INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-155576-06

Director

Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

Taxpayer =
Location 1 =
Location 2 =
Credit =
Amount 1 =
Amount 2 =

ISSUES:

Production and Handling Issues:

1. Under the following circumstances, whether Taxpayer's installation activities constitute production activity according to §§ 263A(g)(1) and 1.263A-2(a)(1).
    a. Installation of parts by Taxpayer's service department
        i. Customer-owned vehicles

ii. New vehicles owned by Taxpayer
iii. Used vehicles owned by Taxpayer

b. Sublet Repairs/Installation of parts by subcontractors
i. Customer-owned vehicles
ii. New vehicles owned by Taxpayer
iii. Used vehicles owned by Taxpayer

2. Whether, under § 1.263A-1(b)(11), Taxpayer has property subject to § 263A.
   a. Whether auto repair/installation activity constitutes service activity according to § 1.263A-1(b)(11) with respect to customer-owned vehicles.
   b. Whether the parts provided in the auto repair/installation activity constitute property provided in the provision of services according to § 1.263A-1(b)(11) with respect to customer-owned vehicles.

3. Whether Taxpayer is eligible for the de minimis exception under §1.263A-1(b)(12).

4. Whether Taxpayer is a reseller with production activities under §1.263A-3(a)(2), and, if so, whether those activities qualify as de minimis production activities under § 1.263A-3(a)(2)(iii)(A).

5. Whether Taxpayer's repair/installation activities are handling costs.

6. If Taxpayer is permitted to use the simplified resale method because it has de minimis production under § 1.263A-3(a)(2)(iii), how are the production costs accounted for in the formula?

Retail Sales Facility Issues:

7. Do the following sales constitute on-site sales to retail customers?
   a. Vehicles taken in trade or purchased at auction and subsequently resold at wholesale,
   b. Vehicles sold to another dealership at cost,
   c. Vehicles leased,
   d. Vehicles sold as part of a fleet sale, and
   e. Wholesale sales of parts to purchasers who are, or are not, end users where the parts are picked up at Taxpayer's parts department by the purchaser or delivered to the purchaser by a driver from Taxpayer's parts department.

8. Is Taxpayer's storage facility at Location 1 an on-site, off-site, or dual-function storage facility?

9. Is Taxpayer's storage facility at Location 2 an on-site, off-site, or dual-function storage facility?

Identification and Allocation of Costs Issues:

10. Whether purchasing, storage, and handling costs as described in § 1.263A-3(c) are mixed service costs:
    a. Under the simplified production method.
    b. Under the simplified resale method.

11. Which costs are mixed service costs for purposes of the simplified service cost method?

12. Provided that Taxpayer's self-developed method for capitalizing additional § 263A costs is not a proper method, what method of accounting can the examining agent use in order to compute Taxpayer's taxable income?

CONCLUSIONS:

Production and Handling Conclusions:

1. Under the circumstances described below, when Taxpayer or a subcontractor installs parts to customer-owned vehicles, the installation activity does not constitute production activity under §§ 263A(g)(1) and 1.263A-2(a)(1)(i) because Taxpayer does not hold the underlying benefits and burdens of ownership of the vehicle. When Taxpayer or a subcontractor installs parts to new and used vehicles owned by Taxpayer, the installation of parts may constitute production activities under §§ 263A(g)(1) and 1.263A-2(a)(1)(i).

2. Taxpayer does not qualify for the "property provided incident to services" exception set forth in § 1.263A-1(b)(11) because Taxpayer accounts for the parts as inventory.

3. Taxpayer does not qualify for the de minimis rule under § 1.263A-1(b)(12) because Taxpayer's total indirect costs exceed $200,000.

4. We cannot determine whether Taxpayer qualifies for the de minimis production presumption test described in § 1.263A-3(a)(2)(iii)(A). If the examining agent applies a facts and circumstances test, taking into account volume, Taxpayer's production activities relating to property subject to § 263A may be de minimis within the meaning of § 1.263A-3(a)(2)(iii).

5. Costs attributable to repair/installation activities with respect to customer-owned vehicles are handling costs under § 1.263A-3(c)(4). Costs attributable to certain minor repair/installation activities with respect to Taxpayer-owned vehicles are also handling costs.

6. Under the simplified resale method, the materials and labor costs presently capitalized to inventory are § 471 costs. Accordingly, the costs are included in the denominator of the formula as well as in the multiplicand. The indirect costs relating to production activities are treated as additional § 263A costs and included in either the storage and handling costs absorption ratio or the purchasing costs absorption ratio.

