

INTERNAL REVENUE SERVICE  
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

November 14, 2005

Third Party Communication: None  
Date of Communication: Not Applicable

Number: **200613033**  
Release Date: 3/31/2006  
Index (UIL) No.: 263A.00-00, 263A.03-00, 263A.03-02  
CASE-MIS No.: TAM-137719-05/CC:ITA:B6

Director, Field Operations

Taxpayer's Name:  
Taxpayer's Address:

Taxpayer's Identification No  
Year(s) Involved:  
Date of Conference: None

LEGEND:

Company =

Subsidiary 1 =

Subsidiary 2 =

State =

Year 1 =

X =

Y =

Z =

\$ A =

\$ B =

\$ C =

\$ E =

\$ F =

D1 =

D2 =

D3 =

D4 =  
D5 =  
D6 =

#### ISSUE:

Whether Company properly determined its total mixed service costs by including the entire costs of D1, D2, D3, D4, D5, and D6 (described in detail below) in total mixed service costs, as defined in § 1.263A-1(h)(6) of the Income Tax Regulations, for purposes of the simplified service cost method (“SSCM”) under § 1.263A-1(h).

#### CONCLUSION:

To the extent D1, D2, D3, D4, D5, and D6 are mixed service departments, all service costs incurred by these departments must be included in Company’s total mixed service costs for purposes of the SSCM.

#### FACTS:

##### A. Overview<sup>1</sup>

Company is an investor-owned utility holding company and the common parent corporation of a consolidated group that includes, among others, Subsidiary 1 and Subsidiary 2. It produces, acquires for resale, transmits, distributes, and sells electric energy. Its customers include both direct retail customers and wholesale customers (i.e., other utilities). Subsidiary 1 provides electric service to customers in southern State. Subsidiary 2 provides electric service in northern State and other locations. Company, as well as Subsidiaries 1 and 2, are subject to regulation and oversight by the Federal Energy Regulatory Commission (“FERC”). Company has two types of production activities: (1) the production of electricity; and (2) the production of self-constructed assets, including either generation assets or transmission and distribution (“T&D”) assets. Company uses an overall accrual method of accounting and maintains its books on a calendar year basis.

Prior to Year 1, Company used FERC accounting standards to capitalize costs for federal income tax purposes. Generally, under FERC accounting, the production of electricity is a deductible activity. Also, all direct and indirect costs incurred in constructing assets must be capitalized, including labor, contract work, materials and supplies, transportation, protection, engineering and supervision, engineering services, insurance, legal expenses, machine and shop services, permits, rents, and a portion of general and administration costs incurred in constructing assets. Therefore, items were either expensed or capitalized to self-constructed assets in accordance with the FERC method.

---

<sup>1</sup> The parties to this technical advice memorandum each submitted a set of facts for consideration as they were unable to reach agreement on all the facts. Those disagreements that are material are noted as such in the analysis.

For tax year Year 1, Company (on behalf of its subsidiaries, Subsidiary 1 and Subsidiary 2) filed a Form 3115, Application for Change in Accounting Method, to change its method of accounting for allocating mixed service costs from a facts and circumstances method under FERC accounting to the SSCM under § 263A of the Internal Revenue Code. At that time, Company allocated mixed service costs between production of self-constructed assets and deductible activities using a facts and circumstances method. Company proposed to change its method of accounting to a method using the SSCM under § 1.263A-1(h) to allocate mixed service costs between production activities (for both self-constructed assets and inventory) and deductible activities.

Subsidiary 1 is organized into approximately Y departments and sub-departments structured along functional lines based on the nature of the work performed by department employees. For example, there are departments for gas and oil generation, coal generation, generation engineering, generation planning and analysis, major construction projects, transmission planning, fuel portfolio management, human resources, business development and contracts, and the like. To facilitate its production and resale activities, Subsidiary 1 also engages in a variety of capital projects, including construction projects necessary to provide reliable electric service to its customers. Some examples of recent capital projects include building a new distribution feeder, constructing a transmission line, purchasing a new vehicle, and upgrading a substation.

Subsidiary 1 describes its capital projects activities as falling into three general areas: (1) specific projects, (2) project supervision capital projects, and (3) blanket projects. Most capital projects are accounted for as specific projects. These are projects created for a defined task and designated location that are initiated and tracked by detailed work orders. Time and other expenditures are charged to specific projects (under construction work in progress) as Company personnel work on a specific project, including the time charged by planners and supervisors who actually work on specific projects.

