INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

Company =
A =
B =
C =
D =
E =
F =
G =
H =
I =
J =
K =
L =
M =
Senior Manager =
Manager =
Merchants =

Discount Store =
City =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =

ISSUE(S):

1. Whether the costs incurred by Company's merchandising departments are mixed service costs as defined by § 1.263A-1(e)(4)(ii)(C) of the Income Tax Regulations.

2. Whether Company is entitled to relief under § 7805(b) of the Internal Revenue Code.

CONCLUSION(S):

1. The costs incurred by Company's merchandising departments are not mixed service costs as defined by § 1.263A-1(e)(4)(ii)(C).

2. Company is not entitled to relief under § 7805(b).

FACTS:

Company operates a chain of retail stores and employs many buyers, assistant buyers and other employees ("merchandising employees") that are involved with the purchase of merchandise. Company's merchandising employees are organized into merchandising divisions.[1] Company's merchandising divisions include; A, B, C, D, E, F, G, H, I, J, K, L, and M. Each merchandising division is responsible for one or two departments at a store.

The merchandising employees generally select the items to be purchased, negotiate with vendors, arrange delivery of merchandise, monitor inventory levels and determine the assortment of goods to be offered at each store. Surveys done by Company indicate that two-thirds of the merchandising divisions' costs were attributable to purchasing merchandise. The merchandising divisions only purchase merchandise

[1] For purposes of this technical advice memorandum, the terms "division" and "department" will be used interchangeably.

and do not purchase materials for internal use. Company sometimes refers to the merchandising divisions' purchasing activities as "front of the house" purchasing.

Each of Company's merchandising divisions is supervised by a Senior Manager. The Senior Managers decide the product lines that will be offered for sale and the departments' layouts. The Senior Managers also manage the relationships with major vendors.

The Senior Managers supervise Managers. The Managers are responsible for geographic areas and supervise a handful of Merchants, buyers, and assistant buyers. Each buyer or assistant buyer is assigned to a group of stores. The Merchants work in stores and are liaisons between the buyers and the store's sales floor. Analysts report product levels and prepare analysis for use by the Senior Managers, buyers, and assistant buyers.

The majority of the employees within the merchandising divisions are buyers and assistant buyers. The buyers are primarily responsible for obtaining merchandise for Company's stores. The buyers work with designers and manufacturers concerning product designs and characteristics. In other words, the buyers decide what to buy, how much to pay, and which stores should receive which merchandise. The buyers are also generally responsible for assortment planning and purchase order terms and conditions. The buyers are also responsible for floor merchandising, price management, selling floor education, local sales promotions, and special events. Accordingly, the buyers plan markdowns, decide when to move merchandise to Discount Store, and negotiate with vendors to take back slow-moving merchandise. In order to perform these responsibilities, the buyers must understand what is and what will be selling at Company's stores. Therefore, the buyers must monitor sales figures and talk with the store employees. Moreover, some assistant buyers and Merchants spend time on the stores' sales floors.

Company also maintains several departments (for example, human resources, accounting, data processing, and supplies) that assist the merchandising and store employees. All purchasing for Company's internal use is controlled through the corporate purchasing department. Among other things, the corporate purchasing department provides the following goods and services for Company: (1) printers, (2) miscellaneous supplies, (3) first aid supplies, (4) janitorial supplies, (5) distribution services, (6) promotion items, (7) copying services, (8) sign shop services, (9) wrapping, (10) gift boxes, (11) shopping bags, (12) corrugated packaging supplies, (13) office supplies, (14) forms, labels, and tickets, (15) copiers and fax machines, (16) lighting, and (17) waste hauling services. The corporate purchasing department is located in City, but the work is divided into four geographic areas (Northwest, Southwest, Central, and East Coast). The corporate purchasing department is also responsible for strategic sourcing, information technology hardware purchasing, corporate travel and relocation,

building services, and human resource contract and program services. Company sometimes refers to the activities of the corporate purchasing department as "back of the house" purchasing.

