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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR MICHAEL J. COOPER
ACTING ASSOCIATE AREA COUNSEL (LMSB)
Attention: Virginia L. Hamilton CC:LM:NR:DEN

FROM: Heather C. Maloy
Associate Chief Counsel (Income Tax and Accounting) CC:ITA

SUBJECT: Allocation of Costs Between Long-Term Construction Contracts and Taxpayer-Owned, Self-Constructed Assets

This Chief Counsel Advice responds to your memorandum dated May 11, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

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LEGEND

Taxpayer =

Product =
Location =
A =
Capability =
Consideration =
Year 1 =
Year 2 =
Year 3 =
Date Y =
$Z =
B =
C =

ISSUES

1. Whether, under the facts summarized below, Taxpayer's "incremental cost" method of cost allocation for income tax purposes is a reasonable allocation method that clearly reflects Taxpayer's income for the taxable years at issue.

2. If Taxpayer's cost allocation method is not a reasonable allocation method, what is a reasonable allocation method under the facts described below?

CONCLUSIONS

1. Taxpayer's "incremental cost" method of allocating costs between its long-term contracts and its self-constructed assets does not clearly reflect income because the total costs actually capitalized pursuant to the method differs 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.

2. Where substantially similar Products are installed in the same Location, section 1.263A-1(f)(4) requires a pro rata allocation of the costs referred to in this field service advice as "Common Costs," whether such costs are direct labor or indirect production costs.

FACTS[1]

Taxpayer business of contract installations of Product for its customers,

From the very beginning of Taxpayer's operation, its business strategy was as follows. In the course of installing Product under contract with its customers, Taxpayer installed simultaneously in the contract Locations, with its customers' permission, one or more additional units of Product than the contract required, and retained ownership of the additional Product. For example, if Taxpayer contracted to install three Products for its customers, it actually installed four in the Location, retaining the additional Product for itself. According to certain evidence that you submitted with your request, Taxpayer's apparent goal was to create and own an A Capability of its own. Taxpayer's Capability initially would consist of leased assets, but would evolve into Products and Capabilities that it owned.

During the years at issue, Taxpayer used a calendar year for financial reporting purposes and a fiscal year for income tax reporting purposes. Until the end of calendar Year 2 for financial reporting purposes[2] and Year 3 for tax reporting purposes, Taxpayer used what it calls an "incremental cost method" of accounting for both the Product installed for customers pursuant to construction contracts and its own Product installed in the same locations as the customers' Product. Specifically, Taxpayer allocated to the construction contracts and classified as Cost of Goods Sold for income tax purposes the direct materials associated with the Product installed for customers, plus virtually all of the labor and overhead required to install both the customers' Product and the Product belonging to Taxpayer. Thus, Taxpayer essentially allocated to its self-constructed assets only

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[1]You submitted with your request a significant amount of factual material, much of which is either unique to Taxpayer or descriptive of such a small population of businesses as to raise the possibility of disclosing Taxpayer's identity by its publication. For that reason, we shall limit the exposition of facts to a brief summary in order to protect Taxpayer's identity.

[2]At the end of calendar Year 2, taxpayer changed its cost allocation method to the average cost method for financial reporting purposes, but continued using the "incremental cost" method for tax reporting purposes.

the materials and virtually none of the direct labor and overhead incurred to install its own Product.

Your request included an example of Taxpayer's cost allocation method taken from one of its actual contracts involving the simultaneous installation of three Products (assumed herein to be Products 1 through 3) under a customer contract plus one Taxpayer-owned Product (Product 4). Taxpayer allocated Product Material costs ratably to all four Products installed. However, Taxpayer allocated "Other Material" to Products 1 and 2 only, and none to either Product 3 or Product 4. Thus, Taxpayer allocated no Other Material cost to its self-constructed asset. Also, Taxpayer allocated all Construction Labor (direct labor) costs of the installation to Product 1 (i.e., to the customer contract), and apparently none to the Product 4, the self-constructed asset. Additionally, Taxpayer allocated "Other Material Labor" to Products 1 and 2 (again, all to the customer contract), and none to its self-constructed asset. The analysis accompanying this example suggests that only C per cent of the total installation cost was allocated to Products 2, 3, and 4 combined. This suggests in turn that Taxpayer allocated to its self-constructed asset, and subsequently capitalized, only B per cent of the cost of the entire installation.

