Chapter 6

Uniform Capitalization Rules - §263A

Long-term Contract Rules - §460

Primary Authority (read where referenced in this chapter)

- IRC §§263A, 460
- Regs. §1.263A-1; skim: §1.263A-2 and -3

Learning Objectives – This lesson will enable you to be able to answer these questions:

- What taxpayers are subject to the uniform capitalization rules of §263A?
- What is the basic operation of the uniform capitalization rules (what must taxpayers do to comply)?
- When is a taxpayer required to capitalize interest expense (rather than expense it currently)?
- What is a long-term contract?
- What are the basic rules to follow to account for long-term contract revenues and expenses?

Sample taxpayer questions that arise regarding the material covered in this chapter:

- Which taxpayers are subject to the uniform capitalization rules of §263A?
- What is the simplified cost method of complying with §263A for producers? What are the advantages and disadvantages of using a simplified method for computing §263A costs and calculating ending inventory?
- Is a business constructing a building or leasehold improvements subject to interest capitalization?
- Is a manufacturer subject to interest capitalization? When?

General Rules of §263A

- Capitalize all direct materials, direct labor and certain indirect costs (including mixed service costs that benefit producing/reselling activities and non-producing/non-reselling activities)
- that are allocable to:
  - real property and tangible personal property produced by the taxpayer -
    - for sale
    - for self-use
  - real property and tangible personal property acquired for resale

  Thus, rules apply to producers, retailers, wholesalers and resellers.
- Note that there are exceptions where §263A will not apply to certain types of expenditures (such as R & D) or to certain activities (such as resale activities of a retailer with average annual gross receipts over a 3-year period of $10,000,000 or less) - see §1.263A-1(b). Note that other capitalization rules might apply even though §263A does not (such as §263(a)).

Keys to application of §263A

- Determine if taxpayer subject to §263A
- Identify costs as direct materials, direct labor, indirect costs, mixed service costs (a type of indirect costs that requires further allocation between activities), other costs
- Producers using the simplified production method will also have to distinguish between §1.471-11 (full absorption) costs and additional §263A costs (see §1.263A-1(d))
- Determine if present methods used to allocate §263A costs to §263A property are in line with the final §263A regulations. If not, change in method required.
- Determine if taxpayer wants to change its present allocation method, for example, if taxpayer wants to adopt a simplified method provided in the regulations. If so, must follow change in accounting procedures.

Q&A Overview to §263A and §460

§263A

1. What is the purpose of §263A?

Excerpt from the General Explanation of the Tax Reform Act of 1986, prepared by the Staff of the Joint Committee on Taxation - §263A - UNICAP (pages 508 - 509)

"Reasons for Change

The Congress believed that the rules of prior law regarding the capitalization of costs incurred in producing property were deficient in two respects. First, those rules allowed costs that were in reality costs of producing, acquiring, or carrying property to be deducted currently, rather than capitalized into the basis of the property and recovered when the property was sold or as it was used by the taxpayer. This treatment produced a mismatching of expenses and the related income and an unwarranted deferral of Federal income taxes. Second, different capitalization rules could apply depending on the nature of the property and its intended use. The Congress was concerned that these differences could create distortions in the allocation of economic resources and the manner in which certain economic activity was organized.

The Congress 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, including interest expense, subject to appropriate exceptions where application of the rules might be unduly burdensome."

• raises revenue because of §481(a) adjustment in year §236A adopted and because more costs are capitalized into inventory, thus, expensed later

• §263A is broader than GAAP and full absorption rules of §1.471-11

2. What does "produce" mean? §263A(g), §1.263A-2(a)(1)) and Rev. Rul. 81-172 (Chapter 5)

• construct, build, install, manufacture, develop, improve, create, raise, grow

• also if produced by another for the taxpayer under contract, taxpayer treated as producing

3. What types of property and transactions are exempt from §263A?

- **See §263A(c), §1.263A-1(b)**
- **Also excludes personal use property such as individual constructing own residence**
    - *Ashley v. Comm'r.*, T.C. Memo 2000-376 – the court held that the taxpayer could not add to basis various operating costs related to a home he was renovating because he wasn't in the business of renovating homes for resale.
- **Qualified creative expenses -** TAM 9643003 (7/10/96) provides some clarification of the limited exception from §263A for "qualified creative expenses" (added by TAMRA '88, but retroactive back to the TRA'86). Taxpayer, a cash method individual, composed and recorded

songs on a "rough-cut demo tape" and incurred costs of a recording studio, musicians and a recording engineer. Taxpayer deducted these costs when paid; the IRS disallowed the deduction on the basis that such costs were required to be capitalized under §263A. Taxpayer argued that he is a "writer" excepted from §263A under §263A(h) and that his costs are similar in nature to word processing costs incurred by an author. The IRS reviewed §263A(h) and its legislative history to conclude that the taxpayer's production and engineering costs incurred to produce the sound recording was not a "qualified creative expense" under §263A(h) and therefore, was not excepted from §263A. The IRS pointed out that under §263A(h)(3)(A), a "writer" is a person who creates by writing; therefore the exception for qualified creative expense is limited to written creations, including a written musical composition. However, the demo tape is a not a writing and its production costs are expressly excluded from the definition of qualified creative expenses. Motion picture films and video tapes are specific examples of tangible personal property that is not qualified creative expenses and the demo tape is a "similar item."

4. What are the four categories of costs that a retailer must capitalize into inventory under §263A and the regulations? §1.263A-1(e) and §1.263A-3(c)

• purchasing, handling, off-site storage and G&A (MSC)

5. Retailer J has the following gross receipts:

1995	$8,000,000
1996	$9,500,000
1997	13,000,000
1998	15,000,000

When must J begin to follow §263A? How is the §481(a) adjustment computed for the change in method, what is the spread period for the adjustment and what administrative procedures must J follow?

• 1995 - 1997 average annual GR = $10,166,667, so adopt §263A in 1998

• §1.263A-7 - how to change method/revalue inventory

• change from large to small - follow Rev. Proc. 2008-52

6. What is included in gross receipts? §1.263A-3(b)(2)

• note that the definition is not the same as the GR definition at §1.448-1T(f)(2)(iv)

7. Engineering consulting firm is also a reseller of various computer programs. Its gross receipts from the software sales averages $2,000,000 per year. Its gross receipts from consulting services averages $11,000,000 per year. Must engineering firm apply §263A to its retail sales?

• YES - per holding of Rev. Rul. 89-26 and §1.263A-3(b)(2)(i)

8. Does the $10 million gross receipts exception apply to the following reseller?

Year	Parent	Sub 1	Sub 2	Sub 3 (FSC, can't consolidate)
1984	$5M	$2M	$4M	$2M
1985	$4M	$4M	$3M	$2M
1986	$6M	$3M	$3M	$2M

YES - see §1.263A-3(b)(3) - include GR of all members of controlled group, even if is treated as an excluded component member under §1563(b)

Would the result change if there were no S2? What if S2 only joined the group in 1987?