In Date 1, Company filed a Form 3115, Application for Change in Accounting Method, requesting the Commissioner's consent to change certain aspects of its method of inventory costing pursuant to § 263A. In its Form 3115, Company indicated that its present method of allocating mixed service costs was based on a facts and circumstances method and described the method as a combination of both the simplified service cost method using the labor based allocation ratio provided by § 1.263A-1(h)(4) and the step-allocation method provided by §1.263A-1(g)(4)(iii)(B). The Form 3115 indicated that Company used the simplified resale method without the historic absorption ratio election provided by § 1.263A-3(d)(3) to capitalize additional § 263A costs to ending inventory.

The representations made by Company in its Form 3115 regarding its method of allocating mixed service costs and additional §263A costs did not adequately disclose the method of accounting that it was using. In fact, Company applied a composite absorption ratio to its § 471 costs in ending inventory to determine the amount of additional § 263A costs, including mixed service costs, that were capitalized to ending inventory. Company's composite absorption ratio was comprised of the following six separate absorption ratios: processing, storage, purchasing, G&A storage, G&A purchasing, and G&A production. This method does not correspond to the simplified resale method provided by § 1.263A-3(d).

In its Form 3115, Company proposed to use the simplified service cost method provided by § 1.263A-1(h) to determine capitalizable mixed service costs and the simplified resale method provided by § 1.263A-3(d) to determine additional § 263A costs capitalizable to ending inventory. Company's Form 3115 further stated that it "propose[d] to apply the service department definition under Treas. Reg. § 1.263A-1(e)(4)(i) and has identified the following types of departments as mixed service departments: Accounting, Data Processing, Human Resources, and Merchandising in accordance with Treas. Reg. § 1.263A-1(e)(4)(ii)(C)."

On Date 2, the National Office sent a letter to Company that asked the following question: "Indicate whether the taxpayer, under its present method, is treating its accounting, data processing, human resources, and merchandising department costs as fully capitalizable costs or fully deductible costs."

By letter, dated Date 3, Company responded to this question as follows: "The taxpayer is treating its accounting, data processing, human resources, and merchandising department [sic] as mixed service costs as defined in Treas. Reg. § 1.263A-1(e)(4)(ii)(C)." From this statement, the National Office understood that

Company was not requesting the Commissioner's consent to change the classification of its merchandising department as a mixed service department.

On Date 4, the National Office sent Company a change in accounting method ruling letter and consent agreement. The ruling letter and consent agreement provided, in part, as follows:

> Under the present method, the taxpayer accounts for inventories under the first-in, first-out (FIFO) method valued at retail cost or market, whichever is lower. The cost of merchandise is determined in accordance with §§ 1.471-3 and 1.471-8. The taxpayer determines market in accordance with §§ 1.471-4 and 1.471-8.
>
> The taxpayer determines mixed service costs using a facts and circumstances method. The taxpayer uses the simplified resale method without the historic absorption ratio election to allocate additional § 263A costs to ending inventory. Under this method, the taxpayer uses gross purchases less purchase returns and discounts when computing its § 471 costs.
>
> Under the proposed method, the taxpayer will capitalize all indirect costs related to the acquisition, handling, and storage of merchandise in accordance with § 263A and the regulations thereunder. The taxpayer will continue to account for inventories under the FIFO method valued at retail cost or market, whichever is lower. The taxpayer will determine cost in accordance with §§ 1.471-4, 1.471-8, and § 263A and the regulations thereunder.
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> * * * * *
>
> The taxpayer will use the simplified service cost method with the labor-based allocation ratio to determine capitalizable mixed service costs for those mixed service departments that are not treated as engaged exclusively in resale or non-resale activities under the de minimis rule (because 90 percent or more of the department's costs are not capitalizable service costs or deductible service costs). In determining the total costs of a mixed service department, the taxpayer will include all costs incurred in the department and will not exclude any otherwise deductible service costs. For example, if an activity is a mixed service activity, then in determining the total cost of the activity, the taxpayer may not exclude the costs of personnel engaged in that activity that perform services relating to non-resale activities. See § 1.263A-1(h)(6).
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> The taxpayer will continue to use the simplified resale method without the historic absorption ratio election to allocate additional § 263A costs to ending

