INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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District Director
Director of Field Operations

Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

Taxpayer =
Product 1 =
Product 2 =
Product 3 =
Product 4 =
Product 5 =
Product 6 =
Product 7 =
Product 8 =

ISSUE(S):

Under the facts described below, whether Taxpayer's method of determining the amount of scrap costs includible in inventory costs is a reasonable allocation method within the meaning of § 1.263A-1(f)(4).

CONCLUSION(S):

Taxpayer's method of determining the amount of scrap costs allocable to inventory costs is a reasonable allocation method within the meaning of § 1.263A-1(f)(4).

FACTS:

Taxpayer manufactures Product 1, Product 2, Product 3, Product 4, Product 5, Product 6, Product 7, and Product 8 (hereinafter Products 1-8). Taxpayer's manufacturing process generates scrap materials, such as . Some of these scrap materials are waste that must be disposed of (hereinafter referred to as Waste Scrap), but some of the scrap materials have value and are routinely sold to third parties (hereinafter referred to as Salvageable Scrap).

Taxpayer sells Products 1-8 to customers in the ordinary course of business. Taxpayer also routinely collects and sells its Salvageable Scrap to scrap dealers. Salvageable Scrap is an extremely minor element of Taxpayer's production and sales activities. Consequently, Taxpayer has not established a detailed or precise method of determining the actual cost of Salvageable Scrap and does not maintain records of quantities on hand.

Taxpayer accounts for scrap materials as an indirect production cost allocable to inventory, *i.e.*, Products 1-8. Taxpayer uses a standard cost method of allocating indirect costs, including scrap material costs, to inventory and uses direct labor as the statistical base to allocate indirect costs to inventory. In determining the dollar amount of factory overhead that will be allocable to inventory under its standard cost method, Taxpayer estimates the total scrap costs that it will incur during the taxable year and the amount of revenue that it will derive from sales of Salvageable Scrap. In effect, the scrap material cost allocated as an indirect cost under Taxpayer's allocation method is a net amount, taking into account costs and sales of scrap materials.

Taxpayer does not include the revenues generated by the sale of Salvageable Scrap as sales revenue in computing its gross income. Instead, Taxpayer reduces the amount of factory overhead costs by the amount of revenue from sales of Salvageable Scrap.

The examining agent believes that Taxpayer must treat the entire cost of its scrap materials as an indirect cost includible in inventory costs under § 263A and separately treat the revenue from Salvageable Scrap sales as gross receipts from sales in determining gross income under § 1.61-3. Under the method proposed by the examining agent, Taxpayer's total sales will include revenues derived from sales of Products 1-8 and Salvageable Scrap. Cost basis will not be separately allocated to Salvageable Scrap. Instead, Taxpayer will recover its total scrap material costs through cost of goods sold as Products 1-8 are sold.

LAW AND ANALYSIS:

I.R.C. § 61 provides that "gross income means all income from whatever source derived..." and provides a nonrestrictive list of items of income. Treas. Reg. § 1.61-3(a) provides that in a manufacturing, merchandising, or mining business, "gross income" means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. Gross income is determined without the subtraction of depletion allowances based on a percentage of income to the extent that it exceeds cost depletion which may be required to be included in the amount of inventoriable costs as provided in § 1.471-11 and without subtraction of selling expenses, losses or other items not ordinarily used in computing cost of goods sold or amounts which are of a type for which a deduction would be disallowed under section 162(c), (f), or (g) in the case of a business expense. The cost of goods sold should be determined in accordance with the method of accounting consistently used by the taxpayer. Thus, for example, an amount cannot be taken into account in the computation of cost of goods sold any earlier than the year in which economic performance occurs with respect to the amount.

Treas. Reg. § 1.446-1(c)(1)(ii)(C) provides, in part, that no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. The method used by the taxpayer in determining when income is to be accounted for will generally be acceptable if it accords with generally accepted accounting principles, is consistently used by the taxpayer from year to year, and is consistent with the regulations.

Treas. Reg. § 1.471-3(c)(3) provides, in part, that cost means, in the case of merchandise produced by the taxpayer since the beginning of the taxable year, (1) the cost of raw materials and supplies entering into or consumed in connection with the product, (2) expenditures for direct labor, and (3) indirect production costs incident to and necessary for the production of the particular article, including in such indirect production costs an appropriate portion of management expenses, but not including any cost of selling or return on capital, whether by way of interest or profit.

