INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

March 31, 2006

Third Party Communication: None
Date of Communication: Not Applicable

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CASE-MIS No.: TAM-146711-05
Number: **200630019**
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Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer =

Foreign Parent =

Subsidiary =

Country A =

Product X =

Product Y =

Product Z =

Date 1 =

Agreement =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

ISSUES:

(1) Whether Subsidiary is required to capitalize royalties under section 263A.

(2) Whether Subsidiary's treatment of royalty expense constitutes capitalization within the meaning of section 263A.

(3) Whether Subsidiary changed its method of accounting for royalties when, after reporting them as an expense on line 26 of its Form 1120, it began to include them as costs of goods sold reflected on Schedule A of its Form 1120.

(4) Whether royalties should have been included in additional § 263A costs allocated to equivalent units under Subsidiary's allocation method.

(5) Whether Subsidiary's equivalent units of production ("EUP") method, and its partial conversion of unassigned raw material to equivalent units of finished goods, is a proper method for allocating costs to property produced.

(6) If Subsidiary's method of capitalizing costs under section 263A is improper, whether the Commissioner may require use of the simplified production method.

CONCLUSIONS:

(1) Subsidiary is required to capitalize royalties under section 263A.

(2) Subsidiary's treatment of royalty expense did not constitute capitalization within the meaning of section 263A.

(3) Given that Subsidiary did not capitalize royalties under section 263A and it was required to capitalize such royalties under section 263A, we need not address the issue

of whether or not Subsidiary made an unauthorized change in method of accounting.

(4) Subsidiary was not required to allocate royalties under its EUP allocation method.

(5) We have insufficient facts to reach a conclusion as to the reasonableness of Subsidiary's EUP method.

(6) Since Subsidiary's method of capitalizing costs under section 263A is improper, the Commissioner may place Subsidiary on any reasonable method, including the simplified production method.

FACTS:

Foreign Parent ("FP"), a corporation organized and existing under the laws of Country A, owns 100% of the stock of Taxpayer, a corporation organized under the laws of the United States. Taxpayer owns nearly all of the stock of Subsidiary, which is also a corporation organized under the laws of the United States. FP and its subsidiaries develop, manufacture, distribute, and provide financing for the sale of FP's products, including Product X, Product Y, and Product Z (collectively, "Products") as well as related parts. In connection with this business, FP has acquired and developed industrial property rights, quality standards and manufacturing and other information and know-how relating to such products.

FP has granted Taxpayer the exclusive right to distribute FP's Products in substantially all areas of the United States, and the exclusive right and license to use the trademarks of FP therein.

Subsidiary has been established for the purpose of manufacturing, producing and assembling Products and related parts for sale to Taxpayer. Taxpayer purchases from Subsidiary such products bearing the trademarks of FP so as to enable Taxpayer more effectively and efficiently to provide Products and related parts in the U.S. market.

Effective Date 1, FP and Subsidiary entered into the Agreement. The Agreement was in effect during each of the periods under audit.

Under the Agreement, FP granted to Subsidiary an indivisible, non-transferable and non-exclusive right and license, to manufacture, produce and assemble in the United States, or to have manufactured, produced and assembled for it in the United States by parties not otherwise entitled to do so, the Products and related parts for sale primarily to Taxpayer under the intellectual property rights and by using the technical information in accordance with the Agreement.

Subsidiary was to pay a royalty as consideration for the rights and licenses granted under the Agreement. The royalty itself was based on these various rights described above in the Agreement. However, the amount of the royalty was calculated using the number of units of Products sold by Subsidiary to Taxpayer during each calendar month. For each unit sold, the royalty was increased by an agreed upon amount, representing a percentage of the "domestic value added". The "domestic value added" for each product was determined yearly and represented the difference between the weighted average of Taxpayer's prices for all types of that item for the year and the weighted average of the planned cost of parts in all types of that product for the year. The royalty was "payable for sales by [Subsidiary] to [Taxpayer] during each calendar month."

The intellectual property rights and technical information were utilized by Subsidiary in all units and parts produced, including those that remained on hand at the end of each of the taxable years at issue. In addition, Subsidiary used the intellectual rights and technical information in performing production activities.

For book purposes Subsidiary accrues an expense each month for royalties due to FP based on the number of units sold. Under the rules of section 267(a)(3), Subsidiary deferred deduction of the royalty for federal income tax purposes until payment was made to FP.