inventory. See § 1.263A-3(d)(3). The taxpayer will use gross purchases less discounts when determining § 471 costs. The taxpayer's § 471 costs under the simplified resale method will include the cost of merchandise determined in accordance with § 1.471-3. The taxpayer's additional § 263A costs under the simplified resale method will include all indirect costs, other than interest, that the taxpayer must capitalize under § 263A that are not treated as § 471 costs (including indirect costs related to the acquisition, handling, and storage of merchandise, and capitalized mixed service costs).

On Date 5, the National Office sent Company a revised ruling letter and consent agreement. The revised ruling letter and consent agreement only modified the amount of the requested § 481(a) adjustment.

On Date 6, an officer of Company signed and returned the consent agreement to the National Office.

LAW AND ANALYSIS:

1. Whether the costs incurred by Company's merchandising departments are mixed service costs as defined by § 1.263A-1(e)(4)(ii)(C)

Company contends that the costs incurred by its merchandising departments are mixed service costs that may be allocated between resale activities and non-resale activities using the simplified service cost method provided by § 1.263A-1(h). Company's argument is chiefly premised on § 1.263A-1(e)(4)(iii)(C). Section 1.263A-1(e)(4)(iii) provides examples of capitalizable service departments or functions whose costs are generally allocated among production or resale activities. Subsection C of this section provides that costs of a department that involve "purchasing operations, including purchasing materials and equipment, scheduling and coordinating delivery of materials and equipment to or from factories or job sites, and expediting and follow up" are an example of capitalizable service costs. Company also argues that the costs of its merchandising department are mixed service costs because the department benefits both capitalizable and deductible activities.

The director argues that the Company's merchandising departments are not service departments and therefore, the costs incurred by them are not mixed service costs that may be allocated using the simplified service cost method.

The costs incurred by Company's merchandising divisions are not mixed service costs as defined by § 1.263A-1(e)(4)(ii)(C). Section 263A generally requires a taxpayer to capitalize the direct costs and an allocable share of the indirect costs of real or personal property described in § 1221 that is acquired by the taxpayer for resale. The direct costs of property acquired for resale includes the acquisition costs of such property. See § 1.263A-1(e)(2)(ii). The indirect costs of property acquired for resale

are all costs other than acquisition costs. See § 1.263A-1(e)(3). Indirect costs are properly allocable to property acquired for resale when the costs directly benefit or are incurred by reason of the performance of resale activities. Id. Indirect costs may be allocable to a resale activity and other activities that are not subject to § 263A. Accordingly, taxpayers must make a reasonable allocation of indirect costs between resale and other such activities. See § 1.263A-1(e)(3)(i). Purchasing costs are an example of an indirect cost that must be capitalized to the extent they are properly allocable to property acquired for resale. See § 1.263A-1(e)(3)(ii)(F).

Indirect costs subject to capitalization under § 263A include indirect labor costs, certain overhead costs, and capitalizable service costs. See § 1.263A-1(e)(3). The regulations define service costs as 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. See § 1.263A-1(e)(4)(i)(A). For this purpose, service departments are defined as administrative, service, or support departments that incur service costs. See § 1.263A-1(e)(4)(i)(B). The mere title or activity of a department or function does not determine whether the department or function constitutes a service department. Instead, the facts and circumstances of the taxpayer's activities and business organization control whether a department is a service department. Id. To better understand the application of this definition to a retailer, the law prior to the effective date of § 263A must be examined.

Prior to the effective date of § 263A, retailers were required to include in inventory the invoice price of the goods less any trade or other discounts. Retailers were also required to include in inventory costs the transportation or other necessary charges incurred in acquiring possession of the goods. See § 1.471-3(b). In contrast, costs incurred by a retailer subsequent to the retailer taking possession of the merchandise were not required to be included in inventory costs. See McIntosh-Mills v. Commissioner, 9 B.T.A. 301 (1927).