NO - average annual GR over prior 3-year period still exceeds $10,000,000; also note rule on predecessor and new taxpayers at (b)(2)(i)

9. Does §263A apply to the following taxpayer? Explain and provide a cite to support your answer.

Type of taxpayer	Gross receipts
a) computer manufacturer	> $10,000,000
b) Harriet's Hardware Store sells hardware, makes keys, mixes paints, cuts wood	< $10,000,000

c) Architect - designs buildings - customer keeps copy of blueprint	> $10,000,000
d) Bakery Direct labor $250,000/year Direct materials $180,000/year Indirect costs $130,000/year	< $10,000,000

9. Per §1.263A-1(e)(3)(iii)(E) - depreciation on temporarily idle equipment and facilities does not have to be capitalized. What does this refer to?

- **equipment and facilities are temporarily idle when taken out of service for a finite period. But, not considered temporarily idle during worker breaks, non-working hours, or on regularly scheduled non-working days such as holidays or weekends; during normal interruptions in operation of equipment or facilities; when equipment is enroute to or located at a job site; or when under normal operating conditions, equipment is used or operated only during certain shifts**

10. Which of the following indirect production costs must be capitalized under §263A? §1.263A-1(e)

a. water bill?

YES, -1(e)(ii)(N)

b. engineering costs on new product?

YES, unless is R&D (§174) -1(e)(ii)P)

c. accounting department costs?

YES, capitalizable service cost per -1(e)(4)(iii)(E), but tax services are generally not a capitalizable service cost per -1(e)(4)(iv)M)

d. advertising?

NO -1(e)(3)(iii)(A)

e. recession causes corporation to go from 3 work shifts to 2, can it expense 1/3 of the costs of that facility?

YES - not temporarily idle because still operated for 2 shifts, see Ex 1 at -1(e)(3)(iii)(E)(2)

f. warranty costs on merchandise sold?

NO -1(e)(3)(iii)(H)

g. entertainment expenses of purchasing agent?

- **§1.263A-1(e)(ii)(F) & §1.263A-3(c)(3) - is it a cost attributable to purchasing activities? is it related to the establishment and maintenance of vendor contacts? PROBABLY**

- **note that per §1.263A-1(c)(2), only 50% would be capitalizable and 50% would be disallowed because any cost that may not be taken into account in computing taxable income is not treated as a cost properly allocable to property produced or acquired for resale under §263A and the regulations**

h. Unclassified labor costs: G Corporation's production workers track their time under three categories: 1) specific projects, 2) "unclassified" time spent on report preparation, training, general meetings, school visits, and breakdown time, and 3) vacation, sick and holiday time. The bulk of time spent by these workers is on production activities. How much of these workers' time is a capitalizable cost under §263A?

- Reg. §1.263A-1(e)(3)(ii)(A)

- Also see TAM 9426004 (3/22/94) and ISP on capitalization of Costs - Unclassified Labor Costs, for the Utilities Industry (3/96). Per the ISP paper: "Section 263A requires taxpayers to capitalize the costs of "unclassified time"; i.e., the time of an employee normally engaged in production activities that is not attributable to any particular production activity. The costs of unclassified time should be capitalized under section 263A because these costs are the indirect labor costs of a production department."

i. Officer compensation as Mixed Service Cost (MSC) - *PMT Inc. v. Commissioner*, T.C. Memo 1996-303 - in this reasonable compensation case, the court concluded that part of the officer compensation of the textile manufacturer had to be capitalized under §263A, as allocable to mixed service costs. "Compensation paid to officers attributable to services performed in connection with particular production activities is an example of an indirect cost that must be capitalized."

j. Might environmental remediation costs have to be included in inventory?

- Yes per Rev. Rul. 2005-42 if the costs are capitalizable and associated with production or resale activities.

k. Property taxes of a developer**?**

Reichel v. Comm'r., 112 T.C. No. 2 (1999)—Taxpayer operated a real estate development business as a sole proprietor. The business operations consisted primarily of buying and developing raw land.

In 1991 and 1992, taxpayer purchased two parcels of land for development, but did not undertake any development activity because of adverse economic conditions in the county were the parcels are located. However, taxpayer continued to hold the parcels for development. In 1993, taxpayer paid about $72,000 of real estate taxes on the parcels and deducted this amount on his Schedule C. The Service denied the deduction on the basis that it had to be capitalized as a cost of production under §263A. Taxpayer argued that §263A did not apply unless he undertook positive steps to begin developing the raw land.

The court noted that §263A(g) defining "produce" is a broad definition and encompasses "develop." The general rule of §263A requires a taxpayer to capitalize direct and indirect costs incurred in developing property. Taxpayer argued that per *Von-Lusk*, 104 T.C. 207 (1995), indirect costs only need to be capitalized under §263A if some production activity has occurred with respect to the property. The court held that the taxpayer misinterpreted *Von-Lusk* because the legislative history to §263A provides that the capitalization provision is to apply from the acquisition of the property up until the time of disposition. The court also noted that if indirect costs did not have to be capitalized until the start of production activity, §263A(f)(1)(A) would be superfluous because it provides that *interest* is to be capitalized once production begins. Finally, the court also noted that S. Rept. 99-313 (1986, at page 140), includes a heading - "production, acquisition, and carrying costs."

Footnote 1 in this case refers to §1.263A-2(a)(3)(ii) which also supports the court's holding: "a real estate developer must capitalize property taxes incurred with respect to property if, at the time the taxes are incurred, it is reasonably likely that the property will be subsequently developed."

Comment: For disposition of property, classification is based on the purpose for which the property was held at the time of the disposition (such as investment or property held for sale); see *Neal T. Baker Enterprises Inc. v. Comm'r.,* T.C. Memo 1998-302. Cases in this area have also recognized that a taxpayer's intent is subject to change during the time the property is owned. Would a similar analysis apply under §263A to determine if property is being held for production? What must a developer do to show that certain property is not being held for development, or that his intent with respect to the property has changed? The *Reichel* case does not discuss what the taxpayer was doing with the property; it just states that he continued to hold the property for development.

In FSA 1999-1088 the IRS held that costs of obtaining building permits, negotiating permit fees, performing engineering and feasibility studies, and drafting landscape and architectural plans for real property acquired for production had to be capitalized under §263A. In addition, the real estate taxes on the property acquired for production must also be capitalized. However, interest on debt used to pay the real estate taxes is not capitalizable until production begins.