The project supervision capital projects account is used to track time charged by planners and supervisors whose work is general in nature and contributes to capital construction. For example, where a supervisor works on numerous capital projects such that her time cannot be readily identified to a specific project, the supervisor may charge her time to the project supervision capital projects account. Time charged to this account is subsequently allocated to specific projects based on a predetermined formula.

Under Subsidiary 1's book and FERC accounting system, blanket projects are similar to specific projects in that they also track capital projects, except the projects are generally smaller and do not require the type of approval needed for specific projects. Time and other expenditures are tracked using detailed work orders and generally charged to construction work in progress in the same way as specific projects.

Each project is assigned a unique work order number. Labor cost is a major component of Subsidiary 1's overall cost structure. Employees are required to maintain detailed and accurate timesheets so that labor costs can be charged accordingly. Employees record time directly to a work order number for a specific project, a project supervision capital project, a blanket project, and/or to activities for operations and maintenance, administrative and general, and the like.

#### B. Description of D1

D1 is a multifunctional department. The majority of D1's employees are engineers, technical specialists, or supervisory personnel. D1 has two major functions. D1 supports power plant operations by providing engineering services, processes improvement advice, and provides other technical assistance. D1 also supports management by providing information relating to plant functions, environmental compliance, reliability studies and financial planning. Company asserts that the costs incurred by D1 relate equally to its two functions. For example, D1 supports the construction departments by providing engineering and design services, and managing the construction of generation assets, as well as, supports other departments by providing engineering services related to removal projects and the maintenance of assets used in the generation of electricity. These services are provided directly by D1 employees, or indirectly by supervising third-party engineers that perform the services. D1 is also responsible for procuring, monitoring, and supervising external engineering services to assist with the department's projects. D1 conducts reliability studies, environmental compliance, operations and maintenance improvements, as well as prepares budgets and financial plans, resource plans, regulatory data runs and expert testimony. Company uses the budgeting information for general financial planning and forecasting and incorporates the information into its financial statements.

Throughout Year 1, D1 provided services to numerous construction projects, including, for example, remediation activities, and designing and supervising the construction of lined evaporative pond upgrades. With respect to this project, Subsidiary 1 was required to engage in groundwater remediation, excavation of ponds, replacement of liners, and changes to the configuration of the ponds. By way of illustration, D1's role in this project involved obtaining approval for its activities from the state environmental protection authorities and monitoring the remediation and related activities to ensure compliance with state environmental protection laws. D1 also procured and managed a number of outside consultants, including experts in the field of geotechnical matters.

D1 engineers generally perform engineering, procurement, and construction activities as members of a project team. In the case of small projects, they may implement the project without the assistance of other departments. D1 staff maintains records of the generating plants' outages and performance, and analyzes degradation and power outage information and makes recommendations for changes and upgrades to generation operations. When a problem is identified, D1 staff is responsible for

taking corrective actions to keep the plant at optimum operating capacity. For example, if a leak is found in a boiler, the staff investigates and isolates the cause, establishes the condition and reliability of the boiler, and determines whether the company should repair or replace the boiler.

D1's corporate function begins when financial or operational planning is required. For example, in the case of the leaking boiler noted above, D1 staff would consider advising management to either replace or repair the boiler, the cost involved, and the timing. In some cases, the advice may also include longer term plans such as long-term capital budgeting.

Based on a study of D1's functions, Subsidiary 1 determined that D1 is an administrative, service, or support department that supports both production and non-production activities. These facts lead Company to conclude that D1 is a mixed service department and its costs are mixed service costs which are properly included in total mixed service costs for purposes of the SSCM. In contrast, the director asserts that all of the costs incurred by D1 in Year 1 related to the generation of electricity or to the construction and/or removal of generation assets, and under the FERC method, were charged to capital accounts. Based on this interpretation of the facts, the director contends that the costs incurred by D1 are not mixed service costs but either direct production costs that are clearly traceable to specific capital activities, indirect production costs that are clearly traceable to specific capital activities, or indirect costs that are clearly traceable to deductible production activities; and as such, are not mixed service costs for purposes of the SSCM.

### C. Description of D2

D2 provides services that include organizing, motivating, and inspiring team leaders, as well as preparing capital, operating and maintenance budgeting and capital budgeting through its six employees, including a director ("D2 Director") who organizes and manages five sub-departments (including D3 described below). The D2 Director provides strategy, leadership, and overall direction to assure that Subsidiary 1 is using its resources efficiently. The D2 Director also serves departments that provide engineering services and construct substation facilities, as well as departments that are responsible for developing and monitoring compliance with standards and codes for the efficient operation of substations, testing of substation relays, performing adjustments to relay settings to operate and maintain the system, and regional mapping. In addition to the D2 Director, D2 staff includes clerical and administrative personnel who provide administrative and secretarial support to the department.