After examining the audit cycle covering Taxpayer's taxable Year 1, Year 2, and Year 3, the Service determined that Taxpayer's method of accounting for its Product installations overstates the cost of goods sold on its installation contracts, thus understating Taxpayer's taxable income for the years in question. Additionally, Taxpayer's cost allocation method understates the amount to be capitalized regarding Taxpayer's self-constructed assets, thus causing misstatements of income in future taxable years. Therefore, the examiners concluded that Taxpayer's method of accounting does not clearly reflect income. The examiners proposed adjustments totaling $Z relating to the cost allocation issue.

LAW AND ANALYSIS

Law:

In general, a taxpayer must compute taxable income according to the method of accounting by which the taxpayer computes income in the course of keeping its books. I.R.C. § 446(a). Notwithstanding this general requirement, if a taxpayer's method of accounting does not clearly reflect income, the Secretary may change the taxpayer's method of accounting to a method that, in the Secretary's opinion, does clearly reflect income. I.R.C. § 446(b).

As the Secretary's delegate, the Commissioner has broad discretionary powers under section 446 and its regulations in determining whether a taxpayer's accounting methods clearly reflect income. Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 532 (1979). Because the Commissioner has so much latitude for discretion, "his interpretation of the statute's clear-reflection standard 'should not be interfered with unless clearly unlawful.'" Id., quoting Lucas v. American Code Co., 280 U.S. 445, 449 (1930). Thus, a taxpayer ordinarily has a heavy burden in overcoming the Commissioner's determination. Photo-Sonics, Inc. v. Commissioner, 42 T.C. 926 (1964), aff'd, 357 F.2d 656 (9th Cir. 1966), acq., 1965-2 C.B. 6.

A taxpayer that produces real property or tangible personal property for use in its trade or business or for sale to customers must capitalize all the direct costs of producing the property and the property's properly allocable share of indirect costs. Treas. Reg. § 1.263A-1(a)(3). A taxpayer "produces" property if it constructs, builds, installs, manufactures , develops, improves creates, raises, or grows that property. I.R.C. § 263A(g)(1); Treas. Reg. § 1.263A-2(a)(1)(i). Direct costs for producers of property include direct materials and direct labor costs. Treas. Reg. § 1.263A-1(e)(2)(i). Direct labor costs include basic compensation of the employees producing the asset, plus their overtime, premium pay, vacation pay, sick leave (subject to certain exclusions not at issue herein), shift differential pay, payroll taxes, and payments to a supplemental unemployment benefit plan. Treas. Reg. § 1.263A-1(e)(2)(B). Indirect costs for producers of property are all costs other than direct material and direct labor costs. Treas. Reg. § 1.263A-1(e)(3)(i). Indirect costs are properly allocable to property produced when the costs directly benefit or are incurred by reason of the performance of production activities. Indirect costs may be allocable to production and resale activities, as well as other activities that are not subject to § 263A. Id. Taxpayers subject to § 263A must make a reasonable allocation of indirect costs between production, resale, and other activities. Id.

Section 1.263A-1(f) sets forth various detailed or specific (facts-and-circumstances) methods – specific identification method, burden rate method, and standard cost method – that taxpayers may use to allocate direct and indirect costs to property produced. A specific identification method traces costs to a cost objective such as an activity or product on the basis of a cause and effect or other reasonable relationship between the cost and the cost objective. Treas. Reg. § 1.263A-1(f)(2). A burden rate method allocates an appropriate amount of indirect costs to property produced during a taxable year using predetermined rates that approximate the actual amount of indirect costs incurred by the taxpayer during the taxable year. Treas. Reg. § 1.263A-1(f)(3)(i). 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. Treas. Reg. § 1.263A-1(f)(3)(ii). The proper use of a standard cost method, however, requires that a taxpayer reallocate to the property produced a pro rata portion or any net positive or net negative variances between actual and standard indirect costs and apportion such variance to or among the units of property produced. Id.

Section 1.263A-1(f)(4) provides that a taxpayer may allocate direct and indirect costs to property produced using a facts-and-circumstances allocation method if the method used 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 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.

