Part VII.—Additional Itemized Deductions for Individuals

Section 213.—Medical, Dental, etc., Expenses

26 CFR 1.213–1. Medical, dental, etc., expenses
(Also Section 7805; 301.7805–1.)

Deduction of payments for future medical care. Rev. Ruls. 75–302, 75–303, and 76–481 should not be interpreted to allow a current deduction of payments for future medical care (including medical insurance) extending substantially beyond the close of the taxable year in situations where the future care is not purchased in connection with obtaining lifetime care of the type described in those rulings. Rev. Ruls. 75–302, 75–303, and 76–481 clarified.

Rev. Rul. 93–72

This revenue ruling clarifies Rev. Rul. 75–302, 1975–2 C.B. 86, Rev. Rul. 75–303, 1975–2 C.B. 87, and Rev. Rul. 76–481, 1976–2 C.B. 82. Those revenue rulings should not be interpreted to allow a current deduction of payments for future medical care (including medical insurance) extending substantially beyond the close of the taxable year in situations where the future care is not purchased in connection with obtaining lifetime care of the type described in those rulings.

PROSPECTIVE APPLICATION

Pursuant to the authority contained in section 7805(b) of the Internal Revenue Code, this revenue ruling will not be applied to amounts paid before October 14, 1993, or to amounts paid on or after October 14, 1993, pursuant to terms of a binding contract entered into before that date if such terms were in effect on that date.

EFFECT ON OTHER REVENUE RULINGS

Rev. Ruls. 75–302, 75–303, and 76–481 are clarified.

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26 CFR 1.213–1. Medical, dental, etc., expenses.

The Service will not issue advance rulings or determination letters on whether amounts paid for medical insurance (or other medical care) extending substantially beyond the close of the taxable year may be deducted under section 213 in the year of payment, if the conditions of section 213(d)(7) are not satisfied. See Rev. Proc. 93–43, page 544.

Part IX.—Items Not Deductible

Section 262.—Personal, Living and Family Expenses

26 CFR 1.262–1. Personal, living and family expenses.

What effect does the 1-year limitation on temporary travel, as added by section 1938 of the Energy Policy Act of 1992, Pub. L. No. 102–486, have on the deductibility of away from home travel expenses under section 162(a)(2) of the Code? See Rev. Rul. 93–86, page 71.

Section 263A.—Capitalization and Inclusion in Inventory Costs of Certain Expenses

26 CFR 1.263A–0: Outline of regulations under section 263A.

T.D. 8482

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1 and 602

Capitalization and Inclusion in Inventory of Certain Costs

AGENCY. Internal Revenue Service, Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final regulations under section 263A of the Internal Revenue Code of 1986 relating to accounting for costs incurred in producing property and acquiring property for resale. Section 263A was enacted as part of the Tax Reform Act of 1986. Changes to the applicable law were made by the Omnibus Budget Reconciliation Act of 1987, the Technical and Miscellaneous Revenue Act of 1988, and the Omnibus Budget Reconciliation Act of 1989. This final regulation affects all taxpayers subject to section 263A.

DATES: Effective date: January 1, 1994.

Comments are requested from taxpayers for a 90-day period after the publication of these final regulations in the Federal Register regarding the approach for implementing method changes required under the final regulations.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3504(h)) under control number 1545–0987. The estimated annual burden per respondent varies from 0.5 hour to 2 hours, depending on individual circumstances, with an estimated average of 1 hour. The estimated annual burden per recordkeeper varies from 8 hours to 10 hours, depending on individual circumstances, with an estimated average of 9 hours.

These estimates are approximations of the average time expected to be necessary for a collection of information. They are based on such information as is available to the Internal Revenue Service. Individual respondents/recordkeepers may require more or less time, depending on their particular circumstances.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be directed to the Internal Revenue Service, Attn: IRS Reports Clearance Officer PC:FP, Washington, D.C. 20224, and to the Office of Management and Budget, Attention: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, D.C. 20503.

Background

On March 30, 1987, the Internal Revenue Service published in the Federal Register a notice of proposed rulemaking [LR–168–86, 1987–1 C.B. 808] (52 FR 10118) by cross reference to temporary regulations (T.D. 8131 [1987–1 C.B. 98]) published the same day (52 FR 10052). Amendments to the notice of proposed rulemaking and temporary regulations were published in the Federal Register on August 7, 1987, by notice of proposed rulemaking [LR–37–87, 1987–2 C.B. 1054] (52 FR 29391) by cross reference to temporary regulations (T.D. 8148 [1987–2 C.B. 70]) published the same day (52 FR 29375). A public hearing was held on

December 7, 1987. After consideration of the public comments regarding the proposed regulations, they are adopted as revised by this Treasury decision.

Explanation of Statutory Provisions

Section 263A (the uniform capitalization rules) was enacted as part of the Tax Reform Act of 1986, Pub. L. 99–514, 100 Stat. 2085, 1986–3 C.B. Vol. 1 (the 1986 Act). The statute was amended as part of the Omnibus Budget Reconciliation Act of 1987, Pub. L. 100–203, 101 Stat. 1330, 1987–3 C.B. Vol. 1 (the 1987 Act), the Technical and Miscellaneous Revenue Act of 1988, Pub. L. 100–647, 102 Stat. 3342, 1988–3 C.B. Vol. 1 (the 1988 Act), and the Omnibus Budget Reconciliation Act of 1989, Pub. L. 101–239, 103 Stat. 2106 (the 1989 Act).

Prior to the enactment of section 263A, the rules regarding the capitalization of costs incurred in producing property were deficient in two respects. First, no uniform system regarding the capitalization of costs incurred in producing property existed. Rather, costs were capitalized under a variety of Internal Revenue Code provisions depending on the nature of the underlying property and its intended use. Second, costs incurred in producing, acquiring, or carrying property were permitted, in some instances, to be deducted currently, rather than accounted for in the year when the property was used or sold.

Section 263A was enacted to provide a single, comprehensive set of rules to govern the capitalization of the costs of producing, acquiring, and holding property, subject to appropriate exceptions where application of the rules might be unduly burdensome. These rules are designed to more accurately reflect income and prevent unwarranted deferral of taxes by properly matching income with related expenses. These rules are also intended to make the tax system more neutral by eliminating the differences in the former capitalization rules that created distortions in the allocation of economic resources and in the manner in which certain economic activity is organized. See S. Rep. No. 313, 99th Cong., 2d Sess. 140 (1986), 1986–3 C.B. (Vol. 3), 140.

Section 263A generally requires the capitalization of direct costs and indirect costs properly allocable to real property and tangible personal property produced by a taxpayer. Produced property includes both property that is sold to customers (*e.g.*, inventory) and property that is used in a taxpayer's trade or business (self-constructed assets). Section 263A also requires the capitalization of direct costs and indirect costs properly allocable to real property and personal property acquired by a taxpayer for resale. Personal property acquired for resale includes both tangible and intangible personal property described in section 1221(1). Section 263A(b)(2)(B), however, excepts from the uniform capitalization rules personal property acquired by a taxpayer for resale if its average annual gross receipts for the preceding three taxable years do not exceed $10,000,000 (small reseller).

Certain Administrative Guidance

The following notices regarding section 263A have been published: Notice 87–76, 1987–2 C.B. 384; Notice 88–23, 1988–1 C.B. 490; Notice 88–24, 1988–1 C.B. 491; Notice 88–62, 1988–1 C.B. 548; Notice 88–78, 1988–2 C.B. 394; Notice 88–86, 1988–2 C.B. 401; Notice 88–92, 1988–2 C.B. 416; Notice 88–99, 1988–2 C.B. 422; Notice 88–103, 1988–2 C.B. 442; Notice 88–104, 1988–2 C.B. 443; Notice 88–113, 1988–2 C.B. 448; Notice 89–59, 1989–1 C.B. 700; and Notice 89–67, 1989–1 C.B. 723. (*See* §601.601(d)(2)(ii)(*b*) of this chapter.)

The final regulations incorporate and supersede most of the guidance set forth in the notices referred to above. Therefore, unless otherwise noted, these notices are withdrawn for taxable years to which this Treasury decision applies. However, certain notices or portions thereof are not incorporated in this Treasury decision and continue to remain in effect in whole or in part as provided below.

The following notices continue to remain in effect in their entirety: Notice 87–76 (guidance for farmers); Notice 88–23 (ordering rules for method changes); Notice 88–24 (special election for farmers); Notice 88–62 (safe harbor for certain producers of creative properties); Notice 88–99 (guidance regarding interest capitalization issues); Notice 88–104 (application of section 263A to foreign persons); and Notice 89–59 (deadline for accounting method change requests regarding practical capacity). In addition, certain portions of the follow notices continue to remain in eff section IV (A) of Notice 88–86 (gu ance regarding deferred intercomp exchanges); section IV (B) of Not 88–86 (permission to elect a new b year for LIFO taxpayers); section V Notice 88–86 (guidance for prope produced in a farming business); s tion II (B) of Notice 89–67 (guidar for free-lance authors, artists, a photographers); section II (C) of Noti 89–67 (guidance for farmers); secti III (E) of Notice 89–67 (application section 263A to foreign persons).

The final regulations do not incorp rate, in whole or in part, Notice 88–7 which provides guidance regarding a counting method changes for taxpaye that failed to timely comply with tl uniform capitalization rules. Neverth less, Notice 88–78 does not remain i effect. *See* the discussion of *Accountin Method Changes* below.

Public Comments

Simplification in General

Commentators made several sugges tions for simplifying the rules provide in the temporary regulations an notices. As discussed in more detai below, the final regulations implemen many of these suggestions. For exam ple, the final regulations permit the us of a "historic absorption ratio" t determine additional capitalizable costs under section 263A. In addition, the final regulations provide rules that expand the availability of reasonable allocation methods in determining capitalizable costs, rules that except *de minimis* production activities of small resellers from the capitalization requirements of section 263A, and rules under which producers with *de minimis* indirect costs that use the simplified production method are deemed to have no additional capitalizable costs under section 263A.

Based on specific suggestions of commentators, the final regulations include a table of contents for all final and temporary regulations issued under section 263A. The regulations have also been reorganized to make them easier to use. Instead of having one long section with rules for producers and resellers as the temporary regulations did, the final regulations include three sections organized so that rules relating primarily to producers are

...ate from rules relating primarily to ... In particular, the regulations ...de general rules affecting both ...ers and resellers in §1.263A–1, ...primarily affecting producers in ...1.263A–2, and rules primarily affect... ...sellers in §1.263A–3.

...ions Applicable to All ...ers and Resellers

...lationship to Other ...alization Provisions

The final regulations clarify that ... statutory or regulatory exceptions limit the application of section ...A, costs may still be subject to ...italization under other provisions of the Internal Revenue Code and regulations. For example, a taxpayer not subject to section 263A may nonetheless be subject to the general capitalization provisions of section 263.

... Property Provided Incident to the ...vision of Services

Commentators questioned whether taxpayers that provide property to customers incident to the provision of services are subject to section 263A. The final regulations generally incorporate the *de minimis* exception of Notice 88-86 for acquired property provided to customers incident to the provision of services. However, the regulations expand this exception to cover all property, whether produced or acquired, provided incident to services. Specifically, the final regulations provide that section 263A does not apply to any property provided to a client (or customer) incident to the provision of services if the property provided to the client is (1) *de minimis* in amount, and (2) not inventory in the hands of the service provider.

C. *Economic Performance*

Commentators requested clarification on whether costs that have not met the economic performance requirement of section 461(h) must be capitalized. The final regulations incorporate section 461(h) and underlying regulations contained in T.D. 8408 [1992–1 C.B. 155], [57 FR 12411 (April 10, 1992)]. Accordingly, the final regulations provide that the amount of any costs required to be capitalized under section 263A may not be included in inventory or charged to capital accounts or basis by an accrual method taxpayer any earlier than the taxable year in which economic performance occurs.

D. Direct Material Costs

The temporary regulations define "direct material costs" differently from the definition of direct material costs contained in §1.471–11(b)(2)(i). Commentators questioned why these definitions are different. To alleviate any confusion, the definition of direct material costs in the final regulations has been conformed to the definition of direct material costs provided in §1.471–11(b)(2)(i).

E. *Indirect Costs Subject to Capitalization*

Consistent with the Congressional directive, the final regulations are patterned after the extended-period long-term contract regulations of §1.451–3. See S. Rep. No. 313, 99th Cong., 2d Sess. 141–42 (1986), 1986–3 C.B. (Vol. 3) 141–42. Therefore, indirect costs that were capitalized under the extended-period long-term contract regulations are generally included in the list of indirect costs required to be capitalized under section 263A.

A few commentators requested clarification on the types of taxes required to be capitalized under the temporary regulations. Commentators suggested that excise taxes and franchise taxes (regardless of whether the tax is based on income, capital, etc.) be excluded from capitalization under section 263A. The final regulations adopt this suggestion only for franchise taxes that are based on income. Excluding only taxes based on income from the capitalization requirements of section 263A is consistent with the extended-period long-term contract regulations. See §1.451-3(d)(6)(iii)(H).

Commentators objected to the treatment of depletion in the temporary regulations as an indirect cost required to be capitalized. In response to these concerns, and as indicated in Notice 88-86, the final regulations provide that depletion is properly allocable only to property that has been sold for purposes of determining gain or loss on the sale of the property.

Commentators questioned the distinction in the temporary regulations between engineering and design costs that are subject to capitalization under section 263A and research and experimental costs that are not. The final regulations clarify that engineering and design costs include pre-production costs, such as costs attributable to research, experimental, engineering and design activities, that do not qualify as research and experimental expenditures under section 174 and the regulations thereunder.

One commentator suggested that bidding expenses incurred with respect to a contract to sell standard stock items should not be capitalized because these expenses are essentially selling expenses, which generally are not capitalized. In order to insure that taxpayers are not required to capitalize what are essentially selling expenses, the regulations provide that bidding expenses are only required to be capitalized with respect to certain contracts to produce property and to acquire property for resale. These contracts include both (1) any agreement with respect to a specific unit of property providing for the production or sale of property to a customer if the agreement is entered into before the taxpayer produces or acquires the specific unit of property to be provided to the customer under the agreement, and (2) any agreement with a customer with respect to fungible property to the extent that, at the time the agreement is entered into, the taxpayer has on hand an insufficient quantity of completed fungible items of such property that may be used to satisfy the agreement (plus any other production or sales agreements of the taxpayer).

F. *Indirect Costs Not Subject to Capitalization*

The final regulations expand the list of costs that are not subject to capitalization by providing that section 179 costs and warranty and product liability costs are not capitalized.

As in the temporary regulations, the final regulations except from section 263A, depreciation, amortization, and cost recovery allowances on equipment and facilities that have been placed in service but are temporarily idle. Certain aspects of this exception have been clarified in the final regulations in response to comments. The temporarily idle equipment and facilities exception has not been expanded to include costs other than depreciation, amortization, and cost recovery allowances. The

Service and the Treasury believe that excluding other costs from this exception, such as insurance, taxes, etc., is consistent with Congressional intent that the section 263A regulations be patterned after the extended-period long-term contract regulations. See S. Rep. No. 313, 99th Cong., 2d Sess. 141–42 (1986), 1986–3 C.B. (Vol. 3) 141–42.

In addition, for the reasons set forth in the preamble accompanying T.D. 8148 (52 FR 29375), the final regulations continue to prohibit the use of any practical capacity concept or method to identify the fixed indirect costs subject to capitalization.

G. *Service Costs*

Under the temporary regulations, the total direct and indirect costs (*service costs*) of administrative, service, or support functions or departments (*service departments*) that directly benefit a particular production or resale activity must be directly allocated to that activity. In addition, service costs that benefit production or resale activities as well as other activities (*mixed service costs*) must be allocated to activities based on a factor that reasonably relates the incurring of the service cost to the benefits received by the activity. Commentators indicated that, notwithstanding the above guidance in the temporary regulations, service costs are difficult to identify and therefore difficult to allocate to property produced or property acquired for resale. In response, the final regulations provide definitions of service costs, and service departments, as well as two new categories of service costs, capitalizable service costs, and deductible service costs. In addition, to eliminate confusion about mixed service costs, the final regulations identify the portion of mixed service costs that are allocable to production or resale activities (capitalizable mixed service costs) and the portion of mixed service costs that are allocable to non-production or non-resale activities (deductible mixed service costs).

H. *Cost Allocations*

The temporary regulations provide general rules regarding how direct and indirect costs are allocated to or among the various activities of a taxpayer. Commentators stated that the temporary regulations do not provide specific guidance regarding how the allocation of costs to activities relates to determining the amount of section 263A costs that must be capitalized. In response to this concern, the final regulations explain that after section 263A costs are allocated to a production or resale activity, these costs are generally allocated to the items of property produced or property acquired for resale during the taxable year and capitalized to the items that remain on hand at the end of the taxable year.

The temporary regulations permit taxpayers to use a variety of methods for allocating section 263A costs among their activities and items of property produced or acquired for resale. For example, the temporary regulations permit the use of facts-and-circumstances allocation methods, such as a specific identification method, a burden rate method, a standard cost method, and generally any other reasonable allocation method. Generally, the final regulations continue to allow the use of these methods and adopt, with slight modifications, the criteria in the temporary regulations and Notice 88-86 for determining a reasonable allocation method. The final regulations also continue to permit taxpayers to use certain simplified methods in determining their section 263A costs. (The simplified methods are discussed in more detail below.)

Under the temporary regulations, mixed service costs must be allocated among a taxpayer's production or resale activities as well as its other activities. The temporary regulations permit taxpayers to use any reasonable method to make these allocations. They also provide that a direct reallocation method (which in general allocates mixed service costs to departments engaged in production or resale activities) and a step-allocation method (which in general allocates mixed service costs to all departments benefitting from the mixed service costs including other mixed service departments) are reasonable allocation methods. The final regulations incorporate these provisions and provide examples of a direct reallocation method and a step-allocation method.

I. *Section 263A and Valuations of Inventory at Market*

Section 263A does not explicitly address whether the uniform capitalization rules affect market valuations of inventory. However, the legislative history states, "[t]he uniform capitalization rules are not intended to affect the valuation of inventories on a basis other than cost. Thus, the rules will not affect the valuation of inventories at market by a taxpayer using the lower of cost or market method, or by a dealer in securities or commodities using the market method. However, the rules will apply to inventories valued at cost by a taxpayer using the lower of cost or market method." 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II–305 (1986), 1986–3 C.B. (Vol. 4) 305.

The final regulations interpret the above language in accordance with the overall Congressional intent underlying section 263A. The final regulations provide that section 263A applies to inventories valued at cost, lower of cost or market (LCM), or market. Section 263A does not apply, however, in those cases where the market valuation used by the taxpayer generally equals the fair market value at which the taxpayer would sell its inventories to its customers less, if applicable, only the direct cost of disposition. Thus, section 263A, which applies in determining the cost of property, must be applied in determining the market value of any inventory for which market is determined with reference to replacement cost or reproduction cost. The Service and the Treasury believe that this approach satisfies the fundamental policy objective Congress sought by enacting section 263A—that is, to more accurately reflect income by eliminating "a mismatching of expenses and the related income and an unwarranted deferral of taxes." See S. Rep. No. 313, 99th Cong., 2d Sess. 140 (1986), 1986–3 C.B. (Vol. 3) 140.

The following example demonstrates the mismatching that would occur if section 263A costs were not included in determining the market value of inventory. A reseller, X, values its inventory using LCM in accordance with the FIFO inventory method. X purchases an item for $80 and incurs $8 of indirect costs attributable to the item. The item, which remains on hand at the end of X's taxable year, could be sold to a customer for $100 at year end. If the item is included in ending inventory using X's cost, determined in accordance with section 263A, the item would be valued at $88. On the other hand, if the item is included in ending inventory using its market value (i.e., the current bid price of the item) and section 263A is not applied in determining market at year end, the item

would only be valued at $80. Thus, the $ of additional section 263A costs that Congress intended to be matched against the ultimate $100 of income from the sale of the item would be deducted in a year prior to the year X sells the item.

Producers

A. Ownership of Property Produced

Commentators questioned whether a taxpayer that does not have formal or legal title to the property it is producing is considered a *producer* for purposes of section 263A. The final regulations generally provide that a taxpayer that does not hold legal title to the property it is producing must capitalize its production costs if the taxpayer is considered the owner of the produced property for federal income tax purposes.

The final regulations incorporate two statutory-based exceptions to this general rule. First, section 460(e)(1) provides that section 263A applies to a home construction contract unless that contract will be completed within two years of the contract commencement date and the taxpayer's average annual gross receipts for the three preceding taxable years do not exceed $10,000,000. Because section 460(e)(1) provides that section 263A applies to these home construction contracts (even if the contractor does not own the underlying property), the Service and the Treasury believe that ownership is not a prerequisite to capitalization under section 263A with respect to such contracts. Thus, the final regulations adopt the position in Q & A 4 of Notice 89–15, 1989–1 C.B. 634. (See §601.601(d)(2)(ii)(*b*) of this chapter.)

Second, section 263A(g)(2) provides that, with respect to certain costs, a taxpayer is treated as producing any property that is produced for the taxpayer under contract. Therefore, a taxpayer that has property produced for it under contract is subject to section 263A even though it does not own the underlying property being produced.

Commentators suggested that *contract* be defined for this purpose in a manner that would minimize taxpayer compliance burdens. They noted that a broad interpretation of contract could include routine purchase orders, which would require taxpayers to allocate and capitalize a portion of their general and administrative expenses to items acquired under routine business arrangements. The Service and the Treasury are studying this issue further in connection with a project to finalize proposed regulations under section 263A(f) and intend to issue final regulations defining contract under section 263A(g)(2) when those proposed regulations are finalized. Therefore, the final regulations reserve the paragraph regarding the definition of a contract. The Service is requesting comments from taxpayers for a 60-day period after the publication of these final regulations in the Federal Register regarding the definition of a contract for these purposes.

B. Definition of Tangible Personal Property

Section 263A(b) provides that tangible personal property "include[s] a film, sound recording, video tape, book, or similar property." Additionally, the Conference Report to section 263A defines tangible personal property, for purposes of section 263A, as including "films, sound recordings, video tapes, books, and other similarly [sic] property embodying words, ideas, concepts, images, or sounds, by the creator thereof." 2 H.R. Conf. Rep. No. 841 n.1, 99th Cong., 2d Sess. II–308 (1986), 1986–3 C.B. (Vol. 4) 308 n.1.

The final regulations generally incorporate the definition of tangible personal property used in the Conference Report. The final regulations clarify the definition in the Conference Report by providing further guidance as to what constitutes other similar property for purposes of the tangible personal property definition. In general, the final regulations provide that *other similar property* is intellectual or creative property for which, as costs are incurred in producing the property, it is intended (or is reasonably likely) that any tangible medium in which the property is embodied will be mass distributed by the creator or any one or more third parties in a form that is not substantially altered. However, the final regulations provide an exception to this general rule. Any intellectual or creative property that is embodied in a tangible medium that is mass distributed merely incident to the distribution of a principal product or good of the creator is not other similar property for these purposes.

Several commentators inquired whether the enactment of section 263A has affected the Service's administrative position in Rev. Proc. 69–21, 1969–2 C.B. 303, (see §601.601(d)(2)(ii)(*b*) of this chapter), that computer software development costs so closely resemble the kind of research and experimental expenditures that fall within the purview of section 174 as to warrant accounting treatment similar to that accorded such costs under section 174. The Service has no present intention of changing its administrative position contained in Rev. Proc. 69–21, but continues to study its viability. Thus, as long as Rev. Proc. 69–21 remains in effect, taxpayers are not required to capitalize (and may currently deduct) computer software development costs.

