Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.
Telephone Number:

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Date: July 29, 2005

DO: LMSB Taxable Years

Legend

A

B

Year 1

Year 2

Year 3

Year 4

Year 5

Date 1

Date 2

Date 3

Dear

This ruling is in reply to a request submitted by A (the taxpayer), requesting an extension of time under § 301.9100-1(c) of the Procedure and Administration Regulations and Rev. Proc. 2005-1, 2005-1 I.R.B. 1 (Jan. 3, 2005), to elect the simplified production method with historic absorption ratio election pursuant to

§ 1.263A-2(b)(4) of the Income Tax Regulations, effective for the taxable year ended Date 1.

FACTS

A designs, creates, builds, and sells B. For at least three years prior to its taxable Year 3, A had used the simplified production method without the historic absorption ratio (SPM) election provided by § 1.263-2(b)(3) to determine its additional costs under § 263A of the Internal Revenue Code properly allocable to ending inventories of property produced and other eligible property on hand at the end of the taxable year. Beginning with its taxable year ended Date 1, A began to determine these additional costs using the simplified production method with historic absorption ratio election (HAR).

To reflect this change in its simplified production method, during Year 4, A's Corporate Tax Department reviewed both the requirements for electing the simplified production method with historic absorption ratio and accounting method change procedures. Consequently, the Corporate Tax Department understood that in order to elect this simplified production method, A was required to attach its election of this method to its timely filed federal income tax return for Year 3. The Corporate Tax Department prepared the required statement with the intention of including it with A's Year 3 tax return. However, the election statement was inadvertently placed in the work papers supporting the Year 3 tax return rather than with the tax return itself, and thus was not included in A's Year 3 tax return filed with the Internal Revenue Service. However, A prepared and filed its Year 3 tax return and all subsequent returns consistent with its having duly elected the simplified production method with historic absorption ratio as provided by § 1.263A-2(b)(4).

On or about Date 2, while reviewing documents in preparation for filing Applications for Change in Accounting Method, Forms 3115, for unrelated matters, A's Tax Manager discovered that the required election statement had not been included with A's tax return for Year 3. Shortly thereafter, A filed this request for an extension of time.

A is a taxpayer under continuous examination by the Service. At the time of this request for an extension of time under § 301.9100-1(c), the Service was concluding its examination of A's taxable Year 1 through Year 2. At the time of A's ruling request, the issue of A's timely election of the simplified production method with historic absorption ratio was not under consideration by the examining agent. The next examination cycle, covering taxable Year 3 through Year 5, was due to begin on Date 3. A stated in its ruling request that it would provide a copy of this extension request to the examining agent at the opening conference for this cycle.

THE LAW

Section 263A provides uniform rules for capitalizing certain expenses, including the direct and an allocable portion of the indirect costs of producing real or tangible personal property. In the case of property that is inventory in the taxpayer's hands, such costs must be included in the taxpayer's inventory costs.

Section 1.263A-1(d)(4) defines § 263A costs as the costs that a taxpayer must capitalize under § 263A, consisting of the sum of the taxpayer's § 471 costs, additional § 263A costs, and interest capitalizable under § 263A(f).

Section 1.263A-1(d)(3) defines additional § 263A costs as the costs, other than interest, that were not capitalized under the taxpayer's method of accounting immediately prior to the effective date of § 263A but that are required to be capitalized under § 263A.

Section 1.263A-1(d)(2)(i) generally defines § 471 costs for purposes of the § 263A regulations as the costs (other than interest) capitalized under the taxpayer's method of accounting immediately prior to the effective date of § 263A.

Section 1.263A-2(b) provides simplified methods for determining the additional § 263A costs allocable to ending inventories of property produced and other eligible property on hand at the end of the taxable year. These are the SPM and the HAR.

Section 1.263A-2(b)(3) provides generally that under the SPM, additional § 263A costs allocable to eligible property remaining on hand at the close of the taxable year equal the absorption ratio times the § 471 costs remaining on hand at year end. The absorption ratio equals the additional § 263A costs incurred during the taxable year divided by the § 471 costs incurred during the taxable year. Under the SPM, the taxpayer calculates an absorption ratio for each taxable year.

Section 1.263A-2(b)(4) permits qualifying taxpayers to elect the simplified production method with historic absorption ratio, a method of calculating additional § 263A costs that does not require calculating an absorption ratio for each taxable year. Under § 1.263A-2(b)(4), a taxpayer that properly elects the simplified production method with historic absorption ratio may calculate a historic absorption ratio and use that ratio as its absorption ratio during the qualifying period, as defined in § 1.263A-2(b)(4)(ii)(C), in order to determine the additional § 263A costs allocable to eligible property on hand at the end of each taxable year.

The qualifying period, defined in § 1.263A-2(b)(4)(ii)(C), includes each of the first five taxable years beginning with the first taxable year after a test period (or an updated test period).

Section 1.263A-2(b)(4)(ii) provides that the historic absorption ratio equals the additional § 263A costs incurred during the test period divided by the § 471 costs incurred during the test period.

