

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

July 11, 2001

Number: **200144003**
Release Date: 11/2/2001
Index (UILC) No.: 263A.04-00
CASE MIS No.: TAM-124759-00/CC:ITA:B2

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =
Tax Year 1 =
Tax Year 2 =
\$x =
\$y =

ISSUES:

- (1) Whether Taxpayer's method of allocating additional section 263A costs to ending inventory is a permitted method of accounting under section 263A.
- (2) If Taxpayer's method of allocating additional section 263A costs is not permitted, whether the examining agent may require Taxpayer to use a simplified method described in the section 263A regulations.
- (3) Whether Taxpayer should be granted section 7805(b) relief.

CONCLUSIONS:

- (1) Taxpayer's method of allocating additional section 263A costs to ending inventory is not a permitted method of accounting.
- (2) The Commissioner may compute Taxpayer's taxable income using any method that in his opinion clearly reflects Taxpayer's income, including a simplified

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method described in the section 263A regulations.

(3) Taxpayer is not entitled to section 7805(b) relief.

FACTS:

Taxpayer distributes a certain component product used in the manufacture of vehicles in North America. Large portions of Taxpayer's products are manufactured overseas. Almost all of these overseas products are transported by ship, which often takes six weeks or more to reach their United States destination.

Once these products reach the United States, they are either stored in domestic storage warehouses or shipped directly to Taxpayer's customers. A non-de minimis percentage of Taxpayer's products are shipped directly to Taxpayer's customers and therefore are never stored or handled at Taxpayer's warehouses.

At the end of each year, Taxpayer has a significant amount of inventory that has not reached its United States destination (in-transit inventory). For Tax Year 1, the in-transit inventory totaled \$x, which represented 28.04% of Taxpayer's total ending inventory. The in-transit inventory for Tax Year 2 was \$y, or 26.88% of Taxpayer's total ending inventory.

One reason for this significant amount of in-transit inventory is that the vehicle manufacturers require suppliers, such as Taxpayer, to meet their production schedule without delay. Because the vehicle manufacturers only commit to purchasing from suppliers a few weeks before each delivery, Taxpayer is forced to estimate the actual demand and order sufficient inventory. Another reason for the significant amount of in-transit inventory is due to the significant delivery lead-time. Generally, it takes at least six weeks for the overseas purchases to reach their United States destination (warehouse or direct-to-customer) by ship.

In order to allocate its additional section 263A costs, Taxpayer uses a method of accounting that is generally similar to the Simplified Resale Method provided in section 1.263A-3(d). Like the Simplified Resale Method, Taxpayer computes a "Purchasing Function Ratio" by dividing total purchasing costs incurred during the year by the beginning inventory plus all purchasing costs incurred during the year, including the costs of products in-transit at year-end. Taxpayer multiplies the Purchasing Function Ratio by ending inventory to determine purchasing costs allocated to ending inventory. Unlike the Simplified Resale Method, Taxpayer computes a "Storage and Processing Function Ratio" by dividing the total storage and handling costs incurred during the year by the beginning inventory plus all purchasing costs incurred during the year, except for the costs of the in-transit purchases. Taxpayer multiplies the Storage and Processing

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Function Ratio by ending inventory less in-transit inventory to determine storage and handling costs allocated to ending inventory.

On its original Form 3115, Application for Change of Accounting Method, to comply with the requirements of section 263A, Taxpayer indicated that it was allocating indirect costs using "[a] reasonable method based upon factual apportionments and the simplified resale method was used to allocate indirect and service costs." In the tax returns for Tax Year 1 and Tax Year 2, Taxpayer computed section 263A costs using the same method described in the schedules attached to the Form 3115.

Because a significant amount of Taxpayer's ending inventory remains in-transit at year-end, Taxpayer's method allocates significantly less costs to ending inventory under its method of accounting than the Simplified Resale Method would have allocated. The additional section 263A costs allocated to ending inventory under Taxpayer's method was \$x and \$y less than the additional section 263A costs that would have been allocated to ending inventory under the simplified Resale Method for Tax Year 1 and Tax Year 2, respectively. These amounts represent 24.2% and 16.1% of the total additional section 263A costs required to be allocated and capitalized to ending inventory under the Simplified Resale Method for Tax Year 1 and Tax Year 2, respectively.