Congress enacted § 263A because it believed that "in order to more accurately reflect income and make the income tax system more neutral, a single, comprehensive set of rules should govern the capitalization of costs of producing, acquiring, and holding property." See S. Rep. No. 99-313, 140 (1986), 1986-3 (Vol. 3) C.B. 1, 140. Accordingly, § 263A requires retailers to capitalize costs to inventory in the same manner as manufacturers.

Prior to the effective date of § 263A, manufacturers were required to capitalize some indirect costs, including factory administrative expenses, if such costs were included in inventory costs for purposes of the taxpayer's financial reports. However, manufacturers were not required to capitalize general and administrative expenses incident to and necessary for the taxpayer's activities as a whole rather than to

production or manufacturing operations or processes. See id. See also § 1.471-11. Under § 263A, taxpayers are not only required to capitalize the direct costs of assets produced or acquired for resale, but also an allocable portion of most indirect costs that benefit the assets, including general administrative and overhead costs. See S. Rep. No. 99-313 at 141.

Congress directed the Treasury Department to promulgate regulations under § 263A that provided for allocation of indirect costs that were similar to the methods prescribed under the then existing long-term contract rules provided by § 1.451-3. According to the legislative history of § 263A, those rules provided a large measure of flexibility to taxpayers in allocating indirect costs to contracts inasmuch as they permitted any reasonable method of allocation authorized by cost accounting principles. Accordingly, Congress expected that the Treasury Department would take a similar approach and permit similar allocation methods permitted by cost accounting principles. Congress also indicated that the regulations may adopt other simplifying methods and assumptions, where in the judgment of the Treasury Department, the costs and other burdens of literal compliance may outweigh the benefits. See S.Rep. No. 99-313 at 142.

The Treasury Department promulgated regulations under § 263A that respect traditional cost accounting principles. In particular, the regulations segregate service costs into the following three separate categories: (1) capitalizable service costs, (2) deductible service costs, and (3) mixed service costs. For this purpose, capitalizable service costs are service costs that directly benefit or are incurred by reason of the performance of a production or resale activity of the taxpayer. See § 1.263A-1(e)(4)(ii)(A). Deductible service costs are service costs that do not directly benefit or are not incurred by reason of the performance of a production or resale activity of the taxpayer. See § 1.263A-1(e)(4)(ii)(B). Mixed service costs are service costs that are partially allocable to production or resale activities and partially allocable to non-production or non-resale activities. See § 1.263A-1(e)(4)(ii)(C).

The regulations also generally respect the allocation methods permitted under cost accounting principles by permitting taxpayers to allocate indirect costs 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 § 1.263A-1(f)(4)). See § 1.263A-1(g)(3). With regard to mixed service costs, the regulations again generally respect the allocation methods traditionally permitted under cost accounting principles by permitting taxpayers to allocate mixed service costs using reasonable factors or relationships by applying a direct reallocation method, a step-reallocation method, or any other reasonable allocation method (as defined under the principles of § 1.263A-1(f)(4)). See § 1.263A-1(g)(4). Cost accounting principles generally permit an allocation of costs incurred by service departments using either a direct, step-down, or reciprocal method. The direct reallocation method and the step-reallocation method are

similar to the direct and step-down methods permitted by cost accounting principles. In respect of the Congressional directive, the regulations also provide a simplified method (the simplified service cost method) for determining capitalizable mixed service costs. See § 1.263A-1(h).

Company's argument that its merchandising department is a mixed service cost because its costs are both allocable to resale activities and deductible activities does not properly address the definition of service costs that is contained in § 1.263A-1(e)(4). The definition of indirect costs contained in § 1.263A-1(e)(3) contemplate that such costs may not be fully allocable to capitalizable activities, but instead may be also allocable to activities not subject to § 263A. The regulations do not conclude in § 1.263A-1(e)(3) that indirect costs that are allocable to both capitalizable activities and activities that are not subject to § 263A are mixed service costs. Instead, the regulations separately define service costs and mixed service costs in § 1.263A-1(e)(4). Accordingly, in order to address whether the costs incurred by Company's merchandising department are mixed service costs we must reference the definition of service cost contained in that section.

