••• Reg.IV.18.(d). Special Regulation: Construction Contractors.
[Adopted July 10, 1980]

The following special rules are established in respect to the apportionment of income of long-term construction contractors:

(1) In General. When a taxpayer elects to use the percentage of completion method of accounting, or the completed contract method of accounting for long-term contracts (construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and accepted), and has income from sources both within and without this state from a trade or business, the amount of business income derived from such long-term contracts from sources within this state shall be determined pursuant to this regulation. In such cases, the first step is to determine which portion of the taxpayer's income constitutes "business income" and which portion constitutes "nonbusiness income" under Article IV.1 and Reg. IV.1 thereunder. Nonbusiness income is directly allocated to specific states pursuant to the provisions of Article IV.5 to .8, inclusive. Business income is apportioned among the states in which the business is conducted pursuant to the property, payroll, and sales apportionment factors set forth in this regulation. The sum of (1) the items of nonbusiness income directly allocated to this state and (2) the amount of business income attributable to this state constitutes the amount of the taxpayer's entire net income which is subject to tax by this state.

(2) Business and Nonbusiness Income. For definitions, rules and examples for determining business and nonbusiness income, see Reg. IV.1.

(3) Methods of Accounting and Year of Inclusion. For general rules of accounting, definitions and methods of accounting for long-term construction contracts see [each state adopting this Regulation should insert here reference to its laws and regulations relating in general to accounting methods of reporting income from long-term contracts. This Regulation assumes that the law of the adopting states permits the taxpayer to elect either the percentage of completion or completed contract method. If not, the Regulation will have to be modified to conform to an adopting state's accounting method for long-term construction contracts.]

(4) Apportionment of Business Income.

(i) In General. Business income is apportioned to this state by a three-factor formula consisting of property, payroll and sales regardless of the method of accounting for long-term contracts elected by the taxpayer. The total of the property, payroll and sales percentages is divided by three to determine the apportionment percentage. The apportionment percentage is then applied to business income to determine the amount apportioned to this state.

(ii) Percentage of Completion Method. Under this method of accounting for long-term contracts, the amount to be included each year as business income from each contract is the amount by which the gross contract price which corresponds to the percentage of the entire contract which has been completed during the income year exceeds all expenditures made during the income year in connection with the contract. In so doing, account must be taken of the material and supplies on hand at the beginning and end of the income year for use in each such contract.

Example: A taxpayer using the percentage of completion method of accounting for long-term contracts, entered into a long-term contract to build a structure for $9,000,000. The contract allowed three years for completion and, as of the end of the second income year, the taxpayer's books of account, kept on the accrual method, disclosed the following:

	Receipts	Expenditures
End of 1st income year	$2,500,000	$2,400,000
End of 2nd income year	4,500,000	4,100,000
Totals	$7,000,000	$6,500,000

In computing the above expenditures, consideration was given to material and supplies on hand at the beginning and end of each income year. It was estimated that the contract was 30% completed at the end of the first income year and 80% completed at the end of the second income year. The amount to be included as business income for the first income year is $300,000 (30% of $9,000,000 or $2,700,000 less expenditures of $2,400,000 equals $300,000). The amount to be included as business income for the second income year is $400,000 (50% of $9,000,000 or $4,500,000 less expenditures of $4,100,000 equals $400,000).

(iii) Completed Contract Method. Under this method of accounting business income derived from long-term contracts is reported for the income year in which the contract is finally completed and accepted. Therefore, a special computation is required to compute the amount of business income attributable to this state from each completed contract (see subdivision (5) of this regulation). Thus, all receipts and expenditures applicable to such contracts whether complete or incomplete as of the end of the income year are excluded from business income derived from other sources, as for example, short-term contracts, interest, rents, royalties, etc., which is apportioned by the regular three-factor formula of property, payroll and sales.

(iv) Property Factor. In general the numerator and denominator of the property factor shall be determined as set forth in Article IV.10 to .12, inclusive, and Reg. IV.10 to .12, inclusive. However, the following special rules are also applicable:

(A) The average value of the taxpayer's cost (including materials and labor) of construction in progress, to the extent that such costs exceed progress billings (accrued or received, depending on whether the taxpayer is on the accrual or cash basis for keeping its accounts) shall be included in the denominator of the property factor. The value of any such construction costs attributable to construction projects in this state shall be included in the numerator of the property factor.