Subsidiary identifies its method of capitalizing section 263A costs to inventory as a "facts and circumstances" method under § 1.263A-1(f)(2). Subsidiary deducted all of the royalty fees paid in each period under audit. The royalties were reported on line 26 ("Other Deductions") in the Year 1 and Year 2 tax returns. The royalties were reported on line 5 ("Other Costs") of the Schedule A in the Year 3 and Year 4 tax returns. However, no amount of royalty expense was capitalized to any of the items in ending inventory for Year 3 or Year 4.

Subsidiary used an equivalent units of production ("EUP") method to allocate additional § 263A costs to ending inventory. However, it did not include royalty expense as one of the costs allocated under its EUP method. In addition, Subsidiary did not, under its EUP method, allocate any additional § 263A costs to its in-transit raw materials.

APPLICABLE LAW:

Section 263A(a) provides that the direct costs and indirect costs properly allocable to property that is inventory in the hands of the taxpayer must be included in inventory costs.

Section 1.263A-1(a)(3)(ii) of the Income Tax Regulations provides, in part, that taxpayers that produce tangible personal property must capitalize (1) all direct costs of producing the property, and (2) the property's properly allocable share of indirect costs.

Section 1.263A-1(c)(1) provides that to determine these capitalizable costs, taxpayers must allocate or apportion costs to various activities, including production activities.

Section 1.263A-1(c)(1) further provides that after section 263A costs are allocated to the appropriate production activities, these costs generally are allocated to the items of property produced during the taxable year and capitalized to the items that remain on hand at the end of the taxable year. As a result, costs incurred during the taxable year are either included in the cost of goods sold during the taxable year or are capitalized to the items that remain on hand at the end of the taxable year using a method permitted under § 1.263A-1(f).

Section 1.263A-1(c)(2)(ii) provides 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).

Section 1.263A-1(c)(3) provides that capitalize means, in the case of property that is inventory in the hands of a taxpayer, to include in inventory costs.

Section 1.263A-1(c)(4) provides that costs that are capitalized under section 263A are recovered through depreciation, amortization, cost of goods sold, or by an adjustment to basis at the time the property is used, sold, placed in service, or otherwise disposed of by the taxpayer.

Section 1.263A-1(e)(3)(i) provides, in part, that 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 that must be capitalized to the extent they are properly allocable to property produced. Indirect costs required to be capitalized include licensing and franchise costs incurred in securing the contractual right to use a trademark, corporate plan, manufacturing procedure, special recipe, or other similar right associated with property produced. See § 1.263A-1(e)(3)(ii)(U).

Section 1.263A-1(f) sets forth various detailed or specific (facts-and-circumstances) cost allocation methods that taxpayers may use to allocate direct and indirect costs to property produced and property acquired for resale. In lieu of a facts-and-circumstances allocation method, section 1.263A-1(f) authorizes taxpayers to use the simplified methods provided in sections 1.263A-2(b) and 1.263A-3(d) to allocate direct and indirect costs to eligible property produced.

Section 1.263A-1(f)(4) provides that a taxpayer may use a facts-and-circumstances allocation method if it is a reasonable allocation method. In addition, a taxpayer may use any other reasonable method to allocate direct and indirect costs among units of property produced or acquired for resale during the taxable year. An allocation method is reasonable if:

> (i) the total costs actually capitalized during the taxable year do not differ significantly from the aggregate costs that would be properly capitalized using another permissible method described in sections 1.263A-1(f), 1.263A-2, or 1.263A-3, with appropriate consideration given to the volume and value of the taxpayer's production or resale activities, the availability of costing information, and the time and cost of using various allocation methods, and the accuracy of the allocation method chosen as compared with other allocation methods;
>
> (ii) the allocation method is applied consistently by the taxpayer; and
>
> (iii) the allocation method is not used to circumvent the requirements of the simplified methods provided in sections 1.263A-1(f), 1.263A-2, or 1.263A-3, or the principles of section 263A.

Section 1.263A-2(a)(3)(i) provides that producers must capitalize direct and indirect costs properly allocable to property produced under section 263A, without regard to whether those costs are incurred before, during, or after production.