Retail Sales Facility Conclusions:

7. Vehicles resold at wholesale, vehicles sold to another dealership at cost, leased vehicles, and some parts sales are not on-site sales to retail customers. Parts sales made to end users at Location 1 are on-site sales to retail customers. Fleet sales are on-site sales to retail customers.

8. Taxpayer's storage facility at Location 1 is a dual-function storage facility.

9. Taxpayer's storage facility at Location 2 is an off-site storage facility.

Identification and Allocation of Costs Conclusions:

10. Under the circumstance described below, purchasing, storage, and handling costs described at § 1.263A-3(c) are not mixed service costs under either the simplified production method or the simplified resale method.

11. Under the circumstance described below, the following costs are mixed service costs for purposes of the simplified service cost method:

    1. Salaries - executive costs including payroll tax and employee benefits
    2. Salaries - administrative costs including payroll taxes and employee benefits
    3. Rent, real estate taxes, utilities, repairs and office supplies allocable to administrative departments
    4. Data processing costs
    5. Legal and audit costs

12. The Commissioner may require Taxpayer to use any method that in his opinion clearly reflects income.

FACTS

Taxpayer is a franchised dealership that sells new and used vehicles. Taxpayer also sells vehicle parts. In addition, Taxpayer's service department repairs and installs parts

on vehicles owned by customers and new and used vehicles owned by Taxpayer (Taxpayer-owned vehicles).

Taxpayer stores vehicles at its main sales facility, Location 1. Taxpayer also stores vehicles at Location 2 which is one-half mile from Location 1. There is no sign at Location 2 indicating that it is owned by Taxpayer, and there is no sales office at Location 2.

Types of sales

As is typical of an automobile dealership, Taxpayer has numerous sales of automobiles to retail customers. Taxpayer also has "lease sales." If a retail customer prefers to lease a vehicle, Taxpayer facilitates the lease. In a lease transaction, Taxpayer leases the vehicle to the customer and simultaneously or immediately thereafter sells the vehicle, subject to the lease, to Credit.

To facilitate sales of new and used vehicles, Taxpayer allows its customers to trade in their used vehicles in exchange for a reduction in the price of a new or used vehicle that the customer is purchasing from Taxpayer. If Taxpayer determines that a particular trade-in is not suitable for retail sale by Taxpayer, it sells the trade-in on a wholesale basis. Taxpayer also sells, on a wholesale basis, some trade-in vehicles that it originally intended to sell on a retail basis and some vehicles that it purchased at auction.

If a customer wants to purchase a vehicle that Taxpayer does not have in stock (e.g., a specific model in a particular color), Taxpayer will arrange to acquire the vehicle from another dealership. Usually, dealers accommodate each other and sell such vehicles at the dealer's cost. Likewise, when Taxpayer sells new vehicles to other automobile dealers, it does so at its cost. Taxpayer also sells multiple new vehicles in fleet sales.

Service department – repair/installation activity

One difficulty in explaining the facts and legal principles applicable to this case is that there are significant differences between the meaning of terms used by the automobile dealership industry and terms of art used in tax accounting law. In industry parlance, an automobile dealership has a "service" department that "repairs" automobiles, most of which involves installation of new or replacement automobile parts. The law of tax accounting, on the other hand, frequently distinguishes between a service and a sale of goods. Under tax accounting principles, the activities of an automobile dealership's service department would qualify as providing services to customers as well as sales of goods to customers and production of goods for sale to customers. Similarly, the law of tax accounting distinguishes between repairs and improvements and provides different treatment for each. And, here again, many of the "repairs" performed by an automobile dealership's service department would qualify as improvements under tax accounting

principles. Thus, where it is helpful to avoid confusion, this Technical Advice Memorandum will refer to the activities of Taxpayer's service department as its "repair/installation activity."

