INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

April 25, 2006

Third Party Communication: None
Date of Communication: Not Applicable

Number: **200631029**
Release Date: 8/4/2006
Index (UIL) No.: 263A.04-05, 263A.04-05
CASE-MIS No.: TAM-155106-05

Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

Taxpayer =

f =

b =

c =

d =

e =

g =

h =

j =

k =

X =

Y =

Z =

T =

U =

V =

W =

S =

Year 3 =

Year 1 =

Year 2 =

n =

ts =

ab =

ih =

cd =

tp =

sp =

gg =

np =

t =

wc =

l =

aa =

cc =

ac =

cb =

cz =

cd =

mt =

pn =

hm =

Date 2 =

Date 1 =

Date 3 =

city B =

city M =

w =

ISSUE(S):

1. Whether the Commissioner's letter ruling permits Taxpayer to use the simplified resale method pursuant to § 1.263A-3 of the Income Tax Regulations.

2. Whether Taxpayer qualifies to use the simplified resale method pursuant to § 1.263A-3.

3. Whether the Commissioner's ruling letter authorizing Taxpayer to use the simplified resale method should be modified or revoked, and if so, whether the modification or revocation should apply retroactively.

CONCLUSION(S):

1. The Commissioner's letter granting Taxpayer permission to change its method to the simplified resale method is a letter ruling. Taxpayer ordinarily may rely on the letter ruling and use the simplified resale method unless the Commissioner determines that the consent was granted in error and revokes the letter ruling.

2. Taxpayer does not qualify to use the simplified resale method pursuant to § 1.263A-3. Taxpayer is a producer and does not qualify for the exceptions that permit taxpayers engaged in both production and resale activities to use the simplified resale method.

3. The Commissioner's letter ruling was issued in error. Taxpayer does not satisfy the conditions for relief under § 7805(b) of the Internal Revenue Code. The letter ruling is revoked retroactively.

FACTS:

Taxpayer is a retailer that operates stores selling f, b, and c (products) for h, j, and k under the X, Y, and Z brands. Taxpayer operates retail stores under the following names: X, T, U, V, W, Z, and S. As of early Year 3, the number of stores operated by Taxpayer was more than n.

Taxpayer designs virtually all of its products. The products in turn are manufactured by independent sources (vendors). Taxpayer sells the products under its brands. Specifically, Taxpayer creates designs for its products consistent with its ts. Once designs are created, "ab samples" of the designs are created by outside vendors to help Taxpayer choose the right assortment of products for its stores. However, if there is insufficient time between the creation of the designs and the need for the samples, Taxpayer creates the samples in-house. Once the samples are created, Taxpayer selects the designs that it would like to see in the stores.

Taxpayer does not manufacture any products and does not own production facilities of any kind. Rather, Taxpayer provides vendors with the specifications that detail how the final products should look and the vendors produce the products, which are sold in Taxpayer's stores. These specifications include sketches and other details that convey how the final products should look. The specifications account for cd, ih, tp, etc, for gg.

Taxpayer selects most of the e and other material used to make its finished products. Taxpayer also selects the g that supplies the e and materials used to make

the finished products. Further, Taxpayer works with the g in developing the precise e needed to make the finished products. However, Taxpayer does not purchase the e and other materials from the g used to produce the finished goods.

In addition to the ab samples, Taxpayer obtains "np samples" and "t samples" from the vendors. The np samples are sent to the Taxpayer for approval that the raw material, wc, etc., are as agreed. In addition to the np samples, vendors send samples to Taxpayer to use to t l. The t samples are put on l to check for aa, mt, and pn. These samples are cc, adjusted, ac, and reproduced pursuant to Taxpayer's comments until Taxpayer and the vendors are satisfied that the product meets Taxpayer's needs and can be manufactured by the vendors.

In the typical contract between Taxpayer and vendors, vendors warrant that they will not disclose nor have disclosed to any third party, nor have used or will use for their own benefit, any Taxpayer trade secrets or information which may reasonably be believed to be confidential to Taxpayer such as designs, cb, etc. Further, Taxpayer requires vendors to offer all seconds, overruns, unused goods and rejected goods (collectively seconds) of goods produced for Taxpayer to its cd prior to making such goods available to any third party. Additionally, Taxpayer requires the vendors to remove all reference to its tradenames and trademark on goods in those situations where its cd cannot accept the goods and authorizes their transfer to a third party.

