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subject: Request for CCA Regarding Allocating Cost of Goods Sold That Includes Post-Production Costs

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUE

A taxpayer incurs direct and indirect costs that are includible in inventory costs under § 263A of the Internal Revenue Code. Some of the costs incurred and capitalizable in the current year are attributable to events that occurred prior to the effective date of § 199. Sales of the inventory items generate domestic production gross receipts ("DPGR"). Does § 1.199-4(b)(2)(ii)(B) of the Income Tax Regulations require or permit the taxpayer to allocate some of the cost of goods sold ("CGS") to non-domestic production gross receipts ("non-DPGR")?

CONCLUSION

Section 1.199-4(b)(2)(ii)(B) does not require or permit taxpayers to allocate part of the CGS of an inventory item to non-DPGR when the gross receipts from the sale of that item are treated as DPGR. Because the costs at issue are properly capitalizable to current year production pursuant to § 263A, they must be included in determining CGS allocable to DPGR for the taxable year in which the costs are incurred, and allocated to DPGR using a "reasonable method" pursuant to § 1.199-4(b)(2)(i). Application of a

reasonable method results in the entire amount of the costs at issue being allocated to DPGR.

FACTS

Corporation X manufactured Product A from 1996 through 2004 and Product B from 2005 through 2008 in the United States. Product A and Product B are similar in all important respects. Product B is the next generation of Product A.

At the beginning of its 2008 taxable year, Corporation X had no goods in inventory. During 2008, Corporation X manufactured 1,000 units of Product B. Corporation X sold 900 units of Product B during 2008, and 100% of the gross receipts recognized by Corporation X in 2008 qualified as DPGR.

To account for inventory costs under §§ 471 and 263A, Corporation X uses both a standard cost method and the simplified production method. The standard cost of one unit of Product B in 2008 was $20, including $5 of materials, $5 in labor costs, and $10 in overhead expenses (which includes worker's compensation payments). Corporation X had no variances to allocate in 2008. In 2008, Corporation X incurred additional § 263A costs of $5,000, or $5 per unit (which includes retiree medical expenses and environmental remediation costs).

Employee 1 was involved in Corporation X's production process until he retired from Corporation X in 2000. In 2008, Corporation X paid $30 of Employee 1's medical expenses pursuant to an existing medical plan for retired Corporation X employees. Those expenses were subject to capitalization under § 263A for purposes of computing Corporation X's 2008 taxable income.

Employee 2 has been involved in Corporation X's production process her entire career and was injured in 2004 while manufacturing Product A. In 2008, Corporation X paid Employee 2 $20 of worker's compensation payments for her injuries suffered in 2004. Those expenses were subject to capitalization under § 263A for purposes of computing Corporation X's 2008 taxable income.

Products A and B were manufactured at the same factory. From 2000 through 2004, production activities related to the manufacture of Product A discharged hazardous waste at the factory. As a result, in 2008, Corporation X incurred $400 in environmental remediation costs to clean up the factory and surrounding land. These expenses were subject to capitalization under § 263A for purposes of computing taxable income in 2008.[1]

[1] Beginning in 2005, Corporation X properly disposed of hazardous waste resulting from its production process and properly capitalized its waste removal costs to inventory under § 263A. These costs are not part of the $400 in environmental remediation costs paid in 2008 as a result of Corporation X's production activities from 2000 through 2004.

Corporation X asserts that pursuant to § 1.199-4(b)(2)(ii)(B), a portion of its CGS (the portion attributable to environmental remediation, worker's compensation and retiree medical benefits expenses incurred in 2008 (collectively, "2008 Expenses") must be allocated to non-DPGR, because such costs relate to activities generating gross receipts in years prior to the effective date of § 199.

LAW AND ANALYSIS

Section 199 allows a deduction equal to a specified percentage of income attributable to domestic production activities. Under § 199(a)(1), the deduction is generally limited to a percentage of the lesser of the taxpayer's (a) qualified production activities income ("QPAI") or (b) taxable income for the taxable year. Section 199 is effective for tax years beginning after December 31, 2004.