The temporary regulations provide that the costs of copyrights, licenses, and manuscripts, and other items that may be treated as intangible for other purposes of the Internal Revenue Code are treated as tangible personal property under section 263A (*e.g.*, films, sound recordings, video tapes, and books). One commentator suggested that the final regulations delete the reference to licenses. However, the final regulations retain the reference to licenses because licenses are commonly used in the publishing, sound recording, and film industries and are appropriately considered a cost of publishing a book or producing a sound recording or film. The final regulations also add licensing and franchising fees (or amortization thereof) to the examples of indirect costs that are capitalized to the extent properly allocable to property produced or acquired for resale.

C. Definition of Produce

Many commentators suggested that produce be defined more precisely in the final regulations and that the final regulations include a complete list of all types of production activities. Other commentators requested that produce be defined more narrowly in the final regulations.

The final regulations do not adopt these suggestions. The Service and the Treasury believe that the determination of whether a taxpayer is a producer is generally a facts-and-circumstances determination that must take into account the nature of the taxpayer's trade or business activities. Further, the Service

and the Treasury believe that many of the commentators' concerns regarding the scope of produce have been alleviated in the final regulations through the adoption of various *de minimis* rules. These rules include *de minimis* rules for property provided to customers incident to the provision of services. *de minimis* rules for property produced incident to resale activities, and rules treating producers using the simplified production method as having no additional section 263A costs if they incur *de minimis* indirect costs.

D. *Pre-production Costs*

Commentators questioned whether costs incurred prior to the commencement of production (pre-production costs) must be capitalized. Under the extended-period long-term contract regulations, pre-production costs (*e.g.*, bidding expenses) are capitalized. Accordingly, the final regulations, which are patterned after the extended-period long-term contract regulations, clarify that pre-production costs must be capitalized if it is reasonably likely that they relate to production that will take place in the future. For example, a manufacturer must capitalize the costs of storing and handling raw materials before the raw materials are committed to production. Further, a real estate developer must capitalize taxes incurred with respect to property if it is reasonably likely the property will be subsequently developed.

E. *Post-production Costs*

Commentators questioned whether costs incurred subsequent to completion of production (post-production costs) must be capitalized. The legislative history explains that section 263A was intended to provide a uniform, comprehensive set of capitalization rules governing the cost of both producing and reselling property. S. Rep. No. 313, 99th Cong., 2d Sess. 140 (1986), 1986-3 C.B. (Vol. 3) 140. Because the legislative history specifically states that costs incurred by resellers incident to purchasing property, such as storage costs, must be capitalized, the final regulations clarify that similar costs incurred by producers (such as the cost of storing finished goods) must be capitalized as well. However, as indicated in Notice 88-86, the final regulations provide that producers may deduct the costs of an on-site storage facility to the same extent as resellers.

Reseller Provisions

A. *Resellers with Production Activities*

Commentators questioned whether personal property acquired by a small reseller becomes subject to the uniform capitalization rules under section 263A(g)(2) because the property is produced for the small reseller under contract (*e.g.*, private label goods). In response, the final regulations provide that a small reseller is not required to capitalize additional section 263A costs to personal property produced for it under contract if the contract is entered into with an unrelated person incident to its resale activities and the property is sold to its customers.

In addition, commentators questioned whether a reseller otherwise subject to section 263A (*e.g.*, a reseller with gross receipts of greater than $10,000,000) that acquires property for resale is prohibited from using the simplified resale method merely because the reseller is considered a producer with respect to the property produced for it under contract. The final regulations clarify that such a reseller is not ineligible to use the simplified resale method merely because its personal property acquired for resale is produced under contract with an unrelated third person.

The final regulations also generally provide that a small reseller is not required to capitalize additional section 263A costs associated with any personal property produced incident to its resale activities if the production activities are *de minimis*. For this purpose, a reseller's production activities are presumed *de minimis* if: (1) the gross receipts from the sale of property produced by the reseller are less than 10 percent of the total gross receipts of the trade or business; and (2) the labor costs allocable to the production activities of the trade or business are less than 10 percent of the total labor costs of the trade or business. Further, the final regulations generally provide that resellers are not precluded from using the simplified resale method solely by reason of a *de minimis* amount of production activity.

B. *Costs Capitalized by Resellers*

Commentators expressed concern that the temporary regulations were not clear on which indirect costs resellers are required to capitalize. The final regulations clarify that in addition to purchasing, storage, and handling costs, resellers must also capitalize other indirect costs that are properly allocable to property acquired for resale.

C. *Storage Costs*

Under the temporary regulations, resellers must capitalize their storage costs attributable to their off-site storage facilities but not their on-site storage facilities. The temporary regulations provide that an on-site storage facility is a facility which is physically attached to, and an integral part of, a retail sales facility where the taxpayer sells merchandise stored at the facility to retail customers physically present at the facility. Commentators suggested that the physically attached to and integral part of standards be modified to provide a broader definition of an on-site storage facility.

The final regulations retain both the physically attached to and integral part of standards. The Service and the Treasury believe that these standards are mandated by the legislative history of section 263A. This legislative history provides that off-site storage costs are the "costs of storing goods in a facility distinct from the facility wherein the taxpayer conducts retail sales of ... goods." S. Rep. No. 313, 99th Cong., 2d Sess. 142 (1986), 1986-3 C.B. (Vol. 3) 142. The final regulations clarify, however, that a retail sales facility includes those portions of any specific retail site which are customarily associated with and are an integral part of the operations of that retail site; which are generally open each business day exclusively to retail customers; on or in which retail customers normally and routinely shop to select specific items of merchandise and which are adjacent to or in immediate proximity to other portions of the specific retail site.

Based on several comments received the final regulations permit certain non retail customers to be treated as retail customers for purposes of determining whether a facility is a retail sale facility. For this purpose, a non-retail customer is treated as a retail customer if the following requirements are satisfied: the non-retail customer purchases goods at the facility under the same terms and conditions as are available to

retail customers (*e.g.*, no special discounts); the non-retail customer purchases goods in the same manner as a retail customer (*e.g.*, the non-retail customer may not place orders in advance and must come to the facility to examine and select goods); retail customers shop at the facility on a routine basis (*i.e.*, on most business days) and no special days or hours are reserved for non-retail customers; and more than 50 percent of the gross sales of the facility are made to retail customers.

The temporary regulations provide that a dual-function storage facility is a storage facility that serves as both an on-site storage facility and an off-site storage facility. They also provide that a dual-function storage facility is treated as an on-site storage facility to the extent of the ratio of gross on-site sales of the facility (*i.e.*, gross sales of the facility made to retail customers visiting the premises in person) to total gross sales of the facility. The final regulations include this allocation ratio and also provide that prior to its computation a taxpayer must make appropriate adjustments for other uses of a dual-function storage facility.

D. *Handling Costs*

Handling costs are defined in the temporary regulations as the costs attributable to handling, processing, assembling, repackaging, and transporting property acquired for resale. For purposes of clarification, the final regulations provide definitions of each of the above terms associated with handling costs so that taxpayers can more easily distinguish handling activities from other activities not subject to section 263A.

In addition, commentators requested clarification regarding the types of handling costs that must be capitalized under section 263A. In response, the final regulations provide a bright-line test for determining which handling costs must be capitalized. Under this test, handling costs incurred at a retail sales facility with respect to property sold to retail customers at the facility are not required to be capitalized. Thus, for example, handling costs incurred at a retail sales facility to unload, unpack, mark, and tag goods sold to retail customers at the facility are not required to be capitalized. In addition, handling costs incurred at a dual-function storage facility with respect to property sold to customers from the facility are not required to be capitalized to the extent that the costs are incurred with respect to property sold in on-site sales. Handling costs attributable to property sold to customers from a dual-function storage facility in on-site sales are determined generally by comparing the gross on-site sales of the facility to the total gross sales of the facility.

E. *Exception for Repackaging Costs*

Under the temporary regulations, the costs of repackaging goods in preparation for immediate delivery to particular customers are excepted from handling costs that resellers must capitalize if the repackaging occurs after the customer has ordered the goods. Commentators suggested that this repackaging exception be expanded to include all handling costs incurred after the customer orders the goods. The final regulations reserve the paragraph regarding the repackaging exception. Under a separate Notice of Proposed Rulemaking in *** [IA–64–91, page 621, this Bulletin], it is proposed that the repackaging exception be eliminated for the reasons discussed therein. However, until the Notice of Proposed Rulemaking is finalized, the paragraph in the temporary regulations providing the repackaging exception continues to apply.

F. *Exceptions for Distribution Costs and Costs of Delivering Custom-Ordered Items*

Under the temporary regulations, *distribution costs* are a type of handling costs that are not required to be capitalized (distribution cost exception). Distribution costs are defined in the temporary regulations as the cost of delivering goods directly to an unrelated customer.

Some commentators suggested that the cost of delivering goods to a related customer should be deductible just as the cost of delivering goods to an unrelated customer are deductible. Another commentator suggested that the cost of delivering goods to a related customer should be deductible unless the related persons are members of a consolidated group. As explained in the accompanying Notice of Proposed Rulemaking, these suggestions have not been adopted.

The temporary regulations also exclude from capitalization under section 263A the costs of delivering certain items from an off-site storage facility to a retail sales facility where the sale takes place, provided the items are specifically ordered by customers (custom order exception). The final regulations reserve the paragraph regarding the custom order exception and the distribution cost exception (including a provision regarding costs incurred transporting goods to a related person). As provided therein, the separate Notice of Proposed Rulemaking provides that these exceptions pertain only to transportation costs that are incurred generally outside a storage facility. For this purpose, costs incurred on a loading dock are considered incurred outside a storage facility. However, until the Notice of Proposed Rulemaking is finalized, the paragraphs in the temporary regulations providing the distribution cost exception and the custom order exception continue to apply.

Simplified Allocation Methods

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. *Additional section 263A costs* are those costs, other than interest, that were not capitalized under the taxpayer's method of accounting immediately prior to the effective date of section 263A, but that are required to be capitalized under section 263A. In addition, the final regulations provide a simplified method for allocating costs incurred in a service department (*i.e.*, service costs) to property produced and property acquired for resale.

A. *Simplified Production Method*

The final regulations provide a simplified production method for purposes of determining the aggregate amount of additional section 263A costs that must be added to eligible property held by producers at the close of the taxable year. Under this method, producers determine additional section 263A costs by multiplying their section 471 costs remaining on hand at year end by an absorption ratio consisting of their additional section 263A costs incurred

during the taxable year over their section 471 costs incurred during the taxable year.

The temporary regulations limit the availability of the simplified production method to two types of property: stock in trade of the taxpayer properly includible in inventory; and non-inventory property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business. The final regulations follow Notice 88-86 and expand the categories of produced property eligible for the simplified production method to include: self-constructed assets substantially identical in nature to, and produced in the same manner as, inventory property or other property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business; and self-constructed assets produced by the taxpayer on a routine and repetitive basis in the ordinary course of the taxpayer's production activities.

A number of commentators requested that the simplified production method in the temporary regulations be revised to reduce the amount of section 263A costs allocable to raw materials inventories. These commentators suggested that allocations based on this method may result in an excessive amount of section 263A costs being allocated to raw materials inventories. They argue that this result occurs because the simplified production method does not take into account the fact that fewer indirect costs are incurred with respect to raw materials normally held only a short period of time than are incurred with respect to other items of inventory held longer. For example, a taxpayer that buys additional raw materials on the last day of the year would be required to allocate significantly more additional section 263A costs (such as storage, handling, and carrying costs) to those materials under the simplified production method than it would under a facts-and-circumstances allocation method.

The final regulations do not adopt these recommendations. The Service and the Treasury believe that the simplified production method formula properly reflects the costs of raw materials that are purchased on the last day of the year. First, the taxpayer will have likely incurred purchasing costs and handling costs in obtaining these materials, which should be included in the inventoriable cost of these materials. Second, incorporating these suggestions in the final regulations would reduce the simplicity that the simplified production method is intended to provide. If the simplified production method produces inappropriate results, a taxpayer may request to change its method of accounting to a facts-and-circumstances allocation method.

Commentators requested clarification on determining section 471 costs. They questioned whether a change in financial reporting practices with respect to category iii costs (described in the full absorption regulations of §1.471-11(c)(2)) for years after the effective date of section 263A would automatically change the costs included in section 471 costs for purposes of the simplified production method. The final regulations clarify that in order for a taxpayer to change its costs included in section 471 costs, the taxpayer must first change its method of accounting used in determining section 471 costs for federal income tax purposes. Therefore, a change in the treatment of section 471 costs for financial reporting purposes does not automatically result in a change in the treatment of section 471 costs for federal income tax purposes.

Finally, commentators suggested that the final regulations provide an exception for producers similar to the gross receipts exception available to resellers. Although the final regulations do not adopt this suggestion, they do provide, however, a *de minimis* exception for producers electing the simplified production method. Under this exception, if a producer using the simplified production method has indirect costs of $200,000 or less in a taxable year (excluding certain indirect costs specifically not required to be capitalized), the producer is deemed to have no additional section 263A costs in that year.

B. *Simplified Resale Method*

Prior to issuance of the final regulations, resellers were permitted to choose from three simplified allocation methods to determine the aggregate amount of additional section 263A costs allocable to ending inventory. The final regulations provide only one simplified allocation method for resellers, the simplified resale method, which is the principal simplified allocation method being used by resellers. The simplified resale method is essentially the same as the modified resale method set forth in Notice 89-67. The final regulations permit resellers to modify the formulas provided under the simplified resale method to yield allocations equivalent to the other two simplified allocation methods not specifically retained in the final regulations.

Generally, the simplified resale method may not be elected by taxpayers with production activities. However, the final regulations permit certain taxpayers engaged in both resale and production activities to elect the simplified resale method in two situations. First, the final regulations generally permit a reseller with personal property produced under contract to elect the simplified resale method. Second, the final regulations permit a taxpayer with *de minimis* production activities to elect the simplified resale method. For this purpose, a reseller's production activities are presumed *de minimis* if: (1) the gross receipts from the sale of property produced by the reseller are less than 10 percent of the total gross receipts of the trade or business; and (2) the labor costs allocable to the production activities of the trade or business are less than 10 percent of the total labor costs of the trade or business. If the simplified resale method is elected, it must be used to capitalize all costs allocable to eligible property produced and property acquired for resale.

C. *Simplified Service Cost Method*

The temporary regulations provide a simplified service cost method producers may use to allocate mixed service costs among their various business activities. Under this method, the portion of a taxpayer's mixed service costs required to be capitalized is determined by multiplying the taxpayer's total mixed service costs incurred during the taxable year by the ratio of its total production costs (excluding mixed service costs and interest) incurred during the taxable year to its total costs incurred during the taxable year (excluding mixed service costs, interest, and taxes assessed based on income). Resellers may use a similar simplified service cost method provided they elect the simplified resale method. Comment-

suggested that all resellers, not just resellers using the simplified resale method, be permitted to use the simplified service cost method. In response to this concern, the final regulations provide one simplified service cost method that may be used by all resellers and producers, regardless of whether they elect another simplified method.

In addition, commentators suggested that the allocation ratio under the simplified service cost method in the temporary regulations results in the over capitalization of mixed service costs because the cost of raw materials is included in both the numerator and denominator of the ratio. They also suggested that producers be permitted to use a labor-based allocation ratio similar to the one in the temporary regulations provided for resellers that elect the simplified resale method. As announced in Notice 88-86, the final regulations permit producers to elect to use either a labor-based allocation ratio or the production cost allocation ratio described above.

Commentators also requested that the categories of produced property eligible for the simplified service cost method be expanded. Consistent with Notice 88-86, the final regulations provide that the simplified service cost method is also available for: self-constructed assets substantially identical in nature to, and produced in the same manner as, inventory property or other property held primarily for sale to customers in the ordinary course of the taxpayer's business; and self-constructed assets produced by the taxpayer on a routine and repetitive basis in the ordinary course of the taxpayer's production activities.

In determining total mixed service costs under the simplified service cost method, the temporary regulations require that a taxpayer include the total costs of any department or function performing mixed service activities. For example, a reseller is not permitted to segregate non-resale activities performed in a mixed service department from the department's other costs. Commentators requested that this restriction be removed in the final regulations. The Service and the Treasury, however, believe this restriction is appropriate to prevent distortions in the allocation of mixed service costs to production and resale activities.

Simplification for Both Producers and Resellers

A. *Historic Absorption Ratio Election*

Commentators expressed concern that computations under the simplified production method and the simplified resale method are costly and time consuming because a taxpayer must determine its absorption ratio annually. In response, the final regulations permit producers and resellers to elect to use a historic absorption ratio in conjunction with the simplified production method or the simplified resale method.

In general, if a taxpayer elects to use a historic absorption ratio, the additional section 263A costs allocable to a taxpayer's ending inventory are computed by multiplying the taxpayer's historic absorption ratio by its section 471 costs remaining in ending inventory. A taxpayer's historic absorption ratio is generally based on the percentage of additional section 263A costs capitalized by the taxpayer during a three-year test period. Taxpayers are required to test the accuracy of the historic absorption ratio by computing an actual absorption ratio once every six years. If the test of the ratio indicates a more than one-half of one percentage point difference (plus or minus) from the taxpayer's actual absorption ratio, the taxpayer must redetermine its historic absorption ratio using an updated test period.

For the following reasons, the historic absorption ratio is only available to taxpayers that use one of the simplified methods. First, it is difficult for taxpayers that do not use a simplified production method or simplified resale method to identify additional section 263A costs. Second, the historic absorption ratio results in certain complexities for dollar-value LIFO taxpayers that must allocate additional section 263A costs to specific items of property.

Taxpayers will be permitted to elect a historic absorption ratio in their first, second, or third taxable year beginning after December 31, 1993.

B. *Taxpayers Not Electing Simplified Methods*

Taxpayers that do not use a simplified method must capitalize their costs under section 263A based on the facts and circumstances of the particular taxpayer's operations, with the same degree of specificity as required of manufacturers capitalizing costs prior to the enactment of section 263A.

C. *Trade or Business Requirement*

A number of commentators suggested that taxpayers should be permitted to apply the simplified methods to more discrete business units than a separate and distinct trade or business (*e.g.*, a product line). The final regulations have not adopted this suggestion. Applying the simplified methods to business units smaller than a trade or business is not consistent with the legislative history, which intended that the simplified methods would be applied separately to each trade or business of a taxpayer. See 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-306 (1986), 1986-3 C.B. (Vol. 4) 306. Also, applying the simplified methods to business units smaller than a trade or business is contrary to the goals of administrative convenience and simplicity for both taxpayers and the Service.

D. *Add-on Percentage Method*

Some commentators suggested that the final regulations permit producers and resellers to capitalize additional section 263A costs based on average absorption percentages experienced within various industries. The Service generally believes that, for small taxpayers for which the costs of compliance with section 263A might outweigh the benefits to the government of compliance, the use of industry-specific safe harbor absorption percentages would be a reasonable simplifying assumption under the Secretary's section 263A(i) authority. The Service has, however, encountered difficulty in collecting the necessary industry-specific data (*e.g.*, by Standard Industry Code grouping) to facilitate the development of safe harbor absorption percentages. Thus, the final regulations do not permit the use of an add-on percentage method as requested by commentators.

The regulations do provide, however, a significant simplification through the availability of the historic ratio election and the rule under which producers with *de minimis* indirect costs and using the simplified production method are deemed to have no additional capitalizable costs under section 263A. In addition, the Service is willing to

work with interested taxpayers toward the development of industry-specific safe harbor add-on percentages. In this regard, the final regulations provide that taxpayers may elect any additional simplified methods prescribed by the Commissioner.

Accounting Method Changes

Taxpayers that have previously adopted methods of accounting under section 263A in accordance with guidance published in the temporary regulations and Notices may be required to change their methods of accounting under section 263A to comply with provisions in the final regulations. These taxpayers may also desire to change their methods of accounting to avail themselves of certain simplified methods and elections under the final regulations.

The Service intends to issue a revenue procedure prescribing the procedures, terms, and conditions for effecting method changes arising due to the promulgation of these final regulations. The revenue procedure will generally permit taxpayers to make expedited method changes by attaching a Form 3115 to their tax returns for the year of change. It is anticipated that the revenue procedure will require taxpayers to revalue their inventories as of the effective date of the final regulations to reflect differences between the methods required under the final regulations and those methods used by taxpayers prior to promulgation of the final regulations. The principles of §1.263A-1T(e) of the temporary regulations will be required for revaluing inventories under the revenue procedure. The Service is requesting comments from taxpayers for a 90-day period after the publication of these final regulations in the Federal Register regarding the approach for implementing method changes required under the final regulations.

The Service generally does not intend to permit taxpayers to change their adopted allocation methods under the forthcoming expedited change procedures. It is anticipated that the procedures will generally permit taxpayers to change only those methods necessary to bring them into compliance with the final regulations. The Service does plan, however, to provide a listing in the revenue procedure of certain elective methods that may be changed under the expedited change procedures. For example, the Service plans to permit a taxpayer that adopted a facts-and-circumstances allocation method to change to the simplified production method if that method is now more desirable to the taxpayer by reason of the historic absorption ratio election or the *de minimis* indirect costs exception. During the 90-day period after the publication of these regulations in the Federal Register, taxpayers are invited to comment on elective method changes that should be permitted under the expedited consent procedures.

Special Analysis

It has been determined that these regulations are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required.

* * * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding new entries in numerical order to read as follows:

Authority: 26 U.S.C. 7805 ***

Section 1.263A-1 also issued under 26 U.S.C. 263A. *** Section 1.263A-2 also issued under 26 U.S.C. 263A.

Section 1.263A-3 also issued under 26 U.S.C. 263A.

Section 1.263A-4 also issued under 26 U.S.C. 263A.

Section 1.263A-5 also issued under 26 U.S.C. 263A.

Section 1.263A-6 also issued under 26 U.S.C. 263A.

Section 1.263A-7 also issued under 26 U.S.C. 263A. ***

Section 1.471-4 also issued under 26 U.S.C. 263A.

Section 1.471-5 also issued under 26 U.S.C. 263A. ***

Par. 2. Section 1.56(g)-1 is amended by revising the first sentence of the example in paragraph (a)(5)(ii)(B) to read as follows:

§1.56(g)-1 Adjusted current earnings.

* * * * * *

(a) ***

(5) ***

(ii) ***

(B) Pursuant to section 263A and §1.263A-1(e)(3)(ii)(I), N must capitalize the depreciation allowed for the year for the new manufacturing equipment in the ending inventory of golf clubs. ***

* * * * * *

Par. 3. Section 1.263(a)-1 is amended by revising the fourth sentence of paragraph (b) to read as follows:

§1.263(a)-1 Capital expenditures: in general.

* * * * * *

(b) *** See section 263A and the regulations thereunder for cost capitalization rules that apply to amounts referred to in paragraph (a) of this section with respect to the production of real and tangible personal property (as defined in §1.263A-2(a)(2)), including films, sound recordings, video tapes, books, or similar properties.

* * * * * *

Par. 4. Section 1.263A-0 is added to read as follows:

§1.263A-0 Outline of regulations under section 263A.

This section lists the paragraphs in §§1.263A-1, 1.263A-2, and 1.263A-3.

§1.263A-1 Uniform capitalization of costs.

(a) Introduction.
- (1) In general.
- (2) Effective dates.
- (3) General scope.
  - (i) Property to which section 263A applies.
  - (ii) Property produced.
  - (iii) Property acquired for resale.
  - (iv) Inventories valued at market.
  - (v) Property produced in a farming business.