Example 1: Taxpayer commenced a long-term construction project in this state as of the beginning of a given year. By the end of its second year, its equity in the costs of production to be reflected in the numerator and denominator of its property factor for such year is computed as follows:

	1st Year		**2nd Year**	
	Beginning	Ending	Beginning	Ending
Construction Costs	0	$1,000000		
Progress billings		600,000		
Balance 12/31-(1/1)		$400,000	$400,000	
Construction Costs - Total from beginning of project`				$5,000,000
Progress billings - Total from beginning of project				4,000,000
Balance 12/31				1,000,000
Balance beginning of year				400,000
Total				$1,400,000
Average (1/2) - Value used in property factor				$700,000

Note: It may be necessary to use monthly averages if yearly averages do not properly reflect the average value of the taxpayer's equity; see Article IV.12 and Reg. IV.12.

Example 2: Same facts as in Example 1, except that progress billings exceeded construction costs. No value for the taxpayer's equity in the construction project is shown in the property factor.

(B) Rent paid for the use of equipment directly attributable to a particular construction project is included in the property factor at eight times the net annual rental rate even though such rental expense may be capitalized into the cost of construction.

(C) The property factor is computed in the same manner for all long-term contract methods of accounting and is computed for each income year even though under the completed contract method of accounting, business income is computed separately (see paragraph (5) below).

(v) Payroll Factor. In general the numerator and denominator of the payroll factor shall be determined as set forth in Article IV.13 and .14 and Reg. IV.13 and .14. However, the following special rules are also applicable:

(A) Compensation paid employees which is attributable to a particular construction project is included in the payroll factor even though capitalized into the cost of construction.

(B) Compensation paid employees who in the aggregate perform most of their services in a state to which their employer does not report them for unemployment tax purposes, shall nevertheless be attributed to the state in which the services are performed.

Example: A taxpayer engaged in a long-term contract in state X sends several key employees to that state to supervise the project. The taxpayer, for unemployment tax purposes, reports these employees to state Y where the main office is maintained and where the employees reside. For payroll factor purposes and in accordance with Article IV.14 and Reg. IV.14 thereunder, the compensation is assigned to the numerator of state X.

(C) The payroll factor is computed in the same manner for all long-term contract methods of accounting and is computed for each income year even though, under the completed contract method of accounting, business income is computed separately (see paragraph (5) below).

(vi) Sales Factor. In general, the numerator and denominator of the sales factor shall be determined as set forth in Article IV.15-.17, inclusive, and Reg. IV.15-.17, inclusive. However, the following special rules are also applicable:

(A) Gross receipts derived from the performance of a contract are attributable to this state if the construction project is located in this state. If the construction project is located partly within and partly without this state, the gross receipts attributable to this state are based upon the ratio which construction costs for the project in this state incurred during the income year bear to the total of construction costs for the entire project during the income year, or upon any other method, such as engineering cost estimates, which will provide a reasonable apportionment.

Example 1: A construction project was undertaken in this state by a calendar year taxpayer which had elected one of the long-term contract methods of accounting. The following gross receipts (progress billings) were derived from the contract during the three income years that the contract was in progress.

	1st Year	2nd Year	3rd Year
Gross receipts	$1,000,000	$4,000,000	$3,000,000

The gross receipts to be reflected in both the numerator and denominator of the sales factor for each of the three years are the amounts shown.

Example 2: A taxpayer contracts to build a dam on a river at a point which lies half within this state and half within state X. During the taxpayer's first income year, construction costs in this state were $2,000,000. Total construction costs for the project during the income year were $3,000,000. Gross receipts (progress billings) for the year were $2,400,000. Accordingly, gross receipts of $1,600,000 ($2,000,000/$3,000,000 x $2,400,000) are included in the numerator of the sales factor.

(B) If the percentage of completion method is used, the sales factor includes only that portion of the gross contract price which corresponds to the percentage of the entire contract which was completed during the income year.

Example: A taxpayer which had elected the percentage of completion method of accounting entered into a long-term construction contract. At the end of its current income year (the second since starting the project), it estimated that the project was 30% completed. The bid price for the project was $9,000,000 and it had received $2,500,000 from progress billings as of the end of its current income year. The amount of gross receipts to be included in the sales factor for the current income year is $2,700,000 (30% of $9,000,000), regardless of whether the taxpayer uses the accrual method or the cash method of accounting for receipts and disbursements.

(C) If the completed contract method of accounting is used, the sales factor includes the portion of the gross receipts (progress billings) received or accrued, whichever is applicable, during the income year attributable to each contract.