Based on a study of D2's functions, Subsidiary 1 determined that D2 is an administrative, service, or support department that supports both production and non-production activities. These facts lead Company to conclude that D2 is a mixed service department and its costs are mixed service costs that are properly included in total mixed service costs for purposes of the SSCM. In contrast, the director rejects this determination on the basis that the majority of the costs incurred by D2 are not incurred

by functions that perform mixed service activities. The director asserts that nearly all of the costs incurred by D2 in Year 1 related to construction activities and therefore under the FERC method were charged to capital accounts, except for a nominal amount incurred for office supplies, an awards dinner and catered food, which were deducted in the year incurred. Based on this interpretation of the facts, the director contends that the costs incurred by D2 are not mixed service costs for purposes of the SSCM.

#### D. Description of D3

Like the others, D3 is a multifunctional department and, as noted above, a sub-department of D2. Engineers and design technicians who are responsible for engineering and design of new substation construction and for certain modifications to existing substations generally staff D3. The department does not perform any physical construction activities, but rather provides the pre-planning and up-front work prior to physical construction, including comprehensive engineering design services for substation facilities (*i.e.*, actual design documents and drawings used to construct and repair the substations), evaluation of design standards and development of best practices, policies and procedures. D3's internal customers include construction departments that engage in both capitalizable activities and deductible repair activities, as well as procurement departments that rely on D3's drawings and budgets when ordering materials. D3 provides other departments with information related to T&D budgetary estimates, mapping, design studies and specs, and the like. For book purposes, nearly all of the costs incurred by D3 during Year 1 were charged to construction activities and capitalized under the FERC method.

Based on a study of D3's functions, Subsidiary 1 determined that D3 supports both production and non-production activities. These facts lead Company to conclude that D3 is a mixed service department and its costs are mixed service costs which are properly included in total mixed service costs for purposes of the SSCM. In contrast, the director rejects this determination on the basis that the majority of the costs incurred by D3 are not incurred by functions that perform mixed service activities. Based on this interpretation of the facts, the director contends that the costs incurred by D3 are not mixed service costs for purposes of the SSCM.

#### E. Description of D4

D4 is a multifunctional department that manages and synchronizes the different aspects of Subsidiary 1's large capital and repair projects, including, for example, construction of transmission lines, substations, and power relays. D4 staff includes project managers, financial analysts, and construction managers. These services are provided to construction departments. D4 employees track and monitor all timelines, budgets, and resources for new construction projects to assure the timely completion of the projects. Company asserts that approximately 10% of D4's costs are related to relocation work.

D4 also engages in project management functions, such as preparing project schedules, cash flow schedules, budgets and cost estimates to support the engineering departments. These services are used by management to evaluate labor and work load to avoid overtime and maximize labor efficiency. For book purposes, nearly all of the costs incurred by D4 were charged to capital projects, with nominal amounts charged to removal projects, operations and maintenance, and general and administration.

Based on a study of D4's functions, Subsidiary 1 determined that D4 is an administrative, service, or support department that supports both production and non-production activities. These facts lead Company to conclude that D4 is a mixed service department and its costs are mixed service costs which are properly included in total mixed service costs for purposes of the SSCM. In contrast, the director rejects this determination on the basis that the majority of the costs incurred by D4 are not incurred by functions that perform mixed service activities. The director asserts that nearly all of the costs incurred by D4 in Year 1 related to construction activities and therefore under the FERC method were charged to capital accounts, except for a nominal amount incurred for removal projects, operations and maintenance, and general and administration. Based on this interpretation of the facts, the director contends that the costs incurred by D4 are not mixed service costs for purposes of the SSCM.

#### F. Description of D5

D5 is a multifunctional department responsible for the overall management and supervision of Subsidiary 1's distribution departments that construct distribution assets, and operate and maintain the distribution system. D5 supports these distribution departments by establishing Company policy with respect to construction, management, and operations and maintenance of the distribution of electricity.

D5 is staffed with two employees, one executive and one clerical. According to timesheet data, both employees charged time to capital projects. In addition, the executive charged time to engineering and design accounts, and the clerical employee charged time to clerical and administrative accounts.