Like most automobile dealerships, Taxpayer's repair/installation activity involves many vehicles that Taxpayer does not own (customer-owned vehicles). When a customer brings his or her vehicle to the service department, a service advisor prepares a repair order on an estimation form. Once a formal diagnosis is made, the customer is contacted and authorizes the work. The work typically involves removal of old, worn or defective parts and installation of new parts. The execution of this repair order activates a mechanic's lien on the vehicle to the extent of the value of the parts and repair services (labor and other costs) provided. The mechanic's lien encumbers the customer's title/ownership of the vehicle. The customer can not dispose of the vehicle with a clean title until or unless the mechanic's lien is satisfied. On occasion, when a customer defaults, Taxpayer can sell the encumbered vehicle in satisfaction of the liability incurred for the cost of parts and services rendered. In general, customers can not retrieve repaired vehicles without prior payment being made for the repair. It is common practice that Taxpayer's customers pay for the parts and labor upon completion of the service.

Besides working on customer-owned vehicles, the service department also installs certain options such as air running boards, alarm systems, plow packages, towing packages, air conditioning, stereo equipment, and entertainment systems on new vehicles. Some of these options are installed prior to the sale of the new vehicle being consummated, and some are installed subsequent to the sale transaction being completed. Whether the option is installed before or after the sales transaction is completed depends on the dollar value of the option being installed. If the cost of any option is above $200, Taxpayer will not install the option until the customer completes the sales transaction.

Taxpayer's service department also installs parts on used vehicles to correct defects or to make them more suitable for sale. Taxpayer obtains most of its used vehicles from auction. Taxpayer purchases these vehicles from auction, installs new or replacement parts, if needed, and resells the vehicles. Taxpayer obtains other used vehicles as trade-ins when a customer purchases a new vehicle or a different used vehicle. Many of the vehicles taken in trade are immediately sold, but some need new or replacement parts installed first. The extent of the work done on a vehicle depends on the retail merit of the vehicle and Taxpayer judgment. "Retail merit" in the auto industry refers to the following characteristics of the vehicle: mileage at 15K to 20K per year, condition, year of vehicle and amount of work required to ready for resale.

<u>Subcontractor activities</u>

Taxpayer also has “sublet repairs.” These are repair/installation activities performed by a subcontractor hired by Taxpayer, and may be done with respect to Taxpayer-owned vehicles and customer-owned vehicles. For example, subcontractors install alarm systems and replace transmissions for Taxpayer.

Parts department

Taxpayer also sells automobile parts at its Location 1 facility. Many of Taxpayer’s sales are made via Taxpayer’s repair/installation activity. Some parts are sold to automobile repair shops that install the parts in retail customers’ vehicles. The parts are either picked up at Taxpayer’s parts counter or an employee of Taxpayer delivers the part to the repair shop. Other part sales are made to end users. These sales are also made at Taxpayer’s parts counter or Taxpayer’s employees deliver the parts to the end users.

In 2003, Taxpayer purchased parts totaling Amount 1, and its own service department used 80 percent of the parts purchased. Of the remaining parts purchased in 2003, 14 percent were recorded by Taxpayer as wholesale sales and 6 percent were recorded as retail sales. In 2004, Taxpayer purchased parts totaling Amount 2 and its own service department used 74 percent of the parts purchased. Of the remaining parts purchased in 2004, 21 percent were recorded by Taxpayer as wholesale sales and 5 percent were recorded as retail sales.

The parts department sales counter generates approximately 5 percent of Taxpayer’s parts department sales. Approximately 12 percent in 2003 and 17 percent in 2004 of the sales made by Taxpayer’s parts department are recorded by Taxpayer as wholesale sales. Some of these sales are to end users, but because sales are made at a discount, Taxpayer records them as wholesale sales.

Administrative activities

Taxpayer has executive and administrative departments that perform various duties. The executives oversee the purchasing activities of new and used vehicles, the parts and service departments’ activities, financial reporting, financing, employee benefits, and payroll. In addition, the executives are involved in general planning and policy decisions. The administrative department performs various tasks. These tasks include the reconciliation of the weekly parts invoices to the monthly statements; reconciliation of vehicle inventory; preparation and maintenance of all financial records for the new vehicle sales, used vehicle sales via retail and wholesale, parts department sales via retail and wholesale and service department activity; accounts payable; accounts receivable; payroll and benefit functions; and various support functions of all the Taxpayer’s activities.

Inventory accounting

Taxpayer uses an overall accrual method of accounting. Taxpayer accounts for new vehicle inventory under the last-in, first-out (LIFO) method. Taxpayer accounts for used vehicles and parts inventory under the first-in, first-out (FIFO) method. Taxpayer's average annual gross receipts are over $10,000,000. Accordingly, Taxpayer is subject to the uniform capitalization rules under § 263A of the Internal Revenue Code and the Income Tax Regulations thereunder.