Section 1.263A-2(b) provides the simplified production method for allocating the additional section 263A costs to ending inventories of property produced and other eligible property on hand at the end of the taxable year.

Section 1.263A-2(b)(i) provides that, except as otherwise provided in § 1.263A-2(b)(2)(ii), the simplified production method, if elected for any trade or business of a producer, must be used for all production and resale activities associated with designated categories of property to which section 263A applies.

Section 267(a)(2) provides generally that a taxpayer may not deduct any amount owed to a related party (as defined in Section 267(b)) until it is includible in the payee's gross income. Section 267(a)(3) states that "[t]he Secretary shall by regulations apply the matching principle of paragraph (2) in cases in which the person to whom the payment is to be made is not a United States person."

Section 446(b) provides that, if no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of

taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

Section 446(e) requires that a taxpayer obtain the consent of the Secretary prior to changing its method of accounting from the basis for which taxable income is regularly computed to a new method.

ANALYSIS:

(1) Whether Subsidiary is required to capitalize royalties under section 263A.

Treas. Reg. § 1.263A-1(c)(1) generally requires taxpayers to capitalize the direct costs and a properly allocable share of indirect costs to the property they produce. Indirect costs are all costs other than direct material costs and direct labor costs (in the case of 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. Treas. Reg. § 1.263A-1(e)(3)(i).

Treas. Reg. § 1.263A-1(e)(3)(ii)(U) specifically cites licensing and franchise costs as examples of indirect costs required to be capitalized. Licensing and franchise costs include fees incurred in securing the contractual right to use a trademark, corporate plan, manufacturing procedure, special recipe, or other similar right associated with property produced or property acquired for resale. These costs include the otherwise deductible portion (e.g., amortization) of the initial fees incurred to obtain the license or franchise and any minimum annual payments and royalties that are incurred by a licensee or franchisee.

In *Plastic Engineering & Technical Services, Inc. v. Commissioner*, T.C. Memo 2001-324, the Tax Court dealt directly with the issue of whether, under section 263A, the taxpayer was required to capitalize royalties paid for the right to manufacture and sell an assembly system. The Tax Court, in concluding that the royalty payments were required to be capitalized under section 263A, stated:

> [U]nder the statute and regulations, indirect costs, that is costs other than direct materials costs and direct labor costs or acquisition costs, must be capitalized if properly allocable to property produced. Sec. 1.263A-1(e)(3)(ii), Income Tax Regs. Further, the regulations give as an example of an indirect cost required to be capitalized, licensing and franchise costs. Sec. 1.263A-1(e)(3)(ii)(U), Income Tax Regs. The language found in the regulations speaks directly to petitioner's license of the patented manufacturing process and the royalties incurred in securing that license.

Id. In this case, the Agreement grants Subsidiary the rights to use FP's intellectual property (including patents, design patents, trademarks, service marks and copyrights), know-how and technical information. Subsidiary uses the rights granted in the Agreements in performing its production activities to produce each Product and the related parts.

The royalties Subsidiary pays to FP for the rights under the Agreement are licensing and franchise costs as defined by Treas. Reg. § 1.263A-1(e)(3)(ii)(U). The rights directly benefit Subsidiary's activities in producing the Products as well as the related parts. Consequently, the royalties for Subsidiary's rights under the Agreement are indirect costs that are properly allocable to property produced and must be capitalized under section 263A.

(2) Whether Subsidiary's treatment of royalty expense constitutes capitalization within the meaning of section 263A.

The royalties were reported on line 26 ("Other Deductions") in the Year 1 and Year 2 tax returns and on line 5 ("Other Costs") of the Schedule A in the Year 3 and Year 4 tax returns. On its face, it would appear that in Years 1 and 2, Subsidiary was deducting royalties as a period expense; then in Years 3 and 4 Subsidiary appeared to be capitalizing royalties to inventory but allocating the entire amount to cost of goods sold and none to ending inventory. Subsidiary claims that it was capitalizing royalties to inventory all along, using a specific identification method as provided in § 1.263A-1(f)(2) that allocated royalties only to products that were sold during the year. Subsidiary further claims that it had inadvertently made posting errors in Years 1 and 2 by reporting royalties on its return as a period expense.

