INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-136604-07

Director
Field Operations LMSB:

Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

Taxpayer =
Subsidiary =
Accounting Firm =
Number X =
Number Y =
Year =

ISSUE(S):

Whether the costs described below are properly allocable to the production of self-constructed assets or, alternatively, to the generation, transmission, and/or distribution of electricity under § 263A.

CONCLUSION(S):

Costs incurred to temporarily relocate electric utility lines during a construction period of less than a year are properly allocable to the generation of electricity rather than the

self-constructed assets. Conversely, the costs of working more slowly to construct assets in an energized environment are properly allocable to self-constructed assets.

FACTS:

Taxpayer is a diversified energy company whose Number X electric operating utility companies are involved in the generation, transmission, and distribution of electricity to over Number Y customers. The Number X utility companies use the Federal Energy Regulatory Commission (FERC) rules for preparation of their financial statements.

Taxpayer engages in various capital construction projects to produce self-constructed assets (SCA). Whether to maintain electrical service to existing customers, during these construction projects, is often a consideration. One of Taxpayer's options is to disrupt electrical service to its existing customers. Alternatively, Taxpayer may implement "temporary solutions" (such as temporary cross-arm extensions and temporary distribution lines) that will continue to deliver the electricity to the existing customers while construction of the SCA is being completed.

In six of the ten illustrative situations described below, Taxpayer maintained service to its existing customers. In five situations, Taxpayer constructed temporary solutions for delivery of the electricity to customers. Taxpayer also incurred additional costs working in an energized environment while building the SCA, such as incurring additional labor hours as the result of performing work more slowly while wearing rubber gloves or with a hot-stick (when service to customers is maintained) than with bare hands or work gloves (when service to customers is not maintained). Taxpayer refers to the aforementioned costs as "costs to maintain service to customers" (CTMS), and capitalized such costs as part of its new capital projects for book purposes. Prior to Year, Taxpayer also capitalized such costs to SCA for tax purposes.

Procedural Background

In Year, Taxpayer filed a Form 3115, Application for Change in Accounting Method, pursuant to the automatic consent procedures of Rev. Proc. 2002-9, 2002-1 C.B. 327 (as modified and clarified by Announcement 2002-17, 2002-1 C.B. 561, modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696, and amplified, clarified and modified by Rev. Proc. 2002-54, 2002-2 C.B. 432), requesting to change its method of accounting under § 263A to discontinue capitalizing the CTMS to the new projects for tax purposes citing Rev. Rul. 73-203, 1973-1 C.B. 146, as authority. Taxpayer asserts that these costs are incurred directly or indirectly for the production, transmission, and/or distribution of electricity and are not incurred directly or indirectly for the production of the SCA. Accordingly, Taxpayer has proposed to include these costs in the capitalizable costs of electricity and not in the capitalizable costs of the SCA. The proposed method capitalizes certain labor and overhead costs, specifically, the CTMS,

to inventory (electricity) that under the prior method had been capitalized to SCA. The method change is reflected in its Year income tax return as filed.

Taxpayer's Proposed Accounting Method Change

The change in method of accounting for CTMS was filed as part of a Form 3115 changing Taxpayer's overall § 263A methodology. With respect to the CTMS, the Form 3115 described the present and proposed methods as follows:

> "Under the applicant's present method, … the applicant capitalizes some indirect costs into its self constructed assets that are incurred for the purpose of maintaining continuous service or that otherwise relate to inventory activities or the provision of transmission and distribution services."
>
> "Under the proposed method, … any physical labor costs allocable to the repair and maintenance of transmission and distribution equipment, maintaining continuous transmission and distribution services, or other transmission and distribution activities will be allocated to the electricity transmitted and distributed."

As stated above, under Taxpayer's proposed method, CTMS are allocated to the production, transmission, and/or distribution of electricity, and consequently, become recovered through cost of goods sold (COGS). A significant component of the accounting method change is the change from including CTMS in the capitalizable costs of SCA to including them in the inventoriable costs of electricity that will be immediately recovered through COGS. Taxpayer states that maintaining service is necessary for a variety of reasons, including contractual obligations with large customers, reliability standards imposed and monitored by state agencies, and simply as a good business practice.