Taxpayer capitalizes additional § 263A costs to ending inventory using a self-developed method. Under this method, Taxpayer computes two absorption ratios, one is applied to new vehicle inventory, and the other is applied to parts inventory. Taxpayer capitalizes additional § 263A costs to new vehicles by dividing additional § 263A costs attributable to new vehicles by current year purchases and then multiplying the result by the LIFO increment, if any. Taxpayer capitalizes additional § 263A costs to parts by dividing additional § 263A costs attributable to parts by current year purchases of parts and then multiplying the result by § 471 parts costs in ending inventory.[1] Taxpayer includes a limited amount of mixed service costs in the calculation. Taxpayer does not capitalize any additional § 263A costs to the used vehicle inventory.

When Taxpayer's service department repairs or improves Taxpayer-owned vehicles, the costs of parts and labor are accumulated on documents called "internal repair orders." Taxpayer capitalizes the total on the internal repair order to the inventoriable basis of the new and used vehicles. However, other than a limited amount of mixed service costs, Taxpayer does not capitalize any other indirect costs to new vehicles or to parts.

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 263A(g)(1) provides that the term "produce" includes construct, build, install, manufacture, develop, or improve.

Section 263A(g)(2) provides that the taxpayer shall be treated as producing any property produced for the taxpayer under a contract with the taxpayer; except that only costs paid or incurred by the taxpayer (whether under such contract or otherwise) shall be taken into account in applying subsection (a) to the taxpayer.

Section 1.263A-1(a)(3)(i) provides that taxpayers subject to § 263A must capitalize all direct costs and certain indirect costs properly allocable to real and tangible personal property produced by the taxpayer; and real property and personal property described in section 1221(a), which is acquired by the taxpayer for resale.

[1] Taxpayer did not explain how it initially determines the amount of additional § 263A costs attributable to new vehicle inventory or parts inventory.

Section 1.263A-1(b)(11)(i) provides that § 263A does not apply to property that is provided to a client (or customer) incident to the provision of services by the taxpayer if the property provided to the client is- (A) De minimis in amount; and (B) Not inventory in the hands of the service provider.

Section 1.263A-1(b)(12) provides that § 1.263A-2(b)(3)(iv) provides for a de minimis rule that treats producers with total indirect costs of $200,000 or less as having no additional § 263A costs (as defined in paragraph (d)(3) of this section) for purposes of the simplified production method.

Section 1.263A-1(d)(2)(i) provides that generally a taxpayer's § 471 costs are the costs, other than interest, capitalized under its method of accounting immediately prior to the effective date of § 263A.

Section 1.263A-1(d)(2)(ii) provides that in the case of a new taxpayer, § 471 costs are those acquisition or production costs, other than interest, that would have been required to be capitalized by the taxpayer if the taxpayer had been in existence immediately prior to the effective date of § 263A.

Section 1.263A-1(d)(3) provides that generally a taxpayer's additional § 263A costs are the costs, other than interest, that were not capitalized under its method of accounting immediately prior to the effective date of § 263A, but that are required to be capitalized under § 263A.

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

Section 1.263A-1(e)(2)(i) provides that producers must capitalize direct material costs and direct labor costs.

Section 1.263A-1(e)(2)(i)(A) provides that direct material costs include the costs of those materials that become an integral part of specific property produced and those materials that are consumed in the ordinary course of production and that can be identified or associated with particular units or groups of units of property produced.

Section 1.263A-1(e)(2)(i)(B) provides that direct labor costs include the costs of labor that can be identified or associated with particular units or groups of units of specific property produced.

Section 1.263A-1(e)(2)(ii) provides that resellers must capitalize the acquisition costs of property acquired for resale. In the case of inventory, the acquisition cost is the cost described in § 1.471-3(b).

Section 1.263A-1(e)(3)(i) provides that indirect costs are defined as all costs other than direct materials and direct labor costs (in the case of property produced) or acquisition costs (in the case of property acquired for resale). Taxpayers subject to § 263A must capitalize all indirect costs properly allocable to property produced or property acquired for resale.

Section 1.263A-1(e)(3)(i) also provides that indirect costs are properly allocable to property produced or property acquired for resale when the costs directly benefit or are incurred by reason of the performance of production or resale activities.

Section 1.263A-1(e)(3)(i) further provides that indirect costs may be allocable to both production and resale activities, as well as to other activities that are not subject to § 263A. Taxpayers subject to § 263A must make a reasonable allocation of indirect costs between production, resale, and other activities.