(vi) Creative property.
(vii) Property produced or property acquired for resale by foreign persons.
(b) Exceptions.
(1) Small resellers.
(2) Long-term contracts.
(3) Costs incurred in certain farming businesses.
(4) Costs incurred in raising, harvesting, or growing timber.
(5) Qualified creative expenses.
(6) Certain not-for-profit activities.
(7) Intangible drilling and development costs.
(8) Natural gas acquired for resale.
(i) Cushion gas.
(ii) Emergency gas.
(9) Research and experimental expenditures.
(10) Certain property that is substantially constructed.
(11) Certain property provided incident to services.
(i) In general.
(ii) Definition of services.
(iii) *De minimis* property provided incident to services.
(12) *De minimis* rule for certain producers with total indirect costs of $200,000 or less.
(13) Exception for the origination of loans.
(c) General operation of section 263A.
(1) Allocations.
(2) Otherwise deductible.
(3) Capitalize.
(4) Recovery of capitalized costs.
(d) Definitions.
(1) Self-constructed assets.
(2) Section 471 costs.
(i) In general.
(ii) New taxpayers.
(iii) Method changes.
(3) Additional section 263A costs.
(4) Section 263A costs.
(e) Types of costs subject to capitalization.
(1) In general.
(2) Direct costs.
(i) Producers.
(A) Direct material costs.
(B) Direct labor costs.
(ii) Resellers.
(3) Indirect costs.
(i) In general.
(ii) Examples of indirect costs required to be capitalized.
(A) Indirect labor costs.
(B) Officers' compensation.
(C) Pension and other related costs.
(D) Employee benefit expenses.
(E) Indirect material costs.
(F) Purchasing costs.
(G) Handling costs.
(H) Storage costs.
(I) Cost recovery.
(J) Depletion.
(K) Rent.
(L) Taxes.
(M) Insurance.
(N) Utilities.
(O) Repairs and maintenance.
(P) Engineering and design costs.
(Q) Spoilage.
(R) Tools and equipment.
(S) Quality control.
(T) Bidding costs.
(U) Licensing and franchise costs.
(V) Interest.
(W) Capitalizable service costs.
(iii) Indirect costs not capitalized.
(A) Selling and distribution costs.
(B) Research and experimental expenditures.
(C) Section 179 costs.
(D) Section 165 losses.
(E) Cost recovery allowances on temporarily idle equipment and facilities.
(*1*) In general.
(*2*) Examples.
(F) Taxes assessed on the basis of income.
(G) Strike expenses.
(H) Warranty and product liability costs.
(I) On-site storage costs.
(J) Unsuccessful bidding expenses.
(K) Deductible service costs.
(4) Service costs.
(i) Introduction.
(A) Definition of service costs.
(B) Definition of service departments.
(ii) Various service cost categories.
(A) Capitalizable service costs.
(B) Deductible service costs.
(C) Mixed service costs.
(iii) Examples of capitalizable service costs.
(iv) Examples of deductible service costs.
(f) Cost allocation methods.
(1) Introduction.
(2) Specific identification method.
(3) Burden rate and standard cost methods.
(i) Burden rate method.
(A) In general.
(B) Development of burden rates.
(C) Operation of the burden rate method.
(ii) Standard cost method.
(A) In general.
(B) Treatment of variances.
(4) Reasonable allocation methods.
(g) Allocating categories of costs.
(1) Direct materials.
(2) Direct labor.
(3) Indirect costs.
(4) Service costs.
(i) In general.
(ii) *De minimis* rule.
(iii) Methods for allocating mixed service costs.
(A) Direct reallocation method.
(B) Step-allocation method.
(C) Examples.
(iv) Illustrations of mixed service cost allocations using reasonable factors or relationships.
(A) Security services.
(B) Legal services.
(C) Centralized payroll services.
(D) Centralized data processing services.
(E) Engineering and design services.
(F) Safety engineering services.

(v) Accounting method change.
(h) Simplified service cost method.
(1) Introduction.
(2) Eligible property.
(i) In general.
(A) Inventory property.
(B) Non-inventory property held for sale.
(C) Certain self-constructed assets.
(D) Self-constructed assets produced on a repetitive basis.
(ii) Election to exclude self-constructed assets.
(3) General allocation formula.
(4) Labor-based allocation ratio.
(5) Production cost allocation ratio.
(6) Definition of total mixed service costs.
(7) Costs allocable to more than one business.
(8) *De minimis* rule.
(9) Separate election.
(i) [Reserved]
(j) Special rules.
(1) Costs provided by a related person.
(i) In general.
(ii) Exceptions.
(2) Optional capitalization of period costs.
(i) In general.
(ii) Period costs eligible for capitalization.
(3) Trade or business application.
(4) Transfers with a principal purpose of tax avoidance.
[Reserved]

§1.263A-2 Rules relating to property produced by the taxpayer.

(a) In general.
(1) Produce.
(i) In general.
(ii) Ownership.
(A) General rule.
(B) Property produced for the taxpayer under a contract.
(*1*) In general.
(2) Definition of contract.
[Reserved]
(C) Home construction contracts.
(2) Tangible personal property.
(i) General rule.
(ii) Intellectual or creative property.
(A) Intellectual or creative property that is tangible personal property.
(*1*) Books.
(*2*) Sound recordings.
(B) Intellectual or creative property that is not tangible personal property.
(*1*) Evidences of value.
(*2*) Property provided incident to services.
(3) Costs required to be capitalized by producers.
(i) In general.
(ii) Pre-production costs.
(iii) Post-production costs.
(4) Practical capacity concept.
(5) Taxpayers required to capitalize costs under this section.
(b) Simplified production method.
(1) Introduction.
(2) Eligible property.
(i) In general.
(A) Inventory property.
(B) Non-inventory property held for sale.
(C) Certain self-constructed assets.
(D) Self-constructed assets produced on a repetitive basis.
(ii) Election to exclude self-constructed assets.
(3) Simplified production method without historic absorption ratio election.
(i) General allocation formula.
(ii) Definitions.
(A) Absorption ratio.
(*1*) Additional section 263A costs incurred during the taxable year.
(*2*) Section 471 costs incurred during the taxable year.
(B) Section 471 costs remaining on hand at year end.
(iii) LIFO taxpayers electing the simplified production method.
(A) In general.
(B) LIFO increment.
(C) LIFO decrement.
(iv) *De minimis* rule for producers with total indirect costs of $200,000 or less.
(A) In general.
(B) Related party and aggregation rules.
(v) Examples.
(4) Simplified production method with historic absorption ratio election.
(i) In general.
(ii) Operating rules and definitions.
(A) Historic absorption ratio.
(B) Test period.
(*1*) In general.
(2) Updated test period.
(C) Qualifying period.
(*1*) In general.
(2) Extension of qualifying period.
(iii) Method of accounting.
(A) Adoption and use.
(B) Revocation of election.
(iv) Reporting and recordkeeping requirements.
(A) Reporting.
(B) Recordkeeping.
(v) Transition rules.
(vi) Example.
(c) Additional simplified methods for producers.
(d) Cross reference.

§1.263A-3 Rules relating to property acquired for resale.

(a) Capitalization rules for property acquired for resale.
(1) In general.
(2) Resellers with production activities.
(i) In general.
(ii) Exception for small resellers.
(iii) *De minimis* production activities.
(A) In general.
(B) Example.
(3) Resellers with property produced under a contract.
(4) Use of the simplified resale method.
(i) In general.

(ii) Resellers with *de minimis* production activities.
(iii) Resellers with property produced under a contract.
(iv) Application of simplified resale method.
(c) Gross receipts exception for small resellers.
(1) In general.
(i) Test period for new taxpayers.
(ii) Treatment of short taxable year.
(2) Definition of gross receipts.
(i) In general.
(ii) Amounts excluded.
(3) Aggregation of gross receipts.
(i) In general.
(ii) Single employer defined.
(iii) Gross receipts of a single employer.
(iv) Examples.
(d) Purchasing, handling, and storage costs.
(1) In general.
(2) Costs attributable to purchasing, handling, and storage.
(3) Purchasing costs.
(i) In general.
(ii) Determination of whether personnel are engaged in purchasing activities.
(A) ⅓-⅔ rule for allocating labor costs.
(B) Example.
(4) Handling costs.
(i) In general.
(ii) Processing costs.
(iii) Assembling costs.
(iv) Repackaging costs.
(v) Transportation costs.
(vi) Costs not considered handling costs.
(A) Distribution costs. [Reserved]
(B) Delivery of custom-ordered items. [Reserved]
(C) Repackaging after sale occurs. [Reserved]
(5) Storage costs.
(i) In general.
(ii) Definitions.
(A) On-site storage facility.
(B) Retail sales facility.
(C) An integral part of a retail sales facility.
(D) On-site sales.
(E) Retail customer.
(*1*) In general.
(*2*) Certain non-retail customers treated as retail customers.
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Par. 5. Section 1.263A–1 is added to read as follows:

§1.263A–1 Uniform capitalization of costs.

(a) *Introduction*—(1) *In general.* The regulations under §§1.263A–1 through 1.263A–6 provide guidance to taxpayers that are required to capitalize certain costs under section 263A. These regulations generally apply to all costs required to be capitalized under section 263A except for interest that must be capitalized under section 263A(f) and the regulations thereunder. Statutory or regulatory exceptions may provide that section 263A does not apply to certain activities or costs; however, those activities or costs may nevertheless be subject to capitalization requirements under other provisions of the Internal Revenue Code and regulations.

(2) *Effective dates.* (i) In general, this section and §§1.263A–2 and 1.263A–3 apply to costs incurred in taxable years beginning after December

31, 1993. In the case of property that is inventory in the hands of the taxpayer, however, these sections are effective for taxable years beginning after December 31, 1993. Changes in methods of accounting necessary as a result of the rules in this section and §§1.263A–2 and 1.263A–3 must be made under terms and conditions prescribed by the Commissioner. Under these terms and conditions, the principles of §1.263A–1T(e) generally must be applied in revaluing inventory property.

(ii) For taxable years beginning before January 1, 1994, taxpayers must take reasonable positions on their federal income tax returns when applying section 263A. For purposes of this paragraph (a)(2)(iii), a reasonable position is a position consistent with the temporary regulations, revenue rulings, revenue procedures, notices, and announcements concerning section 263A applicable in taxable years beginning before January 1, 1994. See §601.601(d)(2)(ii)(*b*) of this chapter.

(3) *General scope*—(i) *Property to which section 263A applies.* Taxpayers subject to section 263A must capitalize all direct costs and certain indirect costs properly allocable to—

(A) Real property and tangible personal property produced by the taxpayer; and

(B) Real property and personal property described in section 1221(1), which is acquired by the taxpayer for resale.

(ii) *Property produced.* Taxpayers that produce real property and tangible personal property (producers) must capitalize all the direct costs of producing the property and the property's properly allocable share of indirect costs (described in paragraphs (e)(2)(i) and (3) of this section), regardless of whether the property is sold or used in the taxpayer's trade or business. See §1.263A–2 for rules relating to producers.

(iii) *Property acquired for resale.* Retailers, wholesalers, and other taxpayers that acquire property described in section 1221(1) for resale (resellers) must capitalize the direct costs of acquiring the property and the property's properly allocable share of indirect costs (described in paragraphs (e)(2)(ii) and (3) of this section). See §1.263A–3 for rules relating to resellers. See also section 263A(b)(2)(B), which excepts from section 263A personal property acquired for resale by a small reseller.

(iv) *Inventories valued at market.* Section 263A does not apply to inventories valued at market under either the market method or the lower of cost or market method if the market valuation used by the taxpayer generally equals the property's fair market value. For purposes of this paragraph (a)(3)(iv), the term fair market value means the price at which the taxpayer sells its inventory to its customers (*e.g.*, as in the market value definition provided in §1.471–4(b)) less, if applicable, the direct cost of disposing of the inventory. However, section 263A does apply in determining the market value of any inventory for which market is determined with reference to replacement cost or reproduction cost. See §§1.471–4 and 1.471–5.

(v) *Property produced in a farming business.* Section 263A generally requires taxpayers engaged in a farming business to capitalize certain costs. See section 263A(d) and §1.263A–1T(c) for rules relating to taxpayers engaged in a farming business.

(vi) *Creative property.* Section 263A generally requires taxpayers engaged in the production and resale of creative property to capitalize certain costs.

(vii) *Property produced or property acquired for resale by foreign persons.* Section 263A generally applies to foreign persons.

(b) *Exceptions*—(1) *Small resellers.* See section 263A(b)(2)(B) for the $10,000,000 gross receipts exception for small resellers of personal property. See §1.263A–3(b) for rules relating to this exception. See also the exception for small resellers with *de minimis* production activities in §1.263A–3(a)(2)(ii) and the exception for small resellers that have property produced under contract in §1.263A–3(a)(3).

(2) *Long-term contracts.* Except for certain home construction contracts described in section 460(e)(1), section 263A does not apply to any property produced by the taxpayer pursuant to a long-term contract as defined in section 460(f), regardless of whether the taxpayer uses an inventory method to account for such production.

(3) *Costs incurred in certain farming businesses.* See section 263A(d) for an exception for costs paid or incurred in certain farming businesses. See §1.263A–1T(c) for specific rules relating to taxpayers engaged in a farming business.

(4) *Costs incurred in raising, harvesting, or growing timber.* See section 263A(c)(5) for an exception for costs paid or incurred in raising, harvesting, or growing timber and certain ornamental trees. See §1.263A–1T(c), however, for rules relating to taxpayers that produce certain trees to which section 263A applies.

(5) *Qualified creative expenses.* See section 263A(h) for an exception for qualified creative expenses paid or incurred by certain free-lance authors, photographers, and artists.

(6) *Certain not-for-profit activities.* See section 263A(c)(1) for an exception for property produced by a taxpayer for use by the taxpayer other than in a trade or business or an activity conducted for profit. This exception does not apply, however, to property produced by an exempt organization in connection with its unrelated trade or business activities.

(7) *Intangible drilling and development costs.* See section 263A(c)(3) for an exception for intangible drilling and development costs. Additionally, section 263A does not apply to any amount allowable as a deduction under section 59(e) with respect to qualified expenditures under sections 263(c), 616(a), or 617(a).

(8) *Natural gas acquired for resale.* Under this paragraph (b)(8), section 263A does not apply to any costs incurred by a taxpayer relating to natural gas acquired for resale to the extent such costs would otherwise be allocable to cushion gas.

(i) *Cushion gas.* Cushion gas is the portion of gas stored in an underground storage facility or reservoir that is required to maintain the level of pressure necessary for operation of the facility. However, section 263A applies to costs incurred by a taxpayer relating to natural gas acquired for resale to the extent such costs are properly allocable to emergency gas.

(ii) *Emergency gas.* Emergency gas is natural gas stored in an underground storage facility or reservoir for use during periods of unusually heavy customer demand.

(9) *Research and experimental expenditures.* See section 263A(c)(2) for an exception for any research and experimental expenditure allowable as a deduction under section 174 or the regulations thereunder. Additionally, section 263A does not apply to any

amount allowable as a deduction under section 59(e) with respect to qualified expenditures under section 174.

(10) *Certain property that is substantially constructed.* Section 263A does not apply to any property produced by a taxpayer for use in its trade or business if substantial construction occurred before March 1, 1986. See §1.263A–1T(a)(6)(v) for a definition of substantial construction.

(11) *Certain property provided incident to services*—(i) *In general.* Under this paragraph (b)(11), section 263A does not apply to property that is provided to a client (or customer) incident to the provision of services by the taxpayer if the property provided to the client is—

(A) *De minimis* in amount; and

(B) Not inventory in the hands of the service provider.

(ii) *Definition of services.* For purposes of this paragraph (b)(11), services is defined with reference to its ordinary and accepted meaning under federal income tax principles. In determining whether a taxpayer is a bona fide service provider under this paragraph (b)(11), the nature of the taxpayer's trade or business and the facts and circumstances surrounding the taxpayer's trade or business activities must be considered. Examples of taxpayers qualifying as service providers under this paragraph include taxpayers performing services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

(iii) *De minimis property provided incident to services.* In determining whether property provided to a client by a service provider is *de minimis* in amount, all facts and circumstances, such as the nature of the taxpayer's trade or business and the volume of its service activities in the trade or business, must be considered. A significant factor in making this determination is the relationship between the acquisition or direct materials costs of the property that is provided to clients and the price that the taxpayer charges its clients for its services and the property. For purposes of this paragraph (b)(11), if the acquisition or direct materials cost of the property provided to a client incident to the services is less than or equal to five percent of the price charged to the client for the services and property, the property is *de minimis*. If the acquisition or direct materials cost of the property exceeds five percent of the price charged for the services and property, the property may be *de minimis* if additional facts and circumstances so indicate.

(12) *De minimis rule for certain producers with total indirect costs of $200,000 or less.* See §1.263A–2(b)(3)(iv) for a *de minimis* rule that treats producers with total indirect costs of $200,000 or less as having no additional section 263A costs (as defined in paragraph (d)(3) of this section) for purposes of the simplified production method.

(13) *Exception for the origination of loans.* For purposes of section 263A(b)(2)(A), the origination of loans is not considered the acquisition of intangible property for resale. (But section 263A(b)(2)(A) does include the acquisition by a taxpayer of pre-existing loans from other persons for resale.)

(c) *General operation of section 263A*—(1) *Allocations.* Under section 263A, taxpayers must capitalize their direct costs and a properly allocable share of their indirect costs to property produced or property acquired for resale. In order to determine these capitalizable costs, taxpayers must allocate or apportion costs to various activities, including production or resale activities. After section 263A costs are allocated to the appropriate production or resale activities, these costs are generally allocated to the items of property produced or property acquired for resale during the taxable year and capitalized to the items that remain on hand at the end of the taxable year. See however, the simplified production method and the simplified resale method in §§1.263A–2(b) and 1.263A–3(d).

(2) *Otherwise deductible.* (i) Any cost which (but for section 263A and the regulations thereunder) may not be taken into account in computing taxable income for any taxable year is not treated as a cost properly allocable to property produced or acquired for resale under section 263A and the regulations thereunder. Thus, for example, if a business meal deduction is limited by section 274(n) to 80 percent of the cost of the meal, the amount properly allocable to property produced or acquired for resale under section 263A is also limited to 80 percent of the cost of the meal.

(ii) The amount of any cost required to be capitalized under section 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).

(3) *Capitalize.* Capitalize means, in the case of property that is inventory in the hands of a taxpayer, to include in inventory costs and, in the case of other property, to charge to a capital account or basis.

(4) *Recovery of capitalized costs.* Costs that are capitalized under section 263A are recovered through depreciation, amortization, cost of goods sold, or by an adjustment to basis at the time the property is used, sold, placed in service, or otherwise disposed of by the taxpayer. Cost recovery is determined by the applicable Internal Revenue Code and regulation provisions relating to the use, sale, or disposition of property.

(d) *Definitions*—(1) *Self-constructed assets.* Self-constructed assets are assets produced by a taxpayer for use by the taxpayer in its trade or business. Self-constructed assets are subject to section 263A.

(2) *Section 471 costs*—(i) *In general.* Except as otherwise provided in paragraphs (d)(2)(ii) and (iii) of this section, for purposes of the regulations under section 263A, a taxpayer's section 471 costs are the costs, other than interest, capitalized under its method of accounting immediately prior to the effective date of section 263A. Thus, although section 471 applies only to inventories, section 471 costs include any non-inventory costs, other than interest, capitalized or included in acquisition or production costs under the taxpayer's method of accounting immediately prior to the effective date of section 263A.

(ii) *New taxpayers.* In the case of a new taxpayer, section 471 costs are those acquisition or production costs, other than interest, that would have been required to be capitalized by the taxpayer if the taxpayer had been in existence immediately prior to the effective date of section 263A.

(iii) *Method changes.* If a taxpayer included a cost described in §1.471–11(c)(2)(iii) in its inventoriable costs immediately prior to the effective date of section 263A, that cost is included in the taxpayer's section 471 costs under paragraph (d)(2)(i) of this section. Except as provided in the following sentence, a change in the financial

reporting practices of a taxpayer for costs described in §1.471–11(c)(2)(iii) subsequent to the effective date of section 263A does not affect the classification of these costs as section 471 costs. A taxpayer may change its established methods of accounting used in determining section 471 costs only with the consent of the Commissioner as required under section 446(e) and the regulations thereunder.

(3) *Additional section 263A costs.* Additional section 263A costs are defined as the costs, other than interest, that were not capitalized under the taxpayer's method of accounting immediately prior to the effective date of section 263A (adjusted as appropriate for any changes in methods of accounting for section 471 costs under paragraph (d)(2)(iii) of this section), but that are required to be capitalized under section 263A. For new taxpayers, additional section 263A costs are defined as the costs, other than interest, that the taxpayer must capitalize under section 263A, but which the taxpayer would not have been required to capitalize if the taxpayer had been in existence prior to the effective date of section 263A.

(4) *Section 263A costs.* Section 263A costs are defined as the costs that a taxpayer must capitalize under section 263A. Thus, section 263A costs are the sum of a taxpayer's section 471 costs, its additional section 263A costs, and interest capitalizable under section 263A(f).

(e) *Types of costs subject to capitalization*—(1) *In general.* Taxpayers subject to section 263A must capitalize all direct costs and certain indirect costs properly allocable to property produced or property acquired for resale. This paragraph (e) describes the types of costs subject to section 263A.

(2) *Direct costs*—(i) *Producers.* Producers must capitalize direct material costs and direct labor costs.

(A) *Direct material costs* include the costs of those materials that become an integral part of specific property produced and those materials that are consumed in the ordinary course of production and that can be identified or associated with particular units or groups of units of property produced.

(B) *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. For this purpose, labor encompasses full-time and part-time employees, as well as contract employees and independent contractors. Direct labor costs include all elements of compensation other than employee benefit costs described in paragraph (e)(3)(ii)(D) of this section. Elements of direct labor costs include basic compensation, overtime pay, vacation pay, holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d) as it existed prior to its repeal in 1983), shift differential, payroll taxes, and payments to a supplemental unemployment benefit plan.

(ii) *Resellers.* Resellers must capitalize the acquisition costs of property acquired for resale. In the case of inventory, the acquisition cost is the cost described in §1.471–3(b).

(3) *Indirect costs*—(i) *In general.* Indirect costs are defined as all costs other than direct material costs and direct labor costs (in the case of property produced) or acquisition costs (in the case of property acquired for resale). Taxpayers subject to section 263A must capitalize all indirect costs properly allocable to property produced or property acquired for resale. 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. Indirect costs may be allocable to both production and resale activities, as well as to other activities that are not subject to section 263A. Taxpayers subject to section 263A must make a reasonable allocation of indirect costs between production, resale, and other activities.

(ii) *Examples of indirect costs required to be capitalized.* The following are examples of indirect costs that must be capitalized to the extent they are properly allocable to property produced or property acquired for resale:

(A) *Indirect labor costs.* Indirect labor costs include all labor costs (including the elements of labor costs set forth in paragraph (e)(2)(i) of this section) that cannot be directly identified or associated with particular units or groups of units of specific property produced or property acquired for resale (*e.g.*, factory labor that is not direct labor). As in the case of direct labor, indirect labor encompasses full-time and part-time employees, as well as contract employees and independen contractors.

(B) *Officers' compensation.* Of ficers' compensation includes compen sation paid to officers of the taxpaye

(C) *Pension and other related cost* Pension and other related costs includ contributions paid to or made unde any stock bonus, pension, profit-sharin or annuity plan, or other plan deferrin the receipt of compensation, whether o not the plan qualifies under sectio 401(a). Contributions to employe plans representing past services mu be capitalized in the same manner (an in the same proportion to propert currently being acquired or produce as amounts contributed for curre service.

(D) *Employee benefit expense* Employee benefit expenses include a other employee benefit expenses (n described in paragraph (e)(3)(ii)(C) this section) to the extent such e penses are otherwise allowable deductions under chapter 1 of t Internal Revenue Code. These oth employee benefit expenses inclu worker's compensation; amounts oth wise deductible or allowable in redu ing earnings and profits under secti 404A; payments pursuant to a wa continuation plan under section 105 as it existed prior to its repeal in 19 amounts includible in the gross inco of employees under a method or arrangement of employer contributions compensation that has the effect o stock bonus, pension, profit-sharing annuity plan, or other plan defer receipt of compensation or provic deferred benefits; premiums on life health insurance; and miscellane benefits provided for employees s as safety, medical treatment, rec tional and eating facilities, member dues, etc. Employee benefit expe do not, however, include direct l costs described in paragraph (e)(2)(this section.