Under the FERC accounting rules, costs are allocated between capital and Operations & Maintenance. Accounting procedures implemented by Taxpayer to comply with the FERC rules do not segregate the CTMS from the costs of producing SCA. Moreover, Taxpayer's cost accounting records and work orders do not segregate or classify the CTMS during construction projects.

Members of Accounting Firm performed interviews and prepared memorandums of these interviews with managers and directors of departments of Subsidiary that incurred capitalizable costs under the FERC rules. The memorandums describe the different types of projects and costs incurred to maintain service to customers. The interviews documented in the memorandums were used by Taxpayer as a basis for classifying costs as CTMS under the proposed method.

Taxpayer has provided the following ten factual situations to illustrate the application of its method of accounting for costs (including CTMS when incurred).

Situations 1 through 3

Situations 1 through 3 relate to reconductoring projects.

Situation 1: Taxpayer performs a reconductoring project to upgrade a one-mile stretch of its distribution line. Taxpayer determines that it is not necessary to maintain service to customers during the upgrade of the distribution line. The process includes: de-energizing the distribution line, tying in the new conductors to the end of old conductors; pulling the conductors through on rollers; connecting the new conductor to the hardware (e.g., crossarms); ensuring the conductor has the correct tension; connecting the new line to the system; and restoring service.[1] All of this work would be performed with bare hands or work gloves, and ordinary tools.

The costs of performing this project are as follows: Materials $200x and related indirect costs of $10x and Labor $100x and related indirect costs of $10x. The total cost incurred by Taxpayer is $320x, computed as follows:

Direct Materials	$ 200
Indirect costs attracted by Direct Materials	10
Physical Labor	100
Indirect costs allocated based on labor	10
Total	$ 320

Taxpayer capitalizes $320 and includes it in the costs of the SCA. There are no CTMS because Taxpayer did not maintain service to customers during construction of the SCA.

Situation 2: Same as Situation 1, except that Taxpayer determines that it is necessary to maintain service to customers during the upgrade of the distribution line. In order to maintain service Taxpayer constructs a temporary line. The poles, cross arms, conductor, and related items used in constructing the temporary line are materials that may be reused. Accordingly, Taxpayer incurs no additional material costs related to the temporary line. However, Taxpayer incurs additional labor and support costs related to the temporary line. The process of constructing the temporary lines includes: mapping out where the temporary lines will be located; designing the temporary line; setting up the site for the lines; inspecting the temporary poles, conductors and equipment; digging a hole for each pole; placing the poles in the holes and tamping them in; attaching hardware to each pole (crossarms, connectors, insulators, metal steps, and transformers); installing the running blocks (i.e., rollers) on each new pole; attaching the

[1] Conductor is synonymous with wires. Running blocks are rollers that keep the wire in place and which enable linemen to pull the wire.

conductor to the bull line and pulling it through the running blocks; ensuring the conductor has the correct tension; connecting the temporary line to the system; and transferring service to the temporary line. Then Taxpayer performs the reconductoring work on the permanent line. Once the reconductoring has been performed, service is transferred back to the permanent line and the temporary line must be removed. Under this scenario, Taxpayer incurs the following costs:

Direct Materials	$ 200
Indirect costs attracted by Direct Materials	10
Physical Labor	600
Indirect costs allocated based on labor	60
Total	$ 870

Under Taxpayer's method, Taxpayer capitalizes $320 and includes it in the costs of the SCA. Taxpayer determines that the costs of constructing and removing the temporary line are $550 ($870 – $320). Taxpayer treats the $550 as CTMS that are included in the inventoriable costs of the electricity transmitted and distributed.