Analysis:

Taxpayer is engaged in two production activities that occur concurrently – installation of Products under long-term contracts[3] and installation of Products for use in Taxpayer's own trade or business or for sale to customers. For the years at issue, tax accounting for the former activity is governed by § 460 and the regulations under former § 1.451-3 (to the extent that they do not conflict with § 460). See Notice 89-15, 1989-1 C.B. 634. Tax accounting for the latter activity is governed by § 263A and the regulations thereunder. This field service advice concerns the interplay of these two tax accounting regimes in this novel situation, which involves a taxpayer whose production activities are subject to both sets of rules.

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[3]For purposes of this field service advice, we have assumed that Taxpayer's installation contracts are long-term contracts. However, nothing in this field service advice should be construed as a determination that those contracts are, in fact, long-term contracts within the meaning of § 460(f).

Taxpayer asserts that its allocation of direct costs is required by § 1.451-3, and therefore, is unassailable. Taxpayer further asserts that the applicable regulations, § 1.451-3(d), merely require that indirect costs be allocated based on a reasonable basis. Based on these premises, Taxpayer concludes that the revenue agent's inquiry must be limited to the issue of whether Taxpayer's method of allocating indirect costs is "reasonable," as that term is defined by Webster's Dictionary. We disagree.

At the outset, we note that the legislative history of sections 263A and 460 indicates congressional intent to establish uniform capitalization and allocation rules for costs incurred in the production of real and tangible personal property. Section 263A provides uniform capitalization rules applicable to the production of real and tangible personal property not produced under a long-term contract. Section 460 provides similar rules applicable to the production of real and tangible personal property under a long-term contract. Although sections 263A and 460 cover separate spheres of production activity, the legislative history indicates that the two provisions are intended to work in harmony. See H.R. Conf. Rep. No. 841, 99th Congr., 2d Sess., reprinted at 1986-3 C.B. Vol. 4 at 311.   (Generally, all long-term contracts are subject to rules similar to the uniform capitalization rules.)

The regulations under section 263A require a taxpayer to allocate all direct costs to the property produced by the taxpayer. Ordinarily, direct labor costs and direct materials costs are traced to a specific item (e.g., a taxpayer's inventory of widgets or long-term contract to manufacture widget(s) for a customer). When multiple units are produced for the taxpayer's own inventory, each unit bears a portion of these direct costs. The regulations also require a taxpayer to allocate certain indirect costs to the property produced by the taxpayer. Because indirect costs (e.g., plant manager's salary) generally cannot be traced to a particular item, the regulations require the taxpayer to allocate these costs using a reasonable method. Treas. Reg. § 1.263A-1(e)(3)(i). In addition, the regulations under section 263A require a taxpayer to allocate service costs, which are indirect costs, among production activities, resale activities, and activities not subject to § 263A using a reasonable allocation method. Treas. Reg. § 1.263A-1(g)(4). The service costs that are allocated to the taxpayer's production activities must be allocated to the property produced by the taxpayer using a reasonable allocation method. Treas. Reg. § 1.263A-1(e)(3)(i). In this case, "direct labor costs" is closely analogous to indirect labor costs because the taxpayer incurred them while installing Products both for customers pursuant to contracts and for its own use in the same Location.

The issue in this case is how to apply the regulations under sections 1.263A-1 and 1.451-3 when a taxpayer incurs production costs that apply to two distinct activities and that would not have been less if the taxpayer had been engaged in only one of these activities. For example, the cost of building and launching a rocket into space is virtually the same if the rocket carries two satellites (one for a customer and one for the taxpayer) or just one satellite (for a customer). The types of costs at issue in this case must be incurred for the taxpayer to install a single Product, and the amount of the costs does not materially change whether Taxpayer installs one Product pursuant to a contract or for its own use, or multiple Products pursuant to one or more contracts or for its own use, or a combination of Products pursuant to contract(s) or for its own use. We will refer to these costs as “Common Costs” in this field service advice, though we recognize that the term does not adequately describe the costs.

The Common Costs at issue in this case include both direct labor and indirect costs. The Common Costs that are direct labor costs are similar to indirect costs that are incurred irrespective of the whether the taxpayer is engaged exclusively in an activity subject to § 263A or simultaneously engaged in an activity subject to § 263A and another activity. For example, if a taxpayer operates in a state that requires businesses to annually purchase a business license, the taxpayer will have to purchase the business license whether it manufactures goods and holds them for sale to customers (a § 263A production activity) or it manufactures unique items pursuant to contracts with customers (a § 460 long-term contract activity) or whether it does both.