Treas. Reg. § 1.471-7 provides that a taxpayer engaged in mining or manufacturing who by a single process or uniform series of processes derives a product of two or more kinds, sizes, or grades, the unit cost of which is substantially alike, and who in conformity to a recognized trade practice allocates an amount of cost to each kind, size, or grade of product, which in the aggregate will absorb the total cost of production, may, with the consent of the Commissioner, use such allocated cost as a basis for pricing inventories, provided such allocation bears a reasonable relation to the respective selling values of the different kinds, sizes, or grades of product.

Treas. Reg. § 1.263A-1(c)(1) provides, in part, that under section 263A, taxpayers must include in inventory costs the direct costs and a properly allocable share of the indirect costs of producing property that is inventory in the hands of the taxpayer. Indirect costs properly allocable to property produced are all costs other than direct material and direct labor costs that directly benefit or are incurred by reason of the performance of production activities. See Treas. Reg. § 1.263A-1(e)(3)(i).

Treas. Reg. § 1.263A-1(c)(2)(i) provides, in part, that any cost that (but for section 263A and the regulations thereunder) may not be taken into account in computing taxable income for any taxable year is not treated as a cost properly allocable to property produced or acquired for resale under section 263A and the underlying regulations. Thus, for example, if a business meal deduction is limited by section 274(n) to 80 percent of the cost of the meal, the amount properly allocable to property produced or acquired for resale under section 263A is also limited to 80 percent of the cost of the meal.

Treas. Reg. § 1.263A-1(c)(2)(ii) provides, in part, that the amount of any cost required to be capitalized under section 263A may not be included in inventory or charged to capital accounts or basis any earlier than the taxable year during which the amount is incurred within the meaning of § 1.446-1(c)(1)(ii).

Treas. Reg. § 1.263A-1(e)(3)(ii)(Q) provides that indirect costs that must be capitalized to the extent they are properly allocable to property produced include the costs or rework labor, scrap, and spoilage. (Emphasis added).

Treas. Reg. § 1.263A-1(f)(4) provides that a taxpayer may use any reasonable method to properly allocate direct and indirect costs among units of property produced or property acquired for resale during the taxable year. An allocation is reasonable if, with respect to the taxpayer's production or resale activities taken as a whole – (i) the total costs actually capitalized during the taxable year do not differ significantly from the aggregate costs that would be properly capitalized using another permissible method described in sections 1.263A-1, 1.263A-2, or 1.263A-3, with appropriate consideration given to the volume and value of the taxpayer's production or resale activities, the availability of costing information, the time and cost of using various allocation methods and the accuracy of the allocation method chosen as compared with other allocation methods; (ii) the allocation method is applied consistently; and (iii) the allocation method is not used to circumvent the requirements of the simplified methods in sections 1.263A-1, 1.263A-2, or 1.263A-3, or the principles of § 263A.

The examining agent frames the issue as "whether Taxpayer may include scrap revenue in its indirect costs allocated to inventory through the application of a standard burden rate," and concludes that Taxpayer may not "because the regulations underlying

§§ 263A and 471 only permit costs to be considered when computing burden rates and scrap revenue is not a cost."

In support of this conclusion, the examining agent makes several arguments. According to the agent, Taxpayer's method does not capitalize all of its scrap costs and therefore is inconsistent with § 1.263A-1(e)(3)(ii)(Q). The examining agent further contends that revenue generated through the sale of Salvageable Scrap is not a direct or indirect cost of producing inventory and therefore is not properly allocable to inventory or cost of goods sold under § 263A. Finally, the examining agent argues that, under § 1.61-3, revenue generated through the sale of Salvageable Scrap is includible in "total sales" to determine the amount of gross income for the year or in "income from incidental sources."

We agree with the examining agent that § 1.263A-1(e)(3)(ii)(Q) requires capitalization of scrap costs. However, we believe that that regulation assumes that "scrap" is the type of scrap materials that are discarded, similar to Taxpayer's Waste Scrap. Section 1.263A-1(e)(3)(ii)(Q) does not explain how to determine the amount of scrap cost that is an indirect cost of inventory where part of the scrap is sold. Taxpayer determines the amount that is an indirect cost of the inventory by subtracting the value of the scrap sold from the total cost of scrap. The issue in this case is whether that is a reasonable method within the meaning of § 1.263A-1(f)(4).