It is axiomatic that a cost must first be a "service cost" for it to be considered a "mixed service cost." As explained above, a service cost is an indirect cost that can be identified specifically with a service department or function or that directly benefits or is incurred by reason of a service department or function. See § 1.263A-1(e)(4)(i)(A). Service departments are administrative, service, or support departments that incur service costs. See § 1.263A-1(e)(4)(i)(B). Although this definition may appear to be somewhat circular, when properly analyzed in relation to its underlying cost accounting principles the definition is clear.

Traditionally, cost accounting has distinguished between operating departments and service departments. An operating department (also called a production department with regard to a manufacturer) adds value to a product or service. See Charles T. Horngren, George Foster, & Srikant M. Datar, Cost Accounting, A Managerial Approach, 510 (10th ed. 1998). In contrast, a service department (also called a support department) assists other internal departments (operating departments and other service departments) in the organization. Id. In other words, service departments are those activities that are necessary to facilitate a company's core activities, but in which the core activities themselves are not performed. See John J. W. Neuner & Samuel Frumer, Cost Accounting, Principles and Practice, 223 (Irwin 1967).

Once again, the UNICAP regulations parallel traditional cost accounting by distinguishing between service departments and operating departments. In the context of a manufacturer, the purchasing department is often a service department because such department does not directly engage in the production of the manufacturer's products, but only assists or supports the production departments. See Horngren, supra; Neuner, supra. The example contained in § 1.263A-1(e)(4)(iii)(C) simply

recognizes this. Furthermore, the example does not provide the result that should be reached for all taxpayers. Instead, as directed by the general rule contained in § 1.263A-1(e)(4)(i)(B), taxpayers must examine the particular facts and circumstances of its business activities and business organization to determine whether a department is a service department.

The definitions of operating departments and service departments that have been used for cost accounting have evolved with respect to manufacturers and its application to merchants is not fully explored by texts that discuss cost accounting principles. In any event, the conceptual framework of cost accounting for distinguishing operating departments from service departments of manufacturers is useful in distinguishing the service departments and operating departments of non-manufacturers. That is, in order to determine whether a department is an operating department or a service department the role of a production department within the context of a manufacturer must be analyzed.

In a manufacturing entity, the production department directly acts on the products or goods that will be sold. Accordingly, to some extent the costs of the production department can be directly associated with the manufacturer's products using predetermined rates. On the other hand, the service departments of a manufacturer are not directly associated with the manufacturer's products or goods.

With regard to a retailer, the department that purchases merchandise (i.e., the merchandising or product purchasing department) is generally akin to the manufacturer's production departments. These departments directly act on the products and goods that will be sold to the retailer's customers. Accordingly, within the context of a retailer, a department that acquires merchandise normally is not a service department. In such cases the costs of such a department are not mixed service costs and can not be allocated using the simplified service cost method.

Company's contention that its merchandising department is a mixed service cost also conflicts with a specific section of the regulations that deals with purchasing costs. Section 1.263A-1(e)(3)(ii)(F) provides that purchasing costs are an indirect cost that must be capitalized to the extent such costs are properly allocable to property acquired for resale. This section also cross references § 1.263A-3(c)(3) for a further discussion of purchasing costs. Section 1.263A-3(c)(3) provides that resellers must capitalize the cost of property acquired for resale and purchasing costs that are properly allocable to property acquired for resale. This section defines purchasing costs as costs associated with operating a purchasing department or office, including personnel costs, relating to: (1) the selection of merchandise, (2) the maintenance of stock assortment and volume, (3) the placement of purchase orders, (4) the establishment and maintenance of vendor contacts, and (5) comparison and testing of merchandise. Section 1.263A-3(c)(3)(ii), in part, provides that if a person performs both purchasing and non-purchasing activities,

the taxpayer must reasonably allocate the person's labor costs between these activities. The regulation then suggests that a reasonable allocation would be one based on the amount of time the person spends on each activity. Read together, § 1.263A-1(e)(3) and §1.263A-3(c), clearly indicate that the purchasing costs of a reseller must be capitalized and that if a person performs both purchasing and non-purchasing activities a reasonable allocation method must be employed to determine the purchasing costs. Treating purchasing costs as mixed service costs and allocating such costs using the simplified service cost method does not attain the result mandated by §§ 1.263A-1(e)(3) and 1.263A-3(c) when a taxpayer uses the simplified resale method.