Situation 3: Same as Situation 2, except that Taxpayer determines that instead of installing a temporary line, it will maintain service by temporarily relocating the existing conductor. This is accomplished by installing temporary crossarms that are longer than the existing crossarms and relocating the existing conductor to the temporary cross arms. This process involves: donning rubber gloves and sleeves; attaching protective rubber hoses to the energized primary conductors; placing rubber blankets on the side of the bucket truck or other energized facilities; attaching the temporary cross-arms to the existing cross-arms using bolts and brackets; using a hot stick to untie the conductor from the insulators on the permanent cross-arms; using the hot stick to move the conductor wire to the insulator on the temporary cross-arms; installing the running blocks (i.e., rollers) on the new pole; running a bull line through the running blocks; attaching the new conductor to the bull line and pulling it through the running blocks; tying in the new conductor by jumpering out the old conductors;[2] transferring the load to the new conductor; removing the old conductor; and removing the temporary cross-arms. Under this scenario, Taxpayer incurs the following costs:

Direct Materials	$ 200
Indirect costs attracted by Direct Materials	10
Physical Labor	200
Indirect costs allocated based on labor	20
Total	$ 430

[2] Jumpering means using a short piece of wire to temporarily bypass a circuit. Thus, jumpering out the old conductors means adding a short temporary line to provide an alternate line for the delivery of electricity.

Under Taxpayer's method, Taxpayer capitalizes $320 and includes it in the costs of the SCA. Taxpayer determines that the costs of providing the temporary solution are $110 ($430 – $320). Taxpayer treats the $110 as CTMS that are included in the inventoriable costs of the electricity transmitted and distributed.

Situations 4 through 6

Situations 4 through 6 relate to road widening projects.

Situation 4: Taxpayer relocates its existing overhead power lines to enable the construction of additional lanes on a roadway. Taxpayer determines that service does not have to be maintained to existing customers. Taxpayer de-energizes the existing line. Taxpayer pulls out the entire line being replaced which includes taking down the existing conductor, assets (crossarms, connectors, insulators, metal steps, and transformers) and poles and fills in the old holes. Taxpayer digs a new hole for each pole. Taxpayer then moves the assets to the new line of poles, installs the poles, and restrings the conductor down the new line of poles (e.g., Taxpayer attaches the conductor and hardware to each pole and places the pole into the hole and tamps it in and then reinstalls the conductor). Under this scenario, Taxpayer incurs the following costs:

Direct Materials	$ 500
Indirect costs attracted by Direct Materials	50
Physical Labor	1,000
Indirect costs allocated based on labor	100
Total	$ 1,650

Under Taxpayer's method, Taxpayer capitalizes $1,650 and includes it in the costs of the SCA. There are no CTMS because Taxpayer did not maintain service to customers during construction of the SCA.

Situation 5: Same as Situation 4, except that Taxpayer determines that it must maintain service to existing customers. Taxpayer determines that service to existing customers will be maintained via the use of temporary lines. The poles, cross arms, conductor, and related items used in constructing the temporary line are materials that may be reused. Accordingly, Taxpayer incurs no additional material costs related to the temporary line. However, Taxpayer incurs additional labor and support costs related to the temporary line. The process of constructing the temporary lines includes: mapping out where the temporary lines will be located; designing the temporary line; setting up the site for the lines; inspecting the temporary poles, conductors and equipment; digging a hole for each pole; placing the poles in the holes and tamping them in; attaching hardware to each pole (crossarms, connectors, insulators, metal steps, and transformers); installing the running blocks (i.e., rollers) on each new pole; attaching the conductor to the bull line and pulling it through the running blocks; ensuring the

conductor has the correct tension; connecting the temporary line to the system; and transferring service to the temporary line. Once the new temporary line is in place the customers are transferred over to the temporary line. The crew will then de-energize the old line and move the line to its new location as described in Situation 4 above. Once the old line is in its new location, service is transferred back to the old line, and the temporary line is removed. Under this scenario, Taxpayer incurs the following costs:

Direct Materials	$ 500
Indirect costs attracted by Direct Materials	50
Physical Labor	7,000
Indirect costs allocated based on labor	700
Total	$ 8,250

Under Taxpayer's method, Taxpayer capitalizes $1,650 and includes it in the costs of the SCA. Taxpayer determines that the costs of constructing and removing the temporary line are $6,600 ($8,250 – $1,650). Taxpayer treats the $6,600 as CTMS that are included in the inventoriable costs of the electricity transmitted and distributed.