LAW AND ANALYSIS:

Section 471 provides that whenever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

Section 1.471-1 of the Income Tax Regulations provides that in order to reflect taxable income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor.

Section 263A provides for the nondeductibility of certain direct and indirect costs with respect to property to which section 263A applies.

Section 263A(a)(2) provides that the costs described in this paragraph with respect to any property are the direct costs of such property, and such property's proper share of indirect costs (including taxes) part or all of which are allocable to such property. Any cost which (but for this subsection) could not be taken into account in computing taxable income for any taxable year shall not be treated as a cost described in this paragraph.

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Section 1.263A-1(a)(3)(i) provides, in part, that taxpayers subject to section 263A must capitalize all direct costs and certain indirect costs properly allocable to real property and personal property described in section 1221(1), which is acquired by the taxpayer for resale.

Section 1.263A-1(a)(3)(iii) provides that 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.

Section 1.263A-1(c)(1) provides, in part, that under section 263A, taxpayers must capitalize their direct costs and a properly allocable share of their indirect costs to property acquired for resale. In order to determine these capitalizable costs, taxpayers must allocate or apportion costs to various activities, including resale activities. After section 263A costs are allocated to the appropriate resale activities, these costs are generally allocated to the items of property acquired for resale during the taxable year and capitalized to the items that remain on hand at the end of the taxable year.

Section 1.263A-1(e) describes the types of costs subject to section 263A. Section 1.263A-1(e)(2)(ii) provides that resellers must capitalize the acquisition costs of property acquired for resale. In the case of inventory, the acquisition cost is the cost described in section 1.471-3(b).

Section 1.471-3(b) provides that cost means in the case of merchandise purchased since the beginning of the taxable year, the invoice price less trade or other discounts, except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer, provided a consistent course is followed. To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the goods.

Section 1.263A-1(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. In lieu of a facts-and-circumstances allocation method, section 1.263A-1(f) authorizes taxpayers to use the simplified methods provided in sections 1.263A-2(b) and 1.263A-3(d) to allocate direct and indirect costs to eligible property produced.

Section 1.263A-1(f)(4) provides that a taxpayer may use a facts-and-circumstances allocation method if it is a reasonable allocation method. In addition, a taxpayer may use any other reasonable method to allocate direct and indirect costs among units of property produced or acquired for resale during the taxable year. An allocation method is reasonable if:

- (i) the total costs actually capitalized during the taxable year do not differ

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significantly from the aggregate costs that would be properly capitalized using another permissible method described in sections 1.263A-1(f), 1.263A-2, or 1.263A-3, with appropriate consideration given to the volume and value of the taxpayer's production or resale activities, the availability of costing information, and 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 provided in sections 1.263A-1(f), 1.263A-2, or 1.263A-3, or the principles of section 263A.

Section 1.263A-3(d) provides a simplified method for determining additional section 263A costs properly allocable to ending inventories of property acquired for resale and other eligible property on hand at the end of the year.

Section 1.263A-1(d)(3) defines additional section 263A costs 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, but that are required to be capitalized under section 263A.

Section 1.263A-1(d)(2)(i) defines section 471 costs as the costs, other than interest, capitalized under the taxpayer's method of accounting immediately prior to the effective date of section 263A.

Section 1.263A-1(d)(4) defines section 263A costs 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).

Section 1.263A-2(b)(3) provides that, in general, the additional section 263A costs allocable to eligible property remaining on hand at the close of the taxable year under the Simplified Resale Method is the combined absorption ratio multiplied by the section 471 costs remaining on hand at year-end.

Section 1.263A-3(d)(3)(i)(C)(1) defines the combined absorption ratio as the sum of the storage and handling costs absorption ratio and the purchasing costs absorption ratio.

Section 1.263A-3(d)(3)(i)(D) explains that the storage and handling costs absorption ratio is determined by dividing the current year's storage and handling costs by the sum of beginning inventory and current year's purchases. Current year's storage and handling costs are defined as the total storage costs plus the total handling costs

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incurred during the taxable year that relate to the taxpayer's property acquired for resale and other eligible property.

