Office of Chief Counsel
Internal Revenue Service
memorandum

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subject: Allocation of certain costs to produce food under § 263A

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ISSUE

LB&I Operating Division has under examination a number of restaurants and has asked whether it is appropriate to impose the simplified production method under the facts described below.

CONCLUSION

Under these facts, we would generally not support in examination or litigation the imposition of the simplified production method if the taxpayers are willing to develop and implement a reasonable facts-and-circumstances method instead. In addition, if these taxpayers use the simplified production method, we would support allowing them to treat all of their direct production costs (including "kitchen labor," as defined below) as § 471 costs.

FACTS

A number of restaurants under examination have ending inventories consisting entirely, or almost entirely, of raw materials – specifically, ingredients that have not yet entered the restaurant's production process.[1] These restaurants are generally treating costs incurred related to the kitchen ("back of the house") as capitalizable production costs and costs incurred related to the serving area ("front of the house") as non-capitalizable costs under § 263A. However, some of these restaurants have not capitalized under § 263A certain back-of-the-house costs incurred to produce food, including cook and preparation-cook wages related to producing food (collectively, "kitchen labor").

LAW AND ANALYSIS

Sections 263A(a) and 1.263A-1(a)(3)(ii) provide, in part, that taxpayers that produce real or tangible personal property must capitalize: (1) all direct costs of producing the property; and (2) the property's properly allocable share of indirect costs.

Section 1.263A-1(e)(2)(i)(B) provides that direct labor costs include 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)(A) provides, in part, that indirect costs are all costs other than direct material costs and direct labor costs (in the case of property produced), and that indirect costs are properly allocable to property produced when the costs directly benefit or are incurred by reason of the performance of production activities.

Section 1.263A-1(c)(1) provides that taxpayers must allocate or apportion costs to various activities, including production activities. This section also provides that after § 263A costs are allocated to production activities, the 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-3(a)(2)(iii)(2)(B) addresses the production of food by the in-store bakery of a retail grocery business. The example concludes that the taxpayer's baking activity is production activity (even though under those particular facts, the grocery store is not required to capitalize the costs of producing baked goods because the production activity is *de minimis* and incident to its activities as a small reseller).

Section 1.263A-1(f)(1) allows producers to use the simplified production method under § 1.263A-2(b) to allocate direct and indirect costs to eligible property produced rather than a "facts-and-circumstances" method, which includes a specific identification method, standard cost method, burden rate method, or any other reasonable allocation method (as defined under the principles of § 1.263A-1(f)(4)). A reasonable facts-and-circumstances method is generally more precise than the simplified production method

[1] Restaurants generally purchase, process, and combine ingredients to produce food for sale to customers. We assume for purposes of this memo that the processing and combining of ingredients by the restaurants under examination is production under § 263A(g)(1) and § 1.263A-2(a)(1). Whether an activity is production under § 263A(g)(1) and § 1.263A-2(a)(1) depends on all the facts and circumstances.

because costs can be allocated on the basis of a cause and effect or other reasonable relationship.

The simplified production method uses an allocation formula to determine the additional § 263A costs allocable to ending inventories of property produced and other "eligible" property on hand at the end of the taxable year. The simplified production method allocates additional § 263A costs to ending inventory using an allocation formula that is based on the relationship between the amount of inventory costs incurred during the taxable year that are on hand at the end of the taxable year (§ 471 costs remaining on hand at year end) and the amount of inventory costs incurred during the taxable year (§ 471 costs incurred during the taxable year). See § 1.263A-2(b)(3)(ii)(A) and (B).

Section 1.263A-1(d)(2)(i) provides that § 471 costs are the costs, other than interest, that the taxpayer capitalized under its method of accounting immediately prior to the effective date of § 263A. Section 1.263A-1(d)(2)(ii) provides that, for taxpayers not in existence prior to the effective date of § 263A, § 471 costs generally are the costs, other than interest, that the taxpayer would have been required to capitalize under its method of accounting had it been in existence immediately prior to the effective date of § 263A.

Under these facts, the restaurants have on hand at the end of the taxable year ending inventories consisting entirely, or almost entirely, of ingredients that have not yet entered the restaurant's production process. Accordingly, if kitchen labor were treated as additional § 263A costs under the simplified production method, a significant amount of kitchen labor would be capitalized to the raw materials in ending inventory, even though kitchen labor costs typically relate almost entirely to the production of food that is no longer on hand. However, if kitchen labor were treated as a § 471 cost under the simplified production method or if a more precise facts-and-circumstances method were used, these costs would be allocated to the cost of produced food included in cost of goods sold.

Moreover, if the Service imposed the simplified production method with kitchen labor treated as an additional § 263A cost, the restaurant may request to change its method of accounting to treat kitchen labor as a § 471 cost or change to a more precise facts-and-circumstances method and our office generally would grant such changes as appropriate.

Consequently, under these facts, even though a restaurant may use the simplified production method, we would generally not support the imposition of this method in examination or litigation if the taxpayer is willing to develop and implement a reasonable facts-and-circumstances method instead. In addition, under these facts, if the taxpayer uses the simplified production method, we would support allowing the taxpayer to treat all of their direct production costs (including kitchen labor) as § 471 costs under that method rather than as additional § 263A costs.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please contact Christopher W. Call at (202) 317-7007 if you have any further questions.