(E) *Indirect material costs.* Ind material costs include the cost materials that are not an integral pa specific property produced and the of materials that are consumed ir ordinary course of performing pr tion or resale activities that cann identified or associated with parti units or groups of units of pro Thus, for example, a cost describ §1.162–3, relating to the cost

material or supply, is an indirect material cost.

(F) *Purchasing costs.* Purchasing costs include costs attributable to purchasing activities. See §1.263A–3(c)(3) for a further discussion of purchasing costs.

(G) *Handling costs.* Handling costs include costs attributable to processing, assembling, repackaging and transporting goods, and other similar activities. See §1.263–3(c)(4) for a further discussion of handling costs.

(H) *Storage costs.* Storage costs include the costs of carrying, storing, or warehousing property. See §1.263A–3(c)(5) for a further discussion of storage costs.

(I) ***Cost recovery.*** Cost recovery includes depreciation, amortization, and cost recovery allowances on equipment and facilities (including depreciation or amortization of self-constructed assets or other previously produced or acquired property to which section 263A or section 263 applies).

(J) ***Depletion.*** Depletion includes allowances for depletion, whether or not in excess of cost. Depletion is, however, only property allocable to property that has been sold (*i.e.*, for purposes of determining gain or loss on the sale of the property).

(K) *Rent.* Rent includes the cost of renting or leasing equipment, facilities, or land.

(L) *Taxes.* Taxes include those taxes (other than taxes described in paragraph (e)(3)(iii)(F) of this section) that are otherwise allowable as a deduction to the extent such taxes are attributable to labor, materials, supplies, equipment, land, or facilities used in production or resale activities.

(M) *Insurance.* Insurance includes the cost of insurance on plant or facility, machinery, equipment, materials, property produced, or property acquired for resale.

(N) *Utilities.* Utilities include the cost of electricity, gas, and water.

(O) *Repairs and maintenance.* Repairs and maintenance include the cost of repairing and maintaining equipment or facilities.

(P) *Engineering and design costs.* Engineering and design costs include pre-production costs, such as costs attributable to research, experimental, engineering, and design activities (to the extent that such amounts are not research and experimental expenditures as described in section 174 and the regulations thereunder).

(Q) *Spoilage.* Spoilage includes the costs of rework labor, scrap, and spoilage.

(R) *Tools and equipment.* Tools and equipment include the costs of tools and equipment which are not otherwise capitalized.

(S) *Quality control.* Quality control includes the costs of quality control and inspection.

(T) *Bidding costs.* Bidding costs are costs incurred in the solicitation of contracts (including contracts pertaining to property acquired for resale) ultimately awarded to the taxpayer. The taxpayer must defer all bidding costs paid or incurred in the solicitation of a particular contract until the contract is awarded. If the contract is awarded to the taxpayer, the bidding costs become part of the indirect costs allocated to the subject matter of the contract. If the contract is not awarded to the taxpayer, bidding costs are deductible in the taxable year that the contract is awarded to another party, or in the taxable year that the taxpayer is notified in writing that no contract will be awarded and that the contract (or a similar or related contract) will not be rebid, or in the taxable year that the taxpayer abandons its bid or proposal, whichever occurs first. Abandoning a bid does not include modifying, supplementing, or changing the original bid or proposal. If the taxpayer is awarded only part of the bid (for example, the taxpayer submitted one bid to build each of two different types of products, and the taxpayer was awarded a contract to build only one of the two types of products), the taxpayer shall deduct the portion of the bidding costs related to the portion of the bid not awarded to the taxpayer. In the case of a bid or proposal for a multi-unit contract, all bidding costs must be included in the costs allocated to the subject matter of the contract awarded to the taxpayer to produce or acquire for resale any of such units. For example, where the taxpayer submits one bid to produce three similar turbines and the taxpayer is awarded a contract to produce only two of the three turbines, all bidding costs must be included in the cost of the two turbines. For purposes of this paragraph (e)(3)(ii)(T), a contract means—

(*1*) In the case of a specific unit of property, any agreement under which the taxpayer would produce or sell property to another party if the agreement is entered into before the taxpayer produces or acquires the specific unit of property to be delivered to the party under the agreement; and

(2) In the case of fungible property, any agreement to the extent that, at the time the agreement is entered into, the taxpayer has on hand an insufficient quantity of completed fungible items of such property that may be used to satisfy the agreement (plus any other production or sales agreements of the taxpayer).

(U) *Licensing and franchise costs.* Licensing and franchise costs include fees incurred in securing the contractual right to use a trademark, corporate plan, manufacturing procedure, special recipe, or other similar right associated with property produced or property acquired for resale. These costs include the otherwise deductible portion (*e.g.*, amortization) of the initial fees incurred to obtain the license or franchise and any minimum annual payments and royalties that are incurred by a licensee or a franchisee.

(V) ***Interest.*** Interest includes interest on debt incurred or continued during the production period to finance the production of real property or tangible personal property to which section 263A(f) applies.

(W) *Capitalizable service costs.* Service costs that are required to be capitalized include capitalizable service costs and capitalizable mixed service costs as defined in paragraph (e)(4) of this section.

(iii) *Indirect costs not capitalized.* The following indirect costs are not required to be capitalized under section 263A:

(A) *Selling and distribution costs.* These costs are marketing, selling, advertising, and distribution costs.

(B) *Research and experimental expenditures.* Research and experimental expenditures are expenditures described in section 174 and the regulations thereunder.

(C) *Section 179 costs.* Section 179 costs are expenses for certain depreciable assets deductible at the election of the taxpayer under section 179 and the regulations thereunder.

(D) *Section 165 losses.* Section 165 losses are losses under section 165 and the regulations thereunder.

(E) *Cost recovery allowances on temporarily idle equipment and facilities—(1) In general.* Cost recovery allowances on temporarily idle equipment and facilities include only depreciation, amortization, and cost recovery allowances on equipment and facilities that have been placed in service but are temporarily idle. Equipment and facilities are temporarily idle when a taxpayer takes them out of service for a finite period. However, equipment and facilities are not considered temporarily idle—

(*i*) During worker breaks, non-working hours, or on regularly scheduled non-working days (such as holidays or weekends);

(*ii*) During normal interruptions in the operation of the equipment or facilities;

(*iii*) When equipment is enroute to or located at a job site; or

(*iv*) When under normal operating conditions, the equipment is used or operated only during certain shifts.

(2) *Examples.* The provisions of this paragraph (e)(3)(iii)(E) are illustrated by the following examples:

Example 1. Equipment operated only during certain shifts. Taxpayer A manufactures widgets. Although A's manufacturing facility operates 24 hours each day in three shifts, A only operates its stamping machine during one shift each day. Because A only operates its stamping machine during certain shifts, A's stamping machine is not considered temporarily idle during the two shifts that it is not operated.

Example 2. Facility shut down for retooling. Taxpayer B owns and operates a manufacturing facility. B closes its manufacturing facility for two weeks to retool its assembly line. B's manufacturing facility is considered temporarily idle during this two-week period.

(F) *Taxes assessed on the basis of income.* Taxes assessed on the basis of income include only state, local, and foreign income taxes, and franchise taxes that are assessed on the taxpayer based on income.

(G) *Strike expenses.* Strike expenses include only costs associated with hiring employees to replace striking personnel (but not wages of replacement personnel), costs of security, and legal fees associated with settling strikes.

(H) *Warranty and product liability costs.* Warranty costs and product liability costs are costs incurred in fulfilling product warranty obligations for products that have been sold and costs incurred for product liability insurance.

(I) *On-site storage costs.* On-site storage costs are storage and warehousing costs incurred by a taxpayer at an on-site storage facility, as defined in §1.263A–3(c)(5)(ii)(A), with respect to property produced or property acquired for resale.

(J) *Unsuccessful bidding expenses.* Unsuccessful bidding costs are bidding expenses incurred in the solicitation of contracts not awarded to the taxpayer.

(K) *Deductible service costs.* Service costs that are not required to be capitalized include deductible service costs and deductible mixed service costs as defined in paragraph (e)(4) of this section.

(4) *Service costs—(i) Introduction.* 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.

(A) ***Definition of service costs.*** Service costs are defined as a type of indirect costs (*e.g.*, general and administrative costs) that can be identified specifically with a service department or function or that directly benefit or are incurred by reason of a service department or function.

(B) *Definition of service departments.* Service departments are defined as administrative, service, or support departments that incur service costs. The facts and circumstances of the taxpayer's activities and business organization control whether a department is a service department. For example, service departments include personnel, accounting, data processing, security, legal, and other similar departments.

(ii) *Various service cost categories—*(A) *Capitalizable service costs.* Capitalizable service costs are defined as service costs that directly benefit or are incurred by reason of the performance of the production or resale activities of the taxpayer. Therefore, these service costs are required to be capitalized under section 263A. Examples of service departments or functions that incur capitalizable service costs are provided in paragraph (e)(4)(iii) of this section.

(B) *Deductible service costs.* Deductible service costs are defined as service costs that do not directly benefit or are not incurred by reason of the performance of the production or resale activities of the taxpayer, and therefore, are not required to be capitalized under section 263A. Deductible service costs generally include costs incurred by reason of the taxpayer's overall management or policy guidance functions. In addition, deductible service costs include costs incurred by reason of the marketing, selling, advertising, and distribution activities of the taxpayer. Examples of service departments or functions that incur deductible service costs are provided in paragraph (e)(4)(iv) of this section.

(C) *Mixed service costs.* Mixed service costs are defined as service costs that are partially allocable to production or resale activities (capitalizable mixed service costs) and partially allocable to non-production or non-resale activities (deductible mixed service costs). For example, a personnel department may incur costs to recruit factory workers, the costs of which are allocable to production activities, and it may incur costs to develop wage, salary, and benefit policies, the costs of which are allocable to non-production activities.

(iii) *Examples of capitalizable service costs.* Costs incurred in the following departments or functions are generally allocated among production or resale activities:

(A) The administration and coordination of production or resale activities (wherever performed in the business organization of the taxpayer).

(B) Personnel operations, including the cost of recruiting, hiring, relocating, assigning, and maintaining personnel records or employees.

(C) Purchasing operations, including purchasing materials and equipment, scheduling and coordinating delivery of materials and equipment to or between factories or job sites, and expediting and follow-up.

(D) Materials handling and warehousing and storage operations.

(E) Accounting and data processing operations, including, for example, **accounting, accounts payable,** disbursements, and payroll functions (excluding accounts receivable and customer billing functions).

(F) Data processing.

(G) Security services.

(11) Legal services.

(v) *Examples of deductible service costs.* Costs incurred in the following departments or functions are not generally allocated to production or resale activities:

(A) Departments or functions responsible for overall management of the taxpayer or for setting overall policy for all of the taxpayer's activities or trades or businesses, such as the board of directors (including their immediate staff), and the chief executive, financial, accounting, and legal officers (including their immediate staff) of the taxpayer, provided that no substantial part of the cost of such departments or functions benefits a particular production or resale activity.

(B) Strategic business planning.

(C) General financial accounting.

(D) General financial planning (including general budgeting) and financial management (including bank relations and cash management).

(E) Personnel policy (such as establishing and managing personnel policy in general; developing wage, salary, and benefit policies; developing employee training programs unrelated to particular production or resale activities; negotiating with labor unions; and maintaining relations with retired workers).

(F) Quality control policy.

(G) Safety engineering policy.

(H) Insurance or risk management policy (but not including bid or performance bonds or insurance related to activities associated with property produced or property acquired for resale).

(I) Environmental management policy (except to the extent that the costs of any system or procedure benefits a particular production or resale activity).

(J) General economic analysis and forecasting.

(K) Internal audit.

(L) Shareholder, public, and industrial relations.

(M) Tax services.

(N) Marketing, selling, or advertising.

(f) *Cost allocation methods*—(1) *Introduction.* This 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. Paragraph (g) of this section 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; see those sections for definitions of eligible property. 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.

(2) *Specific identification method.* A specific identification method traces costs to a cost objective, such as a function, department, activity, or product, on the basis of a cause and effect or other reasonable relationship between the costs and the cost objective.

(3) *Burden rate and standard cost methods*—(i) *Burden rate method*—(A) *In general.* A burden rate method allocates an appropriate amount of indirect costs to property produced or property acquired for resale during a taxable year using predetermined rates that approximate the actual amount of indirect costs incurred by the taxpayer during the taxable year. Burden rates (such as ratios based on direct costs, hours, or similar items) may be developed by the taxpayer in accordance with acceptable accounting principles and applied in a reasonable manner. A taxpayer may allocate different indirect costs on the basis of different burden rates. Thus, for example, the taxpayer may use one burden rate for allocating the cost of rent and another burden rate for allocating the cost of utilities. Any periodic adjustment to a burden rate that merely reflects current operating conditions, such as increases in automation or changes in operation or prices, is not a change in method of accounting under section 446(e). A change, however, in the concept or base upon which such rates are developed, such as a change from basing the rates on direct labor hours to basing them on direct machine hours, is a change in method of accounting to which section 446(e) applies.

(B) *Development of burden rates.* The following factors, among others, may be used in developing burden rates:

(*1*) The selection of an appropriate level of activity and a period of time upon which to base the calculation of rates reflecting operating conditions for purposes of the unit costs being determined.

(*2*) The selection of an appropriate statistical base, such as direct labor hours, direct labor dollars, machine hours, or a combination thereof, upon which to apply the overhead rate.

(*3*) The appropriate budgeting, classification, and analysis of expenses (for example, the analysis of fixed versus variable costs).

(C) *Operation of the burden rate method.* The purpose of the burden rate method is to allocate an appropriate amount of indirect costs to production or resale activities through the use of predetermined rates intended to approximate the actual amount of indirect costs incurred. Accordingly, the proper use of the burden rate method under this section requires that any net negative or net positive difference between the total predetermined amount of costs allocated to property and the total amount of indirect costs actually incurred and required to be allocated to such property (*i.e.*, the under or over-applied burden) must be treated as an adjustment to the taxpayer's ending inventory or capital account (as the case may be) in the taxable year in which such difference arises. However, if such adjustment is not significant in amount in relation to the taxpayer's total indirect costs incurred with respect to production or resale activities for the year, such adjustment need not be allocated to the property produced or property acquired for resale unless such allocation is made in the taxpayer's financial reports. The taxpayer must treat both positive and negative adjustments consistently.

(ii) *Standard cost method*—(A) *In general.* A standard cost method allocates an appropriate amount of direct and indirect costs to property produced by the taxpayer through the use of preestablished standard allowances, without reference to costs actually incurred during the taxable year. A

taxpayer may use a standard cost method to allocate costs, provided variances are treated in accordance with the procedures prescribed in paragraph (f)(3)(ii)(B) of this section. Any periodic adjustment to standard costs that merely reflects current operating conditions, such as increases in automation or changes in operation or prices, is not a change in method of accounting under section 446(e). A change, however, in the concept or base upon which standard costs are developed is a change in method of accounting to which section 446(e) applies.

(B) *Treatment of variances.* For purposes of this section, net positive overhead variance means the excess of total standard indirect costs over total actual indirect costs and net negative overhead variance means the excess of total actual indirect costs over total standard indirect costs. The proper use of a standard cost method requires that a taxpayer must reallocate to property a pro rata portion of any net negative or net positive overhead variances and any net negative or net positive direct cost variances. The taxpayer must apportion such variances to or among the property to which the costs are allocable. However, if such variances are not significant in amount relative to the taxpayer's total indirect costs incurred with respect to production and resale activities for the year, such variances need not be allocated to property produced or property acquired for resale unless such allocation is made in the taxpayer's financial reports. A taxpayer must treat both positive and negative variances consistently.

(4) *Reasonable allocation methods.* A taxpayer may use the methods described in paragraph (f)(2) or (3) of this section if they are reasonable allocation methods within the meaning of this paragraph (f)(4). In addition, 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—

(i) 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 §§1.263A–2 and 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;

(ii) The allocation method is applied consistently by the taxpayer; and

(iii) The allocation method is not used to circumvent the requirements of the simplified methods in this section or in §1.263A–2, 1.263A–3, or the principles of section 263A.

(g) *Allocating categories of costs*—(1) *Direct materials.* Direct material costs (as defined in paragraph (e)(2) of this section) incurred during the taxable year must be allocated to the property produced or property acquired for resale by the taxpayer using the taxpayer's method of accounting for materials (*e.g.*, specific identification; first-in, first-out (FIFO); or last-in, first-out (LIFO)), or any other reasonable allocation method (as defined under the principles of paragraph (f)(4) of this section).

(2) *Direct labor.* Direct labor costs (as defined in paragraph (e)(2) of this section) incurred during the taxable year are generally allocated to property produced or property acquired for resale using a specific identification method, standard cost method, or any other reasonable allocation method (as defined under the principles of paragraph (f)(4) of this section). All elements of compensation, other than basic compensation, may be grouped together and then allocated in proportion to the charge for basic compensation. Further, a taxpayer is not treated as using an erroneous method of accounting if direct labor costs are treated as indirect costs under the taxpayer's allocation method, provided such costs are capitalized to the extent required by paragraph (g)(3) of this section.

(3) *Indirect costs.* Indirect costs (as defined in paragraph (e)(3) of this section) are generally allocated to intermediate cost objectives such as departments or activities prior to the allocation of such costs to property produced or property acquired for resale. Indirect costs are allocated using either a specific identification method, a standard cost method, a burden rate method, or any other reasonable allocation method (as defined under the principles of paragraph (f)(4) of this section).

(4) *Service costs*—(i) *In general.* Service costs are a type of indirect costs that may be allocated using the same allocation methods available for allocating other indirect costs described in paragraph (g)(3) of this section. Generally, taxpayers that use a specific identification method or another reasonable allocation method must allocate service costs to particular departments or activities based on a factor or relationship that reasonably relates the service costs to the benefits received from the service departments or activities. For example, a reasonable factor for allocating legal services to particular departments or activities is the number of hours of legal services attributable to each department or activity. See paragraph (g)(4)(iv) of this section for other illustrations. Using reasonable factors or relationships, a taxpayer must allocate mixed service costs under a direct reallocation method described in paragraph (g)(4)(iii)(A) of this section, a step-allocation method described in paragraph (g)(4)(iii)(B) of this section, or any other reasonable allocation method (as defined under the principles of paragraph (f)(4) of this section).

(ii) *De minimis rule.* For purposes of administrative convenience, if 90 percent or more of a mixed service department's costs are deductible service costs, a taxpayer may elect not to allocate any portion of the service department's costs to property produced or property acquired for resale. For example, if 90 percent of the costs of an electing taxpayer's industrial relations department benefit the taxpayer's overall policy-making activities, the taxpayer is not required to allocate any portion of these costs to a production activity. Similarly, if 90 percent or more of a mixed service department's costs are capitalizable service costs, a taxpayer may elect to allocate 100 percent of the department's costs to the production or resale activity benefitted. For example, if 90 percent of the costs of an electing taxpayer's accounting department benefit the taxpayer's manufacturing activity, the taxpayer must allocate 100 percent of the costs of the accounting department to the manufacturing activity. An election under this paragraph (g)(4)(ii) applies to all of a taxpayer's mixed service departments and constitutes the adoption of a (or a change

method of accounting under section 471 of the Internal Revenue Code.

(iii) *Methods for allocating mixed service costs*—(A) *Direct reallocation method.* Under the direct reallocation method, the total costs (direct and indirect) of all mixed service departments are allocated only to departments or cost centers engaged in production or resale activities and then from those departments to particular activities. This direct reallocation method ignores benefits provided by one mixed service department to other mixed service departments, and also excludes other mixed service departments from the base used to make the allocation.

(B) *Step-allocation method.* (*1*) Under a step-allocation method, a sequence of allocations is made by the taxpayer. First, the total costs of the mixed service departments that benefit the greatest number of other departments are allocated to—

(*i*) Other mixed service departments;

(*ii*) Departments that incur only deductible service costs; and

(*iii*) Departments that exclusively engage in production or resale activities.

(*2*) A taxpayer continues allocating mixed service costs in the manner described in paragraph (g)(4)(iii)(B)(*1*) of this section (*i.e.*, from the service departments benefitting the greatest number of departments to the service departments benefitting the least number of departments) until all mixed service costs are allocated to the types of departments listed in this paragraph (g)(4)(iii). Thus, a step-allocation method recognizes the benefits provided by one mixed service department to another mixed service department and also includes mixed service departments that have not yet been allocated in the base used to make the allocation.

(C) *Examples.* The provisions of this paragraph (g)(4)(iii) are illustrated by the following examples:

Example 1. Direct reallocation method. (i) Taxpayer E has the following five departments: the Assembling Department, the Painting Department, and the Finishing Department (production departments), and the Personnel Department and the Data Processing Department (mixed service departments). E allocates the Personnel Department's costs on the basis of total payroll costs and the Data Processing Department's costs on the basis of data processing hours.

(ii) Under a direct reallocation method, E allocates the Personnel Department's costs directly to its Assembling, Painting, and Finishing Departments, and not to its Data Processing department.

Department	*Total Dept. Costs*	*Amount of Payroll Costs*	*Allocation Ratio*	*Amount Allocated*
Personnel	$ 500,000	$ 50,000	—	<$500,000>
Data Proc'g	250,000	15,000	—	—
Assembling	250,000	15,000	15,000/285,000	26,315
Painting	1,000,000	90,000	90,000/285,000	157,895
Finishing	2,000,000	180,000	180,000/285,000	315,790
	$4,000,000	$350,000		

(iii) After E allocates the Personnel Department's costs, E then allocates the costs of its Data Processing Department in the same manner.

Department	*Total Dept. Costs After Initial Allocation*	*Total Data Proc. Hours*	*Allocation Ratio*	*Amount Allocated*	*Tot'l Dept. Cost After Final Allocation*
Personnel	$ 0	2,000	—	—	$ 0
Data Proc'g	250,000	—	—	<$250,000>	
Assembling	276,315	2,000	2,000/10,000	50,000	326,315
Painting	1,157,895	0	0/10,000	0	1,157,895
Finishing	2,315,790	8,000	8,000/10,000	200,000	2,515,790
	$4,000,000	12,000			$4,000,000

Example 2. Step-allocation method. (i) Taxpayer F has the following five departments: the Manufacturing Department (a production department), the Marketing Department and the Finance Department (departments that incur only deductible service costs), the Personnel Department and the Data Processing Department (mixed service departments). F uses a step-allocation method and allocates the Personnel Department's costs on the basis of total payroll costs and the Data Processing Department's costs on the basis of data processing hours. F's Personnel Department benefits all four of F's other departments, while its Data Processing Department benefits only three departments. Because F's Personnel Department benefits the greatest number of other departments, F first allocates its Personnel Department's costs to its Manufacturing, Marketing, Finance and Data Processing departments, as follows:

Department	*Total Dept. Costs*	*Amount of Payroll Costs*	*Allocation Ratio*	*Amount Allocated*
Personnel	$ 500,000	$ 50,000	—	<$500,000>
Data Proc'g	250,000	15,000	15,000/300,000	25,000
Finance	250,000	15,000	15,000/300,000	25,000
Marketing	1,000,000	90,000	90,000/300,000	150,000
Manufac'g	2,000,000	180,000	180,000/300,000	300,000
	$4,000,000	$350,000		

(ii) Under a step-allocation method, the denominator of F's allocation ratio includes the payroll costs of its Manufacturing, Marketing, Finance, and Data Processing departments.

(iii) Next, F allocates the costs of its Data Processing Department on the basis of data processing hours. Because the costs incurred by F's Personnel Department have already been allocated, no allocation is made to the Personnel Department.

Department	Total Dept. Costs After Initial Allocation	Total Data Proc. Hours	Allocation Ratio	Amount Allocated	Tot'l Dept. Cost After Final Allocation
Personnel	$ 0	2,000	—	—	$ 0
Data Proc'g	275,000	—	—	<$275,000>	0
Finance	275,000	2,000	2,000/10,000	55,000	330,000
Marketing	1,150,000	0	0/10,000	0	1,150,000
Manufac'g	2,300,000	8,000	8,000/10,000	220,000	2,520,000
	$4,000,000	12,000			$4,000,000

(iv) Under the second step of F's step-allocation method, the denominator of F's allocation ratio includes the data processing hours of its Manufacturing, Marketing, and Finance Departments, but does not include the data processing hours of its Personnel Department (the other mixed service department) because the costs of that department have previously been allocated.

