INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

October 27, 2005

Third Party Communication: None
Date of Communication: Not Applicable

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CASE-MIS No.: TAM-157531-04/CC:ITA:B6

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Year(s) Involved:
Date of Conference:

LEGEND:

Parent =

SUB1 =

SUB2 =

Date 1 =

Date 2 =

Date 3 =

X =

ISSUES:

(1) Are amounts capitalized by Taxpayer prior to the enactment of § 263A of the Internal Revenue Code § 471 costs within the meaning of § 1.263A-1(d)(2)?

(2) Did Taxpayer properly change its method of accounting for the costs at issue when it removed those costs from the numerator of the simplified production method ratio for purposes of calculating the historic absorption ratio ("HAR")?[1]

CONCLUSIONS:

(1) Those amounts capitalized by Taxpayer prior to the enactment of § 263A are § 471 costs within the meaning of § 1.263A-1(d)(2).

(2) Taxpayer did not properly change its method of accounting for the costs at issue when it removed those costs from the numerator of the simplified production method ratio for purposes of calculating the historic absorption ratio.

FACTS:

SUB1 and SUB2 (collectively, "SUBS") are subsidiaries of Parent. Parent and SUBS (collectively, "Taxpayer") are members of an affiliated group that files consolidated federal income tax returns. Taxpayer is primarily engaged in the manufacture and sale of X products. As a manufacturer, Taxpayer is subject to the requirements of § 263A of the Internal Revenue Code and the regulations thereunder.

Taxpayer uses its book standard cost method to allocate direct costs and indirect costs to property produced during the taxable year. The standard cost rates used to allocate § 471 costs are Taxpayer's book standard cost rates. Taxpayer's indirect costs include costs capitalized prior to the enactment of § 263A and costs initially capitalized subsequent to the enactment of § 263A.

On or about Date 1, Parent, on behalf of SUBS, filed an Application for Change in Accounting Method (Form 3115) under the provisions of section 6.01(4) of Rev. Proc. 97-27, 1997-1 C.B. 680. Parent requested to change SUBS' methods of accounting for certain inventory costs under § 263A for the taxable year beginning Date 2.

Taxpayer requested permission to change certain items of costs in its computations under § 263A. In particular, Taxpayer requested permission to change its method of accounting for pick and pack costs, distribution costs, recovery allowances for temporarily idle facilities, and costs related to budgeting, general policy making and strategic business planning. Taxpayer sought permission to change from capitalizing

[1] The request for technical advice also asked whether Taxpayer's removal of § 471 costs from the numerator of the simplified production method ratio under § 263A, for purposes of calculating the historic absorption ratio, clearly reflects income under § 446. It is unnecessary to address this issue given the resolution of the second issue.

these amounts to currently deducting them. Some of these costs had been capitalized by Taxpayer prior to the enactment of § 263A while other costs were initially capitalized subsequent to the enactment of § 263A. The costs which had been capitalized by Taxpayer under its standard cost method prior to the enactment of § 263A were included in its "§ 471 costs" for purposes of the simplified production method calculation under § 263A.

Taxpayer did not propose, as part of the change in method of accounting, to reclassify any § 471 costs as additional § 263A costs, or vice-versa. In response to a request for additional information regarding its proposed change in method of accounting, Taxpayer stated:

> The taxpayers are not changing their definition of § 471 costs and additional § 263A costs as a result of this accounting method change. Additional § 263A costs will continue to be defined as all costs, other than interest, that were not capitalized by the taxpayers prior to the effective date of § 263A but that are now required to be capitalized under § 263A. As such, additional § 263A costs represent the difference between the total amount of costs required to be capitalized under § 263A and those amounts properly classified as § 471 costs. Thus, additional § 263A costs consist principally of mixed service costs and certain production costs. Section 471 costs will continue to be defined as all costs, other than interest, that were capitalized by the taxpayers immediately prior to the effective date of § 263A.