Section 1.263A-3(d)(3)(i)(E) defines the purchasing costs absorption ratio as the ratio that the current year's purchasing costs bear to the current year's purchases. 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. Current year's purchases generally mean the taxpayer's 471 costs incurred with respect to purchases of property acquired for resale during the current taxable year.

Congress intended taxpayers to allocate additional costs required to be capitalized under section 263A with the same degree of specificity that was required of inventoriable costs under prior law. Congress contemplated that taxpayers would continue to use the same methods of allocating costs to items in their inventory that were available under prior law. See S. Rep. No. 313, 99th Cong. , 2d Sess. 142 (1986), reprinted in 1986-3 C.B. (Vol. 3) 1 (citing section 1.471-11(d) (authorizing use of the manufacturing burden rate method, the standard cost method, or any other method that fairly apportions such costs among items of inventory); T.D. 8131, 1987-1 C.B. 98, 100.

Because resellers did not have cost accounting procedures in place prior to the adoption of the uniform capitalization rules, Congress directed the Service to provide a simplified method for taxpayers acquiring property for resale to alleviate the administrative burdens of complying with the uniform capitalization rules. See H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-305 (1986), reprinted in 1986-3 C.B. (Vol. 4)1. Congress also authorized the Service to adopt simplified allocation methods where the costs and other burdens of literal compliance outweigh the benefits. See S. Rep. No. 313, 99th Cong., 2d Sess. 142 (1986), 1986-3 C.B. (Vol. 3)1.

The Preamble to the temporary regulations discussed how taxpayers acquiring property for resale must allocate additional costs required to be capitalized under section 263A to property on hand at the end of the taxable year:

Taxpayers acquiring such property may elect a simplified method of accounting for the costs required to be capitalized under the temporary regulations (the "simplified resale method"). The allocation rules applicable to production activities will apply to those taxpayers that acquire property for resale who do not elect to use the simplified resale method. Thus, absent the election of the simplified resale method, taxpayers acquiring property for resale are required to allocate the additional costs required to be capitalized under section 263A with the same degree of specificity as was required of manufacturers of inventory under prior law.

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T.D. 8131, 1987-1 C.B. 98, 100.

In the Preamble to the final regulations, the Service stated that “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.” T.D. 8482, 1993-2 C.B. 77, 80.

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 method. The final regulations also continue to permit taxpayers to use certain simplified methods in determining their section 263A costs.

T.D. 8482, 1993-2 C.B. at 80.

The Preamble to the final regulations also stated:

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.

Id. at 83.

Section 446(b) provides that, if no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

Section 446(e) requires that a taxpayer obtain the consent of the Secretary prior to changing its method of accounting from the basis for which taxable income is regularly computed to a new method.

Section 7805(b) provides that the Commissioner may prescribe the extent, if any, to which any ruling (including any judicial decision or any administrative determination other than by regulation) relating to the internal revenue laws shall be applied without

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retroactive effect. See also Treas. Reg. § 301.7805-1(b). Treas. Reg. § 601.201(a)(2) defines “ruling” as a written statement issued to a taxpayer by the National Office which interprets and applies the tax laws to a specific set of facts.

Issue 1: Whether Taxpayer’s method of allocating additional section 263A costs to ending inventory is a permitted method of accounting under section 263A.

Taxpayer uses what it calls an “other reasonable method” of allocating additional section 263A costs, but acknowledges that it is based on a modification of the Simplified Resale Method set forth in section 1.263A-3(d)(3). Taxpayer modified the storage and handling costs component of the Simplified Resale Method in two related respects. First, inventory that is in-transit at year-end is excluded from the denominator of the ratio, resulting in what the Taxpayer denotes as a Storage and Processing Function Ratio. Second, inventory that is in-transit at year-end is also excluded from the denominator of the multiplicand against which the ratio is applied to determine the amount of storage and handling costs allocated and capitalized to ending inventory. Taxpayer argues that its method appropriately allocates storage and handling costs based on its unique facts and circumstances. Because the in-transit goods have not been handled or processed at year-end, and because the amount of goods in-transit at year-end is substantial, Taxpayer argues that the exclusion of the in-transit inventory in calculating and allocating its additional section 263A costs is a reasonable allocation method based on its unique situation and is permitted under section 1.263A-1(f)(4).

