

Reg. Section 1.460-6(d)(4)(i)(C)

Look-back method

(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:		
At .40	2,000x	-----
At .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.

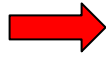
(4) Application—

(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 or 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 interests 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 subsequent 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.