Section 199(c) generally provides that QPAI is the excess of the taxpayer's domestic production gross receipts for the taxable year over the sum of the CGS allocable to such receipts, and other expenses, losses and deductions (determined without regard to § 199) properly allocable to such receipts.

Section 1.199-1(d)(1) provides that a taxpayer must determine the portion of its gross receipts for the taxable year that is DPGR and the portion of its gross receipts that is non-DPGR.

Section 1.199-1(d)(2) provides that factors taken into consideration in determining whether the taxpayer's method of allocating gross receipts between DPGR and non-DPGR is reasonable include whether the taxpayer uses the most accurate information available and the accuracy of the method chosen as compared with other possible methods. Thus, if a taxpayer has the information readily available and can, without undue burden or expense, specifically identify whether the gross receipts derived from an item are DPGR, then the taxpayer must use that specific identification to determine DPGR.

Section 1.199-4(b)(1) provides that in the case of a sale, exchange, or other disposition of inventory, CGS is equal to beginning inventory, plus purchases and production costs incurred during the taxable year and included in inventory costs, less ending inventory. CGS is determined under the methods of accounting that the taxpayer uses to compute taxable income pursuant to §§ 263A, 471, and 472. If § 263A requires a taxpayer to include additional § 263A costs in inventory, additional § 263A costs must be included in determining CGS.

Section 1.199-4(b)(1) also provides that CGS allocable to DPGR for a taxable year includes the inventory cost and adjusted basis of qualifying production property ("QPP")

that will generate (or have generated) DPGR notwithstanding that the gross receipts attributable to the disposition of the QPP will be, or have been, included in the computation of gross income for a different taxable year. For example, advance payments that are DPGR may be included in gross income under § 1.451-5(b)(1)(i) in a different taxable year than the related CGS allocable to that DPGR.

Section 1.199-4(b)(2)(i) provides that a taxpayer must use a reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances to allocate CGS between DPGR and non-DPGR. Depending on the facts and circumstances, reasonable methods may include methods based on gross receipts, number of units sold, number of units produced, or total production costs. Ordinarily, if a taxpayer uses a method to allocate gross receipts between DPGR and non-DPGR, then the use of a different method to allocate CGS that is not demonstrably more accurate than the method used to allocate gross receipts will not be considered reasonable. However, if a taxpayer has information readily available to specifically identify CGS allocable to DPGR and can specifically identify that amount without undue burden or expense, CGS allocable to DPGR is that amount irrespective of whether the taxpayer uses another allocation method to allocate gross receipts between DPGR and non-DPGR.

Section 1.199-4(b)(2)(ii) provides that, generally, if a taxpayer recognizes and reports gross receipts on a Federal income tax return for a taxable year, and incurs CGS related to such gross receipts in a subsequent taxable year, then regardless of whether the gross receipts ultimately qualify as DPGR, the taxpayer must allocate the CGS to--

> (A) DPGR if the taxpayer identified the related gross receipts as DPGR in the prior taxable year; or
>
> (B) Non-DPGR if the taxpayer identified the related gross receipts as non-DPGR in the prior taxable year or if the taxpayer recognized under the taxpayer's methods of accounting those gross receipts in a taxable year to which § 199 does not apply.

Section 263A provides that taxpayers must capitalize their direct costs and a properly allocable share of their indirect costs to inventory. Section 1.263A-1(c)(1) provides that to determine these capitalizable costs, taxpayers must allocate or apportion costs to various activities, including production activities (in the case of a manufacturer). After § 263A costs are allocated to production activities, these costs are generally allocated to the items of property produced during the taxable year and capitalized to the items that remain on hand at the end of the taxable year.

Section 1.263A-1(c)(3) provides that capitalize means, in the case of property that is inventory in the hands of a taxpayer, to include in inventory costs.

Section 1.263A-1(c)(2)(ii) provides that the amount of any cost required to be capitalized under § 263A may not be included in inventory or charged to capital

accounts or basis any earlier than the taxable year during which the amount is incurred within the meaning of § 1.446-1(c)(1)(ii). Section 1.446-1(c)(1)(ii) provides that a liability is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.