Section 1.263A-1(e)(4)(i)(A) provides that service costs are defined as a type of indirect costs (e.g., general and administrative costs) that can be identified specifically with a service department or function or that directly benefit or are incurred by reason of a service department or function.

Section 1.263A-1(e)(4)(i)(B) provides that service departments are defined as administrative, service, or support departments that incur service costs. The facts and circumstances of the taxpayer's activities and business organization control whether a department is a service department. For example, service departments include personnel, accounting, data processing, security, legal, and other similar departments.

Section 1.263A-1(e)(4)(ii)(A) provides that capitalizable service costs are defined as service costs that directly benefit or are incurred by reason of the performance of the production or resale activities of the taxpayer. Therefore, these service costs are required to be capitalized under § 263A. Examples of service departments or functions that incur capitalizable service costs are provided in § 1.263A-1(e)(4)(iii).

Section 1.263A-1(e)(4)(ii)(B) provides that deductible service costs are defined as service costs that do not directly benefit or are not incurred by reason of the performance of the production or resale activities of the taxpayer, and therefore, are not required to be capitalized under § 263A. Deductible service costs generally include costs incurred by reason of the taxpayer's overall management or policy guidance functions. In addition, deductible service costs include costs incurred by reason of the marketing, selling, advertising, and distribution activities of the taxpayer. Examples of service departments or functions that incur deductible service costs are provided in § 1.263A-1(e)(4)(iv).

Section 1.263A-1(e)(4)(ii)(C) provides that mixed service costs are defined as service costs that are partially allocable to production or resale activities (capitalizable mixed service costs) and partially allocable to non-production or non-resale activities (deductible mixed service costs). For example, a personnel department may incur costs to recruit factory workers, the costs of which are allocable to production activities, and it may incur costs to develop wage, salary, and benefit policies, the costs of which are allocable to non-production activities.

Section 1.263A-1(e)(4)(iii) provides examples of costs that are incurred in departments or functions that are generally allocated among production or resale activities. These departments include purchasing operations, including purchasing materials and equipment, scheduling and coordinating delivery of materials and equipment to or from factories or job sites, and expediting and follow-up; and materials handling and warehousing and storage operations.

Section 1.263A-1(e)(4)(iv) provides examples of costs that are incurred departments or functions that are not generally allocated to production or resale activities. These departments include departments or functions responsible for overall management of the taxpayer or for setting overall policy for all of the taxpayer's activities or trades or businesses, such as the board of directors (including their immediate staff), and the chief executive, financial, accounting, and legal officers (including their immediate staff) of the taxpayer, provided that no substantial part of the cost of such departments or functions benefits a particular production or resale activity; strategic business planning; general financial accounting; general financial planning (including general budgeting) and financial management (including bank relations and cash management); and personnel policy (such as establishing and managing personnel policy in general; developing wage, salary, and benefit policies; developing employee training programs unrelated to particular production or resale activities; negotiating with labor unions; and maintaining relations with retired workers).

Section 1.263A-1(f)(2) provides that a taxpayer may use a specific identification method to allocate costs to property produced and property acquired for resale.

Section 1.263A-1(f)(3) provides that a taxpayer may use a burden rate method to allocate an appropriate amount of indirect costs to property produced or property acquired for resale and a standard cost method to allocate an appropriate amount of direct and indirect costs to property produced.

Section 1.263A-1(f)(4) provides that a taxpayer may use the methods described in § 1.263A-1(f)(2) or (3) if they are reasonable allocation methods within the meaning of this paragraph (f)(4). In addition, a taxpayer may use any other 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 method 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 this section or in §§ 1.263A-2 and 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 by the taxpayer; and
(iii) The allocation method is not used to circumvent the requirements of the simplified methods in this section or in § 1.263A-2, § 1.263A-3, or the principles of § 263A.

Section 1.263A-1(h) provides a simplified method for determining capitalizable mixed service costs incurred during the taxable year with respect to eligible property (i.e., the aggregate portion of mixed service costs that are properly allocable to the taxpayer's production or resale activities).

Section 1.263A-2(a)(1)(i) provides that for purposes of § 263A, produce includes the following: construct, build, install, manufacture, develop, improve, create, raise or grow.