Section 1.263A-3(d) generally provides a simplified method, the simplified resale method, for determining the additional § 263A costs properly allocable to property acquired for resale.[2] Under this method, the additional § 263A costs allocable to eligible property remaining on hand at the close of the taxable year are determined by multiplying the § 471 costs remaining on hand at year end by the "combined absorption ratio." The combined absorption ratio is defined as the sum of the taxpayer's storage and handling ratio and the taxpayer's purchasing ratio. The purchasing ratio is equal to the taxpayer's current year's purchasing costs divided by its current year's purchases. The taxpayer's current year's purchasing costs are generally defined as the total purchasing costs incurred during the taxable year that relate to the taxpayer's property acquired for resale. Purchasing costs include the amount of allocable mixed service costs determined in § 1.263A-3(d)(3)(i)(F). This section provides, in part, that if a taxpayer uses the simplified service cost method, the amount of mixed service costs allocated to and included in purchasing costs in the purchasing absorption ratio is determined by multiplying the taxpayer's total mixed service costs by the ratio of the taxpayer's labor allocable to purchasing to its total labor costs. Labor costs allocable to purchasing are defined as total labor costs allocable to purchasing, excluding labor costs included in mixed service costs.

Used together the simplified resale and simplified service cost methods would result in a retailer's purchasing absorption ratio being zero if the retailer were permitted to treat its merchandise purchasing costs as mixed service costs. Obviously, this was not the intended result of the statute and the regulations. Moreover, the legislative history of § 263A clearly states that retailers "are required to treat as inventory costs … costs incident to purchasing inventory (e.g., wages or salaries of employees responsible for purchasing)." See S. Rep. No. 99-313, supra at 142. Accordingly, interpreting § 1.263A-1(e)(4)(i)(B) in a way that is contrary to the legislative history of §263A and its regulatory scheme is not tenable.

[2] Additional § 263A costs are generally 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 § 263A, but that are required to be capitalized under § 263A. See § 1.263A-1(d)(3).

Additionally, the direct and step allocation methods for allocating mixed service costs provided by the regulations, §§ 1.263A-1(g)(4)(iii)(A) and (B), contemplate that the costs of mixed service departments are allocable to other internal departments or cost centers. Company's proposed definition for a service department (i.e., a department that benefits both capitalizable and deductible costs) does not fit this model. Instead, Company's definition merely expresses the notion that indirect costs are generally allocated between two or more activities. Company's definition does not reflect that the costs of a mixed service department are allocable to other internal departments or cost centers. Accordingly, the definition of a service department argued by Company can not be the definition contemplated by the regulations.

Company also argues that the Service should not adopt a bright-line rule that holds that a department can not be a service department because it incurs merchandise purchasing costs. For example, Company contends that an accounting department that contains buyers can be a mixed service department. In this regard, Company argues that the accounting function is clearly a service function. Likewise, Company also contends that a family owned and operated retail store could have an owner/employee that manages a sales floor, works behind a cash register, takes inventory counts of goods, and purchase and reorders merchandise. Company argues that this owner/employee should be treated as mixed service department or function. Company has also pointed out that a taxpayer that uses the simplified service cost method is required to include all cost incurred within its mixed service departments and cannot exclude any otherwise deductible costs when computing capitalizable mixed service costs using the method. Accordingly, Company questions how the purchasing costs in such a case would be handled.