The Service granted Taxpayer consent ("Consent Agreement") for the requested change on Date 3. The Consent Agreement allows Taxpayer to exclude from inventory the costs described in its Form 3115. The Consent Agreement also states the following, in relevant parts:

> The taxpayers will continue to use the standard cost method to allocate direct and indirect costs to property produced during the taxable year. The taxpayers will continue to determine capitalizable mixed service costs using a reasonable allocation method. The taxpayer will continue to use the simplified production method without the historic absorption ratio election to allocate additional § 263A costs to ending inventory. [2]

The Consent Agreement did not specify a methodology for calculating Taxpayer's § 481 adjustment. In addition, while the Consent Agreement specified the particular cost items that would no longer be capitalized under Taxpayer's proposed method of accounting, the Consent Agreement did not specify the computational methodology for

[2] While Taxpayer did in fact make a HAR election for the years at issue, Taxpayer's submissions relating to its change in accounting method, as well as the Consent Agreement, stated that it was not using the HAR. Nevertheless, the Service is not presently challenging Taxpayer's use of the HAR.

the removal of these costs in the determination of Taxpayer's inventory valuations subsequent to the change in method of accounting.

After receiving the Consent Agreement, Taxpayer filed elections to use a HAR for the taxable years at issue. Taxpayer used the simplified production method with the HAR to allocate additional § 263A costs to ending inventory.

In order to implement the change in method of accounting and discontinue the capitalization of the relevant costs, Taxpayer adjusted variables in the formula for the simplified production method, and in particular, the HAR. Specifically, in determining the amount of Taxpayer's § 481 adjustment, as well as in determining the value of its ending inventory under its new method of accounting subsequent to the accounting method change, Taxpayer did not remove the deductible costs from its § 471 costs. Rather, Taxpayer removed these deductible costs from the numerator of the simplified production method absorption ratio (i.e., from additional § 263A costs incurred during the test period) and not from the denominator (i.e., not from § 471 costs incurred during the test period). Taxpayer also did not remove the costs at issue from its § 471 costs in ending inventory. In short, neither the § 471 costs contained in the denominator of the simplified production method absorption ratio nor the § 471 costs in ending inventory were adjusted for the amount of the deductible costs.

Taxpayer's method of discontinuing capitalizing the costs at issue affected the amount of other costs included in ending inventory. In particular, Taxpayer's method of removing the costs at issue from additional § 263A costs in the aggregate results in the removal of an amount of different from the amount that would be removed if Taxpayer had readjusted its standard costs to stop including such costs in § 471 costs. This difference results because the costs at issue were capitalized to different items at different rates by Taxpayer under its book method of accounting while the costs were removed from ending inventory based on the overall percentage of costs remaining in ending inventory. As a result, in each of the years at issue, the decrease in ending inventory exceeded the amount of costs at issue originally capitalized and included in ending inventory by Taxpayer. That is, Taxpayer's method of removing costs from ending inventory resulted in more costs being removed than were first included.

LAW AND ANALYSIS:

At issue in this case is the manner in which Taxpayer changed its method of accounting for pick and pack costs, distribution costs, recovery allowances for temporarily idle facilities, and costs related to budgeting, general policy making and strategic business planning that Taxpayer capitalized prior to the enactment of § 263A. On Date 3 the Service granted Taxpayer permission to change its method of accounting for these amounts from capitalizing them to deducting them currently. The field is challenging the manner in which Taxpayer implemented this change in its method of accounting.

Determining whether the costs at issue are § 471 costs within the meaning of § 1.263A-1(d)(2) is the first step in resolving the issues in this request for technical advice. This determination is necessary to resolve whether Taxpayer properly changed its method of accounting for the costs at issue. For the reasons described below, the costs at issue in this case are § 471 costs within the meaning of § 1.263A-1(d)(2) and Taxpayer did not properly change its method of accounting for these costs.

(1) Amounts capitalized by Taxpayer prior to the enactment of § 263A are § 471 costs within the meaning of § 1.263A-1(d)(2).