In support of this position, Subsidiary argues that the change in treatment (from Year 2 to Year 3) was not a change in method of accounting since it had no effect on its calculations or on its net income for the years in question. The amount of royalty expense that Subsidiary is permitted to take into account for federal income tax purposes is determined based upon the vehicles sold during the year. Thus, the computation of the amount of royalty expense incurred for the taxable year is unaffected by Subsidiary's method of accounting. Further, whether that amount is deducted on line 26 or included entirely in cost of goods sold has no bottom line effect on Subsidiary's taxable income; taxable income is the same either way. Subsidiary notes that allocation of an inventory cost entirely to cost of goods sold does constitute capitalization under section 263A. Subsidiary concludes that because there is no difference in taxable income between deducting a cost as a period expense and including it in cost of goods sold, its method was capitalization.

Under section 263A, "capitalize" means to include in inventory costs. *See* § 1.263A-1(c)(3). Costs that are included in inventory costs under section 263A are recovered

through cost of goods sold. *See* § 1.263A-1(c)(4). Thus, whether a capitalized cost remains in ending inventory or is included in cost of goods sold is determined by the taxpayer's inventory accounting method.

Section 1.263A-1(f) provides various methods of cost allocation which taxpayers may use to allocate direct and indirect costs to property produced or held for resale. One such permissible method is a specific identification method. *See* § 1.263A-1(f)(2). Whether a method constitutes capitalization is a separate issue from whether a method of capitalization is reasonable, and thus permissible. Thus, a taxpayer including a cost in inventory is capitalizing that cost even if the cost is allocated entirely to cost of goods sold. Such a capitalization method may or may not be reasonable depending upon whether it satisfies the requirements of a "reasonable allocation method" in § 1.263A-1(f)(4).

Given that an allocation of a cost entirely to cost of goods sold does constitute capitalization, the next issue is whether Subsidiary's method was in fact to include royalties in inventory costs and to allocate royalties to cost of goods sold in Year 1, the first year under examination.

"The question of which accounting method is used by the taxpayer is one of fact." *Hamilton Indus., Inc. v. Commissioner*, 97 T.C. 120, 142 (1991) (citing *Daley v. U.S.*, 243 F.2d 466, 471 (9th Cir. 1957); *Peninsula Steel Products & Equipment Co. v. Commissioner*, 78 T.C. at 1039 (1982)). The fact that Subsidiary labeled royalties as a period expense rather than as an item of inventory cost in Year 1 is relevant, but not dispositive. The Supreme Court, in *Aluminum Castings, Co. v. Routzahn*, 282 U.S. 92 (1930), dealt with the issue of whether a taxpayer was using an overall accrual method or the cash receipts and disbursements method of accounting:

> But whether a return is made on the accrual basis, or on that of actual receipts and disbursements, is not determined by the label which the taxpayer chooses to place upon it. The use of inventories, and the inclusion in the returns of accrual items of receipts and disbursements appearing on petitioner's books, indicate the general and controlling character of the account … and support the finding of the trial court that books and returns were on the accrual basis.

Id. at 99. "Generally, a question concerning the identity of an accounting method used by a taxpayer is resolved by examining the manner in which the method operates and by classifying that manner of operation under the recognized method it most closely resembles." *Hamilton*, at 142.

In this case, Subsidiary's treatment of royalties could be consistent with a capitalization method. However, it is also clearly consistent with the method of deducting the item as a period expense. Subsidiary argues, as evidence that it was capitalizing royalties all

along, that the change in treatment (from Year 2 to Year 3) had no effect on its calculations or on its net income for the years in question. However, even assuming that to be the case, there is also no indication that the calculations or net income would have changed if Subsidiary were originally deducting royalties and then in Year 3 began allocating the entire amount to cost of goods sold. Further, while it is possible to have a reasonable capitalization method which allocates the entire amount of a cost to cost of goods sold, capitalization in the vast majority of cases involves the allocation of some portion of items of cost to ending inventory. Subsidiary's treatment is consistent only with a small minority of cases in which costs are capitalized, and the treatment is not consistent with the manner in which capitalization of an item most commonly operates. Subsidiary's treatment is, however, perfectly consistent with the manner in which deduction of an item as a period expense most commonly operates.

Given these facts, as well as the label chosen by Subsidiary itself for the item, its treatment of royalties most closely resembles the method of deduction as a period expense. Consequently, we conclude that Subsidiary's actual method of accounting for the royalty expense, as of Year 1, is deduction as a period expense. Since Subsidiary was deducting it as a period expense as of Year 1, Subsidiary was not capitalizing royalty expense within the meaning of section 263A.