11. Apply the simplified production method to the following facts to compute this manufacturer's §263A adjustment:

Production costs:

Direct costs	$21,000
Variable manufacturing overhead	$ 3,000
Fixed manufacturing overhead	$ 5,000

Additional §263A costs (includes production service costs of $1,000) = $3,200

G & A Costs (Category 2):

Production service costs	$1,000
Mixed service costs	$1,200
Policy service costs	$ 900

Federal taxes	$2,000
total full absorption costs =	**$29,000**
add'l §263A costs =	**$ 3,200**
Total §263A costs =	**$32,200**

Allocation of MSC using simplified service cost-production cost allocation ratio method:

$$\frac{\$32,200}{\$32,200 + \$900} = .9728$$

(note, per §1.263A-1(h)(5), numerator and denominator exclude MSC & interest & taxes described at §1.263A-1(e)(3)(iii)(F) - income taxes[1])

$1,200 x .9728 = $1,167

Additional capitalized costs $3,200 + $1,167 = $4,367

Absorption ratio = $\frac{\$4,367}{\$29,000} = .1506$

EI x .1506 = §263A adjustment

Permissible §263A allocation method - in TAM 9717002, the IRS ruled that taxpayer's §263A cost allocation method was not permissible because it did not follow the simplified production method which is intended to be the only exception to the "general rule that costs required to be capitalized under section 263A must be allocated to specific items in a taxpayer's inventory." The IRS did not find the taxpayer's burden rate method to be reasonable compared to the simplified production method because it allocated less costs to ending inventory.

The second issue was how to select a replacement method once the IRS held that the originally selected method was impermissible. The taxpayer argued that per *Silver Queen Motel*, 55 T.C. 1101 (1971), acq. 1972-2 C.B. 3, it could select its replacement method of accounting. In *Silver Queen*, the court ruled that a taxpayer could amend its return to use the allowable 150% DB method of depreciation, rather than the straight-line method the IRS said it should use when the taxpayer had originally adopted an impermissible method. The rationale was that since the IRS disallowed the method the taxpayer originally adopted, it had never regularly used a method of depreciation for the property, and therefore was not changing its method, and §446(e) did not apply. In the TAM, the IRS ruled that the holding in *Silver Queen* is "limited to situations where a taxpayer has adopted an impermissible method of depreciation. See Rev. Rul. 72-491, 1972-2 C.B. 104. *Silver Queen Motel* does not apply to other situations where a taxpayer has adopted an impermissible method of accounting. Also see TAM 9821001.

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[1] Per TAM 200624067, "Federal income taxes are not includible in the denominator of the production cost allocation ratio provided by §1.263A-1(h)(5)."

12. What is the dividing line between a producer subject to 263A and a reseller only subject if it meets the $10 million gross receipts test?

- See 263A(g) and regulations under 1.263A-1
- *Suzy's Zoo v. Commissioner*, 114 T.C. 1 (2000); aff'd 88 AFTR2d 2001-6916 (9th Cir.)
  Tax Court Syllabus:

  "P, a corporation the stock of which is owned 84 percent by S and 16 percent by two individuals unrelated to S, sells greeting cards and other paper products bearing an image of one or more of P's licensed cartoon characters. P's employees develop and draw the originals of all of the characters, and P transfers the original drawings to independent printing companies to reproduce images of the drawings onto P's paper products, which are made by the printers on P's behalf. The printers must reproduce the drawings and make the products in accordance with P's specifications, and they may not sell to a third party either P's original drawings, or reproductions thereof, or P's paper products.

  HELD: P produces, rather than resells, its paper products; thus, P does not qualify for the "small reseller" exception to the uniform capitalization (UNICAP) rules of sec. 263A, I.R.C.

  HELD, further, P is not excepted from the UNICAP rules by virtue of the artist exemption of sec. 263A(h), I.R.C.; none of P's shareholders owns "substantially all" of P's stock within the meaning of sec. 263A(h)(3)(D)(i)(I), I.R.C.

  HELD, further, the "year of change" for purposes of sec. 481, I.R.C., is the subject year (i.e., the year in which P's method of accounting is changed to conform to the UNICAP rules), rather than the first year to which the UNICAP rules apply."

  The 9th Circuit agreed with the Tax Court, finding that a producer does not have to manufacture its own products in order to be subject to §263A.

13. How are gross receipts measured for purposes of determining if the reseller is excepted from §263A?

- Rev. Rul. 89-26, 1989-1 C.B. 87: "Gross receipts from all businesses of the taxpayer are included in the computation for purposes of the $10 million test."

14. Which of the following costs must be capitalized by a reseller subject to §263A?

a. rent and utilities for a warehouse located ten blocks from the store?

§1.263A-3(c)(5) - capitalizable storage cost, assuming is not on-site (5)(ii)

b. rent and utilities for warehouse located in same parking lot as the store?

off-site or on-site? is it physically attached to, and an integral part of, a retail sales facility - an essential and indispensable part of the retail sales facility? if yes, is deductible on-site storage

c. lease payments for a lot where manufactured homes are stored so that independent salespersons can show them to potential customers (90% of the sales are then for custom manufactured homes)?

Off-site because not "on-site." "An on-site storage facility is defined in the regulations as a storage facility that is physically attached to and that is an integral part of a "retail sales facility". Sec. 1.263A-3(c)(5)(ii)(A), Income Tax Regs.

A 'retail sales facility' is further defined as the location at which merchandise is sold 'exclusively to retail customers in on-site sales'. Sec. 1.263A-3(c)(5)(ii)(B)(1), Income Tax Regs.

With an exception not here relevant, a retail customer is defined as the final purchaser of merchandise and does not include a person who resells the merchandise to others. Sec. 1.263A-3(c)(5)(ii)(E)(1), Income Tax Regs.

If a storage facility does not meet the above definition of an on-site storage facility, it is considered an 'off-site storage facility,' and storage costs relating to property held for resale are to be included in the taxpayer's inventory. Sec. 1.263A-3(c)(5)(ii)(F), Income Tax Regs."

The court did not find that the lease payments were marketing, selling or distribution costs either. Thus, the costs had to be included in inventory. [*Load, Inc.,* TC Memo 2007-51]

d. purchasing agent's salary and benefits?

capitalize - §1.263A-3(c)(3)

e. salary and benefits of purchasing agent's clerk who spends 80% of his time in the purchasing department and 20% in the advertising office?

§1.263A-3(c)(3)(ii) - 1/3-2/3 rule IF elected would treat all as purchasing cost because spends more than 2/3 of her activities in purchasing dept.

f. costs to operate forklift in the warehouse?

assuming off-site storage - is a handling cost - transportation - §1.263A-3(c)(4)(v)

15. How does a taxpayer's §263A calculations affect its AMT calculations? Must a corporation compute separate COGS for AMT and ACE?