As noted above, the first issue in this case is whether the amounts at issue are § 471 costs within the meaning of § 1.263A-1(d)(2). This is relevant because the regulations under § 263A distinguish between amounts that a taxpayer capitalized before enactment of § 263A and amounts that a taxpayer is required to capitalize under § 263A. The distinction between § 471 costs and additional § 263A costs is particularly important for taxpayers, such as Taxpayer, that use the simplified production method with the historic absorption ratio election to allocate additional § 263A costs to ending inventory. See § 1.263A-2(b)(4).

Section 1.263A-1(d)(2)(i) provides that a taxpayer's § 471 costs are the costs, other than interest, capitalized under its method of accounting immediately prior to the effective date of § 263A. The regulation further clarifies that although § 471 applies only to inventories, § 471 costs include any non-inventory costs, other than interest, capitalized or included in acquisition or production costs under the taxpayer's method of accounting immediately prior to the effective date of § 263A. See § 1.263A-1(d)(2)(i).

In this case, Taxpayer capitalized the amounts at issue prior to the enactment of §263A. These amounts were part of Taxpayer’s standard (book) costing system prior to the enactment of § 263A and were included in § 471 costs by Taxpayer for purposes of the simplified production method calculation under § 263A. Accordingly, the amounts at issue are § 471 costs within the meaning of § 1.263A-1(d)(2).

(2) Taxpayer did not properly change its method of accounting for the costs at issue when it removed those costs from the numerator of the simplified production method ratio for purposes of calculating the historic absorption ratio.

Given that the amounts at issue are § 471 costs, the second issue is whether Taxpayer’s removal of those amounts from the numerator of the simplified production method absorption ratio was a proper method of implementing the terms of the Consent Agreement. As noted above, the Consent Agreement gives Taxpayer permission to discontinue capitalizing the costs at issue. Under the Consent Agreement, the field must apply the ruling in determining Taxpayer’s liability unless it recommends that the ruling be modified or revoked. Further, the field is to ascertain, inter alia, whether the change in method of accounting was implemented as proposed in accordance with the

terms and conditions of the Consent Agreement and Rev. Proc. 97-27. Taxpayer did not properly implement the Consent Agreement for the reasons described below.

(a) Adjusting additional § 263A costs is not a proper way of removing amounts from § 471 costs.

The first reason Taxpayer did not properly implement the Consent Agreement is that Taxpayer's methodology improperly treated § 471 costs as additional § 263A costs. Section 1.263A-1(d)(2)(i) provides generally that a taxpayer's § 471 costs are the costs, other than interest, capitalized under its method of accounting immediately prior to the effective date of § 263A. As noted above, the costs at issue in this request for technical advice are § 471 costs within the meaning of § 1.263A-1(d)(2).

Additional § 263A costs are defined under § 1.263A-1(d)(3) 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. In this case, Taxpayer received permission to stop capitalizing and start deducting pick and pack costs, distribution costs, recovery allowances for temporarily idle facilities, and costs related to budgeting, general policy making and strategic business planning. These costs were capitalized by Taxpayer immediately prior to the effective date of § 263A. These costs are not required to be capitalized under § 263A. These costs are not additional § 263A costs as defined by § 1.263A-1(d)(3).

Before it received its Consent Agreement, Taxpayer capitalized the costs at issue by including them in its § 471 costs. The Consent Agreement permitted Taxpayer to stop capitalizing and start deducting these costs. Taxpayer did not implement the Consent Agreement by ceasing to include the costs at issue in its § 471 costs. Rather, Taxpayer continued to include those costs in its § 471 costs but made a downward adjustment in the amount of its additional § 263A costs. In effect, Taxpayer treated the costs at issue as additional § 263A costs. This was improper because, as noted above, the costs at issue are not additional § 263A costs.

It could be argued that removing the costs at issue from additional § 263A costs is consistent with its use of the simplified production method under § 1.263A-2(b). The regulations under § 263A provide simplified methods for determining the additional § 263A costs properly allocable to ending inventories. See § 1.263A-2(b) (simplified production method) and § 1.263A-3(d) (simplified resale method). However, the regulations do not provide a simplified method for removing § 471 costs by making an adjustment to additional § 263A costs. Rather, the regulations provide a mechanism for a taxpayer to change its method of accounting for § 471 costs. See § 1.263A-1(d)(2). Accordingly, if a taxpayer wishes to stop capitalizing amounts it is treating as § 471 costs, it must do so by making an adjustment to § 471 costs, not to additional § 263A costs.