The vendors assume all risk of loss prior to delivery of goods to Taxpayer or its agent. The vendors also assume all risk of loss after delivery if the goods are not accepted, nonconforming, or if they have otherwise breached any term of the agreement with Taxpayer.

On Date 2, Taxpayer filed a Form 3115, Application for Change in Accounting Method, requesting the Commissioner's consent to change certain aspects of its method of inventory costing pursuant to § 263A. In the Form 3115, Taxpayer requested to use the simplified resale method without the historic absorption ratio election to allocate additional § 263A costs to ending inventory.

Taxpayer's response in its Form 3115 to the question asking it to describe its trade or business was as follows:

> The taxpayer is a d retailer that operates stores selling its brand name f, b, and c for h, j, and k as well as hm. The taxpayer operates retail stores under the X, T,U, V, Y, and Z names. . . . The taxpayer operates state-of-the-art distribution centers to receive merchandise manufactured to its specifications and purchased from unrelated third party manufacturers. The taxpayer has headquarters in city B, product development offices in city M and offices coordinating sourcing activities around the globe.

On Date 3, the Internal Revenue Service (IRS) national office issued a ruling to Taxpayer granting it permission to change its method of accounting to the simplified resale method under § 1.263A-3(d)(3) for the w taxable year beginning Date 1.

The examination team currently examining Taxpayer's returns for fiscal years Year 1 and Year 2 believes that Taxpayer is ineligible to use the simplified resale method and that the consent to use that method should be revoked.

LAW AND ANALYSIS:

1. Whether the Commissioner's letter ruling permits Taxpayer to use the simplified resale method pursuant to § 1.263A-3.

Section 601.204(c) of the Statement of Procedural Rules provides in part that written permission to a taxpayer by the national office consenting to a change in his accounting method is a "ruling." Similarly, Rev. Proc. 2005-1, 2005 I.R.B. 6, provides in part that a letter ruling includes the written permission or denial of permission by an Associate office to a request for a change in a taxpayer's accounting method.

Section 9.19 of Rev. Proc. 2005-1 provides that a taxpayer may rely on a change in accounting method letter ruling received from the Associate office, subject to certain conditions and limitations. See §§ 9, 10, and 11 of Rev. Proc. 97-27, 1997-1 C.B. 680, as modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696.

Section 10 of Rev. Proc. 97-27 sets forth the condition that a taxpayer that changes to a method of accounting pursuant to a change in method letter ruling may be required to change or modify that method upon written notice to the taxpayer that the change in method of accounting was granted in error or is not in accord with the current views of the Service. Moreover, § 601.201(l)(4) of the Statement of Procedural Rules provides that a ruling found to be in error or not in accord with the current views of the Service may be revoked or modified.

In this case, Taxpayer submitted a request for permission to change its method of accounting to the simplified resale method. On Date 3, the Commissioner, through the national office, granted Taxpayer permission to change its method of accounting to the simplified resale method. Therefore, the Date 3 letter is a ruling. It is written permission consenting to a change in accounting method. Accordingly, Taxpayer ordinarily may rely on the letter ruling and use the simplified resale method unless the Commissioner determines that the consent was granted in error and revokes the ruling.

2. Whether Taxpayer qualifies to use the simplified resale method pursuant to § 1.263A-3(a)(4).

Section 263A provides for the nondeductibility of certain direct and indirect costs with respect to property to which § 263A applies.

Section 1.263A-1(a)(3)(i) provides that taxpayers subject to § 263A must capitalize all direct costs and certain indirect costs properly allocable to (1) real property and tangible personal property produced by the taxpayer and (2) real property and personal property described in § 1221(1), which is acquired by the taxpayer for resale.

Section 1.263A-1(a)(3)(ii) provides that taxpayers that produce real property and tangible personal property (producers) must capitalize all the direct costs of producing the property and the property's properly allocable share of indirect costs, regardless of whether the property is sold or used in the taxpayer's trade or business.