- **see §1.56(g)-1(r) (T.D. 8340 3/91, amended by T.D. 8352 6/91 and T.D. 8454 12/92) and as modified by final §263A regulations**
- **Blue Book to TRA'86 (page 438) - "... for minimum tax purposes it was intended that ... section 263A ... apply with regard to minimum tax depreciation deductions ..."**

Current Issue: Notice 2007-29, 2007-14 IRB ___ - "The Internal Revenue Service and Treasury Department are studying the appropriateness of the use of negative amounts in computing additional costs for purposes of the simplified methods of accounting under §263A of the Internal Revenue Code. This notice invites public comment on changes to the simplified production method under §1.263A-2(b) and the simplified resale method under §1.263A-3(d) of the Income Tax Regulations. This notice also provides interim guidance pending the publication of future guidance." A negative amount might occur when book depreciation is greater than tax depreciation.

"The Service and Treasury Department are aware of this viewpoint but are concerned that including negative amounts in additional §263A costs may result in significant distortions in some situations. Including negative amounts in additional §263A costs may undercapitalize amounts because the simplified production method formula may remove more of the cost from ending inventory than was actually remaining in ending inventory. Generally, this distortion is caused by the use of a different formula for removing the cost from ending inventory than the formula by which the cost was originally capitalized under §471. The inclusion of raw materials in the simplified production method formula also may cause distortions. For example, including a negative amount for book depreciation greater than tax depreciation (excess depreciation) in the simplified production method formula may reduce ending inventory by more than the amount of excess depreciation actually remaining in ending inventory. In some circumstances this distortion may be a reversal of the overcapitalization of excess tax depreciation over book depreciation in prior years, and thus, may not be a cause for concern. However, the inclusion can cause significant,

lasting distortion in situations in which the taxpayer has a tax basis much lower than book basis in depreciable property."

"The Service and Treasury Department are considering amending the regulations under §263A to prohibit the use of some or all negative amounts in computing additional §263A costs under the existing simplified methods and to provide a new alternative simplified method of cost allocation under §263A."

16. A bank has some of its facility and maintenance employees assisting with the opening and remodeling of a few bank stores. These employees oversee leasing, maintenance and repairs, configuration of space, remodeling projects and construction of new facilities. Should the bank include the indirect costs of these employees' salaries, pensions and employee benefit expenses as a capitalized amount of the new and remodeled facilities, or does the *Wells Fargo* case (224 F.3d 874 (8th Cir. 2000)) that allowed the salaries of employees assisting with a merger be expensed because that is the usual treatment of employee salaries? [CCA 200917031]

These indirect costs must be capitalized to the property produced because they were incurred because of the production activities. Reg. §1.263A-1(e)(3)(i)

Excerpts from CCA 200917031 which includes a helpful explanation of why §263A was enacted in 1986:

"Section 1.263A-1(a)(3)(i)(A) provides taxpayers must capitalize all direct costs and certain indirect costs properly allocable to real property and tangible personal property produced by the taxpayer.

Section 1.263A-1(d)(1) provides that self-constructed assets are assets produced by a taxpayer for use by the taxpayer in its trade or business. Self-constructed assets are subject to § 263A.

Section 1.263A-1(e)(1) provides that, in general, taxpayers subject to § 263A must capitalize all direct costs and certain indirect costs properly allocable to property produced.

Section 1.263A-1(e)(3)(i) provides that indirect costs are defined as all costs other than direct material costs and direct labor costs in the case of property produced. Taxpayers subject to § 263A must capitalize all indirect costs properly allocable to property produced. Indirect costs are properly allocable to property produced when the costs directly benefit or are incurred by reason of the performance of production activities.

Section 1.263A-1(e)(3)(ii) provides examples of indirect costs required to be capitalized to property produced. These examples include, but are not limited to, indirect labor costs, officers' compensation, pension and other related costs, and employee benefit expenses.

Like the transportation property in Commissioner v. Idaho Power Co., 418 U.S. 1, 94 S. Ct. 2757, 41 L. Ed. 2d 535 (1974) (discussed below), the indirect costs at issue — salaries, pensions and other related costs, and employee benefit expenses — are costs that directly benefit or are incurred by reason the construction of self-constructed assets. Moreover, these indirect costs are explicitly identified by the regulations as categories of indirect costs that are required to be capitalized under § 263A. See § 1.263A-1(e)(3)(ii). Accordingly, Taxpayer must capitalize these indirect costs to the property produced as a result of h's construction and remodeling activities.

For its part, Taxpayer believes that the indirect costs at issue should be analyzed under Wells Fargo & Co. v. Commissioner, 224 F.3d 874 (8th Cir. 2000). As explained below, Wells Fargo is irrelevant to the issue of whether these costs must be capitalized to real and tangible personal property under §263A.

In Wells Fargo, corporate officers of a subsidiary spent part of their time negotiating a merger transaction with the taxpayer. The subsidiary paid the officers the same compensation that it was paying them to perform their day-to-day operational duties. After completion of the merger, the taxpayer, which became the 100 percent owner of the subsidiary, deducted the portion of the salaries paid to these corporate officers that was attributable to services performed in merging the companies.

The Wells Fargo Court analyzed whether the indirect costs at issue (salaries paid to corporate officers) were "ordinary" under §162(a) and thus fully deductible in the taxable year, or whether these costs were capital expenditures under §263(a). [1] In applying the origin of the claim doctrine, the Wells Fargo Court concluded "that if an expense is directly related to the capital transaction (and therefore, the long term benefit), then it should be capitalized." [2] In reversing the Tax Court, the Wells Fargo Court held that the salaries at issue were currently deductible because "there is only an indirect relationship between the salaries (which originate from the employment relationship) and the acquisition (which provides the long term benefit [])." [3]

Wells Fargo simply does not apply here. The Wells Fargo Court addressed whether the costs to create an intangible asset must be capitalized under § 263(a). Accordingly, we disagree with Taxpayer's argument that the "direct relationship" test in Wells Fargo should be used in determining whether the costs at issue constitute indirect costs under § 1.263A-1(e)(3)(i) because, in Taxpayer's case, the examining agent is arguing that the indirect costs at issue must be capitalized to real property and tangible personal property produced as a result of the h's construction and remodeling activities.