Section 1.263A-1(e)(3)(i) provides that indirect costs are properly allocable to property produced when the costs directly benefit or are incurred by reason of the performance of production or resale activities.
Section 1.263A-1(e)(3)(ii)(C) provides that pension and other related costs are indirect costs required to be capitalized. Section 1.263A-1(e)(3)(ii)(C) further provides that contributions to employee plans representing past services must be capitalized in the same manner as amounts contributed for current service.

Section 1.263A-1(e)(3)(ii)(D) provides that, generally, all other employee benefit expenses (not described in § 1.263A-1(e)(3)(ii)(C)), including worker's compensation, payments pursuant to a wage continuation plan under § 105(d) as it existed prior to its repeal in 1983, and benefits provided for employees such as medical treatment, are indirect costs required to be capitalized.

Section 1.263A-2(a)(3)(i) provides that producers generally must capitalize direct and indirect costs properly allocable to property produced under § 263A, without regard to whether those costs are incurred before, during, or after the production period.

Rev. Rul. 2005-42, 2005-2 C.B. 67, holds that environmental remediation costs incurred to clean up land that a taxpayer contaminated with hazardous waste as a result of the taxpayer's manufacturing activities are incurred by reason of production activities and are properly allocable under § 263A to the inventory produced during the taxable year the costs are incurred.

For purposes of computing QPAI under § 199, CGS is determined using the methods of accounting that the taxpayer uses to compute taxable income. § 1.199-4(b)(1). Additional § 263A costs must be included in determining CGS allocable to DPGR if a taxpayer is required to include such costs in inventory pursuant to § 263A. Accordingly, to the extent Corporation X's 2008 Expenses are properly excluded from inventoriable costs, these expenses may be excluded for purposes of determining CGS allocable to DPGR. Section 263A and the related regulations, however, require a properly allocable share of indirect costs to be included in the inventory cost of goods produced during the taxable year (in the case of a manufacturer). Thus, as described in more detail below, the 2008 Expenses are properly treated as the cost of producing property in the current taxable year, are required to be included in inventory costs under § 263A, and are included in inventory costs under Corporation X's methods of accounting.

For pension and other related expenses, contributions for past services must be capitalized in the same manner as amounts contributed for current services. § 1.263A-1(e)(3)(ii)(C). Furthermore, § 1.263A-1(e)(3)(ii)(D) provides that all other employee benefit expenses not described in § 1.263A-1(e)(3)(ii)(C) should be capitalized (to the extent allowable as deductions). Such costs specifically include payments for the benefit of former employees, such as worker's compensation benefits, which often involve payments of benefits years after the end of the period of employment, as well as payments pursuant to a § 105(d) wage continuation plan, which involve payments to former employees who retired on disability. § 1.263A-1(e)(3)(ii)(D).

Accordingly, the retiree medical expenses paid by Corporation X, which are employee benefit costs, should be capitalized to property produced in 2008 pursuant to § 1.263A-1(e)(3)(ii)(D). This regulation applies broadly to employee benefit expenses, and specifically includes examples of expenses which arise from services performed by an employee in a prior year. Worker's compensation expenses paid by Corporation X are subject to capitalization pursuant to § 1.263A-1(e)(3)(ii)(D), and should also be capitalized to property produced in 2008.

Additionally, Rev. Rul. 2005-42 holds that environmental remediation costs incurred by a taxpayer to clean up land are costs that directly benefit or are incurred by reason of current production activities, even if the costs are necessitated by the use of facilities for the production of property in a prior taxable period. Thus, the environmental remediation costs incurred by Corporation X in 2008 are capitalizable to property produced during 2008.

Because § 263A and the associated regulations require the 2008 Expenses to be capitalized to property produced in the current year, and because the treatment of § 199 expenses are generally required to conform to the treatment of § 263A costs, the 2008 Expenses likewise must be included in determining CGS allocable to DPGR. Pursuant to § 1.199-4(b)(2)(i), CGS is then allocated to DPGR using a "reasonable method." The most reasonable method for allocating CGS under these facts is the specific identification method. All of the units of Product B sold by Corporation X generated DPGR. Therefore, the inventory cost of each unit of Product B sold should be allocated to DPGR. A taxpayer's methods of accounting under §§ 263A and 471 determine the inventory cost of each unit of property. The unit cost of Product B is $25 ($20 of § 471 costs + $5 of additional § 263A costs). Other reasonable methods described in § 1.199-4(b)(2)(i) – allocation based on gross receipts, number of units sold, number of units produced and total production costs – would yield the same result.