Situation 6: Same as Situation 5, except that Taxpayer determines that instead of installing a temporary line, it will maintain service by relocating the line in steps. Moving the line in steps means that Taxpayer will have to work one pole and the attached assets at a time. The crew sets new poles parallel with the existing distribution line. Then the crew makes ties on the backside of an energized conductor and jumpers around the pole assets (rerouting the flow of energy around the assets using short temporary lines) and cuts in a line break on the other side of the asset to isolate and de-energize the specific asset that is going to be moved and allow the energy flow to customers. Once energy load is temporarily transferred to another conductor, the assets are transferred to the new line of poles one pole at a time. By jumpering around the pole assets, the linemen build in enough slack such that the conductor can be moved from the old location to the new location one pole at a time. All of the activities described above require crew members and bucket trucks in addition to those required in Situation 4. Finally, in order to perform these activities, protective rubber gear will have to be installed or donned. After the assets and conduit are moved to each new pole, the protective rubber gear (e.g. hoses, blankets, aprons) will have to be moved from one pole location to the next. Under this scenario, Taxpayer incurs the following costs:

Direct Materials	$ 500
Indirect costs attracted by Direct Materials	50
Physical Labor	2,000
Indirect costs allocated based on labor	200
Total	$ 2,750

Under Taxpayer's method, Taxpayer capitalizes $1,650 and includes it in the costs of the SCA. Taxpayer determines that the costs of relocating the line are $1,100 ($2,750 – $1,650). Taxpayer treats the $1,100 as CTMS that are included in the inventoriable costs of the electricity transmitted and distributed.

Situations 7 through 8

Situations 7 through 8 relate to transformer replacements.

Situation 7: Taxpayer replaces a transformer and determines that service does not have to be maintained to existing customers. Taxpayer de-energizes the line or lines to which the transformer is connected or is in the vicinity of. A lineman disconnects the conductor from the transformer either by climbing the pole or from the bucket truck. The transformer is taken off of the pole and a new transformer is installed. The conductor is reconnected to the new transformer and the line is energized. Under this scenario, Taxpayer incurs the following costs:

Direct Materials	$ 100
Indirect costs attracted by Direct Materials	10
Physical Labor	50
Indirect costs allocated based on labor	5
Total	$ 165

Under Taxpayer's method, Taxpayer capitalizes $165 and includes it in the costs of the SCA. There are no CTMS because Taxpayer did not maintain service to customers during construction of the SCA.

Situation 8: Same as Situation 7, except that Taxpayer determined that it must maintain service to existing customers. Taxpayer determines that service to existing customers will be maintained via the use of a short temporary line constructed next to the permanent line. The poles, cross arms, conductor, and related items used in constructing the temporary line are materials that may be reused. Accordingly, Taxpayer incurs no additional material costs related to the temporary line. However, Taxpayer incurs additional labor and support costs related to the temporary line. The process of constructing the temporary line includes: mapping out where the temporary line will be located; setting up the site for the line; inspecting the temporary poles, conductors, equipment, and transformers; digging a hole for each pole; placing the poles in the holes and tamping them in; attaching hardware to each pole (crossarms, connectors, insulators, metal steps, and transformers); installing the running blocks (i.e., rollers) on each new pole; attaching the conductor to the bull line and pulling it through the running blocks; ensuring the conductor has the correct tension; connecting the temporary line to the system; and transferring service to the temporary line. Once the new temporary line is in place the customers are transferred over to the temporary line. Taxpayer de-energizes the existing line. A lineman then disconnects the conductor

from the transformer by either climbing the pole or by bucket truck. The transformer is taken off of the pole and a new transformer is installed. The conductor is reconnected to the new transformer and the line is energized and customers are transferred over to the permanent line. The temporary line is then removed and may be reused. Under this scenario, Taxpayer incurs the following costs:

Direct Materials	$ 100
Indirect costs attracted by Direct Materials	10
Physical Labor	350
Indirect costs allocated based on labor	35
Total	$ 495

Under Taxpayer's method, Taxpayer capitalizes $165 and includes it in the costs of the SCA. Taxpayer determines that the costs of constructing and removing the temporary line are $ 330 ($495 – $165). Taxpayer treats the $330 as CTMS that are included in the inventoriable costs of the electricity transmitted and distributed.