Section 1.263A-2(a)(1)(ii)(A) provides that except as provided in paragraphs (a)(1)(ii)(B) and (C) of this section, a taxpayer is not considered to be producing property unless the taxpayer is considered an owner of the property produced under federal income tax principles. The determination as to whether a taxpayer is an owner is based on all of the facts and circumstances, including the various benefits and burdens of ownership vested with the taxpayer. A taxpayer may be considered an owner of property produced, even though the taxpayer does not have legal title to the property.

Section 1.263A-2(a)(1)(ii)(B)(1) provides that property produced for the taxpayer under a contract with another party is treated as property produced by the taxpayer to the extent the taxpayer makes payments or otherwise incurs costs with respect to the property. A taxpayer has made payment under this section if the transaction would be considered payment by a taxpayer using the cash receipts and disbursements method of accounting.

Section 1.263A-2(a)(3)(ii) provides that if property is held for future production, taxpayers must capitalize direct and indirect costs allocable to such property (e.g., purchasing, storage, handling, and other costs), even though production has not begun. If property is not held for production, indirect costs incurred prior to the beginning of the production period must be allocated to the property and capitalized if, at the time the costs are incurred, it is reasonably likely that production will occur at some future date. Thus, for example, a manufacturer must capitalize the costs of storing and handling raw materials before the raw materials are committed to production.

Section 1.263A-2(b)(1) provides a simplified method for determining the additional § 263A costs properly allocable to ending inventories of property produced and other eligible property on hand at the end of the taxable year.

Section 1.263A-2(b)(3)(i)(A) provides that generally the additional § 263A costs allocable to eligible property remaining on hand at the close of the taxable year under the simplified production method are computed as follows: Absorption ratio X section 471 costs remaining on hand at year end.

Section 1.263A-2(b)(3)(ii)(A) provides that under the simplified production method, the absorption ratio is determined as follows:

$$\frac{\text{Additional § 263A costs incurred during the taxable year}}{\text{Section 471 costs incurred during the taxable year}}$$

Section 1.263A-2(b)(3)(ii)(A)(1) provides that additional section 263A costs incurred during the taxable year are defined as the additional section 263A costs described in § 1.263A-1(d)(3) that a taxpayer incurs during its current taxable year.

Section 1.263A-2(b)(3)(ii)(A)(2) provides that section 471 costs incurred during the taxable year are defined as the section 471 costs described in § 1.263A-1(d)(2) that a taxpayer incurs during its current taxable year.

Section 1.263A-2(b)(3)(ii)(B) provides that section 471 costs remaining on hand at year end means the section 471 costs, as defined in § 1.263A-1(d)(2), that a taxpayer incurs during its current taxable year which remain in its ending inventory or are otherwise on hand at year end. For LIFO inventories, the section 471 costs remaining on hand at year end means the increment, if any, for the current year stated in terms of section 471 costs.

Section 1.263A-2(b)(3)(iv) provides that if a producer using the simplified production method incurs $200,000 or less of total indirect costs in a taxable year, the additional § 263A costs allocable to eligible property remaining on hand at the close of the taxable year are deemed to be zero. Solely for purposes of this paragraph (b)(3)(iv), taxpayers are permitted to exclude any category of indirect costs (listed in § 1.263A-1(e)(3)(iii)) that is not required to be capitalized (e.g., selling and distribution costs) in determining total indirect costs.

Section 1.263A-3(a)(1) provides that § 263A applies to real property and personal property described in § 1221(a)(1) acquired for resale by a retailer, wholesaler, or other taxpayer (reseller). For this purpose, personal property includes both tangible and intangible property. Property acquired for resale includes stock in trade of the taxpayer or other property which is includible in the taxpayer's inventory if on hand at the close of

the taxable year, and property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business. See, however, § 1.263A-1(b)(11) for an exception for certain de minimis property provided to customers incident to the provision of services.

Section 1.263A-3(a)(2)(i) provides that resellers with production activities generally must capitalize all direct costs and certain indirect costs associated with real property and tangible personal property it produces.

Section 1.263A-3(a)(2)(iii)(A)(1) provides that in determining whether a taxpayer's production activities are de minimis, all facts and circumstances must be considered. For example, the taxpayer must consider the volume of the production activities in its trade or business. Production activities are presumed de minimis if-
(i) The gross receipts from the sale of the property produced by the reseller are less than 10 percent of the total gross receipts of the trade or business; and
(ii) The labor costs allocable to the trade or business' production activities are less than 10 percent of the reseller's total labor costs allocable to its trade or business.