As explained in more detail below, we disagree with Taxpayer’s contention that the section 263A regulations generally permit taxpayers to modify the simplified methods to fit their own particular facts and circumstances and with Taxpayer’s conclusion that its modification to the Simplified Resale Method is appropriate for its particular facts and circumstances.

Section 1.263A-1(f) provides acceptable methods of allocating costs to inventory. Under section 1.263A-1(f)(2) and (f)(3), a taxpayer may elect to use a facts-and-circumstances allocation method, such as the specific identification method, burden rate and standard cost methods. A taxpayer may also use any other reasonable allocation method. Section 1.263A-1(f)(4). Under section 1.263A-1(f)(4), a method is reasonable if 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, the allocation method is applied consistently, and the allocation method is not used to circumvent the requirements of the simplified methods in sections 1.263A-2, 1.263A-3, or the principles of section 263A. In addition to the facts and circumstances methods and the reasonable allocation methods, section 1.263A-1(f) and other regulations make clear that taxpayers may also use the simplified methods provided in sections 1.263A-2(b) and 1.263A-3(d) for producers and resellers, respectively.

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Taxpayers are generally required to allocate additional section 263A costs to specific items in their inventory. Congress required taxpayers to allocate costs required to be capitalized under section 263A with the same degree of specificity that was required of inventoriable costs under prior law. Congress contemplated that taxpayers would continue to use the same methods of allocating costs to items in their inventory that were available under prior law. See S. Rep. No. 313, 99th Cong., 2d Sess. 142 (1986), reprinted in 1986-3 C.B. (Vol. 3)1, 141-2 (citing section 1.471-11(d) (authorizing use of the manufacturing burden rate method, the standard cost method, or any other method that fairly apportions such costs among items of inventory)); T.D. 8131, 1987-1 C.B. 98, 101. The simplified resale and the simplified production methods described in sections 1.263A-2 and 1.263A-3 are exceptions to the general rule that costs required to be capitalized under section 263A must be allocated to specific items of inventory.

The Preambles to both the temporary regulations under section 263A and the final regulations to section 263A support the conclusion that the only exceptions to the general rule to allocate additional costs to specific items of inventory are the simplified methods provided in the section 263A regulations. In the Preamble to the temporary regulations, the Service and Treasury stated:

Taxpayers acquiring [property for resale] may elect a simplified method of accounting for the costs required to be capitalized under the temporary regulations (the “simplified resale method”). The allocation rules applicable to production activities will apply to those taxpayers that acquire property for resale who do not elect to use the simplified resale method. Thus, absent the election of the simplified resale method, taxpayers acquiring property for resale are required to allocate the additional costs required to be capitalized under section 263A with the same degree of specificity as was required of manufacturers of inventory under prior law.

T.D. 8131, 1987-1 C.B. 98, 100. In the Preamble to the final regulations, the Service and the Treasury note that “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.” T.D. 8482, 1993-2 C.B. 77, 80. The Preamble further provides:

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. ... The final regulations also continue to permit taxpayers to use certain simplified methods in determining their section 263A costs.

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Id. at 80. Later, the Preamble explains how additional section 263A costs are allocated under the simplified 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.

Id. at 83.

When a taxpayer capitalizes costs to specific items in its inventory, the allocation between ending inventory and cost of goods sold is governed by the taxpayer's cost flow assumption. If the items are in ending inventory under the taxpayer's cost flow assumption, then the costs are also in ending inventory. Whether the items are correctly in the ending inventory is governed by the inventory rules of sections 471 and 472, and not by section 263A.

When a simplified method is used, however, the allocation between the cost of goods sold and the ending inventory is not made by the taxpayer's cost flow assumption. Rather, an absorption ratio is calculated and, based on that, an amount of costs that otherwise would have been deducted is allocated to the ending inventory. Simplified methods are often referred to as "add-on" methods because they simply allocate a lump-sum of costs to the ending inventory.

The purpose of the simplified methods is to reduce the complexity and administrative burdens of developing cost accounting systems for the additional costs ("additional section 263A costs") required to be capitalized under section 263A. See T.D. 8482, 1993-2 C.B. 77, 80. The simplified methods permitted by the regulations, the Simplified Production Method and the Simplified Resale Method, are essentially mechanical in nature. Under these methods, the amount of additional section 263A costs allocated and capitalized to ending inventory is easily computed by the taxpayer and easily verified by the Service.