Section 1.263A-1(f)(4) permits any reasonable method, as defined therein, of allocating § 263A costs. A method of allocating costs under § 263A, is considered a reasonable allocation method under § 1.263A-1(f)(4) if it satisfies a three-prong test. The first prong is that the total costs actually capitalized during the taxable year do not differ significantly from the aggregate costs that would be properly capitalized using another permissible method described in § 1.263A-1, § 1.263A-2 or § 1.263A-3, with appropriate consideration given to the volume and value of the taxpayer's production or resale activities, the availability of costing information, the time and cost of using various allocation methods and the accuracy of the allocation method chosen as compared with other allocation methods. The second prong is that the method is used consistently. The third prong is that the method is not used to circumvent the requirements of the simplified production or resale method or the principles of § 263A. The first prong is the only one at issue in this case.

By its terms, the first prong of the § 1.263A-1(f)(4) test requires a comparison between the results of the taxpayer's method and the results of another permissible method. Mechanically, Taxpayer's method first determines Taxpayer's net scrap cost by offsetting the total scrap costs incurred by the revenues from the sale of scrap and then allocates this net scrap cost to inventory under its standard cost method. The examining agent has characterized Taxpayer's method as one in which revenue is allocated to inventory under § 263A and contends that § 263A only applies to the

allocation of costs. We think that there is a better way to characterize Taxpayer's method. Taxpayer's method, essentially though not mechanically, allocates the total scrap cost incurred between Waste Scrap and Salvageable Scrap. It then allocates the Waste Scrap cost to Products 1-8, and it offsets or matches the Salvageable Scrap cost against the revenues from sales of Salvageable Scrap. In other words, Taxpayer's method produces results similar to a method that treats Salvageable Scrap as inventory and allocates to that inventory an amount of cost that is equal to its sales value. Therefore, we believe that it is appropriate under § 1.263A-1(f) to compare Taxpayer's method to a method which treats the Salvageable Scrap as inventory or other property held for sale and allocates inventory costs thereto. Because Salvageable Scrap is produced as a result of the production of Products 1-8, we believe that allocating inventory costs thereto based on relative fair market values similar to the method permitted for joint products under § 1.471-7 is an appropriate method for comparison under § 1.263A-1(f).

The examining agent contends that comparing Taxpayer's method to a method permitted by § 1.471-7 is inappropriate because Taxpayer's Salvageable Scrap is not inventory. The examining agent further argues that because Salvageable Scrap is not inventory or other property subject to § 263A, no cost can be allocated to it. We disagree. Irrespective of whether Salvageable Scrap is properly characterized as inventory,[1] it is property, and it is routinely sold. Section 263A requires allocation of an appropriate amount of costs to property acquired for resale or produced by the taxpayer. Implicit in the rules of § 263A is that only the costs allocable to the § 263A activity will be allocated thereto. We believe that § 263A only requires allocation of the cost of Waste Scrap to Products 1-8 produced by Taxpayer. The remainder of the scrap cost is allocable to the Salvageable Scrap and is properly recovered when the Salvageable Scrap is sold.

In evaluating the different results of the taxpayer's method and another permissible method, § 1.263A-1(f)(4) requires that appropriate consideration to be given to the availability of costing information, the time and cost of using more precise allocation methods and the accuracy of the allocation method chosen as compared with a more precise allocation methods. We do not believe Taxpayer's method allocates an amount of scrap material costs to ending inventory that differs significantly from the amount that would be allocated if Taxpayer allocated costs to Salvageable Scrap according to the principles of § 1.471-7. Moreover, because Taxpayer's scrap is such an extremely minor element of its production and sales activities, we believe Taxpayer's method of allocating net scrap cost is a reasonable allocation method within the meaning of section 1.263A-1(f)(4). Thus, based on the facts of this case, we conclude that

[1] We express no opinion on whether Taxpayer's Salvageable Scrap is inventory or can be accounted for as such. We emphasize, however, that the determination of whether property that is routinely sold by a taxpayer constitutes inventory is not dependent upon the label affixed to that property in the taxpayer's accounting records.

Taxpayer's method of accounting for scrap materials cost is a reasonable allocation method under § 1.263A-1(f)(4).

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.