Corporation X asserts that § 1.199-4(b)(2)(ii)(B) requires the 2008 Expenses to be allocated to non-DPGR, as it believes these expenses are "related to" gross receipts received in a year prior to the effective date of § 199. The 2008 Expenses, however, are not "related to" gross receipts received in a prior year; rather, the 2008 Expenses are included in the inventory cost of property produced in the current year, and thus, are "related to" the gross receipts generated from sale of those goods. As discussed

previously, inventory costs incurred in the current year are generally allocated to property produced in the current year, and the treatment of § 199 expenses are generally required to conform to the treatment of § 263A costs. Accordingly, Corporation X's reading of the regulation is contrary to the cost allocation methods contained in the § 199 regulations (and, by extension, § 263A and the associated regulations). Section 1.199-4(b)(1) plainly requires the taxpayer to determine CGS allocable to DPGR under the same methods of accounting used to compute taxable income pursuant to §§ 263A, 471, and 472.

By arguing that the 2008 Expenses should be allocated to non-DPGR, Corporation X proposes to segregate each unit of Product B into its component costs and then allocate those costs between DPGR and non-DPGR, notwithstanding the fact that the sale of the unit generated DPGR. We do not believe that § 1.199-4(b)(2)(ii) allows taxpayers or the Service to segregate the cost of a unit of inventory into component costs and then allocate those component costs between CGS allocable to DPGR and CGS allocable to non-DPGR. Rather, we believe § 1.199-4(b)(2)(ii) addresses the allocation of CGS determined on the basis of unit costs when gross receipts from the sale of those units are received in a prior year. There is no language in § 1.199-4(b)(2)(ii) indicating that the component costs, rather than the unit costs, of property are to be allocated. To the contrary, the fact that a taxpayer's §§ 263A and 471 methods determine the unit cost of property, and the requirement to use those methods to compute CGS for purposes of § 199, indicates that the allocation of CGS between DPGR and non-DPGR is premised on unit costing.

Our view is reinforced by § 1.199-1(d)(2), which requires a taxpayer that can specifically identify whether gross receipts derived from an item are DPGR to use a specific identification method for determining the portion of its gross receipts that are DPGR. Section 1.199-4(b)(2) generally requires a taxpayer to use the same method of allocating CGS that is used for allocating gross receipts. Read together, § 1.199-1(d)(2) and § 1.199-4(b)(2) indicate that a taxpayer that can determine through specific identification that gross receipts from disposition of a unit of property qualify as DPGR, and that can determine the inventory cost per unit of that property, must allocate the gross receipts to DPGR and the corresponding inventory cost of the unit to DPGR.

The theme of § 1.199-4(b)(2) is that the cost of property should be allocated to the type of receipts, DPGR or non-DPGR, that the sale of the property generated. Paragraph (b)(2)(ii) of § 1.199-4 is consistent with that theme. Section 1.199-4(b)(2)(ii) applies in limited circumstances not applicable to Corporation X, such as when a taxpayer receives an advance payment or uses the cash receipts and disbursements method. Pursuant to § 1.199-4(b)(1), advance payments that qualify as DPGR may be included in gross income in a different taxable year than the related CGS allocable to that DPGR. Section 1.199-4(b)(2)(ii) then clarifies how to allocate the related CGS for purposes of § 199. Example 1 of § 1.199-4(b)(7) illustrates the application of § 1.199-4(b)(2)(ii). In the example, a furniture manufacturer receives an advance payment and incurs costs related to the advance payment when it manufactures the furniture in a subsequent

year. The example refers the reader to § 1.199-4(b)(2)(ii) “for rules regarding gross receipts and costs recognized in different taxable years.”

Accordingly, § 1.199-2(b)(2)(ii) is not applicable to the facts described above, and all of Corporation X’s CGS, which includes a portion of the 2008 Expenses, must be allocated to DPGR.

Please contact Natasha Mulleneaux on 202-622-4970 if you have any further questions.