October 31, 1991

COORDINATED ISSUE
AEROSPACE INDUSTRY
COST OVERRUNS AND UNDERRUNS

Issue

Whether or not the taxpayer is entitled to claim as a current deduction the government's share of cost underruns for which a repayment of an undetermined amount will be made by taxpayer in an uncertain future period. There is no issue with cost overruns.

Background

Cost Plus Incentive Fee (CPIF) and Fixed Price Incentive (FPI) contracts provide for an adjustment of profit and the establishment of the final contract cost and price by a formula based on the relationship which final negotiated total cost bears to the total target cost. The formula or share ratio provides that the Government and contractor will share the responsibility of cost greater or less than those originally estimated, as determined by a comparison of negotiated final cost with target cost.

Under these types of incentive contracts there is negotiated at the outset a target cost, a target profit and the above mentioned share ratio. After contract performance, the final cost is negotiated and the final price is then established. A cost underrun results when the final cost is less than target cost and the final profit then becomes greater than the target profit. This also, results with an increase to gross profit as set forth in the contracts fee sharing formula.

In a cost underrun position the contractor bills the Government at target terms which exceeds the (sales) amount reported as income. For example, in those Fixed Price Incentive contracts which provide for a share ratio, the taxpayer will keep the government's share of the underrun. It may be many years after contract delivery before remittance is made to the Government. It is the future payment of this excess in an uncertain period which is at issue.

Those taxpayers who maintain an account title unbilled accounts receivable in the General Ledger are likely to show a debit balance at year end. An analysis of the unbilled accounts receivable is required to show those FPI contracts which have credit balances and those contracts with debit balances. The issue arises with those FPI contracts with credit balances in unbilled accounts receivable.

Before raising the cost underrun issue on those taxpayers who are on the completed

contract method of accounting, it is necessary to consider the eligibility status of the FPI contract. At least three considerations are required on FPI contracts with credit balances:

1. The cost underrun issue exists on FPI contracts which have not been allowed to qualify as long term contracts.

2. The cost underrun issue exists on FPI contracts which have not been placed on the CCMA by the taxpayer; i.e., service contracts.

3. The cost underrun issue exists on FPI which have been determined to qualify for the CCMA, but the contract has been closed or completed, i.e. income has been recognized per Regs 1.451-3(d)(1).

Large defense contractors and others who do business with the Government are required to adhere to DAR (Defense Acquisition Regulations). The intent of these regulations is to have these types of businesses adhere to a uniform set of rules and practices. Included in DAR, is a clause which provides for repayment of the underrun within 45 days after its existence. The facts may show that the repayment clause is not being followed by the company. In actual practice, the taxpayer may be remitting the government's share of the cost underrun 3 to 7 years after final delivery and acceptance. Further review may also indicate the taxpayer may not be revealing the proper amount of the underrun it owes to the Government.

Law

Because the cost underrun issue arises as a credit balance in an asset account, i.e., unbilled accounts receivable, one can argue that a taxpayer is holding on to the Government's share of the cost underrun under the claim of right doctrine. Accordingly an argument can be make to include this excess as income under the claim of right doctrine which involves income received and held during the year of receipt, under a claim that the taxpayer is entitled to it. "Income is taxable when it is received under a claim of right and without restriction as to its disposition, although the taxpayer's right to retain the income is disputed and although he may subsequently have to return it" as held in North American Oil Consol v. Burnet (1932), 286 U.S. 417, 76 L. ed 1197, 52 S ct. 613, 11 AFTR 16. As stated in the Supreme Court decision Healy v. Comm., 345 U.S. 278 "...there is a claim of right when funds are received and treated by a taxpayer as belonging to him."

In the present situation the contractor enjoys the economic benefit of possessing the Government's share of the cost underrun without restriction as to its disposition. It may be a number of years before the contractor has to pay back the Government's share of

the cost underrun. At the time of payment the contractor will be entitled to the deduction.

Now that the taxpayer has been taxed on the cost underrun under the claim of right doctrine, the taxpayer is generally entitled to a deduction for subsequent repayment in the year when the liability to repay becomes fixed under the accrual method.

Regulation Section 1.461-1(a)(2) provides that under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy.

At this time the repayment of the Government's share of the cost underrun will not be allowed as a deduction until:

1. The taxpayer formally acknowledges the Government's share of the cost underrun in writing to the Government.

2. The taxpayer determines the exact amount of underrun which should correspond to the credit balance in unbilled accounts receivable.

Conclusion

The underrun situation provides a problem that is not found in overruns. The taxpayer is billing at target rates while incurring lesser costs. This difference between what has been billed and received and what has been included in income remains in the hands of the taxpayer for long periods of time while not being reported for tax purposes. The IRS is requiring the taxpayer to include in income the Government's share of the cost underrun and to receive an offsetting deduction when the taxpayer formally acknowledges the underrun and determines the exact amount it owes to the Government.

Even through the completed contract method of accounting election has mitigated the potential size of the cost underrun adjustment, it is likely to exist on those FPI contracts which have been closed out by the taxpayer per Regs 1.451-3(d), or non-qualifying, long-term FPI contracts.