Based on a study of D5's functions, Subsidiary 1 determined that D5 is an administrative, service, or support department that supports both production and non-production activities. These facts lead Company to conclude that D5 is a mixed service department and its costs are mixed service costs which are properly included in total mixed service costs for purposes of the SSCM. The director rejects this determination on the basis that the majority of the costs incurred by D5 are not incurred by functions that perform mixed service activities. The director asserts that nearly all of the costs incurred by D5 in Year 1 related to construction activities and therefore under the FERC method were charged to capital accounts. Based on this interpretation of the facts, the director contends that the costs incurred by D5 are not mixed service costs for purposes of the SSCM.

#### G. Description of D6

D6 provides vehicles for each department's use. The costs of this department are collected in a balance sheet account and allocated to the departments that used its services. Departments that use a fleet vehicle are charged by D6 based on the type of vehicle used. The charge also reflects labor and vehicle maintenance costs, fuel, and related fleet expenses.

Company and the director agree that D6 is a mixed service department and that all service costs incurred in D6 must be included in Company's total mixed service costs for purposes of the SSCM. Accordingly, the following analysis addresses only the treatment of costs incurred by D1, D2, D3, D4 and D5.

#### LAW AND ANALYSIS:

The issue in this request for technical advice is whether Company properly determined its total mixed service costs by including the entire costs of D1, D2, D3, D4, and D5 in total mixed service costs for purposes of the SSCM under § 1.263A-1(h). In analyzing this issue, Company and the director disagree on several points. In particular, they disagree on whether (1) direct costs are included among the amounts treated by Company as mixed service costs, (2) the departments are mixed service departments, and (3) capitalizable service costs incurred in departments that perform mixed service activities may be excluded from Company's total mixed service costs. The following analysis of these points leads to the conclusion that, to the extent D1, D2, D3, D4, and D5 are mixed service departments, all service costs incurred by these departments must be included in Company's total mixed service costs for purposes of the SSCM.

1. Are direct costs included among the amounts treated by Company as mixed service costs?

In determining whether Company properly determined its total mixed service costs in this case, the first issue is whether direct costs are included among amounts treated by Company as mixed service costs. This issue is analyzed by first reviewing the mechanics of the SSCM and then focusing on the definition of service costs. For the reasons described below, this analysis leads to the conclusion that direct costs may not be included among the amounts treated by Company as mixed service costs.

a. SSCM

Section 263A generally requires a taxpayer to capitalize the direct costs and an allocable share of the indirect costs of real or tangible personal property that is produced by the taxpayer. The direct costs of produced property include direct materials costs and direct labor costs. See § 1.263A-1(e)(2)(i). Direct labor costs include the costs of labor that can be identified or associated with particular units or groups of units of specific property produced. See § 1.263A-1(e)(2)(B). The indirect costs of produced property are all costs other than direct material costs and direct labor



costs. See § 1.263A-1(e)(3). Indirect costs are properly allocable to produced property when the costs directly benefit or are incurred by reason of the performance of production activities. Id. Indirect costs may be allocable to a production activity and other activities that are not subject to § 263A. Accordingly, taxpayers must make a reasonable allocation of indirect costs between production and other such activities. See § 1.263A-1(e)(3)(i).

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.

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 generally require 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 generally require 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). The regulations also provide a simplified method (the SSCM) for determining capitalizable mixed service costs. See § 1.263A-1(h). As noted above, Company uses the SSCM to allocate its mixed service costs.

b. Mixed Service Costs

Company's use of the SSCM to allocate its mixed service costs raises the issue of whether the costs it is allocating are, in fact, mixed service costs. In particular, the focus in this case is on whether direct costs are service costs that can be allocated

under the SSCM. As discussed below, direct costs are not service costs that can be allocated using the SSCM.

Producers must capitalize direct labor costs. See § 1.263A-1(e)(2)(i). Direct labor costs include the costs of labor that can be identified or associated with particular units or groups of specific property produced. See § 1.263A-1(e)(2)(I)(B). For this purpose, elements of direct labor costs include basic compensation, overtime pay, vacation pay, holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under § 105(d) as it existed prior to its repeal in 1983), shift differential, payrolls taxes, and payments to a supplemental unemployment benefit plan. See § 1.263A-1(e)(2)(i)(B). In contrast, service costs are defined as a type of indirect costs (e.g., general and administrative costs) that can be identified specifically with a service department or function or that directly benefit or are incurred by reason of a service department or function. See § 1.263A-1(e)(4)(i)(A). Further, indirect costs are all costs other than direct material costs and direct labor costs. See § 1.263A-1(e)(3)(ii)(A). Under § 1.263A-1(e)(3)(ii)(A) indirect labor costs include all labor costs that cannot be directly identified or associated with particular units or groups of units of specific property produced (i.e., direct labor costs). It follows from these definitions that direct costs are not service costs.