Section 1.263A-3(a)(4)(i) provides that a taxpayer generally may elect the simplified production method (as described in § 1.263A-2(b)) but may not elect the simplified resale method (as described in paragraph (d) of this section) if the taxpayer is engaged in both production and resale activities with respect to the items of eligible property listed in § 1.263A-2(b)(2) but may not elect the simplified resale method (as described in paragraph (d) of this section) if the taxpayer is engaged in both production and resale activities with respect to the items of eligible property listed in § 1.263A-2(b)(2).

Section 1.263A-3(a)(4)(ii) provides that a reseller otherwise permitted to use the simplified resale method may use the simplified resale method if its production activities with respect to the items of eligible property listed in § 1.263A-2(b)(2) are de minimis (within the meaning of paragraph (a)(2)(iii) of this section) and incident to its resale of personal property described in § 1221(a)(1).

Section 1.263A-3(a)(4)(iii) provides that a reseller otherwise permitted to use the simplified resale method in paragraph (d) of this section may use the simplified resale method even though it has personal property produced for it (e.g., private label goods) under a contract with an unrelated person if the contract is entered into incident to its resale activities and the property is sold to its customers.

Section 1.263A-3(a)(4)(iv) provides that a taxpayer that uses the simplified resale method and has de minimis production activities incident to its resale activities or property produced under contract must capitalize all costs allocable to eligible property produced using the simplified resale method.

Section 1.263A-3(c)(1) provides that resellers must capitalize the acquisition cost of property acquired for resale, as well as indirect costs described in § 1.263A-1(e)(3), which are properly allocable to property acquired for resale. The indirect costs most often incurred by resellers are purchasing, handling, and storage costs.

Section 1.263A-3(c)(3)(ii) provides that if a person performs both purchasing and non-purchasing activities, the taxpayer must reasonably allocate the person's labor costs between these activities. For example, a reasonable allocation is one based on the amount of time the person spends on each activity.

Section 1.263A-3(c)(4)(i) provides that handling costs include costs attributable to processing, assembling, repackaging, transporting, and other similar activities with respect to property acquired for resale, provided the activities do not come within the meaning of the term produce as defined in § 1.263A-2(a)(1).

Section 1.263A-3(c)(4)(i) also provides that handling costs are generally required to be capitalized under § 263A. Under this paragraph (c)(4)(i), however, handling costs incurred at a retail sales facility (as defined in paragraph (c)(5)(ii)(B) of this section) with respect to property sold to retail customers at the facility are not required to be capitalized. Thus, for example, handling costs incurred at a retail sales facility to unload, unpack, mark, and tag goods sold to retail customers at the facility are not required to be capitalized.

Section 1.263A-3(c)(4)(i) further provides that handling costs incurred at a dual-function storage facility (as defined in paragraph (c)(5)(ii)(G) of this section) with respect to property sold to customers from the facility are not required to be capitalized to the extent that the costs are incurred with respect to property sold in on-site sales. Handling costs attributable to property sold to customers from a dual-function storage facility in on-site sales are determined by applying the ratio in paragraph (c)(5)(iii)(B) of this section.

Section 1.263A-3(c)(4)(ii) provides that processing costs are the costs a reseller incurs in making minor changes or alterations to the nature or form of a product acquired for resale. Minor changes to a product include, for example, monogramming a sweater, altering a pair of pants, and other similar activities.

Section 1.263A-3(c)(4)(iii) provides that assembling costs are costs associated with incidental activities that are necessary in readying property for resale (e.g., attaching wheels and handlebars to a bicycle acquired for resale).

Section 1.263A-3(c)(5)(i) provides that in general, storage costs are capitalized under § 263A to the extent they are attributable to the operation of an off-site storage or warehousing facility (an off-site storage facility).

Section 1.263A-3(c)(5)(i) also provides that storage costs attributable to the operation of an on-site storage facility (as defined in paragraph (c)(5)(ii)(A) of this section) are not required to be capitalized under § 263A. Storage costs attributable to a dual-function storage facility (as defined in paragraph (c)(5)(ii)(G) of this section) must be capitalized to the extent that the facility's costs are allocable to off-site storage.

Section 1.263A-3(c)(5)(ii)(A) provides that an on-site storage facility is defined as a storage or warehousing facility that is physically attached to, and an integral part of, a retail sales facility.