Section 1.263A-1(a)(3)(iii) provides that retailers, wholesalers, and other taxpayers that acquire property described in § 1221(1) for resale (resellers) must capitalize the direct costs of acquiring the property and the property's properly allocable share of indirect costs.

For purposes of § 263A, the term "produce" includes construct, build, install, manufacture, develop, improve, create, raise, or grow. § 263A(g)(1); § 1.263A-2(a)(1)(i). In general, except in the case of property produced for the taxpayer under contract and home construction contracts, a taxpayer is not considered to be producing property unless it is considered an owner of the property produced under federal income tax principles. § 1.263A-2(a)(1)(ii)(B).

Generally, property produced for the taxpayer under a contract with another party is treated as property produced by the taxpayer to the extent the taxpayer makes payments or otherwise incurs costs with respect to the property. § 263A(g)(2); § 1.263A-2(a)(1)(ii)(B)(1). Except in the case of a routine purchase order for fungible property, a contract is any agreement providing for the production of property if the agreement is entered into before the production of the property to be delivered under the contract is completed. § 1.263A-2(a)(1)(ii)(B)(2).

Section 1.263A-2(a)(1)(ii)(B)(2)(ii) provides that a routine purchase order for fungible property is not treated as a contract for purposes of determining whether a taxpayer is a producer. Section 1.263A-2(a)(1)(ii)(B)(2)(ii) also provides that an agreement will not be treated as a routine purchase order for fungible property, however, if the contractor is required to make more than de minimis modifications to the property to tailor it to the customer's specific needs, or if at the time the agreement is entered into, the customer knows or has reason to know that the contractor cannot satisfy the agreement within 30 days out of existing stocks and normal production of finished goods.

Section 1.263A-1(f) sets forth various detailed or specific (facts-and-circumstances) cost allocation methods that taxpayers may use to allocate direct and indirect costs to property produced and property acquired for resale. In lieu of a facts-and-circumstances allocation method, § 1.263A-1(f) authorizes taxpayers to use the simplified methods provided in §§ 1.263A-2(b) and 1.263A-3(d) to allocate direct and indirect costs to eligible property produced. In general, these simplified methods determine aggregate amounts of additional § 263A costs allocable to ending inventory. Additional § 263A costs are those 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. § 1.263A-1(d)(3).

Regarding the simplified methods, § 1.263A-2(b)(1) provides that producers may elect to use the simplified production method to determine the additional § 263A costs properly allocable to ending inventories of property produced and other eligible property on hand at the end of the taxable year. Similarly, § 1.263A-3(d)(1) provides that resellers may elect to use the simplified resale method to determine the additional § 263A costs properly allocable to property acquired for resale and other eligible property on hand at the end of the taxable year.

In general, a taxpayer may elect the simplified production method if engaged in both production and resale activities with respect to items of eligible property. § 1.263A-3(a)(4). However, generally, the simplified resale method is only available to a trade or business exclusively engaged in resale activities. § 1.263A-3(d)(2). Therefore, as a general rule, if a reseller is engaged in both production and resale activities with respect to the items of eligible property, then the reseller may only elect the simplified production method and is not allowed to elect the simplified resale method. § 1.263A-3(a)(4).

Despite the general rule prohibiting resellers engaged in production activities from using the simplified resale method, § 1.263A-3(a)(4) provides two exceptions which allow resellers engaged in both production and resale activities to elect the simplified resale method.

Under the first exception, a reseller otherwise permitted to use the simplified resale method may use the simplified resale method if its production activities with respect to the items of eligible property are de minimis and incident to its resale of personal property described in § 1221(1). § 1.263A-3(a)(4)(ii). In determining whether the reseller's production activities are de minimis, all facts and circumstances must be considered. Production activities are presumed de minimis if: (1) gross receipts from the sale of property are less than ten percent of the total gross receipts of the trade or business, and (2) labor costs allocable to the trade or business' production activities are less than ten percent of the reseller's total labor costs allocable to its trade or business. § 1.263A-3(a)(2)(iii).

Under the second exception, a reseller otherwise permitted to use the simplified resale method may use the simplified resale method even though it has personal property produced for it (e.g., private label goods) under a contract with an unrelated person if the contract is entered into incident to its resale activities and the property is sold to its customers. § 1.263A-3(a)(4)(iii).

Taxpayer argues that it is entitled to use the simplified resale method. In support of its position Taxpayer contends that it is a reseller and is subject to the provisions under which resellers that enter into contracts for the production of property (private label goods) may use the simplified resale method if the contracts are entered into incident to its resale business.

We disagree. Taxpayer is a producer and does not qualify for the exceptions that permit taxpayers engaged in both production and resale activities to use the simplified resale method. Therefore, Taxpayer does not qualify to use the simplified resale method. Accordingly, the Commissioner's letter ruling granting Taxpayer's consent to use the simplified resale method was issued in error.

Taxpayer is a producer because virtually all, if not all, of Taxpayer's goods are produced for Taxpayer under a contract with another party. The agreement between Taxpayer and its vendors providing for the production of goods is a contract pursuant to § 1.263A-2(a)(1)(ii)(b)(2). This is because it is entered into before the production of the goods to be delivered under the agreement is completed.

The agreement between Taxpayer and its vendors does not qualify as a routine purchase order for fungible goods. This is because the vendors have to make more than de minimis modifications to the property to tailor it to the Taxpayer's specific needs or specifications. In this regard, the vendors cannot begin to make Taxpayer's products until they receive Taxpayer's designs of the products, which must conform to Taxpayer's specifications. Further, the vendors who manufacture Taxpayer's products transform basic material to finished goods. Thus, far from resulting in de minimis modifications, the manufacturing process involves significant changes to the property tailored to the specific needs of Taxpayer. Additionally, Taxpayer exercises a significant degree of control over the manufacturing process. It selects the raw materials used to make the products as well as the suppliers. Further, Taxpayer controls the manufacturing process of its products through strict oversight and precise cz demands.

Because Taxpayer is a producer, Taxpayer is prohibited from using the simplified resale method unless Taxpayer qualifies for the reseller with de minimis production activities exception under § 1.263A-3(a)(4)(ii) or the reseller with property produced under contract incident to resale activities exception under § 1.263A-3(a)(4)(iii). To meet the reseller with de minimis production activities exception, Taxpayer must be a reseller and its production activities with respect to the items of eligible property must be de minimis and incident to its resale of personal property described in § 1221(1).

Taxpayer does not qualify for the reseller with de minimis production activities exception because its primary activity is the production of products for sale in its stores and its resale activities are, at best, de minimis. Its production activities are not incident to its resale activities.

To satisfy the resellers with property produced under contract exception, Taxpayer's contract with vendors for the production of products must be entered into incident to its resale activities. Taxpayer does not qualify for the resellers with property produced under contract exception because these contracts are not entered into incident to Taxpayer's resale activities. Taxpayer is engaged exclusively, or nearly exclusively, in production activities under § 263A. Taxpayer has little, if any, activities that qualify as resale activities under § 263A. Thus, Taxpayer's contracts are not entered into incident to a resale activity.

The conclusion that Taxpayer is a producer and not eligible to use the simplified resale method is consistent with the holding of the Ninth Circuit in Suzy's Zoo v. Commissioner, 273 F.3d 875 (9th Cir. 2001). There, the taxpayer was in the business of creating cartoon characters that were imprinted on greeting cards and other merchandise that it sold to retail stores. However, the taxpayer also sold licensee products at its own store. The Ninth Circuit concluded that the taxpayer was a producer and not a reseller for purposes of § 263A, even though the taxpayer contracted with independent contractors to manufacture its greeting cards and other merchandise and to have the cartoon characters it created imprinted on those products. In so concluding, the Ninth Circuit noted that the taxpayer exercised significant control over the manufacturing process and did not qualify for the exceptions to the capitalization requirement of § 263A available to small resellers engaged in production and resale activities because the taxpayer's only resale activity was the sale of licensee products at its own store, the revenue for which was a small percentage of its gross revenue. As in Suzy's Zoo, Taxpayer's resale activity is only a small or de minimis percentage of its business activity. Therefore, as noted, Taxpayer's production contracts are not incident to its resale activities and Taxpayer is not eligible to avail itself of the exceptions for resellers engaged in production and resale activities.

3. Whether the Commissioner's letter ruling authorizing Taxpayer to use the simplified resale method should be modified or revoked, and if so, whether the modification or revocation should apply retroactively.

Section 601.201(l)(4) of the Statement of Procedural Rules provides that a ruling found to be in error or not in accord with the current views of the Service may be revoked or modified. Section 601.201(l)(1) of the Statement of Procedural Rules provides in part that a ruling, except to the extent incorporated in a closing agreement, may be revoked or modified at any time in the wise administration of the taxing statutes.

Because Taxpayer is a producer and is not eligible to avail itself of the exceptions for resellers engaged in production and resale activities to use the simplified resale method, the Date 3 ruling letter granting Taxpayer consent to change to the simplified resale method was issued in error. Therefore, the consent to change to the simplified resale method granted in that letter ruling is hereby revoked.

Section 601.201(l)(1) of the Statement of Procedural Rules provides that if a ruling is revoked or modified, the revocation or modification applies to all open years under the statutes, unless the Commissioner or his delegate exercises the discretionary authority under § 7805(b) to limit the retroactive effect of the revocation or modification. Section 7805(b)(8) provides that the Secretary may prescribe the extent, if any, to which any ruling (including any judicial decision or any administrative determination other than by regulations) relating to the internal revenue laws shall be applied without retroactive effect.

Section 601.201(l)(5) of the Statement of Procedural Rules provides in part that except in rare or unusual circumstances, the revocation or modification of a ruling will not be applied retroactively with respect to the taxpayer to whom the ruling originally was issued or to a taxpayer whose tax liability directly was involved in such ruling if (i) there has been no misstatement or omission of material facts, (ii) the facts subsequently developed are not materially different from the facts on which the ruling was based, (iii) there has been no change in the applicable law, (iv) the ruling originally was issued with respect to a prospective or proposed transaction, and (v) the taxpayer directly involved in the ruling acted in good faith in reliance upon the ruling and the retroactive revocation would be to his detriment. Similarly, section 11.05 of Rev. Proc. 2005-1 provides in part that an Associate office will revoke or modify a letter ruling and apply the revocation retroactively to the taxpayer for whom the letter ruling was issued or to a taxpayer whose tax liability was directly involved in the letter ruling if, among other things, there has been a misstatement or omission of controlling facts. See also section 10.02 of Rev. Proc. 97-27.

In the instant case, the only factor at issue is whether Taxpayer omitted or misstated material facts. Taxpayer's position is that no basis exists for the retroactive revocation of the letter ruling. In support of its position Taxpayer contends that it provided complete information of its business activities on the Form 3115. Thus, Taxpayer claims that there is sufficient information on the Form 3115 for the Commissioner to understand that Taxpayer was engaged in product development activities and to determine whether Taxpayer is eligible to use the simplified resale method. Taxpayer argues that if it is not entitled to use the simplified resale method, the letter ruling should be modified prospectively.

When a taxpayer files a Form 3115 requesting the Commissioner's consent to a change in method of accounting, the taxpayer has "a duty to reveal all material factors pertinent to its request for an accounting method change," and must fully inform the

Commissioner about all material facts. Cochran Hatchery, Inc., v. Commissioner, T.C. Memo. 1979-390. In this case, that duty requires disclosure of all facts that are material to the determination of whether Taxpayer is a producer or reseller and eligible to use the simplified resale method under § 1.263A-3(d). Therefore, Taxpayer in this case had an affirmative obligation to disclose in its application sufficient relevant material information about its inventory, business operations, and arrangement with vendors for the national office to determine that Taxpayer is a producer under § 263A and did not qualify for the exceptions under §1.263A-3(a)(4)(ii) and (iii) permitting taxpayers engaged in both production and resale activities to use the simplified resale method.

Taxpayer disclosed on Form 3115 that it was a d retailer selling "its brand name products." According to Taxpayer, d retailers selling f commonly have most or all of their products produced to their specifications under contract. Taxpayer contends that by disclosing it was a d retailer, the national office should have understood, and was alerted, that Taxpayer did not qualify for the §1.263A-3(a)(4)(ii) exception permitting resellers with property produced under a contract with an unrelated person to use the simplified resale method. We disagree. It is not the obligation of the national office to know or understand that if a taxpayer is a d retailer selling its brand name products, then all of the brand name goods the taxpayer sells constitute property produced for the taxpayer under a contract as defined in § 1.263A-2(a)(1)(ii)(B). If an industry term or industry jargon is a critical fact related to a requested change in accounting method, the term must be defined or the jargon explained in the Form 3115 if the taxpayer wants to rely on the consent letter.

On the Form 3115, Taxpayer also stated that it operates distribution centers "to receive merchandise manufactured to its specifications and purchased from unrelated third party manufacturers." Additionally, Taxpayer disclosed that it had product development offices and offices coordinating sourcing activities. Taxpayer contends that this information was sufficient for the national office to have understood that Taxpayer sold "only" private label goods produced for the taxpayer under a contract as defined in § 1.263A-2(a)(1)(ii)(B). Taxpayer did not state on its Form 3115 that all, or virtually all, of the products sold at its retail stores were produced under contract. Nor did Taxpayer state that few, if any, of its products were purchased for resale. It is not sufficient to provide information on the Form 3115 that could have, or, in taxpayer's opinion, should have, caused the national office to seek clarification or request additional information. Whether or not the national office requested additional information, or could have requested information, it is the obligation of the taxpayer to provide all of the relevant facts with the Form 3115. Moreover, it is not the obligation of the national office to design specific questions covering every conceivable circumstance relating to an accounting method change request. See Cochran Hatchery, Inc. For example, it is not the obligation of the national office to ask, or to know to ask, a taxpayer that identifies itself as a d retailer eligible to use the simplified resale method whether it sells "only" products that qualify as goods produced for the taxpayer under

contract or whether its resale activities are de minimis. Further, as suggested in Cochran Hatchery, Inc., it is not the obligation of the national office to be "adept at jigsaw puzzles" or connecting disparate facts to arrive at a complete picture of the facts pertinent to a taxpayer's request for an accounting method change. Rather, it is the taxpayer's obligation to provide all the information necessary for the national office to make a determination as to taxpayer's eligibility for a requested accounting method change.

Taxpayer did not disclose on its Form 3115 that it was a producer. It did not disclose that it created or designed virtually all, if not all, of the goods produced for it under contract with vendors and sold in its stores. Also, it did not disclose that it exercised significant control over the production process. Further, it did not disclose that virtually all, if not all, of the products produced for it by vendors qualified as goods produced for Taxpayer under contract pursuant to § 263A(g)(2) and §1.263A-2(a)(1)(ii)(B). Taxpayer's failure to disclose these factors was an omission of material facts.

Taxpayer claims that it qualifies to use the simplified resale method by virtue of the exception for goods produced under contract in § 1.263A-3(a)(4)(iii). However, it is significant that Taxpayer failed to provide with its Form 3115 an explanation of the legal basis supporting its proposed use of the simplified resale method or a discussion of the reason(s) it met the requirements of § 1.263A-3(a)(4)(iii) to use the simplified resale method. In this regard, in response to Part II, line 10 of Form 3115, which requested Taxpayer to attach an explanation of the legal basis supporting its proposed use of the simplified resale method, Taxpayer merely described the manner in which the simplified resale method works. A taxpayer's failure to provide the legal basis for its eligibility to use the proposed simplified resale method and to apply the law to the facts provided is a significant factor that is material to the determination of a taxpayer's entitlement to a requested method change.

As a result of Taxpayer's omissions of material facts, the national office did not have a complete picture of Taxpayer's inventory and business operations. Thus, the national office did not have sufficient information to conclude that Taxpayer was not entitled to use the simplified resale method and did not satisfy the exceptions which allow resellers engaged in both production and resale activities to elect the simplified resale method.

In summary, the Form 3115 should be complete as filed, i.e., it should include all the information necessary to make a correct legal determination. A consent letter is based on the facts presented, and can only be relied upon to the extent those facts are accurate and complete. Thus, the taxpayer bears the risk of undisclosed facts. Here, Taxpayer failed to provide all the necessary information in its application for change in accounting method. Therefore, the consent to use the simplified resale method granted in the Date 3 letter ruling is hereby revoked retroactively.

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.