A brief history of § 263A may be helpful at this point. Prior to enactment of § 263A, the issue of whether a taxpayer must capitalize the cost of constructing real property and tangible personal property was addressed on a case-by-case basis and yielded different results for different industries. In Idaho Power, the Supreme Court held that § 263(a)(1) of the 1954 Code bars depreciation deductions on transportation equipment, including passenger cars, trucks, power-operated equipment, and trailers, that a taxpayer owned and used in the construction of the taxpayer's capital facilities. The Idaho Power Court reasoned that the depreciation on the transportation equipment is similar to "wages paid in connection with the construction or acquisition of the capital asset," which "must be capitalized and are then entitled to be amortized over the life of the capital asset so acquired." [4]

In 1986, Congress, unsatisfied with this "case-by-case" approach, effectively codified and extended the Idaho Power result to production activities of all industries by enacting §263A. See §§263A(a)(1)(B), (a)(2), and (b)(1). Section 263A and the regulations thereunder require a taxpayer who produces real property and tangible personal property to capitalize the property's properly allocable share of indirect costs to the property produced, regardless of whether the property is sold or is used in the taxpayer's trade or business. See § 263A and § 1.263A-1(a)(3)(ii). These statutory and regulatory rules are intended to provide uniform rules regarding capitalization of direct and indirect costs of producing real property and tangible personal property, regardless of the industry involved or the type of real property and tangible personal property produced.

Accordingly, the issue, properly stated, is whether the h's costs, consisting of salaries, pensions and other related costs, and employee benefit expenses, are properly allocable to property produced as a result of the h's construction and remodeling activities. See § 1.263A-1(e)(3)(i). The criteria for analyzing and determining whether those costs are properly allocable under § 263A to the real property and tangible personal property produced by the taxpayer are found in § 1.263A-1(e)(3). The analysis of the Wells Fargo Court to determine whether costs are allocable or capitalizable to intangible property under § 263(a) is simply irrelevant. Moreover, reliance on that judicial analysis of §263(a) would be a reversion to the state of affairs that Congress sought to remedy by enacting §263A."

[1] Wells Fargo, 224 F.3d at 880 (citing INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 112 S. Ct. 1039, 117 L. Ed. 2d 226 (1992) (holding that, while "the mere presence of a future benefit may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether" the expense should be deducted or capitalized); Commissioner v. Lincoln Savings and Loan Assoc., 403 U.S. 345, 29 L. Ed. 519, 91 S.Ct. 1893 (1971) (holding that a taxpayer must capitalize an amount p aid to create or enhance a separate and distinct asset)).

[2] Id. at 887 (citing INDOPCO, 503 U.S. 79) (emphasis in original).

[3] Id. (emphasis in original).

[4] Idaho Power Co., 418 U.S. at 13 (citing Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775, 781 (2 nd Cir. 1973); Perlmutter v. Commissioner, 44 T.C. 382, 404 (1965), aff'd, 373 F.2d 45 (10 th Cir. 1967); Jaffa v. United States, 198 F.Supp. 234, 236 (ND Ohio 1961); § 1.266-1 (e)).

17. ABC Manufacturer paid $300,000 of royalties in the current year under trademark licensing agreements. The agreements allow ABC to use the trademarks of others for manufacturing, advertising and packaging. Some of the licensors require that ABC show it a sample item produced so the licensor can be sure it meets their quality standards. Should ABC treat the royalties as an inventoriable cost?

Maybe - §1.263A-1(e)(3)(ii)(U) lists licensing as an example of an indirect cost required to be capitalized. The fact pattern of the question is based on *Robinson Knife Manufacturing Co.,* TC Memo 2009-9. In that case, because the license agreements pertained to manufacturing, they had to be capitalized as an inventoriable cost rather than a deductible selling expense.

The taxpayer also argued that the cost should not be included in the simplified production cost method calculation because it distorts income. The court noted that the simplified method was designed to lessen administrative burden, not to be accurate.

On appeal, the taxpayer won. Per the court: "while we may agree with the Tax Court's implicit conclusion that "directly benefit or are incurred by reason of" boils down to a but-for causation test, we hold that under the plain text of the regulation it is the costs, and not the contracts pursuant to which those costs are paid, that must be a but-for cause of the taxpayer's production activities in order for the costs to be properly allocable to those activities and subject to the capitalization requirement." The court seems to be saying that there must be a link between the expenditure and inventory to include the cost as a Unicap cost. [105 AFTR 2d 2010-1467, 600 F.3d 121 (2nd Cir.)]

Subsequent the 2nd Circuit decision, the IRS issued:

- **AOD 2011-10 – "We disagree with the Second Circuit's analysis. We think that the court confused the timing with the purpose of the payments. Robinson incurred the royalty expenses to first produce then sell the trade-marked items. Like all manufacturers, Robinson had to manufacture the tools to sell them. We think that the Tax Court correctly held that Robinson incurred the royalty expenses "by reason of" its production activities, and the royalty payments were production costs within the meaning of §1.263A-1(e)(3)(i).**

  The Service and Treasury Department published proposed regulations stating that sales-based royalties are production costs required to be capitalized under §263A and are allocated to inventory sold during the taxable year. 75 F.R. 78940 (December 17, 2010). The Service will not follow the Second Circuit's holding that sales-based royalty payments are deductible expenses except in litigating cases appealable to the Second Circuit.

  Recommendation: Nonacquiescence.

- **Proposed regulations on the topic (REG-149335-08 (12/17/10)).**
- **LB&I *Field Guidance on the Planning & Examination of Sales-Based Royalty Payments and Sales-Based Vendor Allowances* (3/1/11)**
  http://www.irs.gov/businesses/article/0,,id=236800,00.html

Interest Capitalization

18. What is the general rule for when a taxpayer must capitalize interest expense per §263A(f)?

Required when taxpayer has:

1) property:

- subject to §263A

- self-produced real or tangible personal property with either, a long useful life (real property or personal property with class life ≥ 20 years), or estimated production period > 2 years, or estimated production period > 1 year & cost > $1,000,.000

[referred to as "designated property" in final regulations at §1.263A-8(b)]

and

2) interest paid or incurred during the production period

• In TAM 9327007, the IRS ruled that the time that wine was aging in the bottle was considered part of the production period such that if it took over 2 years, interest capitalization would be required.

19. Law firm X, a personal service corporation, borrowed $100,000 to install leasehold improvements in its new office for which it entered a 20-year lease. Could §263A(f) apply to X?

YES - self-produced real property - need to capitalize interest on traced debt during production period and if accumulated production costs > traced debt, check for other eligible debt for which interest may need to be capitalized under the avoided cost rule.

20. What is the theory behind the requirement to capitalize interest expense on avoided cost debt when production expenditures exceed traced debt? Reg. §1.263A-9(a).

"any interest that the taxpayer theoretically would have avoided if accumulated production expenditures had been used to repay or reduce the taxpayer's outstanding debt" - such interest expense could have been avoided if production payments had instead been used to pay down outstanding debt. Similar in theory to FAS #34.