The simplified methods differ from other permissible methods of capitalizing inventory costs in several important respects. The simplified methods do not allocate inventory costs to specific units; they simply allocate a lump-sum of costs to ending inventory. The simplified methods capitalize additional section 263A costs based on a ratio of those costs to other inventoriable costs. See sections 1.263A-1(f)(3)(i)(A) and 1.263A-1(f)(3)(ii)(A). Other permissible methods described in the regulations (specific identification method, burden rate method, and standard cost method) are generally based on the facts and circumstances of the taxpayer's business. These other permissible methods require a periodic re-evaluation of the facts and circumstances

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and, if necessary, adjustments to the capitalization rates. See sections 1.263A-1(f)(3)(i)(A) and 1.263A-1(f)(3)(ii)(A). The ratios used for the simplified methods, on the other hand, are developed and applied mechanically, without regard to changes in the facts and circumstances from year-to-year.¹

By their very nature, the simplified methods will not necessarily produce the same inventory value as a facts and circumstances method. The simplified methods may capitalize more costs or less costs than a facts and circumstances method depending upon the facts and circumstances. In written comments on the temporary regulations under section 263A, some commentators expressed dissatisfaction with the simplified methods in cases where such methods capitalized more costs than a facts and circumstances method. Specifically,

[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 the 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 costs of these material. Second, *incorporating these suggestions in the final regulations would reduce the*

¹Certain factual changes may require a change from one simplified method to another. For example, a reseller may become a producer and thereby become ineligible to continue using the Simplified Resale Method. See section 1.263A-3(a)(2). Also, a taxpayer using a simplified method with an historic absorption ratio may be required to compute a new historic absorption ratio under certain circumstances. See sections 1.263A-2(b)(4)(ii)(C)(2) and 1.263A-3(d)(4)(ii)(c)(2).

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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.

T.D. 8482, 1993-2 C.B. 77, 83-4 (emphasis added).

The simplified methods prescribed in the section 263A regulations are available to any taxpayer required to capitalize additional section 263A costs to inventory. A taxpayer is not required to demonstrate that a simplified method is appropriate for its particular facts and circumstances. Thus, the simplified methods provide something of a safe harbor method for capitalizing additional section 263A costs. As indicated in the Preamble to the final regulations, a taxpayer may use the authorized simplified methods even if they produce inappropriate results. If a taxpayer is unsatisfied with the results of the simplified methods, its only option is to change to a facts and circumstances allocation method.

The simplified methods capitalize additional section 263A costs based on a ratio of those costs to other inventoriable costs. This ratio is multiplied against the other inventoriable costs found in ending inventory (the multiplicand) to determine the amount of additional section 263A costs allocated and capitalized to ending inventory. Certain facts and circumstances of an electing taxpayer's business will push the ratio or the multiplicand upward; other facts and circumstances will push the ratio or the multiplicand downward. The facts and circumstances could be as simple as the volume of business, the cost of the goods, and the amount of storage space available to the taxpayer. For example, the storage costs allocable to ending inventory pursuant to a simplified method will decrease if the taxpayer's volume of sales, in terms of dollars, increases. If, on the other hand, the taxpayer's storage costs increase at a faster rate than the prices it pays for merchandise, the storage costs allocable to ending inventory pursuant to a simplified method will increase.

Apparently, at the time it was required to begin capitalizing additional section 263A costs, Taxpayer foresaw that the significant amount of in-transit inventory at year-end would tend to push the multiplicand of the Simplified Resale Method upward resulting in the allocation of storage and handling costs to goods that had not yet been stored. Taxpayer believes that it is inappropriate for storage and handling costs to be allocated to goods that had never been stored. Accordingly, Taxpayer modified the Simplified Resale Method to prevent the perceived over-capitalization. Taxpayer excluded goods in-transit from the denominator of the Storage and Handling Costs Ratio of the Simplified Resale Method and renamed the ratio the "Storage and Processing Function Ratio." Taxpayer applied this ratio against the ending inventory excluding in-transit goods to determine the amount of storage and handling costs allocable and capitalizable to ending inventory.