As is discussed above, the facts and circumstances of a taxpayer's activities and business organization control whether a department is a service department. See § 1.263A-1(e)(4)(i)(B). Accordingly, we do not need to address the treatment of the taxpayer's hypothetical department.

For purposes of the regulations, a service department is a department that assists or supports other internal departments so that its costs are allocable to such departments. Company's merchandising departments do not satisfy this definition. Therefore, we conclude that Company's merchandising department is not a service department and, therefore, the costs of such department are not mixed service costs.

2. Whether Company is entitled to relief under §7805(b) of the Internal Revenue Code.

Company argues that if the Service concludes in this technical advice memorandum that it cannot treat its merchandising department costs as mixed service costs, it should be granted relief from retroactive application pursuant to § 7805(b). Company contends that it relied upon the change in accounting method ruling letter that

it received when it changed its accounting procedures and data collection processes to comply with the simplified service cost method. The director contends that the ruling letter only granted Company consent to change its method of allocating mixed service costs and that it did not express any opinion concerning the status of Company's merchandising departments as mixed service departments.

Company is not entitled to relief under § 7805(b). A letter ruling granting consent to a change in accounting method is a letter ruling. A letter ruling found to be in error or not in accord with the current views of the Service may be revoked or modified. See section 601.204(c) of the Procedural and Administrative Regulations; see also section 12.04 of Rev. Proc. 2001-1, 2001-1 I.R.B. 1, 46. When a letter ruling is revoked, the revocation applies to all years open under the statute of limitations unless the Service exercises its discretionary authority under § 7805(b) to limit the retroactive effect of the revocation. See id. However, section 601.201(l)(5) of the Procedural and Administrative Regulations provides, in part, that except in rare and unusual circumstances, the revocation or modification of a ruling will not be applied retroactively with respect to the taxpayer to whom the ruling originally was issued or to a taxpayer whose tax liability directly was involved in such ruling if (i) there has been no misstatement or omission of material facts, (ii) the facts subsequently developed are not materially different from the facts on which the ruling was based, (iii) there has been no change in the applicable law, (iv) the ruling originally was issued with respect to a prospective or proposed transaction, and (v) the taxpayer directly involved in the ruling acted in good faith in reliance upon the ruling and the retroactive revocation would be to his detriment. See also section 12.05 of Rev. Proc. 2001-1. Failure to satisfy any one of the conditions contained in that section justifies the denial of relief.

The change in accounting method ruling letter granted Company consent to change its method of capitalizing additional § 263A in the following three respects: (1) it granted Company consent to change its method of determining the amount of capitalizable mixed service costs from a facts and circumstances method to the simplified service cost method; (2) it granted Company consent to use the de minimis rule provided by § 1.263A-1(g)(4)(ii) to determine if any portion of or all of a mixed service department's costs are allocable to property acquired for resale; and (3) it granted Company consent to use gross purchases less discounts when determining § 471 costs under its continued use of the simplified resale method. None of these rulings granted Company consent to change its classification of its merchandising department as a mixed service department. Accordingly, the change in accounting method ruling letter issued to Company did not grant it consent to treat its merchandising department as a mixed service department.

Moreover, on Date 2, the National Office sent a letter to Company that asked whether under its then present accounting method it was treating its accounting, data processing, human resources, and merchandising department costs as fully

capitalizable costs or fully deductible costs. Company responded to this question as follows: "The taxpayer is treating its accounting, data processing, human resources, and merchandising department [sic] as mixed services costs as defined in Treas. Reg. § 1.263A-1(e)(4)(ii)(C)." From this statement, the National Office understood that Company was not requesting the Commissioner's consent to change or reclassify its merchandising departments as mixed service departments, but that instead under its then present method it was already treating its merchandising departments as mixed service departments. Accordingly, Company's treatment of its merchandising department as a mixed service department was not due to its reliance on the change in accounting method ruling letter it received.

Company does not dispute this conclusion. Instead, Company argues that it should be granted relief from retroactive application of this technical advice because the National Office understood the nature of the change and the tax consequences arising in connection with granting consent to the change as it related to the treatment of its merchandising costs. Company further contends that it should be granted relief because the National Office has granted other retailers permission to treat their merchandising department costs as mixed service costs.