The director asserts that many of the engineering costs (including material and labor costs) incurred by Company's various departments qualify, as a factual matter, as direct costs because they are directly traceable to projects. The director reasons from this that these costs are not indirect costs and, therefore, are not service costs that can be allocated under the SSCM. In contrast, Company argues that its engineering costs are not directly traceable to projects and, therefore, are not direct costs. As a result, Company characterizes the engineering costs at issue in D1, D2, D3, D4, and D5 as indirect costs that are properly included in service costs under § 1.263A-1(e)(4). The differing facts provided by the director and Company are material and result in alternative answers. If the director determines that the engineering costs incurred by Company's various departments are specifically tracked to projects, such costs constitute direct labor costs. However, if the director determines that the engineering costs incurred by Company's various departments are not specifically tracked to projects, such costs are not direct costs. Given this resolution of the issue, the director must process the case consistent with this legal analysis as applied to the facts as they are ultimately determined. See § 12.12 of Rev. Proc. 2005-2, 2005-1 I.R.B. 86 (Jan. 3, 2005).

2. Are D1, D2, D3, D4, and D5 mixed service departments?

The next step in determining whether Company properly determined its total mixed service costs in this case requires determining whether D1, D2, D3, D4, and D5 are mixed service departments within the meaning of § 1.263A-1(e)(4)(i)(B). Company argues that the costs of D1, D2, D3, D4 and D5 are mixed service costs because they are allocable to both production activities and deductible activities. In contrast, the

director argues that the departments are not mixed service departments because the departments do not support both production activities and non-production activities.

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). 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.

In this case, the director argues that the departments are not mixed service departments because the departments do not support both production activities and non-production activities. The director reviewed detailed timesheet data, conducted interviews of the departments' personnel, and examined related work order data, and found that that the costs incurred by these departments included direct production costs (both material and labor), or, clearly capitalizable service costs, and/or, clearly deductible service costs, but not mixed service costs (as defined in § 1.263A-1(e)(4)(ii)(C)). Based on these findings, the director believes that the costs of the departments are not mixed service costs and should not be included in the determination of total mixed costs for purposes of the SSCM. For example, the director points out that D1 performs two types of activities, capital activities and deductible activities, but not a mixed service activity. Therefore, the director contends that because D1 does not perform a mixed service activity, its costs cannot be mixed service costs. The director reasons that to be mixed service costs they must be (1) service costs, (2) that are not exclusively capitalizable service costs, and (3) that are not exclusively deductible service costs.

A service department is an administrative, service, or support department that incurs service costs. See § 1.263A-1(e)(4)(i)(B). In defining a service department the regulations do not specify that a department incurs only a particular type of service cost. Indeed, although the regulations define various types of service costs, see § 1.263A-1(e)(4)(ii), the definition of service department refers only to the more generic phrase “service cost.” Further, the regulations contemplate that a service department may incur both capitalizable and deductible service costs. For example, § 1.263A-1(h)(6) provides that in determining the total mixed service costs of a trade or business, a taxpayer must include all costs incurred in its mixed service departments and cannot exclude any otherwise deductible service costs. Similarly, the de minimis rule in § 1.263A-1(g)(4)(ii) clarifies that the ratio of capitalizable to deductible service costs is not a factor in determining whether a department is a service department. Moreover, § 1.263A-1(g)(4)(ii) expressly refers to capitalizable service costs and deductible service costs as costs included in a mixed service department. Accordingly, where a department incurs capitalizable service costs and deductible service costs, but not mixed service costs, the department is nonetheless a mixed service department. Under § 1.263A-1(h), taxpayers may use the SSCM for determining capitalizable mixed service costs incurred during the taxable year (*i.e.*, the aggregate portion of mixed service costs that are properly allocable to the taxpayer’s production or resale activities).<sup>2</sup> However, a service department that undertakes exclusively capitalizable or exclusively deductible activities is not a mixed service department within the meaning of § 1.263A-1(e)(4)(i)(B).