Situations 9 through 10

Situations 9 through 10 relate to underground projects:

Situation 9: Taxpayer must repair a conductor in a three-phase primary distribution line. Taxpayer determined that service does not have to be maintained to existing customers. Taxpayer de-energizes all three conductors. The crew repairs the damaged conductor. Under this scenario, Taxpayer incurs the following costs:

Direct Materials	$ 100
Indirect costs attracted by Direct Materials	10
Physical Labor	32
Indirect costs allocated based on labor	3
Total	$ 145

Under Taxpayer's method, Taxpayer capitalizes $145 and includes it in the costs of the SCA. There are no CTMS because Taxpayer did not maintain service to customers during construction of the SCA.

Situation 10: Same as Situation 9, except that Taxpayer determines that service must be maintained to some existing customers. Taxpayer de-energizes the damaged conductor, while the other two conductors remain energized. Taxpayer must place rubber blankets over the energized conductors and the crew must work while wearing rubber gloves. Under this scenario, Taxpayer incurs the following costs:

Direct Materials	$ 100
Indirect costs attracted by Direct Materials	10
Physical Labor	40

Indirect costs allocated based on labor	4
Total	$ 154

Under Taxpayer's method, Taxpayer capitalizes $145 and includes it in the costs of the SCA. Taxpayer determines that the costs associated with maintaining service to customers is $9 ($154 – $145). Taxpayer treats the $9 as CTMS that are included in the inventoriable costs of the electricity transmitted and distributed.

LAW AND ANALYSIS:

Section 263A(a)(1)(A) of the Internal Revenue Code provides that the direct costs and indirect costs properly allocable to property that is inventory in the hands of the taxpayer shall be included in inventory costs. Section 263A(a)(1)(B) provides that the direct costs and indirect costs properly allocable to any other covered property shall be capitalized. Section 263A(b)(1) provides that § 263A applies to real or tangible personal property produced by the taxpayer.

Section 263A(g)(1) provides that the term "produce" includes construct, build, install, manufacture, develop, or improve.

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 real and tangible personal property produced by the taxpayer; and real property and personal property described in section 1221(a), which is acquired by the taxpayer for resale.

Section 1.263A-1(e)(1) provides that taxpayers subject to § 263A must capitalize all direct costs and certain indirect costs properly allocable to property produced or property acquired for resale.

Section 1.263A-1(e)(2)(i)(B) provides that producers must capitalize the costs of labor that can be identified or associated with particular units or groups of units of specific property produced.

Section 1.263A-1(e)(3)(i) provides that indirect costs are defined as all costs other than direct materials and direct labor costs (in the case of property produced) or acquisition costs (in the case of property acquired for resale). Taxpayers subject to § 263A must capitalize all indirect costs properly allocable to property produced or property acquired for resale. Id.

Section 1.263A-1(e)(3)(i) also provides that indirect costs are properly allocable to property produced or property acquired for resale when the costs directly benefit or are incurred by reason of the performance of production or resale activities. Further, § 1.263A-1(e)(3)(i) provides that indirect costs may be allocable to both production and resale activities, as well as to other activities that are not subject to

§ 263A. Taxpayers subject to § 263A must make a reasonable allocation of indirect costs between production, resale, and other activities. Id.

Rev. Rul. 70-332, 1970-1 C.B. 31, held that premium time or overtime paid or incurred solely to expedite the installation of capital assets must be capitalized as part of the cost of the capital assets under § 263(a). The primary construction contract that the taxpayer entered into with the contractor provided for a certain completion date. The taxpayer entered into a separate contract with the contractor for the payment of premium time or overtime that would be required to minimize the shutdown time while the new equipment was being installed in its production facility. Rev. Rul. 70-332 concludes that since the subject costs were incurred solely to expedite the installation of the capital assets, such costs were not an ordinary and necessary business expense but must be capitalized into the capital assets, as opposed to the inventory that the taxpayer produced in the facility. The ruling further held it is immaterial whether or not the premium time adds value or life to the capital assets installed or whether income was earned on such installation from the moment the assets were placed in early service.