The test period generally is the three-year period immediately preceding the taxable year that the simplified production method with historic absorption ratio is adopted. *See* § 1.263A-2(b)(4)(ii)(B).

Section 1.263A-2(b)(4)(i) provides that a taxpayer may elect the simplified production method with historic absorption ratio if: (1) the taxpayer has used the SPM for three or more consecutive years immediately prior to the taxable year of election; (2) the taxpayer has capitalized additional § 263A costs using an actual absorption ratio for its three most recent consecutive taxable years; and (3) the taxpayer was not deemed to have zero additional § 263A costs under the *de minimis* rule of § 1.263A-2(b)(3)(iv).

Section 1.263A-2(b)(4)(iii)(A) provides that a taxpayer using the SPM may elect the simplified production method with historic absorption ratio in any taxable year, if permitted under § 1.263A-2(b)(4), provided the taxpayer has not obtained the Commissioner's consent to revoke this method within its prior six taxable years.

Section 1.263A-2(b)(4)(iv)(A) provides that a taxpayer electing to use the simplified production method with historic absorption ratio must attach a statement to its income tax return for the taxable year in which the election is made. The statement must show the actual absorption ratios determined under the SPM during the taxpayer's first test period. Additionally, the statement must disclose the historic absorption ratio that the taxpayer will use during its qualifying period.

Under § 301.9100-1(c), the Commissioner has discretion to grant a reasonable extension of time to make a regulatory election under all subtitles of the Code except subtitles E, G, H, and I, provided that the taxpayer acted reasonably and in good faith, and provided that granting relief will not prejudice the interests of the Government. Section 301.9100-1(b) defines a regulatory election as an election whose due date is prescribed by a regulation published in the Federal Register, or a revenue ruling, revenue procedure, notice, or announcement published in the Internal Revenue Bulletin. An election is defined to include a request to adopt, change, or retain an accounting method.

Section 301.9100-2 sets forth rules governing automatic extensions for regulatory elections. If the provisions of § 301.9100-2 do not apply to a taxpayer's situation, the provisions of § 301.9100-3 may apply instead.

Section 301.9100-3 sets forth the standards that the Commissioner will use in determining whether to grant an extension of time to make a regulatory election. It also sets forth information and representations that must be furnished by the taxpayer to enable the Service to determine whether the taxpayer has satisfied these standards.

The standards to be applied in this case are whether the taxpayer acted reasonably and in good faith and whether granting relief would prejudice the interests of the Government.

Under § 301.9100-3(b)(1)(i), a taxpayer applying for relief for failure to make an election before the failure is discovered by the Service ordinarily will be deemed to have acted reasonably and in good faith. However, pursuant to § 301.9100-3(b)(3), a taxpayer will not be considered to have acted reasonably and in good faith if the taxpayer seeks to alter a return position for which an accuracy-related penalty has been or could be imposed under § 6662 at the time the taxpayer requests relief and the new position requires or permits a regulatory election for which relief is requested, or if the taxpayer was informed in all material respects of the required election and related tax consequences but chose not to file the election. Furthermore, a taxpayer ordinarily will not be considered to have acted reasonably and in good faith if the taxpayer uses hindsight in requesting relief.

Section 301.9100-3(c)(1)(i) provides that the interests of the Government are prejudiced if granting relief would result in a taxpayer having a lower tax liability in the aggregate for all tax years affected by the regulatory election than the taxpayer would have had if the election had been timely made (taking into account the time value of money). Likewise, if the tax consequences of more than one taxpayer are affected by the election, the Government's interests are prejudiced if extending the time for making the election may result in the affected taxpayers, in the aggregate, having a lower tax liability than if the election had been timely made.

Further, § 301.9100-3(c)(1)(ii) provides that the interests of the Government are ordinarily prejudiced if the tax year in which the regulatory election should have been made or any tax years that would have been affected by the election had it been timely made are closed by the period of limitations on assessment under § 6501(a) before the taxpayer's receipt of a ruling granting relief under § 301.9100-3.

CONCLUSION

Based solely on the facts and representations submitted, we conclude that the requirements of §§ 301.9100-1 and 301.9100-3 have been satisfied. Accordingly, we grant an extension of time for A to file the necessary documents to satisfy the requirements for electing the simplified production method with the historic absorption ratio, effective with A's taxable year ended Date 1. This extension shall be for a period of 30 days from the date of this ruling. A copy of this letter must be attached to any income tax return to which it is relevant.

The ruling contained in this letter is based upon information and representations submitted by A and its representatives 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 this ruling, they are subject to verification on examination.

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 referenced in this letter. Further, no opinion is expressed as to the application of any other provisions of the Code or regulations that may be applicable to this election. Specifically, this ruling addresses only the request to extend the period for electing the simplified production method with historic absorption ratio and does not, directly or indirectly, approve any inventory accounting method used by A to capitalize costs. Particularly, A's qualification to use the HAR and the validity of its data supporting its simplified § 263A method, will be determined upon examination.

This ruling is directed only to A, the taxpayer requesting it. Section 6110(k)(3) 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 A's authorized representative.

Sincerely,

Jeffery G. Mitchell
Branch Chief, Branch 6
(Income Tax & Accounting)