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Although Taxpayer's method does not allocate storage and handling costs to in-transit goods, it does allocate storage and handling costs to goods that have never been stored or handled – goods shipped directly to customers. Under Taxpayer's Storage and Processing Function Ratio, storage costs are allocated to ending inventory, and to the cost of goods sold, based on the ratio of total storage costs to beginning inventory plus purchases during the year, except in-transit purchases at year-end. Thus, every purchase during the year that was either sold or in the warehouses at year-end is taken into account in the allocation. If there was a purchase during the year that was directly shipped to customers, storage costs were effectively allocated to such a purchase pursuant to Taxpayer's ratio. For example, if Taxpayer made five purchases during the year, and the first four purchases were directly shipped to customer, with only the last purchase stored in the warehouse at year-end, Taxpayer's storage costs incurred during the year would be allocated four-fifths to cost of goods sold and one-fifth to ending inventory. Thus, eighty percent of the storage costs would be allocated to cost of goods sold, even though those goods were never handled or stored. Only twenty percent would be capitalized to ending inventory, even though the costs incurred in storage and handling are related entirely to these items.²

In arguing that its method is a reasonable method based on its own unique facts and circumstances, Taxpayer attempts to isolate its specific modification to the Simplified Resale Method and frame the issue as a question of whether the modification, itself, is reasonable.³ Assuming, arguendo, that taxpayers were permitted to modify the simplified methods provided in the section 263A regulations, we do not believe that this would be the relevant standard. Instead, the relevant standard would be whether the resulting allocation method, in its entirety, is reasonable.

Taxpayer's method would fall far short of the latter standard. Taxpayer has identified a single fact related to its inventory – some goods are in-transit at the end of the year – and modified the Simplified Resale Method to take that fact into account. Taxpayer has not considered whether the method in its entirety is appropriate for Taxpayer's facts and circumstances. Specifically, Taxpayer made no determination as to whether its facts and circumstances justify an allocation of storage and handling costs based on the total cost of its beginning inventory and purchases incurred during the year. Taxpayer simply assumed that allocation of storage and handling costs on

²The facts of this example are intended to clearly illustrate the fact that Taxpayer's allocation method allocates storage and handling costs to direct-shipped goods by virtue of the absorption ratio formula. They are not intended to suggest that a majority of Taxpayer's sales were direct-shipped to customers.

³This is essentially the same argument made by commentators to the temporary regulations under section 263A. See Preamble to final regulations, T.D. 8482, 1993-2 C.B. 77, 83-4.

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that basis was appropriate because that is the basis upon which such costs are allocated under the simplified methods. Furthermore, Taxpayer's allocation method failed to take into account the fact that a significant amount of its inventory was shipped directly to customers. These purchases were not handled or stored in Taxpayer's warehouses, yet Taxpayer's method of allocating storage costs allocates costs to these purchases. Failure to take into account direct-shipped goods in the cost allocation is inconsistent with Taxpayer's asserted justification (*i.e.*, that storage and handling costs should not be allocated to goods that have never been stored or handled) for not allocating storage and handling costs to in-transit inventory.

Nonetheless, we believe that both of these standards are inconsistent with the purpose of the simplified methods. Under Taxpayer's standard, which focuses exclusively on the modification, a taxpayer could identify the facts that push its ratio or multiplicand upward, remove their effects from the computation, and rely on the acceptability of the simplified methods as justification for not removing the effects of facts that push the ratio or multiplicand downward. Under the other standard, which focuses on the entire method, the simplified method would have to be modified to take into account not only facts closely related to the facts identified by the taxpayer as justifying an adjustment, but all of the relevant facts and circumstances. Both of these standards would reduce the simplicity that the simplified methods were intended to provide.

Although we believe that taxpayers are not generally permitted to modify the simplified methods provided in the section 263A regulations, the regulations provide a 3-prong test for determining whether an allocation method (even a modified simplified method) is a reasonable allocation method. Section 1.263A-1(f)(4) provides that an allocation method is reasonable if: (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 sections 1.263A-1, 1.263A-2, or 1.263A-3, with appropriate consideration given to the volume and value of the taxpayer's production or resale activities, the availability of costing information, and 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 taxpayer⁴; and (iii) the allocation method is not used to circumvent the requirements of the simplified methods provided in sections 1.263A-1(f), 1.263A-2, or 1.263A-3, or the principles of section 263A.