21. Would accounts payable that do not bear interest be considered eligible debt under?

Notice 88-99 - yes (but superseded by final regulations)

Final reg. §1.263A-9(a)(4)(ii) - no unless bears interest

What difference does it make if non-interest bearing debt is included in eligible debt?

If non-interest bearing debt is included, total capitalized interest is lowered.

22. For which of the following debts might a partnership or its partners need to capitalize interest if partnership production costs exceed traced and avoided cost debt?

a. a partner's qualified residence loan?

not eligible debt per §1.263A-9(a)(4)(v)

b. the partnership's debt secured by tax-exempt bonds?

not eligible debt per §1.263A-9(a)(4)(i)

23. Corporation X is constructing a new warehouse for itself. It is using a forklift it owns in the construction activity. However, 20% of the time, the forklift is used in its manufacturing plant. How does this forklift affect the computation of X's accumulated production expenditures? See Reg. §1.263A-11(d)

Include 80% of the adjusted basis in the production expenditures for purposes of determining how much interest needs to be capitalized

TAM 199913030—A public utility acquired land on which to construct a facility in the future. Under the rate setting rules, T is allowed to include in the land in its rate calculation. Once construction began, T only included construction costs in its accumulated production costs for purposes of determining how much interest to capitalize during the production period per §263A(f). The Service ruled that the land must also be included in the accumulated production costs despite the fact that T began to earn income with respect to the land prior to the production period. The land was purchased solely for the production activity and must be factored in when computing capitalized interest expense.

24. Z Corporation is planning on building a new retail store and acquired the land on 1/1/98. It does not plan to start building until 9/1/98. On 5/1/98, the fire department made Z clear the brush from the land. Which date is considered the beginning of Z's production period? Reg. §1.263A-12(c)(2) & (e).

Per regulations, 5/1/98 probably constitutes the start of the production period. Note per §1.263A-12(g), if production ceases for at least 120 days after 5/1/98, the production period would be suspended.

Production for other §263A purposes may have started earlier. See *Reichel* and *Von Lusk.*

25. When Z Corporation's production period ends for the building it is constructing for itself, what should it do with the capitalized interest? How should it treat the interest expense incurred after the production period ends?

add it to the basis of the property

26. Reseller Y incurred $50,000 of interest expense in 1998 on working capital loans used to acquire inventory. Must Y capitalize this interest expense?

No requirement exists for Y to capitalize interest - see §263A(f).

§460

NOTE: This is introductory material and all that we will cover on this topic. The key takeaway is to know when a taxpayer has a long-term contract and the basics of how it is to be accounted for. The details are in the statute and regulations. While there is an example of a calculation of the lookback method required under §460, just skim it for awareness.

27. What is the purpose of §460?

Excerpt from the *General Explanation of the Tax Reform Act of 1986*, prepared by the Staff of the Joint Committee on Taxation (page 527)

"Reasons for Change

The Congress believed that the completed contract method of accounting for long-term contracts permitted an unwarranted deferral of the income from those contracts. The Congress noted that the Study of 1983 Effective Tax Rates on Selected Large U.S. Corporations by the Joint Committee on Taxation indicated that some corporations had large deferred taxes and low effective tax rates as a result of their use of the completed contract method for tax purposes. Annual reports for certain large defense contractors reflected negative tax rates due to net operating loss carryforwards generated through use of the completed contract method in prior years.

The Congress believed it was appropriate to limit the tax deferral obtainable through use of the completed contract method by requiring that a portion of the income from long-term contracts be reported on a percentage of completion method. However, the Congress recognized that use of the percentage of completion method may produce harsh results for taxpayers in some cases, for example, where an overall loss is experienced on the contract, or where actual profits are significantly less than projected. The method was also subject to manipulation by taxpayer. In order to address these deficiencies in the percentage of completion method under prior law, the Congress adopted a modified version of the method, applicable whether the taxpayer uses the percentage of completion method for all or only a portion of a long-term contract. Under this modified percentage of completion method, variances between the estimated and the actual completion during each year of the contract are accounted for at the end of the contract through an interest charge or credit to the taxpayer.

The Congress also believed that, with respect to the portion of a long-term contract reported under the completed contract method (or an inventory method of accounting), income would be more clearly reflected if certain costs reimbursed under a contract, but not treated as contract costs under prior law, were subject to capitalization.

Finally, the Congress believed it was desirable to resolve (retroactively as well as prospectively) a controversy between taxpayers and the Internal Revenue Service concerning the treatment of independent research and development costs."

The change to the percentage of completion method was gradually achieved starting with changes by TRA'86. Changes were made to IRC §460 by tax acts subsequent to TRA'86.

Tax Act	% completion	normal	Effective for contracts entered into after:
TRA'86	40%	60%	2/28/86
RA'87	70	30	10/13/87
TAMRA'88	90	10	6/20/88
RA'89	100	0	7/10/89

28. Under §460, must a taxpayer use the percentage of completion method assuming no exception applies, or is §460 elective?

It is mandatory for any project that meets the definition of a "long-term contract" although certain contracts of some types of taxpayers are excepted – see §460(e).

29. Which of the following are long-term contracts?

a. architect agrees to provide blueprints and consultation during construction of high-rise building. Begins in 2/06 and finishes 6/08.

This is not a long-term contract. Although it starts and ends in different tax years, it is not for manufacturing, building, installation or construction. See §460(f).

b. calendar year taxpayer agrees to construct a small building for a customer. Contract entered into 11/1/07 and completed 2/1/08.

This is a long-term contract. It begins and ends in different tax years and is for construction. You'd want to check §460(e) to see if it is excepted from §460 treatment.

c. contract to manufacture 15,000 folding chairs, will take over 12 months to complete.

This is not a long-term contract. Special rules apply before a manufacturing contract can be a long-term contract. Such a contract must involve the manufacture of either (A) a unique item of a the that is not normally included in the finished goods inventory of the taxpayer, or (B) an item that normally requires more than 12 calendar months to complete. See §460(f)(2).

While the entire contract takes over 12 months (so involves more than one tax year), the chairs are not unique to the taxpayer and each one does not take over 12 months to produce.

d. DX Company is constructing roads for a new housing tract. [See §460(e) and Prop. Regs REG-120844-07 (8/4/08)]

Is this a home construction contract under §460(e)? This was a point of controversy in how to interpret the statutory language. In 2008, the IRS issued proposed regulations that broadened the definition to include some common improvements, such as roads.

More on "unique"

Molds in Auto Industry Are Unique–TAM 199925002—T manufactures metal molds, wood molds, and fixtures to produce plastic parts for the auto industry. Each mold is to produce a part used on a particular model or car-body configuration. It takes about 10 months for T to design, fabricate and assemble a complete mold for a customer. T was granted permission via Form 3115 to change its accounting method for long-term contracts from an impermissible hybrid method to the accrual-shipment method. Upon audit, the IRS engineer determined that the molds were unique items and the Agent proposed that T change from the accrual-shipment method to the percentage-of-completion method under §460.