(iv) *Illustrations of mixed service cost allocations using reasonable factors or relationships.* This paragraph (g)(4)(iv) illustrates various reasonable factors and relationships that may be used in allocating different types of mixed service costs. Taxpayers, however, are permitted to use other reasonable factors and relationships to allocate mixed service costs. In addition, the factors or relationships illustrated in this paragraph (g)(4)(iv) may be used to allocate other types of service costs not illustrated in this paragraph (g)(4)(iv).

(A) *Security services.* The costs of security or protection services must be allocated to each physical area that receives the services using any reasonable method applied consistently (*e.g.*, the size of the physical area, the number of employees in the area, or the relative fair market value of assets located in the area).

(B) *Legal services.* The costs of legal services are generally allocable to a particular production or resale activity on the basis of the approximate number of hours of legal service performed in connection with the activity, including research, bidding, negotiating, drafting, reviewing a contract, obtaining necessary licenses and permits, and resolving disputes. Different hourly rates may be appropriate for different services. In determining the number of hours allocable to any activity, estimates are appropriate, detailed time records are not required to be kept, and insubstantial amounts of services provided to an activity by senior legal staff (such as administrators or reviewers) may be ignored. Legal costs may also be allocated to a particular production or resale activity based on the ratio of the total direct costs incurred for the activity to the total direct costs incurred with respect to all production or resale activities. The taxpayer must also allocate directly to an activity the cost incurred for any outside legal services. Legal costs relating to general corporate functions are not required to be allocated to a particular production or resale activity.

(C) *Centralized payroll services.* The costs of a centralized payroll department or activity are generally allocated to the departments or activities benefitted on the basis of the gross dollar amount of payroll processed.

(D) *Centralized data processing services.* The costs of a centralized data processing department are generally allocated to all departments or activities benefitted using any reasonable basis, such as total direct data processing costs or the number of data processing hours supplied. The costs of data processing systems or applications developed for a particular activity are directly allocated to that activity.

(E) *Engineering and design services.* The costs of an engineering or a design department are generally directly allocable to the departments or activities benefitted based on the ratio of the approximate number of hours of work performed with respect to the particular activity to the total number of hours of engineering or design work performed for all activities. Different services may be allocated at different hourly rates.

(F) *Safety engineering services.* The costs of a safety engineering departments or activities generally benefit all of the taxpayer's activities and, thus, should be allocated using a reasonable basis, such as: the approximate number of safety inspections made in connection with a particular activity as a fraction of total inspections, the number of employees assigned to an activity as a fraction of total employees, or the total labor hours worked in connection with an activity as a fraction of total hours. However, in determining the allocable costs of a safety engineering department, costs attributable to providing a safety program relating only to a particular activity must be directly assigned to such activity. Additionally, the cost of a safety engineering department only responsible for setting safety policy and establishing safety procedures to be used in all of the taxpayer's activities is not required to be allocated.

(v) *Accounting method change.* A change in the method or base used to allocate service costs (such as changing from an allocation base using direct labor costs to a base using direct labor hours), or a change in the taxpayer's determination of what functions or departments of the taxpayer are to be allocated, is a change in method of accounting to which section 446(e) and the regulations thereunder apply.

(h) *Simplified service cost method—*(1) *Introduction.* This paragraph (h) provides a simplified method for determining capitalizable mixed service costs incurred during the taxable year with respect to eligible property (*i.e.*, the aggregate portion of mixed service costs that are properly allocable to the taxpayer's production or resale activities).

(2) *Eligible property—*(i) *In general.* Except as otherwise provided in paragraph (h)(2)(ii) of this section, the simplified service cost method, if elected for any trade or business of the taxpayer, must be used for all production and resale activities of the trade or business associated with any of the following categories of property that are subject to section 263A:

(A) *Inventory property.* Stock in trade or other property properly includible in the inventory of the taxpayer

(B) *Non-inventory property held for sale.* Non-inventory property held by a taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

(C) *Certain self-constructed assets.* Self-constructed assets substantially identical in nature to, and produced in the same manner as, inventory property produced by the taxpayer or other property produced by the taxpayer and

(d) primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

(D) *Self-constructed assets produced on a repetitive basis.* Self-constructed assets produced by the taxpayer on a routine and repetitive basis in the ordinary course of the taxpayer's trade or business.

(iii) *Election to exclude self-constructed assets.* At the taxpayer's election, the simplified service cost method may be applied within a trade or business to only the categories of inventory property and non-inventory property held for sale described in paragraphs (h)(2)(i)(A) and (B) of this section. Taxpayers electing to exclude self-constructed assets described in paragraphs (h)(2)(i)(C) and (D) of this section from application of the simplified service cost method must, however, allocate service costs to such property in accordance with paragraph (g)(4) of this section.

(3) *General allocation formula.* (i) Under the simplified service cost method, a taxpayer computes its capitalizable mixed service costs using the following formula:

Allocation ratio × Total mixed service costs.

(ii) A producer may elect one of two allocation ratios, the labor-based allocation ratio or the production cost allocation ratio. A reseller that satisfies the requirements for using the simplified resale method of §1.263A–3(d) (whether or not that method is elected) may elect the simplified service cost method, but must use a labor-based allocation ratio. (See §1.263A–3(d) for labor-based allocation ratios to be used in conjunction with the simplified resale method.) The allocation ratio used by a trade or business of a taxpayer is a method of accounting which must be applied consistently within the trade or business.

(4) *Labor-based allocation ratio.* (i) The labor-based allocation ratio is computed as follows:

$$\frac{\text{Section 263A labor costs}}{\text{Total labor costs.}}$$

(ii) Section 263A labor costs are defined as the total labor costs (excluding labor costs included in mixed service costs) allocable to property produced and property acquired for resale under section 263A that are incurred in the taxpayer's trade or business during the taxable year. Total labor costs are defined as the total labor costs (excluding labor costs included in mixed service costs) incurred in the taxpayer's trade or business during the taxable year. Total labor costs include labor costs incurred in all parts of the trade or business (*i.e.*, if the taxpayer has both property produced and property acquired for resale, the taxpayer must include labor costs from resale activities as well as production activities). For example, taxpayer G incurs $1,000 of total mixed service costs during the taxable year. G's section 263A labor costs are $5,000 and its total labor costs are $10,000. Under the labor-based allocation ratio, G's capitalizable mixed service costs are $500 (*i.e.*, $1,000 × ($5,000 divided by $10,000)).

(5) *Production cost allocation ratio.* (i) Producers may use the production cost allocation ratio, computed as follows:

$$\frac{\text{Section 263A production costs}}{\text{Total costs.}}$$

(ii) Section 263A production costs are defined as the total costs (excluding mixed service costs and interest) allocable to property produced (and property acquired for resale if the producer is also engaged in resale activities) under section 263A that are incurred in the taxpayer's trade or business during the taxable year. Total costs are defined as all costs (excluding mixed service costs and interest) incurred in the taxpayer's trade or business during the taxable year. Total costs include all direct and indirect costs allocable to property produced (and property acquired for resale if the producer is also engaged in resale activities) as well as all other costs of the taxpayer's trade or business, including, but not limited to: salaries and other labor costs of all personnel; all depreciation taken for federal income tax purposes; research and experimental expenditures; and selling, marketing, and distribution costs. Such costs do not include, however, taxes described in paragraph (e)(3)(iii)(F) of this section. For example, taxpayer H, a producer, incurs $1,000 of total mixed service costs in the taxable year. H's section 263A production costs are $10,000 and its total costs are $20,000. Under the production cost allocation ratio, H's capitalizable mixed service costs are $500 (*i.e.*, $1,000 × ($10,000 divided by $20,000)).

(6) *Definition of total mixed service costs.* Total mixed service costs are defined as the total costs incurred during the taxable year in all departments or functions of the taxpayer's trade or business that perform mixed service activities. See paragraph (e)(4)(ii)(C) of this section which defines mixed service costs. In determining the total mixed service costs of a trade or business, the taxpayer must include all costs incurred in its mixed service departments and cannot exclude any otherwise deductible service costs. For example, if the accounting department within a trade or business is a mixed service department, then in determining the total mixed service costs of the trade or business, the taxpayer cannot exclude the costs of personnel in the accounting department that perform services relating to non-production activities (*e.g.*, accounts receivable or customer billing activities). Instead, the entire cost of the accounting department must be included in the total mixed service costs.

(7) *Costs allocable to more than one business.* To the extent mixed service costs, labor costs, or other costs are incurred in more than one trade or business, the 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 paragraph (f)(4) of this section.

(8) *De minimis rule.* If the taxpayer elects to apply the *de minimis* rule of paragraph (g)(4)(ii) of this section to any mixed service department, the department is not considered a mixed service department for purposes of the simplified service cost method. Instead, the costs of such department are allocated exclusively to the particular activity satisfying the 90-percent test.

(9) *Separate election.* A taxpayer may elect the simplified service cost method in conjunction with any other allocation method used at the trade or business level, including the simplified methods described in §§1.263A–2(b) and 1.263A–3(d). However, the election of the simplified service cost method must be made independently of the election to use those other simplified methods.

(i) [Reserved]

(j) *Special rules*—(1) *Costs provided by a related person*—(i) *In general.* A taxpayer subject to section 263A must capitalize an arm's-length charge for any section 263A costs (*e.g.*, costs of materials, labor, or services) incurred by a related person that are properly allocable to the property produced or property acquired for resale by the taxpayer. Both the taxpayer and the related person must account for the transaction as if an arm's-length charge had been incurred by the taxpayer with respect to its property produced or property acquired for resale. For purposes of this paragraph (j)(1)(i), a taxpayer is considered related to another person if the taxpayer and such person are described in section 482. Further, for purposes of this paragraph (j)(1)(i), arm's-length charge means the arm's-length charge (or other appropriate charge where permitted and applicable) under the principles of section 482. Any correlative adjustments necessary because of the arm's-length charge requirement of this paragraph (j)(1)(i) shall be determined under the principles of section 482.

(ii) *Exceptions.* The provisions of paragraph (j)(1)(i) of this section do not apply if, and to the extent that—

(A) It would be inappropriate under the principles of section 482 for the Commissioner to adjust the income of the taxpayer or the related person with respect to the transaction at issue; or

(B) A transaction is accounted for under an alternative Internal Revenue Code section resulting in the capitalization (or deferral of the deduction) of the costs of the items provided by the related party and the related party does not deduct such costs earlier than the costs would have been deducted by the taxpayer if the costs were capitalized under section 263A. Thus, for example, paragraph (j)(1)(i) of this section does not apply if, and to the extent that, a transaction is treated as a deferred intercompany transaction under §1.1502-13, and the gain or loss is deferred by the selling member under that section.

(2) *Optional capitalization of period costs*—(i) *In general.* Taxpayers are not required to capitalize indirect costs that do not directly benefit or are not incurred by reason of the production of property or acquisition of property for resale (*i.e.*, period costs). A taxpayer may, however, elect to capitalize certain period costs if: the method is consistently applied; is used in computing beginning inventories, ending inventories, and cost of goods sold; and does not result in a material distortion of the taxpayer's income. A material distortion relates to the source, character, amount, or timing of the cost capitalized or any other item affected by the capitalization of the cost. Thus, for example, a taxpayer may not capitalize a period cost under section 263A if capitalization would result in a material change in the computation of the foreign tax credit limitation under section 904. An election to capitalize a period cost is the adoption of (or a change in) a method of accounting under section 446 of the Internal Revenue Code.

(ii) *Period costs eligible for capitalization.* The types of period costs eligible for capitalization under this paragraph (j)(2) include only the types of period costs (*e.g.*, under paragraph (e)(3)(iii) of this section) for which some portion of the costs incurred is properly allocable to property produced or property acquired for resale in the year of the election. Thus, for example, marketing or advertising costs, no portion of which are properly allocable to property produced or property acquired for resale, do not qualify for elective capitalization under this paragraph (j)(2).

(3) *Trade or business application.* Notwithstanding the references generally to taxpayer throughout this section and §§1.263A-2 and 1.263A-3, the methods of accounting provided under section 263A are to be elected and applied independently for each separate and distinct trade or business of the taxpayer in accordance with the provisions of section 446(d) and the regulations thereunder.

(4) *Transfers with a principal purpose of tax avoidance.* [Reserved]

Par. 6. Section 1.263A-1T is amended by adding three sentences to the end of paragraph (a)(4) to read as follows:

§1.263A-1T Capitalization and inclusion of inventory costs of certain expenses (temporary).

(a) ***

(4) *** Paragraphs (a), (b), and (d) (excluding paragraphs (d)(3)(ii)(C)(*2*), (*3*), and (*4*)) are not effective for costs incurred after December 31, 1993, in taxable years beginning after that date. In the case of property that is inventory in the hands of the taxpayer, however, those paragraphs are not effective for taxable years beginning after December 31, 1993. See §§1.263A-1, 1.263A-2, and 1.263A-3 for rules applicable in taxable years beginning after December 31, 1993, for taxpayers previously subject to those paragraphs.

* * * * * *

Par. 7. Sections 1.263A-2 and 1.263A-3 are added, and §§1.263A-4 through 1.263A-6 are added and reserved to read as follows:

§1.263A-2 Rules relating to property produced by the taxpayer.

(a) *In general.* Section 263A applies to real property and tangible personal property produced by a taxpayer for use in its trade or business or for sale to its customers. In addition, section 263A applies to property produced for a taxpayer under a contract with another party. The principal terms related to the scope of section 263A with respect to producers are provided in this paragraph (a). See §1.263A-1(b)(11) for an exception in the case of certain *de minimis* property provided to customers incident to the provision of services.

(1) *Produce*—(i) *In general.* For purposes of section 263A, *produce* includes the following: construct, build, install, manufacture, develop, improve, create, raise, or grow.

(ii) *Ownership*—(A) *General rule.* Except as provided in paragraphs (a)(1)(ii)(B) and (C) of this section, a taxpayer is not considered to be producing property unless the taxpayer is considered an owner of the property produced under federal income tax principles. The determination as to whether a taxpayer is an owner is based on all of the facts and circumstances, including the various benefits and burdens of ownership vested with the taxpayer. A taxpayer may be considered an owner of property produced, even though the taxpayer does not have legal title to the property.

(B) *Property produced for the taxpayer under a contract*—(*1*) *In general.* Property produced for the taxpayer under a contract with another party is treated as property produced by the taxpayer to the extent the taxpayer makes payments or otherwise incurs costs with respect to the property. A

taxpayer has made payment under this section if the transaction would be considered payment by a taxpayer using the cash receipts and disbursements method of accounting.

(2) *Definition of contract.* [Reserved]

(C) *Home construction contracts.* Section 460(e)(1) provides that section 263A applies to a home construction contract unless that contract will be completed within two years of the contract commencement date and the taxpayer's average annual gross receipts for the three preceding taxable years do not exceed $10,000,000. Section 263A applies to such a contract even if the contractor is not considered the owner of the property produced under the contract under federal income tax principles.

(2) *Tangible personal property*—(i) *General rule.* In general, section 263A applies to the costs of producing tangible personal property, and not to the costs of producing intangible property. For example, section 263A applies to the costs manufacturers incur to produce goods, but does not apply to the costs financial institutions incur to originate loans.

(ii) *Intellectual or creative property.* For purposes of determining whether a taxpayer producing intellectual or creative property is producing tangible personal property or intangible property, the term tangible personal property includes films, sound recordings, video tapes, books, and other similar property embodying words, ideas, concepts, images, or sounds by the creator thereof. Other similar property for this purpose generally means intellectual or creative property for which, as costs are incurred in producing the property, it is intended (or is reasonably likely) that any tangible medium in which the property is embodied will be mass distributed by the creator or any one or more third parties in a form that is not substantially altered. However, any intellectual or creative property that is embodied in a tangible medium that is mass distributed merely incident to the distribution of a principal product or good of the creator is not other similar property for these purposes.

(A) *Intellectual or creative property that is tangible personal property.* Section 263A applies to tangible personal property defined in this paragraph (a)(2) without regard to whether such property is treated as tangible or intangible property under other sections of the Internal Revenue Code. Thus, for example, section 263A applies to the costs of producing a motion picture or researching and writing a book even though these assets may be considered intangible for other purposes of the Internal Revenue Code. Tangible personal property includes, for example, the following:

(*1*) *Books.* The costs of producing and developing books (including teaching aids and other literary works) required to be capitalized under this section include costs incurred by an author in researching, preparing, and writing the book. (However, see section 263A(h), which provides an exemption from the capitalization requirements of section 263A in the case of certain free-lance authors.) In addition, the costs of producing and developing books include prepublication expenditures incurred by publishers, including payments made to authors (other than commissions for sales of books that have already taken place), as well as costs incurred by publishers in writing, editing, compiling, illustrating, designing, and developing the books. The costs of producing a book also include the costs of producing the underlying manuscript, copyright, or license. (These costs are distinguished from the separately capitalizable costs of printing and binding the tangible medium embodying the book (*e.g.*, paper and ink).) See §1.174–2(a)(1), which provides that the term research or experimental expenditures does not include expenditures incurred for research in connection with literary, historical, or similar projects.

(*2*) *Sound recordings.* A sound recording is a work that results from the fixation of a series of musical, spoken, or other sounds, regardless of the nature of the material objects, such as discs, tapes, or other phonorecordings, in which such sounds are embodied.

(B) *Intellectual or creative property that is not tangible personal property.* Items that are not considered tangible personal property within the meaning of section 263A(b) and paragraph (a)(2)(ii) of this section include:

(*1*) *Evidences of value.* Tangible personal property does not include property that is representative or evidence of value, such as stock, securities, debt instruments, mortgages, or loans.

(*2*) *Property provided incident to services.* Tangible personal property does not include *de minimis* property provided to a client or customer incident to the provision of services, such as wills prepared by attorneys, or blueprints prepared by architects. See §1.263A–1(b)(11).

(3) *Costs required to be capitalized by producers*—(i) *In general.* Except as specifically provided in section 263A(f) with respect to interest costs, producers must capitalize direct and indirect costs properly allocable to property produced under section 263A, without regard to whether those costs are incurred before, during, or after the production period (as defined in section 263A(f)(4)(B)).

(ii) *Pre-production costs.* If property is held for future production, taxpayers must capitalize direct and indirect costs allocable to such property (*e.g.*, purchasing, storage, handling, and other costs), even though production has not begun. If property is not held for production, indirect costs incurred prior to the beginning of the production period must be allocated to the property and capitalized if, at the time the costs are incurred, it is reasonably likely that production will occur at some future date. Thus, for example, a manufacturer must capitalize the costs of storing and handling raw materials before the raw materials are committed to production. In addition, a real estate developer must capitalize property taxes incurred with respect to property if, at the time the taxes are incurred, it is reasonably likely that the property will be subsequently developed.

(iii) *Post-production costs.* Generally, producers must capitalize all indirect costs incurred subsequent to completion of production that are properly allocable to the property produced. Thus, for example, storage and handling costs incurred while holding the property produced for sale after production must be capitalized to the property to the extent properly allocable to the property. However, see §1.263A–3(c) for exceptions.

(4) *Practical capacity concept.* Notwithstanding any provision to the contrary, the use, directly or indirectly, of the practical capacity concept is not permitted under section 263A. For purposes of section 263A, the term practical capacity concept means any concept, method, procedure, or formula (such as the practical capacity concept described in §1.471–11(d)(4)) whereunder fixed costs are not capitalized because of the relationship between the

actual production at the taxpayer's production facility and the practical capacity of the facility. For purposes of this section, the practical capacity of a facility includes either the practical capacity or theoretical capacity of the facility, as defined in §1.471–11(d)(4), or any similar determination of productive or operating capacity. The practical capacity concept may not be used with respect to any activity to which section 263A applies (*i.e.*, production or resale activities). A taxpayer shall not be considered to be using the practical capacity concept solely because the taxpayer properly does not capitalize costs described in §1.263A–1(e)(3)(iii)-(E), relating to certain costs attributable to temporarily idle equipment.

(5) *Taxpayers required to capitalize costs under this section.* This section generally applies to taxpayers that produce property. If a taxpayer is engaged in both production activities and resale activities, the taxpayer applies the principles of this section as if it read production or resale activities, and by applying appropriate principles from §1.263A–3. If a taxpayer is engaged in both production and resale activities, the taxpayer may elect the simplified production method provided in this section, but generally may not elect the simplified resale method discussed in §1.263A–3(d). If elected, the simplified production method must be applied to all eligible property produced and all eligible property acquired for resale by the taxpayer.

(b) ***Simplified production method*—(1)** ***Introduction.*** **This paragraph (b) provides a simplified method for determining the additional section 263A** costs properly allocable to ending inventories of property produced and other eligible property on hand at the end of the taxable year.

(2) *Eligible property*—(i) *In general.* Except as otherwise provided in paragraph (b)(2)(ii) of this section, the simplified production method, if elected for any trade or business of a producer, must be used for all production and resale activities associated with any of the following categories of property to which section 263A applies:

(A) *Inventory property.* Stock in trade or other property properly includible in the inventory of the taxpayer.

(B) *Non-inventory property held for sale.* Non-inventory property held by a taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

(C) *Certain self-constructed assets.* Self-constructed assets substantially identical in nature to, and produced in the same manner as, inventory property produced by the taxpayer or other property produced by the taxpayer and held primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

(D) *Self-constructed assets produced on a repetitive basis.* Self-constructed assets produced by the taxpayer on a routine and repetitive basis in the ordinary course of the taxpayer's trade or business.

(ii) *Election to exclude self-constructed assets.* At the taxpayer's election, the simplified production method may be applied within a trade or business to only the categories of inventory property and non-inventory property held for sale described in paragraphs (b)(2)(i)(A) and (B) of this section. Taxpayers electing to exclude the self-constructed assets, defined in paragraphs (b)(2)(i)(C) and (D) of this section, from application of the simplified production method must, however, allocate additional section 263A costs to such property in accordance with §1.263A–1(f).

(3) *Simplified production method without historic absorption ratio election*—(i) *General allocation formula*—(A) *In general.* Except as otherwise provided in paragraph (b)(3)(iv) of this section, the additional section 263A costs allocable to eligible property remaining on hand at the close of the taxable year under the simplified production method are computed as follows:

Absorption ratio × Section 471 costs remaining on hand at year end.

(B) *Effect of allocation.* The absorption ratio generally is multiplied by the section 471 costs remaining in ending inventory or otherwise on hand at the end of each taxable year in which the simplified production method is applied. The resulting product is the additional section 263A costs that are added to the taxpayer's ending section 471 costs to determine the section 263A costs that are capitalized. See, however, paragraph (b)(3)(iii) of this section for special rules applicable to LIFO taxpayers. Except as otherwise provided in this section or in §1.263A–1 or 1.263A–3, additional section 263A costs that are allocated to inventories on hand at the close of the taxable year under the simplified production method of this paragraph (b) are treated as inventory costs for all purposes of the Internal Revenue Code.

(ii) ***Definitions*—(A)** ***Absorption ratio.*** Under the simplified production method, the absorption ratio is determined as follows:

$$\frac{\text{Add'l section 263A costs incurred during the taxable year}}{\text{Section 471 costs incurred during the taxable year.}}$$

(1) Additional section 263A costs incurred during the taxable year. Additional section 263A costs incurred during the taxable year are defined as the additional section 263A costs described in §1.263A–1(d)(3) that a taxpayer incurs during its current taxable year.

(2) Section 471 costs incurred during the taxable year. Section 471 costs incurred during the taxable year are defined as the section 471 costs described in §1.263A–1(d)(2) that a taxpayer incurs during its current taxable year.