In Rev. Rul. 73-203, 1973-1 C.B. 146, a governmental body ordered the taxpayer, a regulated public utility, to relocate its overhead electric power lines at its own cost wherever they interfered with the construction of an expressway. In order to furnish continuous service, some existing power lines were temporarily relocated while the utility installed new sections of overhead and underground lines to take the place of the overhead lines retired. The utility used the temporary lines for less than a year. Rev. Rul. 73-203 concludes that the expenditures incurred for the new installation of both overhead and underground electric transmission and distribution lines that took the place of the retired lines are capital expenditures under § 263(a) and § 1.263(a)-1. The ruling further concludes that the costs of temporary relocations of existing power lines for the purpose of maintaining service during the construction period of less than a year are business expenses deductible under § 162(a) in the year incurred.

In Rev. Rul. 2004-18, 2004-1 C.B. 509, the taxpayer incurred environmental remediation costs to clean up land that was contaminated as part of the ordinary business operations of its manufacturing of inventory. The ruling held that the taxpayer's environmental remediation costs were incurred by reason of its production activities within the meaning of § 1.263A-1(e)(3)(i). The costs were properly allocable to inventory produced by the taxpayer. Accordingly, the taxpayer must capitalize the otherwise deductible environmental remediation costs by including the costs in inventory costs in accordance with § 1.263A-1(c)(3). Similarly, costs incurred to replace underground storage tanks and depreciation cost recoveries of the groundwater treatment facility must be included in inventory costs to the extent properly allocable to inventory.

Analysis

The request for technical advice focuses on whether and to what extent Rev. Rul. 73-203 applies in this case following the enactment of § 263A, and what the proper capitalization or deductibility treatment is with respect to the CTMS.

With respect to the illustrative Situations, there is no disagreement between Taxpayer and the Director concerning Situations 1, 4, 7 and 9, which involve construction of SCA in a de-energized environment. CTMS are not incurred in those Situations and thus there is no issue regarding application of the proposed method of accounting.

The parties disagree on whether Taxpayer's application of its proposed method is proper in the six other Situations where Taxpayer maintains service to customers during the construction of SCA[3], and the construction work occurs in an energized environment. In Situations 2, 5 and 8, Taxpayer constructs a temporary line or lines (Temporary Lines Situations) to maintain service during the construction period. In Situations 3, 6 and 10, Taxpayer maintains service to its customers, but does not construct a separate temporary line.

In Situations 3 and 6, some of the costs incurred apparently relate to temporary relocation of existing capital assets and some apparently relate to additional safety precautions necessary for working in an energized environment that result in Taxpayer's crews working more slowly (WMS), thereby increasing the cost of producing the SCA. Situation 3 involves the temporary relocation of the existing conductor by the installation of temporary crossarms. Situation 6 involves relocating the line in steps by working on one pole and its attached assets at a time. In Situation 10, there are no temporary relocations of existing assets, but Taxpayer's crews work in an energized environment and must take additional safety precautions that result in the additional costs of WMS.

Rev. Rul. 73-203

We first examine the applicability of Rev. Rul. 73-203 and the impact, if any, that the enactment of § 263A had on the ruling.

In Rev. Rul. 73-203, a governmental body required a taxpayer to relocate its electric power lines to make way for a road construction project. The taxpayer temporarily relocated some existing power lines in order to furnish continuous customer service during the construction period. The temporary lines were to be used for a period of less than a year. New sections of overhead and underground lines were installed to take the place of the lines retired. The ruling held that the costs of installing the new permanent lines were capital expenditures under § 263(a) and the costs of temporary relocations of existing power lines for the purpose of maintaining service during the construction

[3] The construction period upon which Rev. Rul. 73-203 was based was less than a year. For purposes of this memorandum, all references to the construction of SCA or a construction period are intended, in accordance with the ruling, to mean for a period of less than a year for each construction project.

period of less than a year are business expenses deductible under § 162(a) in the year incurred.