Example 1: A taxpayer which had elected the completed contract method of accounting entered into a long-term construction contract. By the end of its current income year (the second since starting the project), it had billed and had accrued on its books a total of $5,000,000 of which $2,000,000 had accrued in the first year in which the contract was undertaken and $3,000,000 had accrued in the current (second) year. The amount of gross receipts to be included in the sales factor for the current income year is $3,000,000.

Example 2: Same facts as in Example 1 except that the taxpayer keeps its books on the cash basis and, as of the end of its current income year, had received only $2,500,000 of the $3,000,000 billed during the current year. The amount of gross receipts to be included in the sales factor for the current income year is $2,500,000.

(D) The sales factor, except as noted above in subparagraphs (B) and (C), is computed in the same manner, regardless of which long-term method of accounting the taxpayer has elected, and is computed for each income year even though, under the completed contract method of accounting, business income is computed separately.

(vii) Apportionment Percentage. The total of the property, payroll and sales percentages is divided by three to determine the apportionment percentage. The apportionment percentage is then applied to business income to establish the amount apportioned to this state.

(5) Completed Contract Method - Special Computation. The completed contract method of accounting requires that the reporting of income (or loss) be deferred until the year in which the construction project is completed or accepted. Accordingly, a separate computation is made for each such contract completed during the income year, regardless of whether the project is located within or without this state, in order to determine the amount of income which is attributable to sources within this state. The amount of income from each contract completed during the income year apportioned to this state, plus other business income apportioned to this state by the regular three-factor formula such as interest income, rents, royalties, income from short-term contracts, etc., plus all nonbusiness income allocated to this state is the measure of tax for the income year.

The amount of income (or loss) from each contract which is derived from sources within this state using the completed contract method of accounting is computed as follows:

(i) In the income year in which the contract is completed, the income (or loss) therefrom is determined.

(ii) The income (or loss) determined at (i) above is apportioned to this state by the following method:

(A) A fraction is determined for each year during which the contract was in progress. The numerator is the amount of construction costs paid or accrued in each year during which the contract was in progress and the denominator is the total of all such construction costs for the project.

(B) Each percentage determined in (A) is multiplied by the apportionment formula percentage for that particular year as determined in subparagraph (4)(vii) of this regulation above.

(C) The percentages determined at (B) for each year during which the contract was in progress are totaled. The amount of total income (or loss) from the contract determined at subparagraph (5)(i) of this regulation is multiplied by the total percentage. The resulting income (or loss) is the amount of business income from such contract derived from sources within this state.

Example 1: A taxpayer using the completed contract method of accounting for long-term contracts is engaged in three long-term contracts; Contract L in this state, Contract M in state X and Contract N in state Y. In addition, it has other business income (less expenses) during the income year 1972 from interest, rents and short-term contracts amounting to $500,000, and nonbusiness income allocable to this state of $8,000. During 1972, it completed Contract M in state X at a profit of $900,000. Contracts L and N in this state and state Y, respectively, were not completed during the income year. The apportionment percentages of the taxpayer as determined in subparagraph (4)(vii) of this regulation and the percentages of contract costs as determined in subparagraph (5)(ii) above for each year during which Contract M in state X was in progress are as follows:

	1970	1971	1972
Apportionment %	30%	20%	40%
% of Construction Costs of Contract M each year to total construction costs -(100%)	20%	50%	30%

The corporation's net income subject to tax in this state for 1972 is computed as follows:

Business Income	$500,000
Apportion 40% to this state	$200,000
Add: Income from Contract M*	$252,000
Total business income derived from sources within this state	452,000
Add: Nonbusiness income allocated to this state	8,000
Net income subject to tax	$460,000

*Income from Contract M apportioned to this state:

	1970	1971	1972	Total
Apportionment %	30%	20%	40%	
% of Construction Costs	20%	50%	30%	100%
Product	6%	10%	12%	28%

28% of $900,000 = $252,000

Example 2: Same facts as in Example 1 except that Contract L was started in 1972 in this state, the first year in which the taxpayer was subject to tax in this state. Contract L in this state and Contract N in state Y are incomplete in 1972.