Although paragraph (f)(4)(i) of section 1.263A-1 could be interpreted several ways, we believe that the amount allocated and capitalized to ending inventory using a simplified or "add-on" method, *i.e.*, a method that does not allocate to specific items of

⁴The second prong of section 1.263A-1(f)(4) is not at issue in this case; Taxpayer applied its allocation method consistently.

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inventory, should be compared to the amount that would have been allocated and capitalized using one of the authorized simplified methods for purposes of determining whether such add-on method is a reasonable method under section 1.263A-1(f)(4)(i).

The third prong of the test set forth in section 1.263A(f)(4) requires that the allocation method is not used to circumvent the requirements of the simplified methods or the principles of section 263A. The temporary regulations merely stated that an allocation method may not be used if it circumvents the principles of section 263A. The prohibition against circumventing the requirements of the simplified methods was added in the final regulations. As discussed above, the Service and Treasury declined to adopt commentators' recommendations that the simplified production method be modified so as to allocate fewer storage and handling costs to raw materials inventories.⁵ We believe that the language in paragraph (f)(4)(iii) was added to prevent taxpayers from doing what the Service and Treasury refused to adopt in the final regulations, *i.e.*, making adjustments to the simplified methods to avoid alleged overcapitalization of certain costs, and then calling that method a "reasonable" allocation method under the regulations. The language in section 1.263A(f)(4)(iii) forces a taxpayer that believes that the simplified methods overcapitalize to change to a genuine facts and circumstances method, such as the specific identification method, a burden rate or standard cost method.⁶ Thus, we believe that paragraph (i) and paragraph (iii) of section 1.263A-1(f)(4) should be read together for purposes of determining whether a method that does not allocate to specific items of inventory actually circumvents the requirements of the simplified methods.⁷ The amount of costs capitalized using an add-on method that allocates costs to ending inventory using an absorption ratio must be compared with the amount of costs capitalized using a simplified method described in sections 1.263A-2 or 1.263A-3 to determine whether the add-on method qualifies as a reasonable method under section 1.263A-1(f)(4).

Taxpayer's method allocates additional section 263A costs to ending inventory using an absorption ratio; Taxpayer's method does not allocate costs to specific items of inventory. Thus, Taxpayer's allocation method is a reasonable method if it capitalizes and allocates an amount of costs that does not differ significantly from the amount of costs that would be capitalized and allocated under the Simplified Resale Method (costs capitalized do not "differ significantly" from the Simplified Resale Method). In Tax Year 1, the difference between the amount of costs capitalized under

⁵T.D. 8482, 1993-2 C.B. 77, 83-4.

⁶*Id.*

⁷Taxpayer's method was undoubtedly intended to avoid one aspect of the Simplified Resale Method, *i.e.*, capitalization of storage and handling costs to in-transit inventory.

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Taxpayer's method and the Simplified resale method was \$x, a 24.2% difference. In Tax Year 2, the difference between the amount of costs capitalized under Taxpayer's method and the Simplified Resale method was \$y, a 16.1%. The amount of costs allocated and capitalized to ending inventory under Taxpayer's method, both in terms of dollars and percentages, differs significantly from the amount of costs that would be allocated and capitalized to ending inventory under the Simplified Resale Method.

Taxpayer argues that the difference between the amount of storage and handling costs capitalized under its method and under the Simplified Resale Method should be compared to either the total cost of its purchases for the year or the total cost of its ending inventory. According to Taxpayer, this comparison gives effect to the language in section 1.263A-1(f)(4)(i) regarding consideration given to the volume and value of the taxpayer's resale activities. We do not believe that this comparison is the comparison required by section 1.263A-1(f)(4)(i). Taxpayer used the method at issue, the add-on method, only to allocate certain indirect costs. Taxpayer accounted for the direct costs of inventory using another method, which is not at issue. Because the method at issue is Taxpayer's add-on method, only costs that are allocated under that method should be considered in determining whether the method capitalizes an amount of costs that does not differ significantly from the amount of such costs that would be capitalized under the Simplified Resale Method. If Taxpayer's comparison were the correct comparison, Taxpayer could argue that none of its storage and handling costs need be capitalized under the regulation because the difference between the total cost of the ending inventory with and without those costs is insignificant.