Rev. Rul. 73-203 could be viewed solely as distinguishing between short-lived assets and assets having a useful life of at least a year. The ruling concludes that the permanent lines must be capitalized under § 263(a), but the temporary lines are not required to be capitalized under § 263(a) because they will be used for less than a year.

However, Rev. Rul. 73-203 states that the purpose of the temporary lines was to maintain service during the construction period of the new lines. This suggests that the purpose of the temporary lines was not to enable or facilitate the construction. The ruling also treats the temporary lines as separate from the new lines. In other words, the ruling analyzes the costs of constructing the temporary lines separately from the costs of constructing the new permanent lines. Although not expressly stated in the ruling, this further suggests that the costs of constructing the temporary lines were not due to the construction of the new permanent lines (the SCA).

We believe that Rev. Rul. 73-203 supports the proposition that the costs of constructing the temporary lines are not a cost of constructing the permanent lines. Rev. Rul. 73-203 does not, however, identify the standard used to determine that the temporary line costs were not costs of constructing the permanent lines.

Section 263A requires capitalization of the costs of labor that can be identified or associated with particular units or groups of units of specific property produced (direct labor costs), and indirect costs that directly benefit or are incurred by reason of the production of inventory and self-constructed assets. See §§ 1.263A-1(e)(2)(i)(B) and 1.263A-1(e)(3)(i). Thus, we must determine whether under the capitalization standards of § 263A the costs of constructing temporary lines are an indirect cost of constructing the permanent lines.

Taxpayer asserts that the enactment of § 263A does not affect the applicability of Rev. Rul. 73-203 to this case. In support of this contention, Taxpayer points out that the Service has not revoked the ruling and that no other ruling or case directly conflicts with the ruling. Taxpayer emphasizes that Rev. Rul. 73-203 reached the substantive conclusion that the costs for temporary relocations of existing power lines were incurred "for the purpose of maintaining service during the construction period" and therefore such costs may be expensed under § 162. Taxpayer further reasons that the costs for the temporary relocations were a cost of providing service; accordingly, the expenditures were costs of providing electricity. Thus, Taxpayer contends that under the applicable § 263A capitalization standards, the costs of the temporary lines are not incurred by reason of the construction of the SCA nor do they directly benefit the construction of SCA.

The Director contends that Taxpayer's reliance on Rev. Rul. 73-203 is misplaced because the ruling was published prior to the enactment of § 263A. The Director cites to the legislative history in support of this argument, proffering that Congress enacted § 263A because it believed that "in order to more accurately reflect income and make the income tax system more neutral, a single, comprehensive set of rules should govern the capitalization of costs of producing, acquiring, and holding property." See S. Rep. No. 99-313 (1986), 1986-3 (Vol. 3) C.B. 1, 140. Thus, the Director asserts that § 263A completely revised the rules for inventory costing and the capitalization of costs for SCA such that § 263A constitutes a more comprehensive and broader capitalization regime than the §263(a) rules that were applied in the ruling. Accordingly, § 263A broadened, rather than narrowed, the scope of § 263(a).

The Director further contends that, because § 263A posits a broader capitalization test than § 263(a), § 263A adds another layer of analysis in this case over that which was contained in Rev. Rul. 73-203. In this regard the Director posits that the ruling is not incorrect, but that it is merely incomplete for purposes of providing the answer here because the analysis under § 263A differs from the § 263(a) analysis. According to the Director, the § 263A analysis must involve applying the § 1.263A-1(e)(3)(i) causal relationship test of determining which production activity (the construction of SCA or the production of electricity) the CTMS "directly benefit or are incurred by reason of," regardless of whether the analysis involves a Temporary Lines Situation or a Situation involving WMS. The Director asserts that that inquiry points to the conclusion that the CTMS are incurred by reason of the construction of SCA because, but for the construction of SCA, Taxpayer would not otherwise either construct temporary lines, or would not be working more slowly in an energized environment in order to maintain service to customers. The Director therefore maintains that Rev. Rul. 73-203 is not dispositive in this case due to the broader capitalization requirements of § 263A.