The corporation's net income subject to tax in this state for 1972 is computed as follows:

Business Income	$500,000
Apportion 40% to this state	$200,000
Add: Income from Contract M*	108,000
Total business income derived from sources within this state	$308,000
Add: Nonbusiness income allocated to this state	8,000
Net income subject to tax	$316,000

*Income from Contract M apportioned to this state:

	1970	1971	1972	Total
Apportionment %	0	0	40%	
% of Construction Costs	20%	50%	30%	100%
Product	0	0	12%	12%

12% of $900,000 = $108,000

Note: Only 12% is used to determine the income derived from sources within this state since the corporation was not subject to tax in this state prior to 1972.

Example 3: Same facts as in example 1 except that the figures relate to Contract L in this state and 1972 is the first year the corporation was taxable in another state (see Article IV.2 and .3 and Reg. IV.2(b)(1) and .3. Contracts M and N in states X and Y were started in 1972 and are incomplete.

The corporation's net income subject to tax in this state for 1972 is computed as follows:

Business Income	$500,000
Apportion 40% to this state	$200,000
Add: Income from Contract L*	738,000
Total business income derived from sources within this state	$938,000
Add: Nonbusiness income allocated to this state	8,000
Net income subject to tax	$946,000

*Income from Contract L apportioned to this state:

	1970	1971	1972	Total
Apportionment %	100%	100%	40%	
% of Construction Costs	20%	50%	30%	100%
Product	20%	50%	12%	82%

82% of $900,000 = $738,000

(6) Computation for Year of Withdrawal, Dissolution or Cessation of Business - Completed Contract Method. Use of the completed contract method of accounting for long-term contracts requires that income derived from sources within this state from incomplete contracts in progress outside this state on the date of withdrawal, dissolution or cessation of business in this state be included in the measure of tax for the taxable year during which the corporation withdraws, dissolves or ceases doing business in this state.

The amount of income (or loss) from each such contract to be apportioned to this state by the apportionment method set forth in subparagraph (5)(ii) of this regulation shall be determined as if the percentage of completion method of accounting were used for all such contracts on the date of withdrawal, dissolution or cessation of business. The amount of business income (or loss) for each such contract shall be the amount by which the gross contract price from each such contract which corresponds to the percentage of the entire contract which has been completed from the commencement thereof to the date of withdrawal, dissolution or cessation of business exceeds all expenditures made during such period in connection with each such contract. In so doing, account must be taken of the material and supplies on hand at the beginning and end of the income year for use in each such contract.

Example: A construction contractor qualified to do business in this state had elected the completed contract method of accounting for long-term contracts. It was engaged in two long-term contracts. Contract L in this state was started in 1971 and completed at a profit of $900,000 on 12/16/73. The taxpayer withdrew on 12/31/73. Contract M in state X was started in 1972 and was incomplete on 12/31/73. The apportionment percentages of the taxpayer, as determined at subdivision (4) of this regulation, and percentages of construction costs, as determined in subparagraph (5)(ii) of this regulation, for each year during which Contract M in state X was in progress are as follows:

	1971	1972	1973	Total
Apportionment %	30%	20%	40%	
% of Construction Costs:				
Contract L, this state	20%	50%	30%	100%
Contract M, state X	0	10%	25%	35%

The corporation had other business income (net of expenses) of $500,000 during 1972 and $300,000 during 1973. The gross contract price of Contract M (state X) was $1,000,000, and it was estimated to be 35% completed on 12/31/73. Total expenditures to date for Contract M (state X) were $300,000 for the period ended 12/31/73.

The measure of tax for the taxable year ended 12/31/73 is computed as follows:

	Taxable Year 1973	
	Income Year 1972	Income Year 1973
Business Income	$500,000	$300,000
Apportionment % to this state	20%	40%
Amount Apportioned to this state	$100,000	$120,000
Add: Income from contracts:		
L* (this state)		$252,000
M** (state X)	_______	6,000
Total business income derived from sources within this state	$100,000	$378,000

*Income from Contract L apportioned to this state:

	1971	1972	1973	Total
Apportionment %	30%	20%	40%	
% of Construction Costs	20%	50%	30%	100%
Product	6%	10%	12%	28%

28% of $900,000=$252,000

**Income from Contract M apportioned to this state:

	1971	1972	1973	Total
Apportionment %	0	20%	40%	
% of Construction Costs	0	10%	25%	35%
Product	0	2%	10%	12%

12% of 50,000***=$6,000

***Computation of apportionable income from Contract M based on percentage of completion method:

Total Contract Price	$1,000,000
Estimated to be 35% completed	$350,000
Less: total expenditures to date	300,000
Apportionable income	$50,000