The differing facts provided by the director and Company are material and result in alternative answers. If the director determines as a factual matter that D1, D2, D3, D4 and D5 do not support both production and non-production activities, then D1, D2, D3, D4 and D5 are not mixed service departments. However, if the director determines that D1, D2, D3, D4 and D5 support production and non-production activities, then D1, D2, D3, D4 and D5 are mixed service departments. Given this resolution of the issue, the director must process the case consistent with this legal analysis as applied to the facts as they are ultimately determined. See § 12.12 of Rev. Proc. 2005-2, supra.

3. May capitalizable service costs incurred in departments that perform mixed service activities be excluded from Taxpayer’s total mixed service costs?

The final step in determining whether Company properly determined its total mixed service costs requires determining whether capitalizable service costs incurred in departments that perform mixed service activities may be excluded from Company’s total mixed service costs.

Under the regulations, service costs are segregated into three categories: (1) capitalizable service costs, (2) deductible service costs, and (3) mixed service costs. Capitalizable service costs are defined as service costs that directly benefit or are

---

<sup>2</sup> As noted above, direct costs are not service costs. Accordingly, they may not be allocated using the SSCM.

incurred by reason of the performance of the production or resale activities of the taxpayer, and therefore, must be capitalized under § 263A. See § 1.263A-1(e)(4)(ii)(A). Deductible service costs are defined as service costs that do not directly benefit or are not incurred by reason of the performance of the production or resale activities of the taxpayer, and therefore, need not be capitalized under § 263A. See § 1.263A-1(e)(4)(ii)(B). Mixed service costs are defined as service costs that are partially allocable to production or resale activities (capitalizable mixed service costs) and partially allocable to non-production or non-resale activities (deductible mixed service costs). See § 1.263A-1(e)(4)(ii)(C).

The regulations generally require 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). Service costs may be allocated using the same allocation methods available for allocating other indirect costs. See § 1.263A-1(g)(4)(i). Using reasonable factors and relationships, taxpayers must allocate mixed service costs under a direct reallocation method, a step-allocation method, or any other reasonable allocation method (as defined under the principles of § 1.263A-1(f)(4)). Id. The regulations also provide a simplified method (the SSCM) for determining capitalizable mixed service costs. See § 1.263A-1(h)(1).

Using the SSCM, a taxpayer computes its capitalizable mixed service costs by multiplying either a labor-based allocation ratio or a production cost allocation ratio by total mixed service costs. See § 1.263A-1(h)(3). Total mixed service costs are defined as the total costs incurred during the taxable year in all departments or functions of the taxpayer's trade or business that perform mixed service activities. In determining the total mixed service costs of a trade or business, the taxpayer must include all costs incurred in its mixed service departments and cannot exclude any otherwise deductible service costs. See § 1.263A-1(h)(6).

Whether Company properly determined its total mixed service costs by including the entire costs of D1, D2, D3, D4, and D5 in total mixed service costs depends on whether the departments are mixed service departments. A service department that benefits both production or resale and non-production or non-resale activities is a mixed service department. Moreover, the regulations provide that mixed service costs are service costs that are partially allocable to production or resale activities (capitalizable mixed service costs) and partial allocable to non-production or non-resale activities (deductible mixed service costs). Section 1.263A-1(e)(4)(ii)(C). Therefore, to the extent that the subject departments are service departments within the meaning of § 1.263A-1(e)(4)(i)(B), and the departments are mixed service departments, all service costs of those departments must be included in total mixed service costs for purposes of the SSCM.

The director asserts that for departments that include functions that perform mixed service activities, Company misapplied the SSCM by including all costs incurred by such departments (including costs incurred by functions that do not perform mixed

service activities) as “total mixed service costs.” This position does not adequately account for § 1.263A-1(h). That regulation provides that in determining the capitalizable mixed service costs incurred during the year, the applicable allocation ratio must be multiplied by the total mixed service costs. Section 1.263A-1(h)(3). The regulations define total mixed service costs as the total costs incurred during the taxable year in all departments or functions of the taxpayer’s trade or business that perform mixed service activities. Section 1.263A-1(h)(6). The regulations further provide that in determining the total mixed service costs of a trade or business, the taxpayer must include all costs incurred in its mixed service department and cannot exclude any otherwise deductible service costs. *Id.* (Emphasis added.) Moreover, § 1.263A-1(g)(4)(ii) expressly refers to capitalizable service costs and deductible service costs as costs included in a mixed service department. Therefore, to the extent that the department is a mixed service department, all service costs of the department (*i.e.*, capitalizable service costs, deductible service costs, and mixed service costs) must be included in determining “total mixed service costs” for purposes of the SSCM.

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.