(B) ***Section 471 costs remaining on hand at year end.*** Section 471 costs remaining on hand at year end means the section 471 costs, as defined in §1.263A–1(d)(2), that a taxpayer incurs during its current taxable year which remain in its ending inventory or are otherwise on hand at year end. For LIFO inventories of a taxpayer, the section 471 costs remaining on hand at year end means the increment, if any, for the current year stated in terms of section 471 costs. See paragraph (b)(3)(iii) of this section.

(iii) *LIFO taxpayers electing* [illegible]

...plified production method—(A) *In ...eral.* Under the simplified produc...n method, a taxpayer using a LIFO ...thod must calculate a particular ...r's index (*e.g.*, under §1.472–8(e)) ...thout regard to its additional section ...A costs. Similarly, a taxpayer that ...usts current-year costs by applicable ...dexes to determine whether there has ...n an inventory increment or decre...ent in the current year for a particular ...FO pool must disregard the addi...onal section 263A costs in making ...at determination.

(B) *LIFO increment.* If the taxpayer ...termines there has been an inventory ...rement, the taxpayer must state the ...mount of the increment in current-year ...llars (stated in terms of section 471 ...sts). The taxpayer then multiplies ...is amount by the absorption ratio. ...he resulting product is the additional ...ction 263A costs that must be added ...the taxpayer's increment for the year ...ated in terms of section 471 costs.

(C) *LIFO decrement.* If the taxpayer ...termines there has been an inventory ...rement, the taxpayer must state the ...mount of the decrement in dollars applicable to the particular year for which the LIFO layer has been invaded. The additional section 263A costs incurred in prior years that are applicable to the decrement are charged to cost of goods sold. The additional section 263A costs that are applicable to the decrement are determined by multiplying the additional section 263A costs allocated to the layer of the pool in which the decrement occurred by the ratio of the decrement (excluding additional section 263A costs) to the section 471 costs in the layer of that pool.

(iv) *De minimis rule for producers with total indirect costs of $200,000 or less*—(A) *In general.* If a producer using the simplified production method incurs $200,000 or less of total indirect costs in a taxable year, the additional section 263A costs allocable to eligible property remaining on hand at the close of the taxable year are deemed to be zero. Solely for purposes of this paragraph (b)(3)(iv), taxpayers are permitted to exclude any category of indirect costs (listed in §1.263A–1(e)(3)(iii)) that is not required to be capitalized (*e.g.*, selling and distribution costs) in determining total indirect costs.

(B) *Related party and aggregation rules.* In determining whether the producer incurs $200,000 or less of total indirect costs in a taxable year, the related party and aggregation rules of §1.263A–3(b)(3) are applied by substituting total indirect costs for gross receipts wherever gross receipts appears.

(v) *Examples.* The provisions of this paragraph (b) are illustrated by the following examples.

Example 1—FIFO inventory method (i) Taxpayer J uses the FIFO method of accounting for inventories. J's beginning inventory for 1994 (all of which is sold during 1994) is $2,500,000 (consisting of $2,000,000 of section 471 costs and $500,000 of additional section 263A costs). During 1994, J incurs $10,000,000 of section 471 costs and $1,000,000 of additional section 263A costs. J's additional section 263A costs include capitalizable mixed service costs computed under the simplified service cost method as well as other allocable costs. J's section 471 costs remaining in ending inventory at the end of 1994 are $3,000,000. J computes its absorption ratio for 1994, as follows:

$$\frac{\text{Add'l §263A costs incurred during 1994}}{\text{Section 471 costs incurred during 1994}} = \frac{\$\ 1,000,000}{\$10,000,000} = 10\%$$

(ii) Under the simplified production method, J determines the additional section 263A costs allocable to its ending inventory by multiplying the ...orption ratio by the section 471 costs remaining in its ending inventory:

$$\text{Add'l §263A costs} = 10\% \times \$3,000,000 = \$300,000.$$

(iii) J adds this $300,000 to the $3,000,000 of section 471 costs remaining in its ending inventory to calculate its total ending inventory of $3,300,000. ...he balance of J's additional section 263A costs incurred during 1994, $700,000, ($1,000,000 less $300,000) is taken into account in 1994 as part of J's ...st of goods sold.

Example 2—LIFO inventory method (i) Taxpayer K uses a dollar-value LIFO inventory method. K's beginning inventory for 1994 is $2,500,000 consisting of $2,000,000 of section 471 costs and $500,000 of additional section 263A costs). During 1994, K incurs $10,000,000 of section 471 costs and ...,000,000 of additional section 263A costs. K's 1994 LIFO increment is $1,000,000 ($3,000,000 of section 471 costs in ending inventory less $2,000,000 ...section 471 costs in beginning inventory).

(ii) To determine the additional section 263A costs allocable to its ending inventory, K multiplies the 10 % absorption ratio ($1,000,000 additional ...tion 263A costs divided by $10,000,000 section 471 costs) by the $1,000,000 LIFO increment. Thus, K's additional section 263A costs allocable to its ...ding inventory are $100,000 ($1,000,000 multiplied by 10 %). This $100,000 is added to the $1,000,000 to determine a total 1994 LIFO increment of ...100,000. K's ending inventory is $3,600,000 (its beginning inventory of $2,500,000 plus the $1,100,000 increment). The balance of K's additional ...tion 263A costs incurred during 1994, $900,000 ($1,000,000 less $100,000), is taken into account in 1994 as part of K's cost of goods sold.

(iii) In 1995, K sells one-half of the inventory in its 1994 LIFO increment. K must include in its cost of goods sold for 1995 the amount of additional ...tion 263A costs relating to this inventory, $50,000 (one-half of the additional section 263A costs capitalized in 1994 ending inventory, or $100,000).

Example 3—LIFO pools (i) Taxpayer L begins its business in 1994 and adopts the LIFO inventory method. During 1994, L incurs $10,000 of section ...1 costs and $1,000 of additional section 263A costs. At the end of 1994, L's ending inventory includes $3,000 of section 471 costs contained in three ...FO pools (X, Y, and Z) as shown below. Under the simplified production method, L computes its absorption ratio and inventory for 1994 as follows:

$$\frac{\text{Additional §263A costs incurred during 1994}}{\text{Section 471 costs incurred during 1994}} = \frac{\$1,000}{\$10,000} = 10\%$$

1994:

	Total	*X*	*Y*	*Z*
Ending section 471 costs	$3,000	$1,600	$600	$800
Additional section 263A costs (10%)	300	160	60	80
1994 ending inventory	$3,300	$1,760	$660	$880

(ii) During 1995, L incurs $2,000 of section 471 costs as shown below and $400 of additional section 263A costs. Moreover, L sells goods from pools X, Y, and Z having a total cost of $1,000. L computes its absorption ratio and inventory for 1995:

$$\frac{\text{Additional §263A costs incurred during 1995}}{\text{Section 471 costs incurred during 1995}} = \frac{\$400}{\$2,000} = 20\%$$

1995:

	Total	*X*	*Y*	*Z*
Beginning section 471 costs	$3,000	$1,600	$600	$800
1995 section 471 costs	2,000	1,500	300	200
Section 471 cost of goods sold	(1,000)	(300)	(300)	(400)
1995 ending Section 471 costs	$4,000	$2,800	$600	$600
Consisting of:				
1994 layer	$2,800	$1,600	$600	$600
1995 layer	1,200	1,200	—	—
	$4,000	$2,800	$600	$600
Additional section 263A costs:				
1994 (10%)	$280	$160	$60	$60
1995 (20%)	240	240	—	—
	$520	$400	$60	$60
1995 ending inventory	$4,520	$3,200	$660	$660

(iii) In 1995, L experiences a $200 decrement in pool Z. Thus, L must charge the additional section 263A costs incurred in prior years applicable to the decrement to 1995's cost of goods sold. To do so, L determines a ratio by dividing the decrement by the section 471 costs in the 1994 layer ($200 divided by $800, or 25%). L then multiplies this ratio (25%) by the additional section 263A costs in the 1994 layer ($80) to determine the additional section 263A costs applicable to the decrement ($20). Therefore, $20 is taken into account by L in 1995 as part of its cost of goods sold ($80 multiplied by 25 %).

(4) *Simplified production method with historic absorption ratio election*—(i) *In general.* This paragraph (b)(4) generally permits producers using the simplified production method to elect a historic absorption ratio in determining additional section 263A costs allocable to eligible property remaining on hand at the close of their taxable years. Except as provided in paragraph (b)(4)(v) of this section, a taxpayer may only make a historic absorption ratio election if it has used the simplified production method for three or more consecutive taxable years immediately prior to the year of election and has capitalized additional section 263A costs using an actual absorption ratio (as defined under paragraph (b)(3)(ii) of this section) for its three most recent consecutive taxable years. This method is not available to a taxpayer that is deemed to have zero additional section 263A costs under paragraph (b)(3)(iv) of this section. The historic absorption ratio is used in lieu of an actual absorption ratio computed under paragraph (b)(3)(ii) of this section and is based on costs capitalized by a taxpayer during its test period. If elected, the historic absorption ratio must be used for each taxable year within the qualifying period described in paragraph (b)(4)(ii)(C) of this section.

(ii) *Operating rules and definitions*—(A) *Historic absorption ratio.* (*1*) The historic absorption ratio is equal to the following ratio:

$$\frac{\text{Add'l section 263A costs incurred during the test period}}{\text{Section 471 costs incurred during the test period.}}$$

(*2*) Additional section 263A costs incurred during the test period are defined as the additional section 263A costs described in §1.263A–1(d)(3) that the taxpayer incurs during the test period described in paragraph (b)(4)(ii)(B) of this section.

(*3*) Section 471 costs incurred during the test period mean the section 471 costs described in §1.263A–1(d)(2) that the taxpayer incurs during the test period described in paragraph (b)(4)(ii)(B) of this section.

(B) *Test period*—(*1*) *In general.* The test period is generally the three taxable-year period immediately prior to the taxable year that the historic absorption ratio is elected.

(*2*) *Updated test period.* The test period begins again with the beginning of the first taxable year after the close of a qualifying period. This new test period, the updated test period, is the three taxable-year period beginning

with the first taxable year after the close of the qualifying period as defined in paragraph (b)(4)(ii)(C) of this section.

(C) Qualifying period—(1) In general. A qualifying period includes each of the first five taxable years beginning with the first taxable year after a test period (or an updated test period).

(2) *Extension of qualifying period.* In the first taxable year following the close of each qualifying period, (*e.g.*, the sixth taxable year following the test period), the taxpayer must compute the actual absorption ratio under the simplified production method. If the actual absorption ratio computed for this taxable year (the recomputation year) is within one-half of one percentage point (plus or minus) of the historic absorption ratio used in determining capitalizable costs for the qualifying period (*i.e.*, the previous five taxable years), the qualifying period is extended to include the recomputation year and the following five taxable years, and the taxpayer must continue to use the historic absorption ratio throughout the extended qualifying period. If, however, the actual absorption ratio computed for the recomputation year is not within one-half of one percentage point (plus or minus) of the historic absorption ratio, the taxpayer must use actual absorption ratios beginning with the recomputation year under the simplified production method and throughout the updated test period. The taxpayer must resume using the historic absorption ratio (determined with reference to the updated test period) in the third taxable year following the recomputation year.

(iii) *Method of accounting*—(A) *Adoption and use.* The election to use the historic absorption ratio is a method of accounting. A taxpayer using the simplified production method may elect the historic absorption ratio in any taxable year if permitted under this paragraph (b)(4), provided the taxpayer has not obtained the Commissioner's consent to revoke the historic absorption ratio election within its prior six taxable years. The election is to be effected on a cut-off basis, and thus, no adjustment under section 481(a) is required or permitted. The use of a historic absorption ratio has no effect on other methods of accounting adopted by the taxpayer and used in conjunction with the simplified production method in determining its section 263A costs. Accordingly, in computing its actual absorption ratios, the taxpayer must use the same methods of accounting used in computing its historic absorption ratio during its most recent test period unless the taxpayer obtains the consent of the Commissioner. Finally, for purposes of this paragraph (b)(4)(iii), the recomputation of the historic absorption ratio during an updated test period and the change from a historic absorption ratio to an actual absorption ratio by reason of the requirements of this paragraph (b)(4) are not considered changes in methods of accounting under section 446(e) and, thus, do not require the consent of the Commissioner or any adjustments under section 481(a).

(B) *Revocation of election.* A taxpayer may only revoke its election to use the historic absorption ratio with the consent of the Commissioner in a manner prescribed under section 446(e) and the regulations thereunder. Consent to the change for any taxable year that is included in the qualifying period (or an extended qualifying period) will be granted only upon a showing of unusual circumstances.

(iv) *Reporting and recordkeeping requirements*—(A) *Reporting.* A taxpayer making an election under this paragraph (b)(4) must attach a statement to its federal income tax return for the taxable year in which the election is made showing the actual absorption ratios determined under the simplified production method during its first test period. This statement must disclose the historic absorption ratio to be used by the taxpayer during its qualifying period. A similar statement must be attached to the federal income tax return for the first taxable year within any subsequent qualifying period (*i.e.*, after an updated test period).

(B) *Recordkeeping.* A taxpayer must maintain all appropriate records and details supporting the historic absorption ratio until the expiration of the statute of limitations for the last year for which the taxpayer applied the particular historic absorption ratio in determining additional section 263A costs capitalized to eligible property.

(v) *Transition rules.* Taxpayers will be permitted to elect a historic absorption ratio in their first, second, or third taxable year beginning after December 31, 1993, under such terms and conditions as may be prescribed by the Commissioner. Taxpayers are eligible to make an election under these transition rules whether or not they previously used the simplified production method. A taxpayer making such an election must recompute (or compute) its additional section 263A costs, and thus, its historic absorption ratio for its first test period as if the rules prescribed in this section and §§1.263A–1 and 1.263A–3 had applied throughout the test period.

(vi) *Example.* The provisions of this paragraph (b)(4) are illustrated by the following example:

Example. (i) Taxpayer M uses the FIFO method of accounting for inventories and for 1994 elects to use the historic absorption ratio with the simplified production method. After recomputing its additional section 263A costs in accordance with the transition rules of paragraph (b)(4)(v) of this section, M identifies the following costs incurred during the test period:

1991:		
Add'l section 263A costs	– $100	Section 471 costs – $3,000
1992:		
Add'l section 263A costs	– 200	Section 471 costs – 4,000
1993:		
Add'l section 263A costs	– 300	Section 471 costs – 5,000

(ii) Therefore, M computes a 5% historic absorption ratio determined as follows:

$$\text{Historic absorption ratio} = \frac{\$100 + 200 + 300}{\$3,000 + 4,000 + 5,000} = \frac{\$600}{\$12,000} = 5\%$$

(iii) In 1994, M incurs $10,000 of section 471 costs of which $3,000 remain in inventory at the end of the year. Under the simplified production method using a historic absorption ratio, M determines the additional section 263A costs allocable to its ending inventory by multiplying its historic absorption ratio (5%) by the section 471 costs remaining in its ending inventory as follows:

Add'l section 263A costs = 5% × $3,000 = $150

(iv) To determine its ending inventory under section 263A, M adds the additional section 263A costs allocable to ending inventory to its section 471 costs remaining in ending inventory ($3,150 = $150 + $3,000). The balance of M's additional section 263A costs incurred during 1994 is taken into account in 1994 as part of M's cost of goods sold.

(v) M's qualifying period ends with the close of its 1998 taxable year. Therefore, 1999 is a recomputation year in which M must compute its actual absorption ratio. M determines its actual absorption ratio for 1999 to be 5.25% and compares that ratio to its historic absorption ratio (5.0%). Therefore, M must continue to use its historic absorption ratio of 5.0% throughout an extended qualifying period, 1999 through 2004 (the recomputation year and the following five taxable years).

(vi) If, instead, M's actual absorption ratio for 1999 were not between 4.5% and 5.5%, M's qualifying period would end and M would be required to compute a new historic absorption ratio with reference to an updated test period of 1999, 2000, and 2001. Once M's historic absorption ratio is determined for the updated test period, it would be used for a new qualifying period beginning in 2002.

(c) ***Additional simplified methods for producers.*** **The Commissioner** may prescribe **additional elective simplified methods by revenue ruling or** revenue **procedure.**

(d) *Cross reference.* **See §1.600–1(a)** regarding the duty of taxpayers to keep **such records as are sufficient to establish the amount of gross income, deductions,** etc.

§1.263A–3 Rules relating to property acquired for resale.

(a) *Capitalization rules for property acquired for resale*—(1) *In general.* Section 263A applies to real property and personal property described in section 1221(1) acquired for resale by a retailer, wholesaler, or other taxpayer (reseller). However, section 263A does not apply to personal property described in section 1221(1) acquired for resale by a reseller whose average annual gross receipts for the three previous taxable years do not exceed $10,000,000 (small reseller). For this purpose, personal property includes **both tangible and intangible property.** Property acquired for resale includes stock in trade of the taxpayer or other property which is includible in the taxpayer's inventory if on hand at the close of the taxable year, and property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business. See, however, §1.263A–1(b)(11) for an exception for certain *de minimis* property provided to customers incident to the provision of services.

(2) *Resellers with production activities*—(i) *In general.* Generally, a taxpayer must capitalize all direct costs and certain indirect costs associated with real property and tangible personal property it produces. See §1.263A–2(a). Thus, except as provided in paragraphs (a)(2)(ii) and (3) of this section, a reseller, including a small reseller, that also produces property must capitalize the additional section 263A costs associated with any property it produces.

(ii) *Exception for small resellers.* Under this paragraph (a)(2)(ii), a small reseller is not required to capitalize additional section 263A costs associated with any personal property that is produced incident to its resale activities, provided the production activities are *de minimis* (within the meaning of paragraph (a)(2)(iii) of this section).

(iii) *De minimis production activities*—(A) *In general.* (*1*) In determining whether a taxpayer's production **activities are *de minimis*, all facts and circumstances must be considered. For example, the taxpayer must consider the volume of the production activities in its trade or business. Production activities are presumed *de minimis* if—**

(*i*) The gross receipts from the sale of the property produced by the reseller are less than 10 percent of the total gross receipts of the trade or business; and

(*ii*) The labor costs allocable to the trade or business' production activities are less than 10 percent of the reseller's total labor costs allocable to its trade or business.

(*2*) For purposes of this *de minimis* presumption, gross receipts has the same definition as provided in paragraph (b) of this section except that gross receipts are measured at the **trade-or-business level rather than at** the single-employer level.

(B) *Example.* The application of this paragraph (a)(2) may be illustrated by the following example:

Example—Small reseller with de minimis production activities. Taxpayer N is a small reseller in the retail grocery business whose average annual gross receipts for the three previous taxable years are less than $10,000,000. N's grocery stores typically contain bakeries where customers may purchase baked goods produced by N. N's gross receipts from its bakeries are 5% of the entire grocery business. N's labor costs from its bakeries are 3% of its total labor costs allocable to the entire grocery business. Because both ratios are less than 10%, N's production activities are *de minimis*. Further, because N's production activities are incident to its resale activities, N is not required to capitalize any additional section 263A costs associated with its produced property.

(3) *Resellers with property produced under contract.* Generally, property produced for a taxpayer under a contract (within the meaning of §1.263A–2(a)(1)(ii)(B)(2)) is treated as property produced by the taxpayer. See §1.263A–2(a)(1)(ii)(B). However, a small reseller is not required to capitalize additional section 263A costs to personal property produced for it under contract with an unrelated person if the contract is entered into incident to the resale activities of the small reseller and the property is sold to its customers. For purposes of this paragraph, persons are related if they are described in section 267(b) or 707(b).

(4) ***Use of the simplified resale method*****—(i)** ***In general.*** **Except as provided in paragraphs (a)(4)(ii) and (iii) of this section, a taxpayer may elect the simplified production method (as described in §1.263A–2(b)) but may not elect the simplified resale method** (as described in paragraph (d) of this section) if the taxpayer is engaged in both production and resale activities with respect to the items of eligible property listed in §1.263A–2(b)(2).

(ii) *Resellers with de minimis production activities.* A reseller otherwise permitted to use the simplified resale method in paragraph (d) of this section may use the simplified resale method if its production activities with respect to the items of eligible property listed in §1.263A–2(b)(2) are *de minimis* (within the meaning of paragraph (a)(2)(iii) of **this section) and incident to its resale** of personal property described in section 1221(1).

(iii) *Resellers with property produced under a contract.* A reseller

herwise permitted to use the simplified resale method in paragraph (d) of this section may use the simplified resale method even though it has personal property produced for it (*e.g.*, private label goods) under a contract with an unrelated person if the contract is entered into incident to its resale activities and the property is sold to its customers. For purposes of this paragraph (a)(4)(iii), persons are related if they are described in section 267(b) or 707(b).

(iv) *Application of simplified resale method.* A taxpayer that uses the simplified resale method and has *de minimis* production activities incident to its resale activities or property produced under contract must capitalize all costs allocable to eligible property produced using the simplified resale method.

(b) *Gross receipts exception for small resellers*—(1) *In general.* Section 263A does not apply to any personal property acquired for resale during any taxable year if the taxpayer's (or its predecessors') average annual gross receipts for the three previous taxable years (test period) do not exceed $10,000,000. However, taxpayers that acquire real property for resale are subject to section 263A with respect to all property regardless of their gross receipts. See section 263A(b)(2)(B).

(ii) *Test period for new taxpayers.* For purposes of applying this exception, if a taxpayer has been in existence for less than three taxable years, the taxpayer determines its average annual gross receipts for the number of taxable years (including short taxable years) that the taxpayer (or its predecessor) has been in existence.

(iii) *Treatment of short taxable year.* In the case of a short taxable year, the taxpayer's gross receipts are annualized by—

(A) Multiplying the gross receipts of the short taxable year by 12; and

(B) Dividing the product determined in paragraph (b)(1)(ii)(A) of this section by the number of months in the short taxable year.

(2) *Definition of gross receipts*—(i) *In general.* Gross receipts are the total amount, as determined under the taxpayer's method of accounting, derived from all of the taxpayer's trades or businesses (*e.g.*, revenues derived from the sale of inventory before reduction for cost of goods sold).

(ii) *Amounts excluded.* For purposes of this paragraph (b), gross receipts do not include amounts representing—

(A) Returns or allowances;

(B) Interest, dividends, rents, royalties, or annuities, not derived in the ordinary course of a trade or business;

(C) Receipts from the sale or exchange of capital assets, as defined in section 1221;

(D) Repayments of loans or similar instruments (*e.g.*, a repayment of the principal amount of a loan held by a commercial lender);

(E) Receipts from a sale or exchange not in the ordinary course of business, such as the sale of an entire trade or business or the sale of property used in a trade or business as defined under section 1221(2); and

(F) Receipts from any activity other than a trade or business or an activity engaged in for profit.

(3) *Aggregation of gross receipts*—(i) *In general.* In determining gross receipts, all persons treated as a single employer under section 52(a) or (b), section 414(m), or any regulation prescribed under section 414 (or persons that would be treated as a single employer under any of these provisions if they had employees) shall be treated as one taxpayer. The gross receipts of a single employer (or the group) are determined by aggregating the gross receipts of all persons (or the members) of the group, excluding any gross receipts attributable to transactions occurring between group members.

(ii) *Single employer defined.* A controlled group, which is treated as a single employer under section 52(a), includes members of a controlled group within the meaning of section 1563(a), regardless of whether such members would be treated as component members of such group under section 1563(b). (See §1.52–1(c).) Thus, for example, the gross receipts of a franchised corporation that is treated as an excluded member for purposes of section 1563(b) are included in the single employer's gross receipts under this aggregation rule, if such corporation and the taxpayer were members of the same controlled group under section 1563(a).

(iii) *Gross receipts of a single employer.* The gross receipts of a single employer for the test period include the gross receipts of all group members (or their predecessors) that are members of the group as of the first day of the taxable year in issue, regardless of whether such persons were members of the group for any of the three preceding taxable years. The gross receipts of the single employer for the test period do not, however, include the gross receipts of any member that was a group member (including any predecessor) for any or all of the three preceding taxable years, and is no longer a group member as of the first day of the taxable year in issue. Any group member that has a taxable year of less than 12 months must annualize its gross receipts in accordance with paragraph (b)(1)(ii) of this section.

