreement without entering into the other, aggregation is required. See § 1.460-1(j) Ex. 10 of the Income Tax Regs.

In contrast, Example 11 analyzes a situation where two agreements, each for manufacture of a certain type of military aircraft, are negotiated two years apart. The pricing under each agreement reflects the taxpayer-contractor's expected total cost of manufacturing the aircraft as ordered, the risks and opportunities associated with the agreement, and other factors considered relevant, and is expected to result in a profit to the taxpayer-contractor. Because the pricing of each agreement standing alone is independent from that of the other, and because a reasonable businessperson would have entered into the first agreement without regard to the other, aggregating the two agreements into one contract is not permitted. It is irrelevant to application of the aggregation rule that, in the year when it enters into the first agreement, the taxpayer-contractor anticipates to receive additional orders for the same type of aircraft over the next few decades. See § 1.460-1(j) Ex. 11 of the Income Tax Regs.

The relationship between Contract A and Contract B is akin to that of the two agreements described in Example 11 of section 1.460-1(j) of the Income Tax Regulations.

First, the pricing arrangements of Contract A and of Contract B were independent and not interdependent. Contract A provided for primarily a fixed fee arrangement, although it did contain some incentive fee provisions. In contrast, Contract B provided for a pricing structure based on an incentive fee formula and contained no fixed fee provision. The pricing structure of each contract, which is based on the costs expected to be incurred under that contract only, was independent from the pricing structure of the other contract. In addition, the interval of more than four years between the execution of the two contracts and the absence of congressional authorization for the construction

of a complete ship as of Date 1 both indicate that Contract A and Contract B were negotiated separately.

Second, Contract A and Contract B each have provided, or are expected to provide, Taxpayer with a reasonable profit. With a fixed fee structure in place, a reasonable businessperson would have entered into Contract A without entering into Contract B. Conversely, with a floor to the fee set at z percent of the total actual costs, a reasonable businessperson would have entered into Contract B without entering into Contract A.

In sum, the two agreements are independently priced, and a reasonable businessperson would have entered into one contract without regard to the other. Accordingly, we hold that Contract A and Contract B should not be aggregated so as to be treated as a single contract for Federal income tax purposes.

Ruling Request 2. Construction Commencement Date

Section 708 of the JOBS Act requires that the taxable income from a qualified naval ship contract be determined by a method identical to that used in the case of a qualified ship contract, for the five taxable year period beginning with the taxable year in which the construction commencement date occurs. § 708(a). Qualified ship contracts are reported under 40/60 PCCM or PCM. Under 40/60 PCCM, 40 percent of contract income is reported using PCM, with the remaining 60 percent reported under the taxpayer's exempt method, e.g., CCM.

For purposes of section 708 of the JOBS Act, a qualified naval ship contract is any contract, or portion thereof, to construct a ship or a submarine in the United States for the Federal Government "if the taxpayer reasonably expects the acceptance date will occur no later than 9 years after the construction commencement date." § 708(c)(1). "The term 'acceptance date' means the date 1 year after the date on which the Federal Government issues a letter of acceptance or other similar document for the ship or submarine. § 708(c)(2). "The term 'construction commencement date' means the date on which the physical fabrication of any section or component of the ship or submarine begins in the taxpayer's shipyard." § 708(c)(3). Section 708 of the JOBS Act applies to contracts for the manufacture of ships or submarines if the construction commencement date occurs after the enactment date (October 22, 2004). § 708(e).

Construing the term "construction commencement date" as a date that can precede the date a taxpayer enters into a contract for the manufacture of a ship or submarine would render section 708 inadministrable. In the case of a qualified naval shipbuilding contract, section 708 permits use of the 40/60 PCCM, for five taxable years, beginning with the taxable year including the construction commencement date. Prior to entering into a qualified naval shipbuilding contract, a taxpayer cannot determine whether it has a qualified naval shipbuilding contract eligible for the special method. The taxpayer also could lack information necessary to estimate the contract price and costs to be reported under the method. In sum, construing the term "construction commencement date" as a

date that can precede the date a contract for the manufacture of a ship or submarine is entered into would require taxpayers to begin using the 40/60 PCCM before they can determine whether they are eligible to use the method and before they have the contract price and cost information necessary to apply the method. It is improbable that Congress intended to create a provision that is impossible for taxpayers to comply with and unreasonable for the Service to enforce.

In construing a statute, courts have recognized that "a statute is to be read as a whole, . . . since the meaning of statutory language, plain or not, depends on context." King v. St. Vincent's Hosp., 502 U.S. 215, 221 (1991). Congress employed the term "construction commencement date" in the context of requiring taxpayers to use specified methods of accounting for income from qualified naval ship contracts. The context in which the term is employed indicates that the “construction commencement date” must occur after a taxpayer has entered into a qualified naval ship contract. Accordingly, we hold that the construction commencement date of Contract B did not occur before Date 3 when Taxpayer entered into that contract.