For the foregoing reasons, we conclude that Taxpayer's method of allocating additional section 263A costs to ending inventory is not a reasonable allocation method under the regulations and thus is not permissible.⁸

Issue 2: If Taxpayer's method of allocating additional section 263A costs is not permitted, whether the examining agent may require Taxpayer to use a simplified method described in the section 263A regulations.

⁸ It should be noted that this technical advice memorandum does not conclude that the section 263A regulations contain an absolute rule that storage costs be allocated to in-transit inventory. The regulations permit taxpayers to develop facts and circumstances allocation methods for storage costs that are based on a cause and effect or other reasonable relationship between the products and costs. See e.g., section 1.263A-1(f)(2). Thus, a taxpayer could use a facts and circumstances allocation method that allocated storage costs to goods based on a reasonable relationship between its products and the storage costs, such as whether or how long the goods were held in a storage facility. But such a method would have to allocate storage costs to specific items and only to items that were actually stored.

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The courts have consistently held that the Commissioner's authority under section 446(b) permits him to select the method of accounting a taxpayer must use once he has determined that a taxpayer's method does not clearly reflect income. See Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979), 1979-1 C.B. 167. Accordingly, we conclude that the Commissioner may compute Taxpayer's taxable income using any method that in his opinion clearly reflects income, including a simplified method described in the section 263A regulations.

Issue 3: Whether Taxpayer should be granted section 7805(b) relief.

Taxpayer argues for section 7805(b) relief on three grounds. First, Taxpayer argues that it attempted to use a reasonable allocation method under section 1.263A-1(f)(4). According to Taxpayer, however, there was no guidance provided by the Service on what was "reasonable." Some methods other than the prescribed methods should be reasonable. Taxpayer's method was reasonable given its unique facts (significant inventory in-transit at year-end).

Second, Taxpayer argues that the language in section 1.263A-1(c)(2)(i) is sufficiently ambiguous that a literal reading of the section would lead to exclusion of in-transit merchandise. The regulation provides in part that costs are not capitalized any earlier than the taxable year during which the amount is incurred within the meaning of regulations under section 446. According to Taxpayer, the "incurred" language of the regulation indicates that handling or storage costs should not be allocated to in-transit inventory because the costs of handling and storing such inventory have not yet been incurred.

Finally, Taxpayer argues that section 1.263A-3(a)(1) is ambiguous. That section provides, in part, that 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. Taxpayer argues that "on hand" means "in possession" and in-transit inventory is not on hand.

Taxpayer's argument regarding lack of standards for what is a "reasonable method" suggests that the absence of guidance established a reliance interest in the use of any method until the Service specifically provided guidance disapproving the method. We disagree. The justification for relief under section 7805(b) is usually based on detrimental reliance: a later ruling should not be retroactively applied if a taxpayer relied on some other earlier ruling to its detriment.⁹ Taxpayer did not rely on an Internal Revenue Service ruling. Furthermore, there was guidance under the

⁹ See e.g., Treas. Reg. § 601.201(l)(5) [regarding retroactive application after revocation or modification of a previous ruling]; Section 12.05 of Rev. Proc. 2001-1 [same].

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regulations. The regulations permit taxpayers to use a facts and circumstances method, such as specific identification, burden rate or standard costs, or a simplified method.

In response to Taxpayer's second argument, we note that the cited regulation prevents taxpayers from using inventory capitalization to circumvent section 461(h). The issue here involves the allocation of storage costs that have been incurred. Storage costs have been incurred by Taxpayer, but since none of those costs are attributable to the in-transit inventory, Taxpayer believes none should be allocated to such inventory. The regulation relied upon, section 1.263A-1(c)(2)(i), does not address the issue of where or how to allocate costs that have been incurred. That regulation simply precludes taxpayers from recovering expenses through cost of goods sold, basis adjustments, or depreciation deductions before the expenses are otherwise incurred.

In response to Taxpayer's final argument, we do not believe that the "on hand" language contained in section 1.263A-3(a)(1) was intended to exclude goods that were acquired for resale but are not yet in possession from the definition of property acquired for resale and thus from the application of section 263A.

Taxpayer's request for relief under section 7805(b) is denied.

CAVEAT(S)

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.