The Service relied on the *Sierracin* case (90 T.C. 341 (1988), acq. 1990-2 C.B. 1), to find that the molds were unique and that T was required to apply §460. The Service's 4-part analysis included:

1. Custom Design—While the process of creating molds is similar for each customer, the actual molds are made to meet each customer's particular needs.

2. Pre-Production Costs—Pre-production costs, including R&D, engineering, and retooling, run about 10% of total costs.

3. Nature of Manufacturing Operation—While the manufacturing process is becoming more automated, a substantial amount of manual labor is required.

4. Length of Production Period—The mean production period was 10 months.

Note: Also see FSA 1999-1122 and regulations under §460 which define "unique." In the FSA, the Service noted that "risk is not a necessary prerequisite to a finding of uniqueness. ... [M]anufacturing risk is irrelevant under the percentage-of-completion method of accounting of section 460. Section 460 requires the taxpayer to use reasonable estimates adjusted annually to determine the portion of expected contract revenue which must be recognized each year; it also requires the taxpayer to "look back" at the actual contact costs and revenues at the completion of the contract and make adjustments for estimating errors."

Also see TAM 8941003 and cases cited therein – but also see final §460 regulations.

More on manufacturing:

Systems Installation Contracts Are Not Manufacturing–In FSA 1999-1108, the Service held that contracts to install computer systems were not long-term under §1.451-3(b)(1). Taxpayer was in the business of selling, installing and designing computer systems. T used the percentage of completion method for financial reporting purposes and the completed contract method for tax purposes. The FSA makes no mention of §460 and thus, likely predates the addition of that provision to the Code in 1986. The Revenue Agent took the position that although the contracts took over 12 months to complete, T's activities did not constitute manufacturing. The Service agreed with the Agent based on its revenue rulings holding that contracts for architectural, engineering, construction management and painting services are not long-term contracts (see Rev. Ruls. 84-32, 82-134, and 70-67). One of the rationales behind the rulings is that the taxpayers were not subject to risks of price changes and losses as a general contractor would be. "Where the taxpayer is not subject to such risks, the completed contract method of accounting is generally not appropriate." The Service also cited PLR 8545007, which held that agreements to provide data processing services were not long-term contracts. This ruling also held that the words, "building, installation, and construction," added to the regulations in 1922, are "in pari materia and, as such, should be construed together to effect the drafter's intent." Thus, "installation" of software is not the type of "installation" contemplated by the regulations.

The FSA also attempts to define the term "manufacturing," relying on a Supreme Court definition from *Anheuser-Busch Brewing Assoc. v. U.S.*, 207 U.S. 556 (1908): "Manufacture implies a change, but every change is not manufacture, and yet every change in an article is the result of treatment, labor, and manipulation. But something more is necessary .... There must be transformation; a new and different article must emerge, 'having a distinctive name, character, or use.' ... a person who makes only minor alterations to a product, which do not affect the basic nature of the product, is not engaged in manufacturing." As T did not cause the computer hardware to be transformed into a new and different item or make it suitable for a different use, T was not engaged in manufacturing.

The Service also did not find that design, development and loading of software constituted manufacturing. It relied on a state decision—*First Data Corp.*, 357 N.E.2d 933 (MA 1976). First Data operated a commercial, online computer time-sharing system. The court held that the transmission or manipulation of knowledge or intelligence did not constitute manufacturing.

30. On 12/20/07, calendar year taxpayer G Corporation entered a long-term contract where the total contract price was $4,000,000 with estimated costs of $3,500,000. On 12/30/07, in order to secure a better price on materials needed for the contract, G prepaid a supplier $1,000,000 for materials to be delivered on 2/1/08. What is the tax effect, if any, to G in 1907? Also see §1.461-4(d)(2)(ii). Would your answer change if the materials purchased on 12/30/07 only cost $300,000? Explain.

31. Would a 50 unit apartment building being built by a partnership with gross receipts under $10,000,000 meet the exception at §460(e)? Why or why not?

Does the building meet the definition of a home construction contract under §469(e)? It is it all one building, then it is not a home construction contract. If it is in buildings with 4 or fewer dwelling units, then it is a home construction contract.

If it is not a home construction contract, does §469(e)(1)(B) apply? You'd need to verify gross receipts of the taxpayer.

Note that even if a taxpayer's contract is exempt from §460, it must still follow the §460(c)(3) interest capitalization rules.

32. **Facts:** • corporate taxpayer W, calendar year, accrual method

- enters into contract to construct waste treatment facility for city of San Jose
- estimated construction costs = $9,000,000
- estimated construction period - contract entered into 2/1/96 and completion date set at 7/1/98
- contract price = $10,500,000 + $250,000 to be paid after satisfactory operation of the facility for 4 months (W actually collects the entire amount by 11/1/98)
- actual construction costs each year are (direct & indirect costs, other than interest expense):

1996	$4,000,000
1997	$4,000,000
1998	$1,600,000

- W also had to borrow $1,000,000 on 3/1/97 for this project which it repaid (principal and interest) on 1/1/98. W incurred $100,000 of interest expense on this loan (not included in above numbers).

TO DO:

1) compute how much revenue and expense W must report under §460 with respect to this long-term contract for 1996, 1997 and 1998 (assume no simplified method is used by W).

2) apply the lookback method by completing Form 8697 to determine how much interest W either owes or will receive in 1998

References:

§460 & 1.460-6
Form 8697

Solution:

(TCR x PC) - I = contract revenue for current year

1996	(10,750,000 x	4,000,000) / 9,000,000)	- 0 =	$ 4,777,777
1997	(10,750,000 x	8,100,000) / 9,100,000)	- 4,777,777 =	$ 4,790,904
1998	(10,750,000 x 1)	- $9,568,681	=	$ 1,181,319
				$10,750,000

Lookback:

					Differences 8697 line 2
1996	(10,750,000 x	4,000,000) / 9,700,000)	- 0 =	$ 4,432,990	(344,787)
1997	(10,750,000 x	8,100,000) / 9,700,000)	- 4,432,990 =	$ 4,543,814	(247,090)
1998	(10,750,000 x 1)	- $8,976,804	=	$ 1,773,196	591,877
				$10,750,000	
					$ -0-

Application of §263A to a Producer

Note: §471 costs are defined at §1.263A-1(d)(2) and §1.471-11.

Taxpayer (T) manufactures and sells widgets. It has a factory with two assembly lines, a storage area for raw materials and supplies and another storage area for finished goods. Each storage area is near a loading dock. The factory building also contains office space where inventory control, shipping and receiving and factory personnel matters are handled.