(iv) *Examples.* The provisions of this paragraph (b)(3) are illustrated by the following examples:

Example 1. Subsidiary acquired during the taxable year. A parent corporation, (P), has owned 100% of the stock of another corporation, (S1), continually since 1989. P and S1 are calendar year taxpayers. S1 acquires property for resale. On January 1, 1994, P acquires 100% of the stock of another calendar year corporation (S2). In determining whether S1's resale activities are subject to the provisions of section 263A for 1994, the gross receipts of P, S1, and S2 for 1991, 1992, and 1993 are aggregated, excluding the gross receipts, if any, attributable to transactions occurring between the three corporations.

Example 2. Subsidiary sold during the taxable year. Since 1989, a parent corporation, (P), has continually owned 100% of the stock of two other corporations, (S1) and (S2). The three corporations are calendar year taxpayers. S1 acquires property for resale. On December 31, 1993, P sells all of its stock in S2. In determining whether S1's resale activities are subject to the provisions of section 263A for 1994, only the gross receipts of P and S1 for 1991, 1992, and 1993 must be aggregated, excluding the gross receipts, if any, attributable to transactions occurring between the two corporations.

(c) *Purchasing, handling, and storage costs*—(1) *In general.* Generally, §1.263A–1(e) describes the types of costs that must be capitalized by taxpayers. Resellers must capitalize the acquisition cost of property acquired for resale, as well as indirect costs described in §1.263A–1(e)(3), which are properly allocable to property acquired for resale. The indirect costs most often incurred by resellers are purchasing, handling, and storage costs. This paragraph (c) provides additional guidance regarding each of these categories of costs. As provided in §1.263A–1(e), this paragraph (c) also applies to producers incurring purchasing, handling, and storage costs.

(2) *Costs attributable to purchasing, handling, and storage.* The costs attributable to purchasing, handling, and storage activities generally consist of direct and indirect labor costs (including the costs of pension plans and other fringe benefits); occupancy expenses including rent, depreciation, insurance, security, taxes, utilities and maintenance; materials and supplies; rent, maintenance, depreciation, and insurance of vehicles and equipment; tools; telephone; travel; and the general and administrative costs that directly benefit or are incurred by reason of the taxpayer's activities.

(3) *Purchasing costs*—(i) *In general.* Purchasing costs are costs associated with operating a purchasing department or office within a trade or business, including personnel costs (*e.g.*, of buyers, assistant buyers, and clerical workers), relating to—

(A) The selection of merchandise;

(B) The maintenance of stock assortment and volume;

(C) The placement of purchase orders;

(D) The establishment and maintenance of vendor contacts; and

(E) The comparison and testing of merchandise.

(ii) *Determination of whether personnel are engaged in purchasing activities.* The determination of whether a person is engaged in purchasing activities is based upon the activities performed by that person and not upon the person's title or job classification. Thus, for example, although an employee's job function may be described in such a way as to indicate activities outside the area of purchasing (*e.g.*, a marketing representative), such activities must be analyzed on the basis of the activities performed by that employee. If a person performs both purchasing and non-purchasing activities, the taxpayer must reasonably allocate the person's labor costs between these activities. For example, a reasonable allocation is one based on the amount of time the person spends on each activity.

(A) *⅓-⅔ rule for allocating labor costs.* A taxpayer may elect the ⅓-⅔ rule for allocating labor costs of persons performing both purchasing and non-purchasing activities. If elected, the taxpayer must allocate the labor costs of all such persons using the ⅓-⅔ rule. Under this rule—

(*1*) If less than one-third of a person's activities are related to purchasing, none of that person's labor costs are allocated to purchasing;

(*2*) If more than two-thirds of a person's activities are related to purchasing, all of that person's labor costs are allocated to purchasing; and

(*3*) In all other cases, the taxpayer must reasonably allocate labor costs between purchasing and non-purchasing activities.

(B) *Example.* The application of paragraph (c)(3)(ii)(A) of this section may be illustrated by the following example:

Example. Taxpayer O is a reseller that employs three persons, A, B, and C, who perform both purchasing and non-purchasing activities. These persons spend the following time performing purchasing activities: A–25%; B–70%; and C–50%. Under the ⅓-⅔ rule, Taxpayer O treats none of A's labor costs as purchasing costs, all of B's labor costs as purchasing costs, and Taxpayer O allocates 50% of C's labor costs as purchasing costs.

(4) *Handling costs*—(i) *In general.* Handling costs include costs attributable to processing, assembling, repackaging, transporting, and other similar activities with respect to property acquired for resale, provided the activities do not come within the meaning of the term produce as defined in §1.263A–2(a)(1). Handling costs are generally required to be capitalized under section 263A. Under this paragraph (c)(4)(i), however, handling costs incurred at a retail sales facility (as defined in paragraph (c)(5)(ii)(B) of this section) with respect to property sold to retail customers at the facility are not required to be capitalized. Thus, for example, handling costs incurred at a retail sales facility to unload, unpack, mark, and tag goods sold to retail customers at the facility are not required to be capitalized. In addition, handling costs incurred at a dual-function storage facility (as defined in paragraph (c)(5)(ii)(G) of this section) with respect to property sold to customers from the facility are not required to be capitalized to the extent that the costs are incurred with respect to property sold in on-site sales. Handling costs attributable to property sold to customers from a dual-function storage facility in on-site sales are determined by applying the ratio in paragraph (c)(5)(iii)(B) of this section.

(ii) *Processing costs.* Processing costs are the costs a reseller incurs in making minor changes or alterations to the nature or form of a product acquired for resale. Minor changes to a product include, for example, monogramming a sweater, altering a pair of pants, and other similar activities.

(iii) *Assembling costs.* Generally, assembling costs are costs associated with incidental activities that are necessary in readying property for resale (*e.g.*, attaching wheels and handlebars to a bicycle acquired for resale).

(iv) *Repackaging costs.* Repackaging costs are the costs a taxpayer incurs to package property for sale to its customers.

(v) *Transportation costs.* Generally, transportation costs are the costs a taxpayer incurs moving or shipping property acquired for resale. These costs include the cost of dispatching trucks; loading and unloading shipments; and sorting, tagging, and marking property. Transportation costs may consist of depreciation on trucks and equipment and the costs of fuel, insurance, labor, and similar costs. Generally, transportation costs required to be capitalized include costs incurred in transporting property—

(A) From the vendor to the taxpayer;

(B) From one of the taxpayer's storage facilities to another of its storage facilities;

(C) From the taxpayer's storage facility to its retail sales facility;

(D) From the taxpayer's retail sales facility to its storage facility; and

(E) From one of the taxpayer's retail sales facilities to another of its retail sales facilities.

(vi) *Costs not considered handling costs*—(A) *Distribution costs.* [Reserved]

(B) *Delivery of custom-ordered items.* [Reserved]

(C) *Repackaging after sale occurs.* [Reserved]

(5) *Storage costs*—(i) *In general.* Generally, storage costs are capitalized under section 263A to the extent they are attributable to the operation of an off-site storage or warehousing facility (an off-site storage facility). However, storage costs attributable to the operation of an on-site storage facility (as defined in paragraph (c)(5)(ii)(A) of this section) are not required to be capitalized under section 263A. Storage costs attributable to a dual-function storage facility (as defined in paragraph

(c)(5)(ii)(G) of this section) must be capitalized to the extent that the facility's costs are allocable to off-site storage.

(ii) *Definitions*—(A) *On-site storage facility.* An on-site storage facility is defined as a storage or warehousing facility that is physically attached to, and an integral part of, a retail sales facility.

(B) *Retail sales facility.* (*1*) A retail sales facility is defined as a facility where a taxpayer sells merchandise exclusively to retail customers in on-site sales. For this purpose, a retail sales facility includes those portions of any specific retail site—

(*i*) Which are customarily associated with and are an integral part of the operations of that retail site;

(*ii*) Which are generally open each business day exclusively to retail customers;

(*iii*) On or in which retail customers normally and routinely shop to select specific items of merchandise; and

(*iv*) Which are adjacent to or in immediate proximity to other portions of the specific retail site.

(2) Thus, for example, two lots of an automobile dealership physically separated by an alley or an access road would generally be considered one retail sales facility, provided customers routinely shop on both of the lots to select the specific automobiles that they wish to acquire.

(C) *An integral part of a retail sales facility.* A storage facility is considered an integral part of a retail sales facility when the storage facility is an essential and indispensable part of the retail sales facility. For example, if the storage facility is used exclusively for filling orders or completing sales at the retail sales facility, the storage facility is an integral part of the retail sales facility.

(D) *On-site sales.* On-site sales are defined as sales made to retail customers physically present at a facility. For example, mail order and catalog sales are made to customers not physically present at the facility, and thus, are not on-site sales.

(E) *Retail customer*—(*1*) *In general.* A retail customer is defined as the final purchaser of the merchandise. A retail customer does not include a person who resells the merchandise to others, such as a contractor or manufacturer that incorporates the merchandise into another product for sale to customers.

(2) *Certain non-retail customers treated as retail customers.* For purposes of this section, a non-retail customer is treated as a retail customer with respect to a particular facility if the following requirements are satisfied—

(*i*) The non-retail customer purchases goods under the same terms and conditions as are available to retail customers (*e.g.*, no special discounts);

(*ii*) The non-retail customer purchases goods in the same manner as a retail customer (*e.g.*, the non-retail customer may not place orders in advance and must come to the facility to examine and select goods);

(*iii*) Retail customers shop at the facility on a routine basis (*i.e.*, on most business days), and no special days or hours are reserved for non-retail customers; and

(*iv*) More than 50 percent of the gross sales of the facility are made to retail customers.

(F) *Off-site storage facility.* An off-site storage facility is defined as a storage facility that is not an on-site storage facility.

(G) *Dual-function storage facility.* A dual-function storage facility is defined as a storage facility that serves as both an off-site storage facility and an on-site storage facility. For example, a dual-function storage facility would include a regional warehouse that serves the taxpayer's separate retail sales outlets and also contains a sales outlet therein. A dual-function storage facility also includes any facility where sales are made to retail customers in on-site sales and to—

(*1*) Retail customers in sales that are not on-site sales; or

(2) Other customers.

(iii) *Treatment of storage costs incurred at a dual-function storage facility*—(A) *In general.* Storage costs associated with a dual-function storage facility must be allocated between the off-site storage function and the on-site storage function. To the extent that the dual-function storage facility's storage costs are allocable to the off-site storage function, they must be capitalized. To the extent that the dual-function storage facility's storage costs are allocable to the on-site storage function, they are not required to be capitalized.

(B) *Dual-function storage facility allocation ratio*—(*1*) *In general.* Storage costs associated with a dual-function storage facility must be allocated between the off-site storage function and the on-site storage function using the ratio of—

(*i*) Gross on-site sales of the facility (*i.e.*, gross sales of the facility made to retail customers visiting the premises in person and purchasing merchandise stored therein); to

(*ii*) Total gross sales of the facility. For this purpose, the total gross sales of the facility include the value of items shipped to other facilities of the taxpayer.

(2) *Illustration of ratio allocation.* For example, if a dual-function storage facility's on-site sales are 40 percent of the total gross sales of the facility, then 40 percent of the facility's storage costs are allocable to the on-site storage function and are not required to be capitalized under section 263A.

(*3*) *Appropriate adjustments for other uses of a dual-function storage facility.* Prior to computing the allocation ratio in paragraph (c)(5)(iii)(B) of this section, a taxpayer must apply the principles of paragraph (c)(5)(iv) of this section in determining the portion of the facility that is a dual-function storage facility (and the costs attributable to such portion).

(C) *De minimis 90-10 rule for dual-function storage facilities.* If 90 percent or more of the costs of a facility are attributable to the on-site storage function, the entire storage facility is deemed to be an on-site storage facility. In contrast, if 10 percent or less of the costs of a storage facility are attributable to the on-site storage function, the entire storage facility is deemed to be an off-site storage facility.

(iv) *Costs not attributable to an off-site storage facility.* To the extent that costs incurred at an off-site storage facility are not properly allocable to the taxpayer's storage function, the costs are not accounted for as off-site storage costs. For example, if a taxpayer has an office attached to its off-site storage facility where work unrelated to the storage function is performed, such as a sales office, costs associated with this office are not off-site storage costs. However, if a taxpayer uses a portion of an off-site storage facility in a manner related to the storage function, for example, to store equipment or sup-

plies that are not offered for sale to customers, costs associated with this portion of the facility are off-site storage costs.

(v) *Examples.* The provisions of this paragraph (c)(5) are illustrated by the following examples:

Example 1. Catalog or mail order center. Taxpayer P operates a mail order catalog business. As part of its business, P stores merchandise for shipment to customers who purchase the merchandise through orders placed by telephone or mail. P's storage facility is not an on-site storage facility because no on-site sales are made at the facility.

Example 2. Pooled-stock facility. Taxpayer Q maintains a pooled-stock facility, which functions as a back-up regional storage facility for Q's retail sales outlets in the nearby area. Q's pooled stock facility is an off-site storage facility because it is neither physically attached to nor an integral part of a retail sales facility.

Example 3. Wholesale warehouse. Taxpayer R operates a wholesale warehouse where wholesale sales are made to customers physically present at the facility. R's customers resell the goods they purchase from R to final retail customers. Because no retail sales are conducted at the facility, all storage costs attributable to R's wholesale warehouse must be capitalized.

(d) *Simplified resale method*—(1) *Introduction.* This paragraph (d) provides a simplified method for determining the additional section 263A costs properly allocable to property acquired for resale and other eligible property on hand at the end of the taxable year.

(2) *Eligible property.* Generally, the simplified resale method is only available to a trade or business exclusively engaged in resale activities. However, certain resellers with property produced as a result of *de minimis* production activities or property produced under contract may elect the simplified resale method, as described in paragraph (a)(4) of this section. Eligible property for purposes of the simplified resale method, therefore, includes any real or personal property described in section 1221(1) that is acquired for resale and any eligible property (within the meaning of §1.263A–2(b)(2)) that is described in paragraph (a)(4) of this section.

(3) *Simplified resale method without historic absorption ratio election*—(i) *General allocation formula*—(A) *In general.* Under the simplified resale method, the additional section 263A costs allocable to eligible property remaining on hand at the close of the taxable year are computed as follows:

Combined absorption ratio × Section 471 costs remaining on hand at year end.

(B) *Effect of allocation.* The resulting product under the general allocation formula is the additional section 263A costs that are added to the taxpayer's ending section 471 costs to determine the section 263A costs that are capitalized.

(C) *Definitions*—(*1*) *Combined absorption ratio.* The combined absorption ratio is defined as the sum of the storage and handling costs absorption ratio as defined in paragraph (d)(3)(i)(D) of this section and the purchasing costs absorption ratio as defined in paragraph (d)(3)(i)(E) of this section.

(*2*) *Section 471 costs remaining on hand at year end.* Section 471 costs remaining on hand at year end mean the section 471 costs, as defined in §1.263A–1(d)(2), that the taxpayer incurs during its current taxable year, which remain in its ending inventory or are otherwise on hand at year end. For LIFO inventories of a taxpayer, the section 471 costs remaining on hand at year end means the increment, if any, for the current year stated in terms of section 471 costs. See paragraph (d)(3)(ii) of this section for special rules applicable to LIFO taxpayers.

Except as otherwise provided in this section or in §1.263A–1 or 1.263A–2, additional section 263A costs that are allocated to inventories on hand at the close of the taxable year under the simplified resale method of this paragraph (d) are treated as inventory costs for all purposes of the Internal Revenue Code.

(D) *Storage and handling costs absorption ratio.*

(*1*) Under the simplified resale method, the storage and handling costs absorption ratio is determined as follows:

Current year's storage and handling costs
Beginning inventory plus current year's purchases.

(*2*) Current year's storage and handling costs are defined as the total storage costs plus the total handling costs incurred during the taxable year that relate to the taxpayer's property acquired for resale and other eligible property. See paragraph (c) of this section, which discusses storage and handling costs. Storage and handling costs must include the amount of allocable mixed service costs as described in paragraph (d)(3)(i)(F) of this section. Beginning inventory in the denominator of the storage and handling costs absorption ratio refers to the section 471 costs of any property acquired for resale or other eligible property held by the taxpayer as of the beginning of the taxable year. Current year's purchases generally mean the taxpayer's section 471 costs incurred with respect to purchases of property acquired for resale during the current taxable year. In computing the denominator of the storage and handling costs absorption ratio, a taxpayer using a dollar-value LIFO method of accounting, must state beginning inventory amounts using the LIFO carrying value of the inventory and not current-year dollars.

(E) *Purchasing costs absorption ratio.* (*1*) Under the simplified resale method, the purchasing costs absorption ratio is determined as follows:

Current year's purchasing costs
Current year's purchases.

(*2*) Current year's purchasing costs are defined as the total purchasing costs incurred during the taxable year that relate to the taxpayer's property acquired for resale and eligible property. See paragraph (c)(3) of this section, which discusses purchasing costs. Purchasing costs must include the amount of allocable mixed service costs determined in paragraph (d)(3)(i)(F) of this section. Current year's

purchases generally mean the taxpayer's section 471 costs incurred with respect to purchases of property acquired for resale during the current taxable year.

(F) *Allocable mixed service costs.* (*1*) If a taxpayer allocates its mixed service costs to purchasing costs, storage costs, and handling costs using a method described in §1.263A–1(g)(4), the taxpayer is not required to determine its allocable mixed service costs under this paragraph (d)(3)(i)(F). However, if the taxpayer uses the simplified service cost method, the amount of mixed service costs allocated to and included in purchasing costs, storage costs, and handling costs in the absorption ratios in paragraphs (d)(3)(i)(D) and (E) of this section is determined as follows:

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

(*2*) Labor costs allocable to activity are defined as the total labor costs allocable to each particular activity (*i.e.*, purchasing, handling, and storage), excluding labor costs included in mixed service costs. Total labor costs are defined as the total labor costs (excluding labor costs included in mixed service costs) that are incurred in the taxpayer's trade or business during the taxable year. See §1.263A–1(h)(6) for the definition of total mixed service costs.

(ii) *LIFO taxpayers electing simplified resale method*—(A) *In general.* Under the simplified resale method, a taxpayer using a LIFO method must calculate a particular year's index (*e.g.*, under §1.472–8(e)) without regard its additional section 263A costs. Similarly, a taxpayer that adjusts current-year costs by applicable indexes to determine whether there has been an inventory increment or decrement in the current year for a particular LIFO pool must disregard the additional section 263A costs in making that determination.

(B) *LIFO increment.* If the taxpayer determines there has been an inventory increment, the taxpayer must state the amount of the increment in current-year dollars (stated in terms of section 471 costs). The taxpayer then multiplies this amount by the combined absorption ratio. The resulting product is the additional section 263A costs that must be added to the taxpayer's increment for the year stated in terms of section 471 costs.

(C) *LIFO decrement.* If the taxpayer determines there has been an inventory decrement, the taxpayer must state the amount of the decrement in dollars applicable to the particular year for which the LIFO layer has been invaded. The additional section 263A costs incurred in prior years that are applicable to the decrement are charged to cost of goods sold. The additional section 263A costs that are applicable to the decrement are determined by multiplying the additional section 263A costs allocated to the layer of the pool in which the decrement occurred by the ratio of the decrement (excluding additional section 263A costs) to the section 471 costs in the layer of that pool.

(iii) *Permissible variations of the simplified resale method.* The following variations of the simplified resale method are permitted:

(A) The exclusion of beginning inventories from the denominator in the storage and handling costs absorption ratio formula in paragraph (d)(3)(i)(D) of this section; or

(B) Multiplication of the storage and handling costs absorption ratio in paragraph (d)(3)(i)(D) of this section by the total of section 471 costs included in a LIFO taxpayer's ending inventory (rather than just the increment, if any, experienced by the LIFO taxpayer during the taxable year) for purposes of determining capitalizable storage and handling costs.

(iv) *Examples.* The provisions of this paragraph (d)(3) are illustrated by the following examples:

Example 1. FIFO inventory method. (i) Taxpayer S uses the FIFO method of accounting for inventories. S's beginning inventory for 1994 (all of which was sold during 1994) was $2,100,000 (consisting of $2,000,000 of section 471 costs and $100,000 of additional section 263A costs). During 1994, S makes purchases of $10,000,000. In addition, S incurs purchasing costs of $460,000, storage costs of $110,000, and handling costs of $90,000. S's purchases (section 471 costs) remaining in ending inventory at the end of 1994 are $3,000,000.

(ii) In 1994, S incurs $400,000 of total mixed service costs and $1,000,000 of total labor costs (excluding labor costs included in mixed service costs). In addition, S incurs the following labor costs (excluding labor costs included in mixed service costs): purchasing—$100,000, storage—$200,000, and handling—$200,000. Accordingly, the following mixed service costs must be included in purchasing costs, storage costs, and handling costs as capitalizable mixed service costs: purchasing—$40,000 ([$100,000 divided by $1,000,000] multiplied by $400,000); storage—$80,000 ([$200,000 divided by $1,000,000] multiplied by $400,000); and handling—$80,000 ([$200,000 divided by $1,000,000] multiplied by $400,000).

(iii) S computes its purchasing costs absorption ratio for 1994 as follows:

$$\frac{\text{1994 purchasing costs}}{\text{1994 purchases}} = \frac{\$460{,}000 + \$40{,}000}{\$10{,}000{,}000}$$

$$= \frac{\$500{,}000}{\$10{,}000{,}000}$$

$$= 5.0\%$$

(iv) S computes its storage and handling costs absorption ratio for 1994 as follows:

$$\frac{\text{Storage and handling costs}}{\text{Beginning inventory plus 1994 purchases}} = \frac{(\$110{,}000+\$80{,}000) + (\$90{,}000+\$80{,}000)}{\$2{,}000{,}000 + \$10{,}000{,}000}$$

$$= \frac{\$190{,}000 + \$170{,}000}{\$12{,}000{,}000}$$

$$= \frac{\$360{,}000}{\$12{,}000{,}000}$$

$$= 3.0\%$$

(v) S's combined absorption ratio is 8.0%, or the sum of the purchasing costs absorption ratio (5.0%) and the storage and handling costs absorption ratio (3.0%). Under the simplified resale method, S determines the additional section 263A costs allocable to its ending inventory by multiplying the combined absorption ratio by its section 471 costs with respect to current year's purchases remaining in ending inventory:

$$\text{Additional §263A costs} = 8.0\% \times \$3{,}000{,}000 = \$240{,}000$$

(vi) S adds this $240,000 to the $3,000,000 of purchases remaining in its ending inventory to determine its total ending FIFO inventory of $3,240,000.

Example 2. LIFO inventory method. (i) Taxpayer T uses a dollar-value LIFO inventory method. T's beginning inventory for 1994 is $2,100,000 (consisting of $2,000,000 of section 471 costs and $100,000 of additional section 263A costs). During 1994, T makes purchases of $10,000,000. In addition, T incurs purchasing costs of $460,000, storage costs of $110,000, and handling costs of $90,000. T's 1994 LIFO increment is $1,000,000 ($3,000,000 of section 471 costs in ending inventory less $2,000,000 of section 471 costs in beginning inventory).

(ii) In 1994, T incurs $400,000 of total mixed service costs and $1,000,000 of total labor costs (excluding labor costs included in mixed service costs). In addition, T incurs the following labor costs (excluding labor costs included in mixed service costs): purchasing—$100,000, storage—$200,000, and handling—$200,000. Accordingly, the following mixed service costs must be included in purchasing costs, storage costs, and handling costs as capitalizable mixed service costs: purchasing—$40,000 ([$100,000 divided by $1,000,000] multiplied by $400,000); storage—$80,000 ([$200,000 divided by $1,000,000] multiplied by $400,000); and handling—$80,000 ([$200,000 divided by $1,000,000] multiplied by $400,000).

