

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

March 17, 2005

Third Party Communication: None
Date of Communication: Not Applicable

Index (UIL) No.: 263A.04-04
CASE-MIS No.: TAM-165593-04
Number: **200624067**
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Director of Field Operations, Natural Resources & Construction

Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

Taxpayer =
Date =

ISSUE(S):

Under the simplified service cost method, are federal income taxes includible in the denominator of the production cost allocation ratio provided by § 1.263A-1(h)(5).

CONCLUSION(S):

Federal income taxes are not includible in the denominator of the production cost allocation ratio provided by § 1.263A-1(h)(5).

FACTS:

For its tax year ending Date, Taxpayer used the simplified service cost method provided by § 1.263A-1(h) to determine its capitalizable mixed service costs incurred

during the year with respect to eligible property.¹ In so doing, Taxpayer used the production cost allocation ratio provided by § 1.263A-1(h)(5). The production cost allocation ratio is computed by dividing the section 263A production costs incurred in the taxpayer's trade or business during the taxable year by the total costs incurred in the taxpayer's trade or business during the taxable year. Taxpayer included federal income taxes in "total costs," the denominator of the ratio, when it computed the production cost allocation ratio.

LAW AND ANALYSIS:

Section 263A of the Internal Revenue Code requires producers of real or tangible personal property and resellers of real or tangible and intangible personal property to capitalize the direct costs and a proper share of the indirect costs of such property. Indirect costs include indirect labor costs, overhead, and service costs. See § 1.263A-1(e)(3). Service costs are indirect costs that can be identified specifically with an administrative or support department. For example, the personnel, accounting, data processing, security, and legal departments are generally service departments. See § 1.263A-1(e)(4).

Service costs consist of capitalizable service costs, deductible service costs, and mixed service costs. Capitalizable service costs directly benefit, or are incurred by reason of, a production or resale activity. Deductible service costs are service costs that do not directly benefit, or are not incurred by reason of, a production or resale activity. Whereas, mixed service costs are service costs that are partially allocable to production or resale activities and partially allocable to non-production and non-resale activities (deductible service costs). For example, a personnel department that hires factory workers and helps to set wage and benefit policies is a mixed service department. See § 1.263A-1(e)(4)(ii).

The regulations under § 263A provide various methods or ratios that can be used to allocate mixed service costs between production and non-production activities. Generally, mixed service costs must be allocated on a reasonable basis. However, the regulations also provide a simplified method (the simplified service cost method) that taxpayers may use to determine the capitalizable mixed service costs incurred during the taxable year with respect to "eligible property." See § 1.263A-1(h). For this purpose, eligible property includes: stock in trade or other property properly includible in the inventory of the taxpayer; non-inventory property held by a taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business; self-constructed assets that are 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 that is held primarily for sale to customers in the ordinary

¹ We express no opinion as to whether the property Taxpayer used the simplified service cost method with respect to is eligible property under § 1.263A-1(h)(2).

course of the taxpayer's trade or business; self-constructed assets produced by the taxpayer on a routine and repetitive basis in the ordinary course of the taxpayer's trade or business.

Under the simplified service cost method, a taxpayer computes its capitalizable mixed service costs by multiplying its total mixed service costs by an allocation ratio. A taxpayer that produces property may either use a labor-based allocation ratio or the production cost allocation ratio. The production cost allocation ratio is computed by dividing the taxpayer's "section 263A production costs" by its "total costs." For this purpose, 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. 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. However, total costs do not include the taxes described in § 1.263A-1(e)(3)(iii)(F). See § 1.263A-1(h)(5)(ii).

Taxes are generally considered indirect costs that are allocable to produced property as long as they are otherwise allowable as a deduction and to the extent they are attributable to labor, materials, supplies, equipment, land, or facilities used in the production activity. See § 1.263A-1(e)(3)(ii)(L). However, § 1.263A-1(e)(3)(iii)(F) provides that state, local, and foreign income taxes and franchise taxes that are assessed based on income are indirect costs that are not required to be capitalized under § 263A.

Federal income taxes can not be capitalized to produced property even though they are not specifically listed in § 1.263A-1(e)(3)(iii)(F). Section 263A and § 1.263A-1(c)(2) provide that any cost that (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 property acquired for resale under section 263A and the regulations thereunder. Section 1.164-2 specifically provides that federal income taxes are not deductible. Similarly, § 275(a) specifically prohibits the deduction of federal income taxes. Accordingly, since federal income taxes are not deductible and may not be taken into account in computing taxable income, they may not be capitalized to property produced for purposes of § 263A.

Taxpayer contends that federal income taxes should be included in total costs when computing the production cost allocation ratio. Taxpayer argues that the plain language of § 1.263A-1(h)(5)(ii) specifically provides that the denominator of the ratio includes all costs of the taxpayer's trade or business, except for three specifically enumerated costs: mixed service costs; interest; and taxes described in § 1.263A-

1(e)(3)(iii)(F). As indicated above, § 1.263A-1(e)(3)(iii)(F) does not explicitly include federal income taxes. Therefore, Taxpayer argues that federal income taxes are included in total costs when computing the production cost allocation ratio. Taxpayer also notes that the temporary § 263A regulations explicitly provided that total costs did not include federal income taxes. Section 1.263A-1(b)(6)(iii)(A)(2) of the Temporary Income Tax Regulations provided that total costs were “the total of all costs incurred in the operation of the taxpayer’s trade or business (excluding mixed service costs and interest) for the taxable year”, and by reference to § 1.263A-1(b)(6)(iii)(C) of the temporary regulations provided that costs of operation did “not include federal, state, local or foreign income taxes.” Taxpayer further notes that when the temporary regulations were finalized, the reference to federal income taxes was eliminated.