T has a separate building which includes sales personnel, executives, accounting, tax, legal, financial/budgeting, human resources, benefits processing, R & D, and shareholder relations.

Costs incurred in the factory and sales include the following:

Factory:

- salaries of assembly line workers, QA inspectors, purchasing agent and assistant, inventory control clerks, shipping and receiving workers, personnel office workers, receptionist
  - overtime
  - vacation and sick pay
  - employment taxes
  - employee benefits
  - workers' compensation costs
- depreciation on build and equip
- §179 costs
- utilities
- security
- building and equipment repairs
- property taxes
- sales tax on equipment purchases
- warranty repair costs

In July, had to stop assembly line #2 for 3 weeks for retooling.

Administrative Office:

- salaries, overtime, vacation and sick pay, benefits, employment taxes, benefits and workers' comp for:
  - sales staff
  - accounting dept.
  - tax dept.
  - legal dept.
  - financial/budgeting dept.
  - shareholder relations dept.
  - human resources office
  - benefits processing office
  - President
  - Vice-president - operations
  - Vice president - marketing
  - Treasurer/controller
- Sales dept costs:
  - mailings
  - brochures
  - phone
  - demo room
  - bidding costs
- Depreciation on building and equipment
- R & D
- Income taxes
- Property taxes
- Sales tax on equipment

Identify the above costs as:

- DM
- DL
- Indirect
- MSC
- non-§263A

Also, for the MSC costs, identify an appropriate base to be used to allocate between §263A activities and non-§263A activities. §1.263A-1(g)(4)(iii) & (iv). Note that there are various methods available to T for allocating its MSC. Each is a method of accounting so can only be changed with permission of the IRS. See §1.263A-1(g) and (h). Also consider the impact of the de minimis rule of §1.263A-1 (g)(4)(ii) and §1.263A-1(h)(8).

Simplified production method - use of this method requires calculation of "additional §263A costs" and "§471 costs" (so does the simplified resale method). A summary of the §471 rules and how §263A has changed them follows:

Cost	§471 treatment	§263A treatment	T's amounts
Category 1: §1.471-11(c)(2)(i)			
repairs & maintenance	capitalize	capitalize	1,000
utilities	capitalize	capitalize	3,000
rent	capitalize	capitalize	-0-
indirect labor and production supervisory wages, including basic compensation, overtime pay, vacation and holiday pay, sick leave pay, shift differential, payroll taxes and contributions to a supplemental unemployment benefit plan	capitalize	capitalize	20,000
indirect materials and supplies	capitalize	capitalize	10,000
tools and equipment not capitalized	capitalize	capitalize	-0-
quality control and inspection	capitalize	capitalize	50,000
		TOTAL	84,000
Category 2: §1.471-11(c)(2)(ii)			
marketing	expense	expense §1.263A-1(e)(iii)(A)	60,000
advertising	expense	expense §1.263A-1(e)(iii)(A)	40,000
selling	expense	expense §1.263A-1(e)(iii)(A) BUT, see special rule on bidding costs at §1.263A-1(e)(3)(ii)(T) & -1(e)(3)(iii)(J)	90,000
other distribution	expense	expense §1.263A-1(e)(iii)(A)	10,000

Cost	§471 treatment	§263A treatment	T's amounts
interest	expense	depends - §1.263A-1(e)(ii)(V) - see §263A(f)	-0-
R & D	expense	expense §1.263A-1(e)(iii)(B)	80,000
§165 losses	expense	expense §1.263A-1(e)(iii)(D)	-0-
percentage depletion in excess of cost depletion	expense	capitalize	-0-
depr and amort reported for federal income tax purposes in excess of depreciation reported by taxpayer on books	expense	capitalize NOTES: • §179 deduction - expense per §1.263A-1(e)(3)(iii)(C) • temporarily idle equipment - expense per §1.263A-1(e)(3)(iii)(E)	10,000
income taxes on income from sale of inventory	expense	expense §1.263A-1(e)(iii)(F)	40,000
pension contributions to extent they represent past services cost	expense	capitalize	-0-
G & A incident to and necessary for t/p's activities as a whole rather than to production or manufacturing operations or processes ASSUME IS A MSC	expense	capitalize - if related to production (MSC to be allocated). §1.263A-1(e)(4)(C)(iii) & (iv); otherwise, expense per §1.263A-1(e)(3)(iii)(K)	40,000
officer salaries attributable to performance of services incident to and necessary for t/p's activities taken as a whole rather than to production or manufacturing operations or processes	expense	expense (unless "properly allocable" to property produced or acquired for resale)	-0-
Category 3: **§1.471-11(c)(2)(iii)** **§1.263A-1(d)(2)(iii)**			
non-income taxes attributable to assets incident to and necessary for production or manufacturing operations or processes	capitalize or expense depending on financial statement treatment	capitalize §1.263A-1(e)(ii)(L)	10,000
depr and depletion on assets incident to and necessary for production or manufacturing operation or processes	capitalize or expense depending on financial statement treatment	capitalize §1.263A-1(e)(ii)(I) & (J) Note - temporarily idle equipment - expense per §1.263A-1(e)(3)(iii)(E)	70,000

Cost	§471 treatment	§263A treatment	T's amounts
employee benefits (e.g. §404, workers' comp, profit-sharing, stock option, life and health insurance) incident to and necessary for production or manufacturing labor	capitalize or expense depending on financial statement treatment	capitalize §1.263A-1(e)(3)(ii)(C) & (D)	100,000
costs attributable to strikes	capitalize or expense depending on financial statement treatment	expense §1.263A-1(e)(3)(iii)(G)	-0-
costs attributable to rework labor, scrap and spoilage	capitalize or expense depending on financial statement treatment	capitalize §1.263A-1(e)(3)(ii)(Q)	8,000
factory administrative expenses	capitalize or expense depending on financial statement treatment	capitalize §1.263A-1(e)(ii)(W)	6,000
officers' salaries attributable to services performed incident to and necessary for production or manufacturing operations or processes	capitalize or expense depending on financial statement treatment	capitalize §1.263A-1(e)(3)(ii)(B)	26,000
insurance costs incident to and necessary for production or manufacturing operations or processes such as insurance on production machinery and equipment	capitalize or expense depending on financial statement treatment	capitalize §1.263A-1(e)(3)(ii)(M)	42,000

To do: Apply the simplified production cost and simplified service cost method (using the production cost allocation ratio) to T. Additional information:

T uses FIFO

Direct labor costs	$500,000	
Direct material costs	$400,000	
Beginning inventory	$200,000	($180,000 §471 costs + $20,000 §263A costs)
Ending inventory	???	($220,000 §471 costs + _____ §263A costs)