(3) Whether Taxpayer changed its method of accounting for monthly royalties when, after including them as royalty expense on line 26 of its Form 1120, Taxpayer began to include them as costs of goods sold reflected on Schedule A of its Form 1120.

Given that Subsidiary did not capitalize royalties under section 263A as of Year 1 and it was required to capitalize such royalties under section 263A, we need not address the issue of whether or not Subsidiary made an unauthorized change in method of accounting.

(4) Whether royalties should have been included in additional 263A costs allocated to equivalent units under Taxpayer's allocation method.

There is no requirement in section 263A or the regulations thereunder that a taxpayer using a facts-and-circumstances method of allocating costs must use the same method or cost objective for each cost allocated to inventory under section 263A. In fact, the regulations specifically contemplate such differences.

For example, § 1.263A-1(f)(3) provides, in part, that "A taxpayer may allocate different indirect costs on the basis of different burden rates." Also, § 1.263A-1(f)(2) provides that "[a] specific identification method traces costs to a cost objective, such as a function, department, activity, or product, on the basis of a cause and effect or other

reasonable relationship between the costs and the cost objective." Typically, not every cost will be traceable to the exact same function, department, activity, or product.

As the regulations allow taxpayers to allocate different costs using different cost objectives, Subsidiary is not required to use the same method of allocating royalties as for other expenses for which it uses an EUP method. Consequently, Subsidiary was not required to allocate royalties under its EUP allocation method.

(5) Whether the equivalent units method, and its partial conversion of unassigned raw material to equivalent units of finished goods, is a proper method for allocating costs to property produced.

There are two aspects to this issue. The first involves the treatment of in-transit raw materials, and the second aspect involves the appropriateness of Subsidiary's EUP method in general.

In regard to the in-transit raw materials, both Subsidiary and the field agree that Subsidiary is not, *under its EUP method*, allocating any additional § 263A costs to these materials. However, it is not clear to what extent, if any, Subsidiary may be allocating some or all of such costs (or other costs) using a method other than its EUP method. The field has argued that Subsidiary is not allocating any additional § 263A costs to its in-transit raw materials. The Taxpayer argues that the in-transit raw materials are not required to be included in the EUP computation because the indirect costs allocable to the in-transit raw materials already are included in the cost of the in-transit raw materials for book and tax purposes.

While Subsidiary is clearly required under section 263A to allocate an appropriate amount of direct and indirect costs related to the in-transit raw materials, we have insufficient information on the costs involved and the extent, if any, to which Subsidiary is already allocating the costs to make a determination on this aspect of the issue.

As to Subsidiary's EUP in general, prior to the enactment of section 263A, the Tax Court, in *Primo Pants Co. v. Commissioner*, 78 T.C. 705 (1982) recognized the equivalent units of production ("EUP") method as the Service had applied it to the particular facts of that case. The method as described in that case was as follows:

> To compute the portion of factory overhead and the allocation of direct labor to the finished goods and work in process, respondent examined the costs of operating petitioner's manufacturing facilities. Then, after adding all the production costs together, respondent divided that total by the equivalent units of production. The factor was then included in valuing the finished pants and the work-in-process inventory under the full absorption method of accounting for all 3 years.

Id. at 710-711. “Each completed pair of pants is considered one equivalent unit. If a pair of pants is in process and is half completed, it is one half of an equivalent unit. Thus, if there are 10,000 items in process that are 50-percent completed, there are 5,000 equivalent units.” *Id*. at 710 n.1.

While *Primo Pants* predated the enactment of section 263A, such prior methods were contemplated in the enactment of the section and the regulations thereunder. The Preamble to the temporary regulations under section 263A discussed how taxpayers producing property must allocate additional costs required to be capitalized under that section to property on hand at the end of the taxable year:

> Taxpayers producing inventory property may elect a simplified method of accounting for the costs required to be allocated under the temporary regulations (the "simplified production method"). Absent the election of the simplified production method, taxpayers are required to allocate additional costs required to be capitalized under section 263A with the same degree of specificity as was required of inventoriable costs under prior law.