Section 1.451-3 does not specify parameters for evaluating whether a taxpayer’s method of allocating direct and indirect costs allocates such costs on a reasonable basis. Section 1.263A-1(f), on the other hand, requires that a taxpayer allocate direct and indirect costs among units of property produced and permits the use of any allocation method that is a reasonable allocation method within the meaning of § 1.263A-1(f)(4).

An allocation method is reasonable under § 1.263A-1(f)(4) if it meets three separate requirements. The first requirement is that the total costs actually capitalized pursuant to the method do not differ 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. The permissible methods described in § 1.263A-1(f) include the specific tracing method, the burden rate method, and the standard cost method. Under a burden rate or standard cost method, similar units of property produced will be allocated a similar amount of direct and indirect costs. This is true for both fixed and variable costs. Taxpayer’s method does not allocate a similar amount of Common Costs to similar units of property. Consequently, the amount of costs actually capitalized is significantly less than the amount that would be capitalized using another permissible method described in § 1.263A-1(f). Therefore, taxpayer’s method does not qualify as a reasonable allocation method.

We believe that, where substantially similar Products are installed in the same Location, § 1.263A-1(f)(4) requires a pro rata allocation of Common Costs, whether such costs are direct labor or indirect production costs. Thus, if Taxpayer installed

4 substantially similar Products in a single Location for use in its business, the Common Costs must be allocated equally to each Product. We further believe that § 1.263A-1(f)(4) requires a pro rata allocation of Common Costs that are incurred both in the production of an asset subject to § 263A and pursuant to a long-term contract. Thus, if Taxpayer installed 4 substantially similar Products in a single Location – 3 for use in Taxpayer's business and 1 pursuant to a contract – and incurred $100 of Common Costs, $75 of the total Common Costs must be allocated equally among the Products installed for use in Taxpayer's business.

As stated previously, § 1.451-3 does not provide guidelines for determining whether a taxpayer's method of allocating costs among separate long-term contracts is "reasonable." The "dictionary definition of reasonableness" approach advocated by Taxpayer is entirely unhelpful in the evaluation of cost allocation methods. Given the nexus between § 460 and § 263A, however, we believe that it is appropriate to apply the standard in § 1.263A-1(f)(4) to determine whether an allocation method is a reasonable method. As stated above, we believe that, where substantially similar Products are installed in the same Location, § 1.263A-1(f)(4) requires a pro rata allocation of Common Costs, whether such costs are direct labor or indirect production costs.

Taxpayer cites Fort Howard Paper Co. v. Commissioner, 49 T.C. 275 (1967), as authority for its incremental cost method of accounting. We believe Fort Howard Paper is questionable for two reasons. First, the Tax Court decided Fort Howard Paper before Congress enacted I.R.C. § 263A and before the Supreme Court decided Commissioner v. Idaho Power Co., 418 U.S. 1 (1974), both of which require a different result. Second, The Tax Court itself has limited Fort Howard Paper to its facts on the ground that there would have been no major difference between Fort Howard's incremental cost method and the full cost absorption method. William K. Coors et al. v. Commissioner, 60 T.C. 368, 396-97 (1973), aff'd sub nom. Adolph Coors Company v. Commissioner, 519 F.2d 1280 (10th Cir. 1975). Therefore, we do not believe that Fort Howard Paper is controlling authority here.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Although we believe that Taxpayer's allocation method is impermissible under §§ 263A and 460, [redacted]

[redacted] In Lychuck, an S corporation's sole business activity was acquiring and servicing installment contracts from automobile dealers selling vehicles to high credit risk purchasers. The Service required capitalization of certain indirect costs relating to acquiring (but not to servicing) installment contracts in the ordinary course of ACC's business. The Tax Court agreed with the Service in part, but found that certain overhead costs were "generally fixed charges which had no meaningful relation to the number of credit applications analyzed ...." Id. at 29. Accordingly, the court held that these costs were currently deductible. Section 263A did not apply in Lychuck because the loans were not acquired for resale. However, we anticipate that taxpayers in other situations might argue that Lychuk applies to a broad range of indirect costs and activities. If Taxpayer in the instant case advances such an argument, please contact us.

[redacted]

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Please call if you have any further questions.

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