In further support of this argument, the Director cites Rev. Rul. 2004-18 for the proposition that some costs that might otherwise be deductible under a § 263(a) - § 162(a) analysis nonetheless must be allocated to the § 263A production activity that they directly benefit or are incurred by reason of. The Director argues that this additional layer of analysis is required by § 263A and leads to the conclusion that the CTMS would not have been incurred but for the construction of SCA. Accordingly, all CTMS must be allocated to SCA.

We agree with the Director that § 263A constitutes a more comprehensive and broader capitalization regime than § 263(a). However, we believe that the determination in Rev. Rul. 73-203 that the purpose of the temporary lines was to provide service to customers during the construction period applies for purposes of § 263A. We do not believe that the costs of temporarily relocating the lines can be considered to be "incurred by reason of" the SCA construction under § 263A where the Internal Revenue Service previously determined that the purpose of such costs is to provide service during the construction period.

In addition, we believe that Rev. Rul. 2004-18 does not require a different conclusion in this case. Rev. Rul. 2004-18 involved only a single § 263A production activity – production of inventory. Thus, the ruling did not require a determination of whether the indirect costs at issue were allocable to inventory or SCA. Here, Taxpayer produces both inventory (electricity) and SCA. And, as stated above, Rev. Rul. 73-203 indicates that the costs are for the purpose of providing service – inventory – to customers.

Costs to Which Rev. Rul. 73-203 Applies

Taxpayer asserts that Rev. Rul. 73-203 stands for the proposition that all "maintenance of service costs" incurred during a construction period of less than one year are costs to transmit and distribute electricity to customers rather than costs to self-construct the permanent facilities. Thus, Taxpayer contends the ruling's sweep is broad enough to encompass all of the Temporary Lines Situations and all of the costs incurred in the Situations that involve WMS so as to treat the costs it refers to as CTMS in each of the six Situations as allocable to the production of electricity.

We find that the holding of Rev. Rul. 73-203 is not as broad as Taxpayer asserts. The ruling simply cannot be read to support the proposition that all "maintenance of service costs," under any circumstance during a construction period of less than one year, are costs to transmit and distribute electricity to customers. The holding in the ruling indicates that it is limited to treating "the costs of temporary relocations of existing power lines for the purpose of maintaining service during the construction period of less than a year" as costs that are deductible under § 162(a) in the year incurred.

In Rev. Rul. 70-332, the taxpayer entered into a contract with a contractor to install some new equipment at its manufacturing facility. The taxpayer entered into a separate contract with the contractor to pay premium time or overtime in excess of the primary contract amounts in order to minimize the shutdown time of its production facility while the new equipment was being installed. The ruling held that since the subject costs were incurred solely to expedite the installation of the capital assets, such costs were not an ordinary and necessary business expense but must be capitalized into the capital assets. The ruling further held it is immaterial whether or not the premium time adds value or life to the capital assets installed or whether income was earned on such installation from the moment the assets were placed in early service.

Like the premium time costs in Rev. Rul. 70-332, the WMS costs are allocable to the SCA to the extent that they are attributable to employees working more slowly in the construction of SCA within the vicinity of energized lines.

We conclude that the costs incurred to relocate electric lines are within the purview of Rev. Rul. 73-203. However, we conclude that the additional costs incurred to actually

construct the SCA in the vicinity of energized lines – the WMS costs – are within the purview of Rev. Rul. 70-332.

These principles must be applied to the Taxpayer's actual facts and circumstances of each construction project. However, based on the facts provided for the six Situations at issue, we believe that the costs incurred to maintain service in Situations 2, 5, and 8 are within the scope of Rev. Rul. 73-203 and allocable to Taxpayer's electricity production activity. The costs of temporarily relocating the energized lines in Situations 3 and 6, similarly are allocable to Taxpayer's electricity production activity. The costs of WMS in Situation 10 are within the scope of Rev. Rul. 70-332 and allocable to the SCA. Similarly, the costs of WMS to construct the SCA in Situations 3 and 6 are allocable to the SCA.

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.