T.D. 8131, 1987-1 C.B. 98. As the EUP method was recognized under the prior law given the specificity requirements in existence at the time, such a method of allocating costs may be considered reasonable currently if it meets the requirements of section 263A and the regulations thereunder.

Any method other than one of the specifically authorized simplified methods must meet the reasonableness requirements of § 1.263A-1(f)(4) in order to be permissible. Section 1.263A-1(f)(4) provides, in part, that one of the requirements for an allocation method to be reasonable is that “the allocation method is not used to circumvent the requirements of the simplified methods provided in sections 1.263A-1(f), 1.263A-2, or 1.263A-3, or the principles of section 263A.”

One important factor in determining the appropriateness of an EUP method is the similarity of the units of inventory to which the costs are allocated. “Process-costing techniques are used for inventory costing when there is continuous, mass production of like units.” Charles T. Horngren, *Cost Accounting: A Managerial Emphasis*, 610 (Prentice-Hall, 3rd Ed. 1972). The similarity of the units produced is significant because if the production of Product X incurs significantly more costs than the production of Product Y, it would not be reasonable to allocate the same amount of costs to a 50 percent completed unit of one as to a 50 percent completed unit of the other.

Another important factor is the rate at which costs are incurred over the process of completing a unit. A process costing system operates under the rough assumption “that all conversion costs are incurred uniformly in proportion to the degree of product completion.” *Id*. It is not expected or required, in order to determine that an EUP

method would be reasonable, that there be an absolutely uniform rate at which costs are incurred across the production process. However, the extent to which costs are incurred unevenly throughout the production process is an important consideration in evaluating the reasonableness of a particular EUP method.

Products X, Y, and Z are significantly different from each other, and those differences would seem to lead to considerable differences in the amount of costs attributable to the production of each product, and possible differences in the rate at which costs are incurred as well. Unfortunately, we have insufficient facts regarding the similarity of the products produced, the relative uniformity of costs incurred during the production process, and other factors to make a determination as to the reasonableness of Subsidiary's EUP method.

(6) If Taxpayer's method of capitalizing costs under section 263A is improper, whether the Commissioner may require use of the simplified production method.

Section 446(b) provides that if the taxpayer's method of accounting does not clearly reflect income, the computation of taxable income shall be made under such method as, in the Commissioner's opinion, does clearly reflect income. *See also* § 1.446-1(a)(2).

The Commissioner "has broad powers in determining whether accounting methods used by a taxpayer clearly reflect income." *Commissioner v. Hansen*, 360 U.S. 446, 467 (1959), 1959-2 C.B. 460.

> Once the Commissioner determines that a taxpayer's method does not clearly reflect income, he may select for the taxpayer a method which, in his opinion, does clearly reflect income. Sec. 446(b). The taxpayer carries the burden of showing that the method selected by the Commissioner is incorrect, and such burden is extremely difficult to carry.

Hamilton Industries at 129 (citing *Photo-Sonics, Inc. v. Commissioner*, 42 T.C. 926, 933 (1964), *affd*. 357 F.2d 656 (9th Cir. 1966)).

> Section 446 vests the Commissioner with wide discretion in determining whether a particular method of accounting clearly reflects income, and a heavy burden is imposed upon the taxpayer to overcome a determination by the Commissioner in this area.

Rotolo v. Commissioner, 88 T.C. 1500, 1513-1514 (1987).

A method of accounting that is "plainly inconsistent" with valid regulations does not clearly reflect income within the meaning of section 446(b). *Thor Power Tool Co. v.*

Commissioner, 439 U.S. 522, 533 (1979). Given that Subsidiary was not properly capitalizing costs in accordance with the requirements of the Code and regulations, its method does not clearly reflect income.

The courts have consistently held that the Commissioner's authority under section 446(b) permits him to select the method of accounting the taxpayer must use once he has determined that a taxpayer's method does not clearly reflect income. *See Thor Power*; *Ford Motor Company v. Commissioner*, 71 F.3d 209 (6th Cir. 1995); *Mulholland v. U.S.*, 28 Fed.Cl. 320, 335 (1993), *aff'd without op.*, 22 F.3d 1105 (Fed. Cir. 1994).

Consequently, if Subsidiary does not use a permissible method of capitalizing costs under section 263A, Commissioner may place Subsidiary on any reasonable method of accounting, including the simplified production method.

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.