(iii) Based on these facts, T determines that it has a combined absorption ratio of 8.0%. To determine the additional section 263A costs allocable to its ending inventory, T multiplies its combined absorption ratio (8.0%) by the $1,000,000 LIFO increment. Thus, T's additional section 263A costs allocable to its ending inventory are $80,000 ($1,000,000 multiplied by 8.0%). This $80,000 is added to the $1,000,000 to determine a total 1994 LIFO increment of $1,080,000. T's ending inventory is $3,180,000 (its beginning inventory of $2,100,000 plus the $1,080,000 increment).

(iv) In 1995, T sells one-half of the inventory in its 1994 LIFO increment. T must include in its cost of goods sold for 1995 the amount of additional section 263A costs relating to this inventory, *i.e.*, one-half of the $80,000 additional section 263A costs capitalized in 1994 ending inventory, or $40,000.

Example 3. LIFO pools. (i) Taxpayer U begins its business in 1994, and adopts the LIFO inventory method. During 1994, U makes purchases of $10,000, and incurs $400 of purchasing costs, $350 of storage costs and $250 of handling costs. U's purchasing costs, storage costs, and handling costs include their proper allocable share of mixed service costs.

(ii) U computes its purchasing costs absorption ratio for 1994, as follows:

$$\frac{\text{1994 purchasing costs}}{\text{1994 purchases}} = \frac{\$400}{\$10{,}000}$$

$$= 4.0\%$$

(iii) U computes its storage and handling costs absorption ratio for 1994, as follows:

$$\frac{\text{1994 storage and handling costs}}{\text{Beginning inventory plus 1994 purchases}} = \frac{\$350 + \$250}{\$0 + \$10{,}000}$$

$$= \frac{\$600}{\$10{,}000}$$

$$= 6.0\%$$

(iv) U's combined absorption ratio is 10%, or the sum of the purchasing costs absorption ratio (4.0%) and the storage and handling costs absorption ratio (6.0%). At the end of 1994, U's ending inventory included $3,000 of current year purchases, contained in three LIFO pools (X, Y, and Z) as shown below. Under the simplified resale method, U computes its ending inventory for 1994 as follows:

1994:

	Total	*X*	*Y*	*Z*
Ending section 471 costs	$3,000	$1,600	$600	$800
Additional section 263A costs (10%)	300	160	60	80
1994 Ending inventory	$3,300	$1,760	$660	$880

(v) During 1995, U makes purchases of $2,000 as shown below, and incurs $200 of purchasing costs, $325 of storage costs and $175 of handling costs. U's purchasing costs, storage costs, and handling costs include their proper share of mixed service costs. Moreover, U sold goods from pools X, Y, and Z having a total cost of $1,000. U computes its ending inventory for 1995 as follows.

(vi) U computes its purchasing costs absorption ratio for 1995:

$$\frac{\text{1995 purchasing costs}}{\text{1995 purchases}} = \frac{\$200}{\$2{,}000} = 10.0\%$$

(vii) U computes its storage and handling costs absorption ratio for 1995:

$$\frac{\text{1995 storage and handling costs}}{\text{Beginning inventory plus 1995 purchases}} = \frac{\$325 + 175}{\$3{,}000 + 2{,}000} = \frac{\$500}{\$5{,}000} = 10.0\%$$

(viii) U's combined absorption ratio is 20.0%, or the sum of the purchasing costs absorption ratio (10.0%) and the storage and handling costs absorption ratio (10.0%).

1995:

	Total	X	Y	Z
Beginning section 471 costs	$5,000	$3,000	$1,000	$1,000
1995 section 471 costs	2,000	1,500	300	200
Section 471 cost of goods sold	(1,000)	(300)	(300)	(400)
1995 Ending Section 471 costs	$4,000	$2,800	$1,000	$600
Consisting of:				
1994 layer	$2,800	$1,600	$600	$600
1995 layer	1,200	1,200	—	—
	$4,000	$2,800	$600	$600
Additional section 263A costs:				
1994 (10%)	$280	$160	$60	$60
1995 (20%)	240	240	—	—
	$520	$400	$60	$60
1995 ending inventory	$4,520	$3,200	$660	$660

(ix) In 1995, U experiences a $200 decrement in Pool Z. Thus, U must charge the additional section 263A costs incurred in prior years applicable to the decrement to 1995's cost of goods sold. To do so, U determines a ratio by dividing the decrement by the section 471 costs in the 1994 layer ($200 divided by $800, or 25%). U then multiplies this ratio (25%) by the additional section 263A costs in the 1994 layer ($80) to determine the additional section 263A costs applicable to the decrement ($20). Therefore, $20 is taken into account by U in 1995 as part of its cost of goods sold ($80 multiplied by 25%).

(4) *Simplified resale method with historic absorption ratio election*—(i) *In general.* This paragraph (d)(4) permits resellers using the simplified resale method to elect a historic absorption ratio in determining additional section 263A costs allocable to eligible property remaining on hand at the close of their taxable years. Except as provided in paragraph (d)(4)(v) of this section, a taxpayer may only make a historic absorption ratio election if it has used the simplified resale method for three or more consecutive taxable years immediately prior to the year of election. The historic absorption ratio is used in lieu of an actual combined absorption ratio computed under paragraph (d)(3)(i)(C)(*1*) of this section and is based on costs capitalized by a taxpayer during its test period. If elected, the historic absorption ratio must be used for the qualifying period described in paragraph (d)(4)(ii)(C) of this section.

(ii) *Operating rules and definitions*—(A) *Historic absorption ratio.* (*1*) The historic absorption ratio is equal to the following ratio:

$$\frac{\text{Add'l section 263A costs incurred during the test period}}{\text{Section 471 costs incurred during the test period.}}$$

(*2*) Additional section 263A costs incurred during the test period are defined as the sum of the products of the combined absorption ratios (defined in paragraph (d)(3)(i)(C)(*1*) of this section) multiplied by a taxpayer's section 471 costs incurred with respect to purchases, for each taxable year of the test period.

(*3*) Section 471 costs incurred during the test period mean the section 471 costs described in §1.263A–1(d)(2) that a taxpayer incurs generally with respect to its purchases during the test period described in paragraph (d)(4)(ii)(B) of this section.

(B) *Test period*—(*1*) *In general.* The test period is generally the three

taxable-year period immediately prior to the taxable year that the historic absorption ratio is elected.

(2) *Updated test period.* The test period begins again with the beginning of the first taxable year after the close of a qualifying period (as defined in paragraph (d)(4)(ii)(C) of this section). This new test period, the updated test period, is the three taxable-year period beginning with the first taxable year after the close of the qualifying period.

(C) *Qualifying period—(1) In general.* A qualifying period includes each of the first five taxable years beginning with the first taxable year after a test period (or updated test period).

(2) *Extension of qualifying period.* In the first taxable year following the close of each qualifying period (*e.g.*, the sixth taxable year following the test period), the taxpayer must compute the actual combined absorption ratio under the simplified resale method. If the actual combined absorption ratio computed for this taxable year (the recomputation year) is within one-half of one percentage point (plus or minus) of the historic absorption ratio used in determining capitalizable costs for the qualifying period (*i.e.*, the previous five taxable years), the qualifying period must be extended to include the recomputation year and the following five taxable years, and the taxpayer must continue to use the historic absorption ratio throughout the extended qualifying period. If, however, the actual combined absorption ratio computed for the recomputation year is not within one-half of one percentage point (plus or minus) of the historic absorption ratio, the taxpayer must use actual combined absorption ratios beginning with the recomputation year under the simplified resale method and throughout the updated test period. The taxpayer must resume using the historic absorption ratio (determined with reference to the updated test period) in the third taxable year following the recomputation year.

(iii) *Method of accounting*—(A) *Adoption and use.* The election to use the historic absorption ratio is a method of accounting. A taxpayer using the simplified resale method may elect the historic absorption ratio in any taxable year if permitted under this paragraph (d)(4), provided the taxpayer has not obtained the Commissioner's consent to revoke the historic absorption ratio election within its prior six taxable years. The election is to be effected on a cut-off basis, and thus, no adjustment under section 481(a) is required or permitted. The use of a historic absorption ratio has no effect on other methods of accounting adopted by the taxpayer and used in conjunction with the simplified resale method in determining its section 263A costs. Accordingly, in computing its actual combined absorption ratios, the taxpayer must use the same methods of accounting used in computing its historic absorption ratio during its most recent test period unless the taxpayer obtains the consent of the Commissioner. Finally, for purposes of this paragraph (d)(4)(iii)(A), the recomputation of the historic absorption ratio during an updated test period and the change from a historic absorption ratio to an actual combined absorption ratio during an updated test period by reason of the requirements of this paragraph (d)(4) are not considered changes in methods of accounting under section 446(e) and, thus, do not require the consent of the Commissioner or any adjustments under section 481(a).

(B) *Revocation of election.* A taxpayer may only revoke its election to use the historic absorption ratio with the consent of the Commissioner in a manner prescribed under section 446(e) and the regulations thereunder. Consent to the change for any taxable year that is included in the qualifying period (or an extended qualifying period) will be granted only upon a showing of unusual circumstances.

(iv) *Reporting and recordkeeping requirements*—(A) *Reporting.* A taxpayer making an election under this paragraph (d)(4) must attach a statement to its federal income tax return for the taxable year in which the election is made showing the actual combined absorption ratios determined under the simplified resale method during its first test period. This statement must disclose the historic absorption ratio to be used by the taxpayer during its qualifying period. A similar statement must be attached to the federal income tax return for the first taxable year within any subsequent qualifying period (*i.e.*, after an updated test period).

(B) *Recordkeeping.* A taxpayer must maintain all appropriate records and details supporting the historic absorption ratio until the expiration of the statute of limitations for the last year for which the taxpayer applied the particular historic absorption ratio in determining additional section 263A costs capitalized to eligible property.

(v) *Transition rules.* Taxpayers will be permitted to elect a historic absorption ratio in their first, second, or third taxable year beginning after December 31, 1993, under such terms and conditions as may be prescribed by the Commissioner. Taxpayers are eligible to make an election under these transition rules whether or not they previously used the simplified resale method. A taxpayer making such an election must recompute (or compute) its additional section 263A costs, and thus, its historic absorption ratio for its first test period as if the rules prescribed in this section and §§1.263A-1 and 1.263A-2 had applied throughout the test period.

(vi) *Example.* The provisions of this paragraph (d)(4) are illustrated by the following example:

Example. (i) Taxpayer V uses the FIFO method of accounting for inventories and in 1994 elects to use the historic absorption ratio with the simplified resale method. After recomputing its additional section 263A costs in accordance with the transition rules of paragraph (d)(4)(v) of this section, V identifies the following costs incurred during the test period:

1991:			
Add'l section 263A costs	– $100	Section 471 costs	– $3,000
1992:			
Add'l section 263A costs	– 200	Section 471 costs	– 4,000
1993:			
Add'l section 263A costs	– 300	Section 471 costs	– 5,000

(ii) Therefore, V computes a 5% historic absorption ratio determined as follows:

$$\text{Historic absorption ratio} = \frac{\$100 + 200 + 300}{\$3,000 + 4,000 + 5,000} = \frac{\$600}{\$12,000} = 5\%$$

(iii) In 1994, V incurs $10,000 of section 471 costs of which $3,000 remain in inventory at the end of the year. Under the simplified resale method using a historic absorption ratio, V determines the additional section 263A costs allocable to its ending inventory by multiplying its historic ratio (5%) by the section 471 costs remaining in its ending inventory:

Add'l section 263A costs = 5% × $3,000 = $150

(iv) To determine its ending inventory under section 263A, V adds the additional section 263A costs allocable to ending inventory to its section 471 costs remaining in ending inventory ($3,150 = $150 + $3,000). The balance of V's additional section 263A costs incurred during 1994 is taken into account in 1994 as part of V's cost of goods sold.

(v) V's qualifying period ends as of the close of its 1998 taxable year. Therefore, 1999 is a recomputation year in which V must compute its actual combined absorption ratio. V determines its actual absorption ratio for 1999 to be 9.25% and compares that ratio to its historic absorption ratio (5.0%). Therefore, V must continue to use its historic absorption ratio of 5.0% throughout an extended qualifying period, 1999 through 2004 (the recomputation year and the following five taxable years).

(vi) If, instead, V's actual combined absorption ratio for 1999 were not between 4.5% and 5.5%, V's qualifying period would end and V would be required to compute a new historic absorption ratio with reference to an updated test period of 1999, 2000, and 2001. Once V's historic absorption ratio is determined for the updated test period, it would be used for a new qualifying period beginning in 2002.

(5) *Additional simplified methods for resellers.* The Commissioner may prescribe additional elective simplified methods by revenue ruling or revenue procedure.

(e) *Cross reference.* See §1.6001–1(a) regarding the duty of taxpayers to keep such records as are sufficient to establish the amount of gross income, deductions, etc.

§1.263A–4 Rules for property produced in a farming trade or business. [Reserved]

§1.263A–5 Exception for qualified creative expenses incurred by certain free-lance authors, photographers, and artists. [Reserved]

§1.263A–6 Rules for foreign persons. [Reserved]

Par. 8. Section 1.446–1 is amended by revising the last sentence of paragraph (c)(1)(ii)(A) to read as follows:

§1.446–1 General rule for methods of accounting.

* * * * * *

(c) ***

(1) ***

(ii) ***

(A) *** As a further example, under section 263 or 263A, a liability that relates to the creation of an asset having a useful life extending substantially beyond the close of the taxable year is taken into account in the taxable year incurred through capitalization (within the meaning of §1.263A–1(c)(3)) and may later affect the computation of taxable income through depreciation or otherwise over a period including subsequent taxable years, in accordance with applicable Internal Revenue Code sections and related guidance.

* * * * * *

Par. 9. Section 1.461–1 is amended by revising the fifth sentence of (a)(2)(i) to read as follows:

§1.461–1 General rule for taxable year of deduction.

(a) ***

(2) *** (i) *** As a further example, under section 263 or 263A, a liability that relates to the creation of an asset having a useful life extending substantially beyond the close of the taxable year is taken into account in the taxable year incurred through capitalization (within the meaning of §1.263A–1(c)(3)), and may later affect the computation of taxable income through depreciation or otherwise over a period including subsequent taxable years, in accordance with applicable Internal Revenue Code sections and guidance published by the Secretary. ***

* * * * * *

Par. 10. Section 1.471–3 is amended by adding a sentence to the end of paragraph (b), and by revising the last sentence of paragraph (c) to read as follows:

§1.471–3 Inventories at cost.

* * * * * *

(b) *** For taxpayers acquiring merchandise for resale that are subject to the provisions of section 263A, see §§1.263A–1 and 1.263A–3 for additional amounts that must be included in inventory costs.

(c) *** See §§1.263A–1 and 1.263A–2 for more specific rules regarding the treatment of production costs.

* * * * * *

Par. 11. Section 1.471–4 is amended by revising paragraph (a); by adding headings for paragraphs (b) and (c), and by adding paragraph (d) to read as follows:

§1.471–4 Inventories at cost or market, whichever is lower.

(a) *In general*—(1) *Market definition.* Under ordinary circumstances and for normal goods in an inventory, *market* means the aggregate of the current bid prices prevailing at the date of the inventory of the basic elements of cost reflected in inventories of goods purchased and on hand, goods in process of manufacture, and finished manufactured goods on hand. The basic elements of cost include direct materials, direct labor, and indirect costs required to be included in inventories by the taxpayer (*e.g.*, under section 263A and its underlying regulations for taxpayers subject to that section). For taxpayers to which section 263A applies, for example, the basic elements of cost must reflect all direct costs and all indirect costs properly allocable to goods on hand at the inventory date at the current bid price of those costs, including but not limited to the cost of purchasing, handling, and storage ac-

tivities conducted by the taxpayer, both prior to and subsequent to acquisition or production of the goods. The determination of the current bid price of the basic elements of costs reflected in goods on hand at the inventory date must be based on the usual volume of particular cost elements purchased (or incurred) by the taxpayer.

(2) *Fixed price contracts.* Paragraph (a)(1) of this section does not apply to any goods on hand or in process of manufacture for delivery upon firm sales contracts (*i.e.*, those not legally subject to cancellation by either party) at fixed prices entered into before the date of the inventory, under which the taxpayer is protected against actual loss. Any such goods must be inventoried at cost.

(3) *Examples.* The valuation principles in paragraph (a)(1) of this section are illustrated by the following examples:

Example 1. (i) Taxpayer A manufactures tractors. A values its inventory using cost or market, whichever is lower, under paragraph (a)(1) of this section. At the end of 1994, the cost of one of A's tractors on hand is determined as follows:

Direct materials	$3,000
Direct labor	4,000
Indirect costs under section 263A	3,000
Total section 263A costs (cost)	$10,000

(ii) A determines that the aggregate of the current bid prices of the materials, labor, and overhead required to reproduce the tractor at the end of 1994 are as follows:

Direct materials	$3,100
Direct labor	4,100
Indirect costs under section 263A	3,100
Total section 263A costs (market)	$10,300

(iii) In determining the lower of cost or market value of the tractor, A compares the cost of the tractor, $10,000, with the market value of the tractor, $10,300, in accordance with paragraph (c) of this section. Thus, under this section, A values the tractor at $10,000.

Example 2. (i) Taxpayer B purchases and resells several lines of shoes and is subject to section 263A. B values its inventory using cost or market, whichever is lower, under paragraph (a)(1) of this section. At the end of 1994, the cost of one pair of shoes on hand is determined as follows:

Acquisition cost	$200
Indirect costs under section 263A	10
Total section 263A costs (cost)	$210

(ii) B determines the aggregate current bid prices prevailing at the end of 1994 for the elements of cost (both direct costs and indirect costs incurred prior and subsequent to acquisition of the shoes) based on the volume of the elements usually purchased (or incurred) by B as follows:

Acquisition cost	$178
Indirect costs under section 263A	12
Total §263A costs (market)	$190

(iii) In determining the lower of cost or market value of the shoes, B compares the cost of the pair of shoes, $210, with the market value of the shoes, $190, in accordance with paragraph (c) of this section. Thus, under this section, B values the shoes at $190.

(b) *Inactive markets.* ***

(c) *Comparison of cost and market.* ***

(d) *Effective date.* This section applies to inventory valuations for taxable years beginning after December 31, 1993. For taxable years beginning before January 1, 1994, taxpayers must take reasonable positions on their federal income tax returns with respect to the application of section 263A, and must have otherwise complied with §1.471–4 (as contained in the 26 CFR part 1 edition revised April 1, 1993). For purposes of this paragraph (d), a reasonable position as to the application of section 263A is a position consistent with the temporary regulations, revenue rulings, revenue procedures, notices, and announcements concerning section 263A applicable in taxable years beginning before January 1, 1994. (See §601.601(d)(2)(ii)(*b*) of this chapter.)

Par. 12. Section 1.471–5 is amended by revising the last sentence of that section in the concluding text to read as follows:

§1.471–5 Inventories by dealers in securities.

*** See §§1.263A–1 and 1.263A–3 for rules regarding the treatment of costs with respect to property acquired for resale.

Par. 13. Section 1.471–8 is amended by revising the last sentence of the concluding text of paragraph (a) to read as follows:

§1.471–8 Inventories of retail merchants.

(a) ***

*** See §§1.263A–1 and 1.263A–3 for rules regarding the computation of costs with respect to property acquired for resale.

* * * * * * *

Par. 14. Section 1.471–11 is amended by revising the last sentence of paragraph (a) to read as follows:

§1.471–11 Inventories of manufacturers.

(a) *** See also §1.263A–1T with respect to the treatment of production costs incurred in taxable years beginning after December 31, 1986, and before January 1, 1994. See also §§1.263A–1 and 1.263A–2 with respect

the treatment of production costs urred in taxable years beginning r December 31, 1993.

* * * * * *

'ar. 15. Section 1.1502–13 is ended by revising the last sentence paragraph (c)(2) to read as follows:

1502–13 Intercompany isactions.

* * * * * *

c) ***

2) *** See the regulations under tion 263A for costs properly includ- in cost of goods sold.

* * * * * *

[illegible]

'ar. 16. The authority citation for t 602 continues to read as follows:

uthority: 26 U.S.C. 7805.

'ar. 17. Section 602.101(c) is ended by adding entries in numeri- order to read as follows:

2.101 OMB Control Numbers.

* * * * * *

c) ***

R part or section re identified described	Current OMB control number
* * * * * *	
63A–1	1545–0987
* * * * * *	
63A–2	1545–0987
63A–3	1545–0987
* * * * * *	

Margaret Milner Richardson,
Commissioner of Internal Revenue.

proved:

Leslie Samuels,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on August 6, 1993, 8:45 a.m., and published in the issue of the Federal Register for August 9, 1993, 58 F.R. 42198 as corrected by 59 F.R. 3318)

Section 267.—Losses, Expenses, and Interest With Respect to Transactions Between Related Taxpayers

26 CFR 1.267(a)–1: Deductions disallowed.

When a payor provides a per diem allowance to an employee who is a related party, the rules set forth for the deemed substantiation to the payor of the amount of the employee's ordinary and necessary business expenses for lodging, meal, and/or incidental expenses incurred while traveling away from home do not apply. See Rev. Proc. 93–50, page 586.

Section 274.—Disallowance of Certain Entertainment, etc., Expenses

26 CFR 1.274–5T: Substantiation requirements (temporary).

Rules are set forth for substantiating the amount of ordinary and necessary business expense of an employee for lodging, meal, and/or incidental expenses incurred while traveling away from home when a payor provides a per diem allowance under a reimbursement or other expense allowance arrangement to pay for such expenses. Rules are also set forth for an optional method for employees and self-employed individuals to use in computing the deductible costs of business meal and incidental expenses paid or incurred while traveling away from home. See Rev. Proc. 93–50, page 586.

26 CFR 1.274–5T: Substantiation requirements (temporary).

Simplified optional method for substantiating the amount of a deduction or expense for business use of an automobile. See Rev. Proc. 93–51, page 593.

26 CFR 1.274(d)–1: Substantiation requirements.

Rules are set forth for substantiating the amount of ordinary and necessary business expense of an employee for lodging, meal, and/or incidental expenses incurred while traveling away from home when a payor provides a per diem allowance under a reimbursement or other expense allowance arrangement to pay for such expenses. See Rev. Proc. 93–50, page 586.

26 CFR 1.274(d)–1: Substantiation requirements.

Simplified optional method for substantiating the amount of a deduction or expense for business use of an automobile. See Rev. Proc. 93–51, page 593.

Section 280F.—Limitation on Depreciation for Luxury Automobiles; Limitation Where Certain Property Used for Personal Purposes

26 CFR 1.280F–5T: Leased property (temporary).

This procedure provides owners and lessees of passenger automobiles with tables detailing the limitations on depreciation deductions for automobiles first placed in service during calendar year 1993 and the amounts to be included in income for automobiles first leased during calendar year 1993. See Rev. Proc. 93–35, page 472.

26 CFR 1.280F–7: Property leased after December 31, 1986.

This procedure provides owners and lessees of passenger automobiles with tables detailing the limitations on depreciation deductions for automobiles first placed in service during calendar year 1993 and the amounts to be included in income for automobiles first leased during calendar year 1993. See Rev. Proc. 93–35, page 472.

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of July 1993. See Rev. Rul. 93–42, page 260.

Federal short-term, mid-term, and long-term rates are set forth for the month of August 1993. See Rev. Rul. 93–51, page 262.

Federal short-term, mid-term, and long-term rates are set forth for the month of September 1993. See Rev. Rul. 93–55, page 263.

Federal short-term, mid-term, and long-term rates are set forth for the month of October 1993. See Rev. Rul. 93–64, page 264.

Federal short-term, mid-term, and long-term rates are set forth for the month of November 1993. See Rev. Rul. 93–71, page 266.

Federal short-term, mid-term, and long-term rates are set forth for the month of December 1993. See Rev. Rul. 93–82, page 267.