Ruling Request 3. Qualified Naval Ship Contract

Contract B obligates Taxpayer to construct a complete ship for the United States Navy, an instrument of the Federal Government. Taxpayer will construct Ship F in State and is required to deliver the completed Ship F on Date 4. On Date 4, Taxpayer expects Agency to issue a DD Form 250 as evidence of acceptance. Thus, the first anniversary of the anticipated issuance of the DD Form 250 will fall on Date 5. Date 5, therefore, is the acceptance date of the ship within the meaning of section 708(c)(2) of the JOBS Act. Because the construction commencement date occurred on Date 3, when Taxpayer entered into Contract B, the acceptance date is expected to occur no later than nine years after the construction commencement date.

Accordingly, Contract B satisfies the requirements of a qualified naval ship contract set forth in section 708(c)(1) of the JOBS Act.

Ruling Request 4. Applicability of the 40/60 PCCM

Section 708 of the JOBS Act refers to the method of accounting used in the case of a qualified ship contract.[1] Under section 10203(b)(2) of the Revenue Act of 1987, Pub. L. No. 100-203, taxpayers may use PCCM to determine the taxable income from qualified ship contracts. Section 1.460-2(d) of the Income Tax Regulations, moreover, permits use of PCM. A taxpayer using the PCCM "determines the income from a long-term contract using the PCM for the applicable percentage of the contract and its exempt

[1] For purposes of accounting for long-term contracts, a qualified ship contract is any contract to construct not more than 5 ships in the United States "if . . . (i) such ships will not be constructed (directly or indirectly) for the Federal Government, and (ii) the taxpayer reasonably expects to complete such contract within 5 years of the contract commencement date." Revenue Act of 1987, Pub. L. No. 100-203, § 10203(b)(2)(B); see also § 1.460-2(d) of the Income Tax Regs.

contract method . . . for the remaining percentage of the contract." For a qualified ship contract, the applicable percentage is 40 percent. See § 1.460-4(e) of the Income Tax Regs.

Prior to the 1986 enactment of section 460, Taxpayer established the CCM as its method of accounting for items attributable to long-term contracts. In years following the enactment of section 460, taxpayer continued to use the CCM to account for portions of long-term contracts exempt from the PCM use requirement. For instance, Taxpayer accounted for items relating to qualified ship contracts that it entered into in Year 1 and thereafter by using the PCCM with the CCM as the method used for the 60-percent exempt portions. Taxpayer's proper method of accounting for qualified ship contracts is the 40/60 PCCM. Accordingly, for taxable years beginning with Year 4, the proper method to determine Taxpayer's taxable income from Contract B is the 40/60 PCCM.

Ruling Request 5. Implementation of the Present Letter Ruling by Filing an Amended Return

Section 446(e) provides that a taxpayer may not change its method of accounting without first obtaining the Commissioner's consent to make the change. Section 1.446-1(e)(2)(i) of the Income Tax Regulations further provides that "[c]onsent must be secured whether or not such method is proper or is permitted" under the Code or the regulations thereunder. See also § 2.06 of Rev. Proc. 2002-18, 2002-1 C.B. 678.

Revenue Ruling 90-38, 1990-1 C.B. 57, concludes that a taxpayer adopts an erroneous method of accounting when it files the second consecutive return using that method. The Revenue Ruling holds that the taxpayer may not, without the Commissioner's consent, retroactively change from an improper to a proper method of accounting by filing an amended return, even if the period of limitations for the first year for which the improper method was used remains open. See also § 2.03 of Rev. Proc. 2002-18.

As noted earlier, Taxpayer had not obtained the Commissioner's consent to change its exempt method of accounting from the CCM to the PCM for Year 4. Accordingly, Taxpayer was required by section 446(e) to continue to use the CCM as its exempt contract method in Year 4. Thus, PCM was an improper method of accounting for Contract B in Year 4. Nonetheless, Taxpayer used the PCM to account for Contract B on its consolidated Federal income tax return for Year 4.

Because PCM was an improper method used for only one taxable year, it has not been adopted as the method of accounting for qualified naval shipbuilding contracts. Accordingly, under the principle underlying Revenue Ruling 90-38, Taxpayer may file an amended return for Year 4 to implement the rulings herein. Such an amended return will not constitute a change in accounting method.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referred to in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The rulings contained in this letter are based upon information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

John M. Aramburu
Senior Counsel, Branch 5
Office of Associate Chief Counsel
(Income Tax & Accounting)

Enclosures

cc: