INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

May 23, 2006

Third Party Communication: None
Date of Communication: Not Applicable

Index (UIL) No.: 263A.04-00, 263A.00-00
CASE-MIS No.: TAM-103875-06
Number: **200635010**
Release Date: 9/1/2006
Director, Field Operations

Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

| | |
|---|---|
| Company | = |
| Sub One | = |
| Sub Two | = |
| B-Type Business | = |
| C-Type Business | = |
| D-Type Services | = |
| E-Type Services | = |
| State One | = |
| State Two | = |
| Year 1 | = |
| Property One | = |
| Property Two | = |
| Subactivities F, G, H, J, and K | = |
| Federal Agency | = |
| $N | = |

$R =
$T =
$U =
$W =
AA =
BB =
CC =
DD =

ISSUE:

Whether Company's method of allocating its capitalizable mixed service costs between production of Property One and production and acquisition for resale of Property Two meets the requirements of section 263A of the Internal Revenue Code.

CONCLUSION:

Under § 263A, Company's method of allocating its capitalizable mixed service costs between production of Property One and production and acquisition for resale of Property Two is subject to the requirements of § 1.263A-1(f). Whether those requirements are satisfied is a factual determination that must be made by the Director based on Company's facts and circumstances.

FACTS:

Company is a B-Type Business. Through Subs One and Two, Company is engaged in production of Property One and production and acquisition for resale of Property Two. Production and acquisition for resale of Property Two may be divided into Subactivities F, G, H, J, and K. As a result of production of Property One and production and acquisition for resale of Property Two, Company provides D-Type Services in State One through Sub One, and provides D-Type and E-Type Services in States One and Two through Sub Two. Company's customers include both direct customers and C-Type businesses.

During Year 1, Company produced Property One and Property Two. Since 1987, Company has been required to account for its production costs in accordance with § 263A and the regulations thereunder. Prior to and during Year 1, Company and Subs One and Two maintained their books and records in compliance with generally accepted accounting principles (GAAP) and the mandates of Federal Agency. The method of accounting for tax purposes for Company and Subs One and Two mirrored their method of accounting for financial reporting purposes prior to Year 1 (hereinafter referred to as the prior method).

During Year 1, Company filed a Form 3115, Application for Change in Accounting Method, under Rev. Proc. 97-27, 1997-1 C.B. 680, requesting advanced consent to change its method of accounting for certain items. Part of Company's request was to elect the simplified service cost method with the production cost allocation ratio to determine capitalizable mixed service costs incurred during the year for both Property One and Property Two. The Service has not granted consent to Company to change its method of accounting pursuant to the Form 3115 request, and the request is still pending. The Service has not determined whether Company's Property One qualifies as eligible property under § 1.263A-1(h)(2). See Rev. Rul. 2005-53, 2005-35 I.R.B. 425. Even though consent has not been granted, Company began using its new method beginning in Year 1.

In implementing the requested accounting method change, Company utilized the simplified service cost method with the production cost allocation ratio to determine capitalizable mixed service costs for Year 1 (hereinafter referred to as the new method). Company performed this calculation by adding (1) the costs of producing Property One plus (2) the costs of producing and acquiring for resale Property Two and dividing the sum by Company's total costs. This amount was then multiplied by Company's total mixed service costs to determine its capitalizable mixed service costs for Year 1. Company then allocated its capitalizable mixed service costs between Property One and Property Two based on the relative contribution that each type of property made to the numerator of the simplified service cost method with the production cost allocation ratio. Company determined the relative contribution of each type of property by dividing the cost of producing (and acquiring for resale in the case of Property Two) that type of property by Company's total production and acquisition for resale costs for Property One and Property Two. Company described this formula used to allocate costs between Property One and Property Two in its Form 3115 submitted during Year 1.

If Sub One had used its prior method in Year 1, Sub One would have incurred $N of mixed service costs.[1] Of this amount its capitalizable mixed service costs would have been $R or approximately AA percent of $N, almost one-half of its total mixed service costs. Sub One would have allocated all of the $R to Property One and none of the $R to Property Two. Sub One would have deducted the non-capitalizable portion of its mixed service costs.

Under the new method of accounting it began using in Year 1, Sub One incurred the same amount of mixed service costs as under its prior method, or $N. Sub One's capitalizable mixed service costs under its new method were determined to be $T, almost twice $R, the amount of capitalizable mixed service costs under its prior method.

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[1] The request for technical advice in this case states that although the request for technical advice focuses on Sub One's activities, the facts and analysis apply equally to Sub Two's activities. Accordingly, although the following analysis of costs is based on Sub One's facts, the analysis applies to both Sub One and Sub Two.

$T is approximately BB percent of $N, almost nine-tenths of Company's total mixed service costs. Sub One capitalized CC percent, or $U of $N to Property One and capitalized DD percent, or $W of $N to Property Two. Sub One deducted the non-capitalizable portion of its mixed service costs. Compared to its prior method, Sub One's total mixed service costs under its new method almost doubled while Sub One's capitalizable mixed service costs allocated to Property One decreased to $U, more than 17 times less than the amount allocated to Property One under its prior method of accounting. Sub One's capitalizable mixed service costs allocated to Property Two increased from zero to $W, representing more than four-fifths of Sub One's total mixed service costs of $N and more than nine-tenths of Sub One's total capitalizable mixed service costs of $T.

LAW AND ANALYSIS

The request for technical advice in this case focuses on whether Company's method of allocating its capitalizable mixed service costs between production of Property One and production and acquisition for resale of Property Two meets the requirements of § 263A. The Director asserts that Company's method of allocating its capitalizable mixed service costs between production of Property One and production and acquisition for resale of Property Two must satisfy the requirements of § 1.263A-1(f). The Director further asserts that Company's method of allocating its capitalizable mixed service costs between production of Property One and production and acquisition for resale of Property Two fails to satisfy those requirements because it is not a reasonable allocation method within the meaning of § 1.263A-1(f)(4). In particular, the Director argues that the amount capitalized by Company under its new method differs significantly from the amount that would have been capitalized under its prior method and that, accordingly, the new method is not a reasonable method under § 1.263A-1(f)(4)(i). In contrast, Company reasons that its method of allocating capitalizable mixed service costs between production of Property One and production and acquisition for resale of Property Two is part of the simplified service cost method described in § 1.263A-1(h) and does not have to satisfy the requirements of § 1.263A-1(f). Company also asserts that its allocation method satisfies the requirements § 1.263A-1(f) in any event.

For the reasons described below, Company's method of allocating its capitalizable mixed service costs between production of Property One and production and acquisition for resale of Property Two must satisfy the requirements of § 1.263A-1(f). However, in determining whether the amount capitalized by Company under its new method differs significantly from the amount that would have been capitalized under any other permissible method under § 1.263A-1(f)(4)(i) the relevant comparison is between the amount capitalized under Company's allocation method and the amount that would be capitalized under any other permissible method, not just amounts capitalized under Company's prior method. As noted below, Company asserts that the

amount capitalized under its present allocation method does not differ significantly from the amount that would be capitalized under the simplified production method. The determination of whether Company's method of allocating capitalizable mixed service costs between production of Property One and production and acquisition for resale of Property Two meets the requirements of § 1.263A-1(f)(4), including whether or not there is a significant difference between the amount capitalized using Company's allocation method and the amount capitalized using any other permissible method, must be made by the Director based on all of Company's facts and circumstances.

After first discussing the procedural background of this case, this memorandum analyzes whether Company's method of allocating capitalizable mixed service costs between production of Property One and production and acquisition for resale of Property Two is part of the simplified service cost method described in § 1.263A-1(h) and concludes that it is not part of that simplified method. This is followed by the analysis of whether Company's allocation method must satisfy the requirements of § 1.263A-1(f).

Procedural Background

As noted above, in Year 1 Company filed a Form 3115, Application for Change in Accounting Method, requesting advanced consent to change its method of accounting for certain items. Part of Company's request was to elect the simplified service cost method with the production cost allocation ratio to determine capitalizable mixed service costs incurred during the year for both Property One and Property Two. This technical advice request is only with respect to whether Company's method of allocating its capitalizable mixed service costs between production of Property One and production and acquisition for resale of Property Two meets the requirements of § 263A. This memorandum does not consider whether any of Company's property, including but not limited to Property One, qualifies as eligible property under § 1.263A-1(h)(2). See Rev. Rul. 2005-53. Further, this memorandum does not consider whether Company's determinations and definitions of mixed service costs were proper under § 263A. As noted above, Company's Form 3115 is still pending with the Service and Company has not yet been granted or denied consent to make the requested change in its accounting method. Nevertheless, Company began using the requested new method of accounting beginning in Year 1. Consideration of this request for technical advice does not grant or imply consent under § 446(e) to Company's request to change its method of accounting.

Company's method of allocating capitalizable mixed service costs between production of Property One and production and acquisition for resale of Property Two is not part of the simplified service cost method under § 1.263A-1(h).

Having noted the scope of the request for technical advice, we next analyze whether Company's method of allocating capitalizable mixed service costs between production of Property One and production and acquisition for resale of Property Two is part of the simplified service cost method described in § 1.263A-1(h). Company uses the simplified service cost method with the production cost allocation ratio to determine its capitalizable mixed service costs. See § 1.263A-1(h). After determining the amount of its capitalizable mixed service costs, Company then allocates that amount between Property One and Property Two based on the relative contribution that each type of property made to the numerator of the simplified service cost method with the production cost allocation ratio.

Company reasons that its method of allocating capitalizable mixed service costs between Property One and Property Two not only complies with the technical requirements for using the simplified service cost method but also is consistent with the underlying rationale for simplified methods such as the simplified service cost method. In contrast, the Director argues that the simplified service cost method merely provides a method for determining a taxpayer's aggregate capitalizable mixed service costs and does not encompass the allocation of that aggregate amount among various activities or properties. For the reasons described below, Company's method of allocating capitalizable mixed service costs is not part of the simplified service cost method described in § 1.263A-1(h).

Company's argument that its method of allocating capitalizable mixed service costs is part of the simplified service cost method described in § 1.263A-1(h) is based on an analysis of § 1.263A-1(c)(1) and § 1.263A-1(e)(4). This analysis starts by noting that § 1.263A-1(c)(1) requires that costs be allocated or apportioned to a taxpayer's various activities, including production or resale activities. The analysis next focuses on § 1.263A-1(e)(4)(i) for the proposition that two alternative methods exist for determining the amount of capitalizable service costs. § 1.263A-1(e)(4)(i) provides:

> This paragraph (e)(4) provides definitions and categories of service costs. Paragraph (g)(4) of this section provides specific rules for determining the amount of service costs allocable to property produced or property acquired for resale. In addition, paragraph (h) of this section provides a simplified method for determining the amount of service costs that must be capitalized.

The final step in Company's analysis notes that § 1.263A-1(e)(4)(ii)(C) explains that mixed service costs are costs that are partially allocable to production or resale activities and partially allocable to non-production and non-resale activities. Company concludes from this that allocating capitalizable mixed service costs to different items of property is an inherent part of the simplified service cost method.

In support of its position that allocating capitalizable mixed service costs between production of Property One and production and acquisition for resale of Property Two is part of the simplified service cost method Company cites the preamble to final regulations under § 263A. T.D. 8482, 1993-2 C.B. 77, 84. The preamble indicates that the regulations provide a simplified service cost method producers may use to allocate mixed service costs among their various activities. In particular, the preamble provides:

> the temporary regulations provide a simplified service cost method producers may use to allocate mixed service costs among their various business activities

T.D. 8482, 1993-2 C.B. 77, 84. Company reasons that the use of the words “among” and “various” connote three or more and indicate that while in some instances the simplified service cost method might be used to allocate mixed service costs between production activities and non-production activities, in other instances the simplified service cost method would be used to allocate mixed service costs among various activities, such as among Company’s Property One, Property Two, and deductible activities.

Company’s assertion that its method of allocating capitalizable mixed service costs between production of Property One and production and acquisition for resale of Property Two is part of the simplified service cost method described in § 1.263A-1(h) is not persuasive and is not consistent with the simplified service cost method. Section 1.263A-1(h)(1) permits taxpayers to use the simplified service cost method to determine the aggregate portion of mixed service costs incurred during the taxable year that are properly allocable to "eligible property." Section 1.263A-1(h)(3)(i) provides that under the simplified service cost method, a taxpayer computes its capitalizable mixed service costs by multiplying its total mixed service costs by an allocation ratio. The allocation ratio can be either the labor-based or production cost allocation ratio. See §§ 1.263A-1(h)(4) and (5). In this case, Company used the production cost allocation ratio under § 1.263A-1(h)(5) and determined its capitalizable mixed service costs in accordance with the following formula:

| | | | | |
|---|---|---|---|---|
| Section 263A Production Costs / Total Costs | x | Total Mixed Service Costs | = | Capitalizable Mixed Service Costs |

That is, Company used the above formula to determine “the aggregate portion of mixed service costs that are properly allocable to the taxpayer’s production or resale method” under § 1.263A-1(h)(1). After determining in the aggregate its total capitalizable mixed service costs using equation one, Company used the following equation to determine the aggregate amount of capitalizable mixed service costs to allocate to Property One:

| | | | | |
|---|---|---|---|---|
| Property One Section 263A Production Costs Property One and Property Two Total Production Costs | x | Total Capitalizable Mixed Service Costs | = | Property One Capitalizable Mixed Service Costs |

Company used the following equation to determine the aggregate amount of capitalizable mixed service costs to allocate to Property Two:

| | | | | |
|---|---|---|---|---|
| Property Two Section 263A Production Costs Property One and Property Two Total Production Costs | x | Total Capitalizable Mixed Service Costs | = | Property Two Capitalizable Mixed Service Costs |

In both of the two equations above, Property Two production costs include the costs of acquiring Property Two for resale. Neither the formula used by Company to allocate capitalizable mixed service costs to Property One nor the formula used to allocate capitalizable mixed service costs to Property Two are found in the regulations governing the simplified service cost method. See § 1.263A-1(h). This indicates that Company's method of allocating capitalizable mixed service costs between the two activities is not part of the simplified service cost method described in § 1.263A-1(h).

Support for the proposition that Company's method of allocating capitalizable mixed service costs between production of Property One and production and acquisition for resale of Property Two is not part of the simplified service cost method is found in other parts of the regulations under § 263A. For example, § 1.263A-1(e)(4) explains that § 1.263A-1(h) provides a simplified method for determining the amount of service costs that must be capitalized. In contrast, § 1.263A-1(f) provides rules for allocating costs to property produced or acquired for resale. In particular, § 1.263A-1(f)(1) provides as follows:

> Paragraph (h) of this section provides a simplified method for determining the amount of mixed service costs required to be capitalized to eligible property. The methodology set forth in paragraph (h) of this section for mixed service costs may be used in conjunction with either a facts-and-circumstances or a simplified method of allocating costs to eligible property produced or eligible property acquired for resale.

In short, § 1.263A-1(f)(1) provides rules for allocating mixed service costs to property produced or acquired for resale.[2] In addition, § 1.263A-3(d)(3)(i)(F) details how a taxpayer using the simplified service cost method allocates mixed service costs in connection with the simplified resale method. The existence of these separate rules indicates that Company's method of allocating capitalizable mixed service costs between the two activities is not part of the simplified service cost method described in § 1.263A-1(h).[3] Further support for this proposition is found in the preamble to the temporary regulations which preceded the final regulations. The preamble provides that:

> The simplified service cost method shall only be used to determine the total amount of certain indirect costs which are required to be allocated to inventory production under section 263A ("inventoriable mixed service costs"). The allocation of such indirect costs to particular items of inventory shall be made pursuant to other methods allowed under the temporary regulations.

T.D.8131, 1987-1 C.B. 99, 102-103. In short, the simplified service cost method does not provide a mechanism for allocating capitalizable mixed service costs to particular activities or property. Accordingly, Company's method of allocating capitalizable mixed service costs between Property One and Property Two is not part of the simplified service cost method described in § 1.263A-1(h).

Company nevertheless argues that treating its method of allocating capitalizable mixed service costs between Property One and Property Two as part of the simplified service cost method is consistent with the underlying logic of the simplified service cost method. It reasons that the simplified service cost method is an alternative to the facts and circumstances methods of allocating costs in that, unlike those methods, the

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[2] Section 1.263A-1(h)(7) provides that, to the extent mixed service costs, labor costs, or other costs are incurred in more than one trade or business, a taxpayer must determine the amounts allocable to the particular trade or business for which the simplified service cost method is being applied by using any reasonable allocation method consistent with the principles of § 1.263A-1(f)(4). Company argues that this provision only applies in determining the amount of capitalizable mixed service costs and not in allocating those costs. While the text of § 1.263A-1(h)(7) does not contain this limitation, it is unnecessary to decide how § 1.263A-1(h)(7) applies in this case as the facts do not indicate that Company has more than one trade or business. Further, the phrase "among their various business activities" in T.D. 8482, 1993-2 C.B. 77, 84, arguably refers to § 1.263A-1(h)(7) and taxpayers with costs that are incurred by more than one trade or business. This weakens Company's argument that the phrase supports allocating mixed service costs among various activities, such as among Company's Property One, Property Two, and deductible activities.

[3] Company asserts that use of the word "may" in § 1.263A-1(f)(1) indicates that other methods of allocating capitalizable mixed service costs are also available to taxpayers. This reasoning is not persuasive as the regulations do not provide for such other methods. Indeed, the lack of such other methods indicates that the word "may" has a restrictive meaning in § 1.263A-1(f)(1); taxpayers are limited to using only the specified methods.

simplified service cost method allocates costs based on a single factor (either the production cost allocation ratio or the labor-based allocation ratio) rather than a variety of factors. Company asserts that this produces a simple and administrable result. This reasoning is not persuasive because, as noted above, § 1.263A-1(f)(1) provides that the simplified service cost method may be used in conjunction with various simplified methods of allocating costs.

Finally, Company also analogizes its method of allocating costs between Property One and Property Two to the allocation of mixed service costs among classes of activities in the context of the simplified resale method under § 1.263A-3(d)(3)(i)(F). Under this section, a taxpayer using the simplified service cost method determines the amount of mixed service costs allocated to and included in purchasing costs, storage costs, and handling costs of the simplified resale method using the following formula:

$$\frac{\text{Labor costs allocable to activity}}{\text{Total labor costs}} \times \text{Total mixed service costs}$$

§ 1.263A-3(d)(3)(i)(F). Company notes that this allocation method is similar to the method it used and is a permissible method under § 263A. Company reasons that its allocation method should also be permissible.

Company's reasoning is not persuasive for several reasons.[4] First, the method described in § 1.263A-3(d)(3)(i)(F) for allocating mixed service costs in the context of the simplified resale method follows, with only technical and minor changes, the method that Congress directed the Treasury Department to provide to taxpayers acquiring property for resale. See H.R. Conf. Rep. No. 99-841, at II-305-308 (1986), reprinted in 1986-3 C. B. (Vol. 4) II-1, II-305-308. Congress did not direct the Treasury Department to provide the same mixed service cost method for taxpayers producing property who choose to use the simplified production method. Second, although the simplified resale method uses two absorption ratios, it ultimately applies a single, combined absorption ratio to a taxpayer's total § 471 costs remaining on hand at the end of the taxable year. The Preamble to the final regulations explains that:

> The final regulations provide several simplified allocation methods for allocating direct and indirect costs to property produced and property acquired for resale. In general, these simplified methods determine aggregate amounts of additional section 263A costs allocable to ending inventory (emphasis added).

[4] Company does not assert that it is actually entitled to use the methodology described in § 1.263A-3(d). The simplified resale method is not a permissible method for Company because its production activities are not de minimis under § 1.263A-3(a)(2)(iii)(A).

T.D. 8482, 1993-2 C.B. 77, 83. The simplified resale method and its accompanying calculations regarding capitalizable mixed service costs determine one aggregate capitalized amount of additional § 263A costs. Company's division of its aggregate capitalizable mixed service costs amount into two separate amounts (an amount capitalizable to Property One and an amount capitalizable to Property Two) performs the exact opposite function. Consequently, Company's analogy of its method to the simplified resale method and the associated simplified service cost method of § 1.263A-3(d)(3)(i)(F) is not persuasive in determining whether Company's method meets the requirements of § 1.263A-1(h).

Company's method of allocating capitalizable mixed service costs between production of Property One and production and acquisition for resale of Property Two must satisfy the requirements of § 1.263A-1(f).

Having determined that Company's method of allocating capitalizable mixed service costs between production of Property One and production and acquisition for resale of Property Two is not part of the simplified service cost method under § 1.263A-1(h), we next consider whether that allocation method is subject to the requirements of § 1.263A-1(f). The Director asserts that Company's method of allocating its capitalizable mixed service costs between production of Property One and production and acquisition for resale of Property Two must satisfy the requirements of § 1.263A-1(f). The Director further asserts that Company's method of allocating its capitalizable mixed service costs between production of Property One and production and acquisition for resale of Property Two fails to satisfy those requirements because it is not a reasonable allocation method within the meaning of § 1.263A-1(f)(4). In particular, the Director argues that the amount capitalized by Company under its new method differs significantly from the amount that would have been capitalized under its prior method and that, accordingly, the new method is not a reasonable method under § 1.263A-1(f)(4)(i). In contrast, Company also asserts that its allocation method satisfies the requirements § 1.263A-1(f). For the reasons described below, Company's method of allocating capitalizable mixed service costs between production of Property One and production and acquisition for resale of Property Two is subject to § 1.263A-1(f)(4).

The Director's assertion that Company's method of allocating its capitalizable mixed service costs between production of Property One and production and acquisition for resale of Property Two must satisfy the requirements of § 1.263A-1(f) finds support in the regulations under § 263A. As noted above, § 1.263A-1(f) provides rules for allocating costs to property produced or acquired for resale. In particular, § 1.263A-1(f)(1) provides as follows:

> Paragraph (h) of this section provides a simplified method for determining the amount of mixed service costs required to be capitalized to eligible property. The methodology set forth in paragraph (h) of this section for

> mixed service costs may be used in conjunction with either a facts-and-circumstances or a simplified method of allocating costs to eligible property produced or eligible property acquired for resale.

In short, § 1.263A-1(f)(1) provides that paragraph (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. It also provides that § 1.263A-1(g) provides general rules for applying these allocation methods to various categories of costs (i.e., direct materials, direct labor, and indirect costs, including service costs). In addition, in lieu of a facts-and-circumstances allocation method, taxpayers may 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 or eligible property acquired for resale. In this case, Company is not using one of the simplified methods provided in § 1.263A-2(b) and § 1.263A-3(d). Accordingly, it is necessary to determine whether Company's method of allocating capitalizable mixed service costs complies with § 1.263A-1(f).

Section 1.263A-1(f) provides that a taxpayer that does not use one of the simplified methods of allocating costs has a choice of methods under §§ 1.263A-1(f)(2) through 1.263A-1(f)(4). The methods described in § 1.263A-1(f)(2) and § 1.263A-1(f)(3) are a specific identification method, a burden rate method, and a standard cost method. The Director asserts, and the Company does not dispute, that the Company's method is not a specific identification method, burden rate method or standard cost method under §§ 1.263A-1(f)(2) and 1.263A-1(f)(3). A taxpayer that does not use one of these methods may use any other reasonable allocation method within the meaning of § 1.263A-1(f)(4).

Under § 1.263A-1(f)(4), a taxpayer may use any other reasonable method to properly allocate direct and indirect costs among units of property produced or property acquired for resale during the taxable year. An allocation method is reasonable if, with respect to the taxpayer's production or resale activities taken as a whole: (1) the total costs actually capitalized during the taxable year do not differ significantly from the aggregate costs that would be properly capitalized using another permissible method described in this section or in sections 1.263A-2 or 1.263A-3, with appropriate consideration given to the volume and value of the taxpayer's production or resale activities, the availability of costing information, the time and cost of using various allocation methods, and the accuracy of the allocation method chosen as compared with other allocation methods; (2) the allocation method is applied consistently by the taxpayer; and (3) the allocation method is not used to circumvent the requirements of the simplified methods in § 1.263A-1(f) or in §§ 1.263A-2 or 1.263A-3, or the principles of § 263A. Company's method of allocating its capitalizable mixed service costs between production of Property One and production and acquisition of Property Two

must satisfy these requirements in order to constitute a reasonable allocation method within the meaning of § 1.263A-1(f)(4).

Section 1.263A-1(e)(4) does not permit a taxpayer to avoid application of the reasonableness standard of § 1.263A-1(f)(4). Any argument that § 1.263A-1(e)(4) refers taxpayers directly to § 1.263A-1(g)(4) for rules on allocating mixed service costs and thereby bypasses § 1.263A-1(f) is contrary to § 1.263A-1(g)(4) itself. Indeed, the allocation methods permitted by § 1.263A-1(g) include certain specified methods that are not at issue in this case and, as an alternative to those specified methods, permit the use of any other reasonable allocation method as defined under the principles of § 1.263A-1(f)(4). See § 1.263A-1(g)(3) and § 1.263A-1(g)(4). Accordingly, an argument that § 1.263A-1(f)(4) is overridden by more specific rules contained in § 1.263A-1(g) is not persuasive. Further, as noted above in footnote 2, § 1.263A-1(h)(7) incorporates the principles of § 1.263A-1(f)(4) into the simplified service cost method in the context of allocating costs between different trades or businesses.

Having determined that Company's method of allocating its capitalizable mixed service costs between production of Property One and production and acquisition for resale of Property Two must satisfy the requirements of § 1.263A-1(f), we next examine the Director's argument that Company's method of allocating its capitalizable mixed service costs between production of Property One and production and acquisition for resale of Property Two fails to satisfy those requirements because the amount capitalized by Company under its new method differs significantly from the amount that would have been capitalized under its prior method with the result that the new method is not a reasonable method under § 1.263A-1(f)(4)(i). This argument is not persuasive because the standard of comparison under § 1.263-1(f)(4)(i) is between the total costs actually capitalized during the taxable year using the taxpayer's allocation method and the total that would be capitalized using another permissible method described in § 1.263A-1, § 1.263A-2 or § 1.263A-3. In short, a taxpayer's allocation method will satisfy § 1.263A-1(f)(4)(i) if the amount capitalized does not differ significantly from the amount capitalized using any other permissible method. Thus, the mere fact that the amount capitalized by Company under its allocation method differs significantly from the amount capitalized under its prior method does not end the inquiry.

Company asserts that its allocation method satisfies the requirements of § 1.263A-1(f)(i) in any event because the amount capitalized under its new method does not differ significantly from the amount that would be capitalized using the simplified production method described in § 1.263A-2. The request for technical advice in this case did not raise this issue. Further, the determination under § 1.263A-1(f)(4)(i) of whether the amount capitalized under Company's allocation method differs significantly in amount from the amount capitalized using the simplified production method is factual in nature and, as such, is best made by the Director based on all of Company's facts and circumstances.

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.