For the reasons discussed below, we conclude that federal income taxes are not included in the denominator of the production cost allocation ratio when determining capitalizable mixed service costs using the simplified service cost method provided by § 1.263A-1(h).

First, including non-deductible costs such as federal income taxes in the denominator of the production cost allocation ratio is contrary to the underlying purpose of the simplified service cost method. The simplified service cost method determines the capitalizable mixed service costs incurred during the year with respect to eligible property. Mixed service costs that are not incurred with respect to eligible property or some other property that is subject to § 263A generally are permitted to be deducted as period costs. Accordingly, the simplified service cost method divides mixed service costs into its component parts (*i.e.*, capitalizable service costs and deductible service costs) and does not allocate mixed service costs to nondeductible activities. Including federal income taxes in the denominator of the allocation ratio would have the effect of attracting mixed service costs to federal income taxes, an expense that is not deductible.²

Second, the fact that non-deductible costs are excluded from the numerator of the production cost allocation ratio indicates that the denominator also does not include non-deductible costs. Some non-deductible costs, e.g., the disallowed portion of meals

² Taxpayer has argued that some mixed service costs should be allocable to nondeductible activities rather than production activities. Taxpayer further argues that including nondeductible expenses in the denominator of the allocation ratio is consistent with the purpose of the simplified service cost method. We disagree. The simplified service cost method only allocates mixed service costs between production and deductible activities and does not make a separate allocation to nondeductible activities. Including nondeductible expenses in the denominator of the production cost allocation ratio results in more mixed service cost being allocated to deductible activities, not to nondeductible activities. We have not been asked, and we will not address, whether mixed service costs that are allocable to nondeductible activities are deductible.

and entertainment expenses, might be incurred by reason of, or directly related to, a production activity under § 1.263A-1(e)(3)(i). The numerator of the production cost allocation ratio includes “the total costs (excluding mixed service costs and interest) allocable to property produced . . . under section 263A that are incurred in the taxpayer’s trade or business during the taxable year.” To be consistent with Taxpayer’s position, the “total costs” allocable to property produced ought to include non-deductible costs incurred by reason of a production activity. Thus, to the extent non-deductible costs are allocable to a production activity, they would attract mixed service costs to the production activity. However, non-deductible costs are not allocable to the property “under § 263A” even if they are incurred by reason of, or directly related to, a production activity. See § 1.263A-1(c)(2). Therefore, such costs cannot be included in the numerator of the production cost allocation ratio. If the denominator of the production cost allocation ratio included non-deductible costs, then even the non-deductible costs that are incurred by reason of the production activity would be included in the denominator. Including such non-deductible costs in the denominator without including them in the numerator of the ratio would have the perverse effect of further reducing the ratio of mixed service costs that are required to be capitalized.

Third, excluding federal income taxes in the denominator of the production cost allocation ratio is consistent with the treatment of other taxes that are assessed based on income. Section 1.263A-1(h)(5)(i) specifically provides that taxes described in § 1.263A-1(e)(3)(iii)(F) that are assessed based on income are not included in total costs for purposes of the denominator of the production cost allocation ratio. These taxes include state, local, and foreign income taxes. Including income taxes in the production cost allocation formula would produce a circular computation because to determine the amount of the income tax expense a taxpayer must have already allocated costs between capitalizable and deductible activities to determine taxable income. The inclusion of federal income taxes in the denominator of the production cost allocation ratio would produce a circular computation because computing taxable income requires a taxpayer to determine capitalizable mixed service cost, but to determine capitalizable mixed service costs a taxpayer would need to compute taxable income.

Finally, even though the final regulations, unlike the temporary regulations, do not specifically exclude federal income taxes from total costs this is not determinative of the issue. When material contained in earlier enacted regulations is excluded from subsequent regulations, there is a general presumption that the earlier included material is repealed. However, this is not an absolute rule when a lawmaker’s intent can be found to be otherwise. See Krukowski v. Commissioner, 114 T.C. 366, 390 (2000)(Beghe, J., concurring in part and dissenting in part)(rejecting majority’s conception of the statutory rule of construction), aff’d. 279 F.3d 547 (7th Cir. 2002). State v. Trulock, 160 S.W. 516 (Ark. 1913); Bank of Metropolis v. Faber, 44 N.E. 779 (N.Y. 1896); Singer, Sutherland Statutory Construction, sec. 23:12 at 498 (6th ed. 2002). In the instant case, the inclusion of federal income taxes in § 1.263A-1(e)(iii)(F) was redundant given the rule provided by § 1.263A-1(c)(2)(i). Section 1.263A-

1(e)(iii)(F) provides that state, local, and foreign income taxes and franchise taxes that are assessed on the basis of income are not indirect costs that are required to be capitalized. Section 1.263A-1(c)(2)(i) already clearly provides that federal income taxes, a nondeductible expense, are not properly allocable to property produced. Accordingly, including federal income taxes in § 1.263A-1(e)(iii)(F) was unnecessary and its deletion from this section should not be read as to indicate that federal income taxes are indirect costs that are properly capitalized under § 263A. Likewise, the removal of federal income taxes from this section should not be construed as permitting the inclusion of federal income taxes in total costs, the denominator of the production cost allocation ratio.

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.