In seeking the Commissioner's consent to change its method of accounting, Company represented to the National Office that under its present method it was already treating its merchandising departments as mixed service departments. Accordingly, the National Office was not requested to and did not grant Company consent to change its classification of its merchandising departments as mixed service departments. Instead, the ruling letter is simply silent and does not express any opinion as to whether Company's merchandising department is a mixed service department. Section 1.263A-1(e)(4)(i)(B) clearly states that the facts and circumstances of the taxpayer's activities and business organization control whether a department is a service department. In order to determine whether Company's merchandising departments were service departments, the National Office would have been required to seek additional information concerning its activities and business organization. A thorough examination of the case file underlying the change in accounting ruling letter reveals that Company did not provide, nor did the National Office seek, information that would have allowed the National Office to make this determination.

When a taxpayer files a Form 3115 requesting the Commissioner's consent to a change in method of accounting, the taxpayer has "a duty to reveal all material factors pertinent to its request for an accounting method change." Cochran Hatchery, Inc. v. Commissioner, T.C. Memo. 1979-390. Taxpayers can not shift this burden to the National Office. See id. In essence, Company's argument attempts to do just that.

In Cochran Hatchery, Inc. v. Commissioner, supra, a taxpayer was granted permission to change from an accrual method of accounting to the cash receipts and

disbursements method of accounting (cash method). In requesting the change, the taxpayer fully and honestly provided all of the information requested on the Form 3115, but failed to disclose that most of its sales were to a related party. In part, the Service granted the requested change on the taxpayer's representation that there was a long delay between the time of the sale and the receipt of payments on accounts receivable. Subsequently, the Service discovered that most of the taxpayer's sales were to a related party and, therefore, retroactively revoked the letter ruling. The taxpayer argued that the Service's revocation was an abuse of discretion.

The Tax Court disagreed with the taxpayer and instead held that the revocation was justified. In doing so, the court reasoned that "[i]t would be exceedingly difficult, if not impossible, for [the Commissioner] to design specific questions covering every conceivable circumstance relating to an accounting method change." See id.

Company represented that it was already treating its merchandising departments as mixed service departments. Although Company may have attempted to fully and honestly provide all the information requested on the Form 3115 and requested by the National Office, this fact does not shift the burden onto the National Office. In other words, the Form 3115 filed by Company did not request the Commissioner's consent to treat its merchandising departments as mixed service departments. Accordingly, the National Office understood that Company was not requesting a determination as to whether its merchandising departments were mixed service departments and it did not seek information that would have permitted it to make the determination. As explained in Cochran Hatchery, the taxpayer bears the burden of completing a Form 3115 so as to accurately notify the National Office of a requested change in method of accounting.

Company's argument in this case would elevate the National Office's silence to a written ruling that may be relied upon. The Service's silence concerning a particular issue should not be construed as acquiescence and can not be relied upon as a basis for obtaining retroactive relief under the provisions of § 7805(b). Cf. section 2.05(2) of Rev. Proc. 2004-1, 2004-1 I.R.B. 1, 8, which provides that a taxpayer can not rely upon oral advice as a basis for obtaining retroactive relief under § 7805(b).

Lastly, Company's contention that the National Office has granted other retailers permission to treat their merchandising department costs as mixed service costs lacks legal significance. As is discussed above, the question as to whether a department is a service department is largely factual and must be addressed on a taxpayer by taxpayer and department by department basis. The nominal title of a department is not controlling, but instead the facts and circumstances of the taxpayer's activities and business organization control whether a department is a service department. See § 1.263A-1(e)(4)(i)(B). Moreover, a taxpayer may not rely on a letter ruling issued to another taxpayer. See § 6110(k)(3); section 11.02 of Rev. Proc. 2004-1, 2004-1 I.R.B. 1, 45.

For the foregoing reasons, Company is not entitled to relief under § 7805(b).

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.