Taxpayer further asserts that requiring it to change its § 471 costs is inconsistent with the purpose of the § 263A regulations. Support for this argument can be found in the definition of § 471 costs in § 1.263A-1(d)(2) as well as in the preamble to the temporary regulations which contains language indicating that taxpayers may treat their § 471 costs as "frozen." See T.D. 8131, 1987-1 C.B. 98, 102; S. Rep. No. 313, 99th Cong., 2d Sess. 142 (1986), 1986-3 C.B. (Vol. 3) 1. Under this theory, a taxpayer may continue to use an improper method of calculating § 471 costs while adding additional § 263A costs to that "improper" amount.

While support exists for the proposition that the Service will not force a taxpayer to correct an improper exclusion or inclusion of costs from its § 471 costs, a taxpayer is not precluded from voluntarily seeking permission to change a method of accounting for § 471 costs. Indeed, the preamble notes that any change in determining § 471 costs is a method change. Specifically, the preamble states:

> The determination by a taxpayer of its section 471 costs under the simplified production method shall be made by reference to the methods of accounting used by such taxpayer immediately prior to the effective date of the Act. Any change in the determination of section 471 costs which would constitute a change in method of accounting under law prior to the Act shall be deemed to constitute a change in method of accounting under section 263A, and is thus subject to all requirements of law regarding such change.

T.D. 8131, 1987-1 C.B. 98, 102. Further, § 1.263A-1(d)(2)(iii) provides rules for changing a taxpayer's method of accounting for § 471 costs. Thus, the preamble to the temporary regulations and the final regulations are consistent in permitting taxpayers to change their method of accounting for § 471 costs. Both contemplate that taxpayers may change their method of accounting for § 471 costs. Neither support the proposition that a taxpayer may never change its method of accounting for § 471 costs.

In this case, Taxpayer asked for permission to change its method of accounting for certain § 471 costs. That is, it sought permission to currently deduct amounts that it capitalized before enactment of § 263A. As noted above, this change is properly implemented by adjusting its § 471 costs as contemplated by § 1.263A-1(d)(2) and not by adjusting additional § 263A costs, another type of cost.

(b) Taxpayer's method of implementing the Consent Agreement resulted in the removal of costs other than the costs for which it was granted permission to remove by the Consent Agreement.

The second reason Taxpayer did not properly implement the Consent Agreement is that Taxpayer stopped capitalizing and started deducting amounts in excess of the amounts covered by the Consent Agreement. Taxpayer's removal of the § 471 costs at issue by reducing its additional § 263A costs results in the removal of an amount of

costs from ending inventory greater than the amount of costs originally included in Taxpayer's ending inventory as § 471 costs under Taxpayer's original method of accounting. This results because the costs at issue were capitalized to different items at different rates by Taxpayer under its book method of accounting while the costs were removed from ending inventory based on the overall aggregate percentage of costs remaining in ending inventory. As a result, in each of the years at issue the decrease in ending inventory exceeded the amount of costs at issue originally capitalized by Taxpayer into ending inventory. By removing costs from ending inventory in excess of the costs that were originally capitalized in ending inventory as § 471 costs, Taxpayer effectively reclassified costs that were not the subject of Taxpayer's Form 3115.

The Consent Agreement granted Taxpayer permission to stop capitalizing and start deducting pick and pack costs, distribution costs, recovery allowances for temporarily idle facilities, and costs related to budgeting, general policy making and strategic business planning. It did not grant Taxpayer permission to stop capitalizing and start deducting other costs. Nevertheless, this resulted from the manner in which Taxpayer implemented its change in method of accounting. As a result, Taxpayer did not properly implement the change in accounting method described in the Consent Agreement.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.