Section 1.263A-3(c)(5)(ii)(B)(1) provides that a retail sales facility is defined as a facility where a taxpayer sells merchandise exclusively to retail customers in on-site sales. For this purpose, a retail sales facility includes those portions of any specific retail site-
(i) Which are customarily associated with and are an integral part of the operations of that retail site;
(ii) Which are generally open each business day exclusively to retail customers;
(iii) On or in which retail customers normally and routinely shop to select specific items of merchandise; and
(iv) Which are adjacent to or in immediate proximity to other portions of the specific retail site.

Section 1.263A-3(c)(5)(ii)(B)(2) provides that for example, two lots of an automobile dealership physically separated by an alley or an access road would generally be considered one retail sales facility, provided customers routinely shop on both of the lots to select the specific automobiles that they wish to acquire.

Section 1.263A-3(c)(5)(ii)(C) provides that a storage facility is considered an integral part of a retail sales facility when the storage facility is an essential and indispensable part of the retail sales facility. For example, if the storage facility is used exclusively for filling orders or completing sales at the retail sales facility, the storage facility is an integral part of the retail sales facility.

Section 1.263A-3(c)(5)(ii)(D) provides that on-site sales are defined as sales made to retail customers physically present at a facility. For example, mail order and catalog sales are made to customers not physically present at the facility, and thus, are not on-site sales.

Section 1.263A-3(c)(5)(ii)(E)(1) provides that a retail customer is defined as the final purchaser of the merchandise. A retail customer does not include a person who resells the merchandise to others, such as a contractor or manufacturer that incorporates the merchandise into another product for sale to customers.

Section 1.263A-3(c)(5)(ii)(E)(2) provides that for purposes of this section, a non-retail customer is treated as a retail customer with respect to a particular facility if the following requirements are satisfied-
(i) The non-retail customer purchases goods under the same terms and conditions as are available to retail customers (e.g., no special discounts);
(ii) The non-retail customer purchases goods in the same manner as a retail customer (e.g., the non-retail customer may not place orders in advance and must come to the facility to examine and select goods);
(iii) Retail customers shop at the facility on a routine basis (i.e., on most business days), and no special days or hours are reserved for non-retail customers; and
(iv) More than 50 percent of the gross sales of the facility are made to retail customers.

Section 1.263A-3(c)(5)(ii)(F) provides that an off-site storage facility is defined as a storage facility that is not an on-site storage facility.

Section 1.263A-3(c)(5)(ii)(G) provides that a dual-function storage facility is defined as a storage facility that serves as both an off-site storage facility and an on-site storage facility. For example, a dual-function storage facility would include a regional warehouse that serves the taxpayer's separate retail sales outlets and also contains a sales outlet therein. A dual-function storage facility also includes any facility where sales are made to retail customers in on-site sales and to-
(1) Retail customers in sales that are not on-site sales; or
(2) Other customers.

Section 1.263A-3(c)(5)(iii)(A) provides that storage costs associated with a dual-function storage facility must be allocated between the off-site storage function and the on-site storage function. To the extent that the dual-function storage facility's storage costs are allocable to the off-site storage function, they must be capitalized. To the extent that the dual-function storage facility's storage costs are allocable to the on-site storage function, they are not required to be capitalized.

Section 1.263A-3(c)(5)(iii)(B)(1) provides that storage costs associated with a dual-function storage facility must be allocated between the off-site storage function and the on-site storage function using the ratio of-
(i) Gross on-site sales of the facility (i.e., gross sales of the facility made to retail customers visiting the premises in person and purchasing merchandise stored therein); to
(ii) Total gross sales of the facility. For this purpose, the total gross sales of the facility include the value of items shipped to other facilities of the taxpayer.

Section 1.263A-3(c)(5)(iii)(B)(2) provides that for example, if a dual-function storage facility's on-site sales are 40 percent of the total gross sales of the facility, then 40 percent of the facility's storage costs are allocable to the on-site storage function and are not required to be capitalized under § 263A.

Section 1.263A-3(c)(5)(iii)(B)(3) provides that prior to computing the allocation ratio in paragraph (c)(5)(iii)(B) of this section, a taxpayer must apply the principles of paragraph (c)(5)(iv) of this section in determining the portion of the facility that is a dual-function storage facility (and the costs attributable to such portion).

Section 1.263A-3(c)(5)(iii)(C) provides that if 90 percent or more of the costs of a facility are attributable to the on-site storage function, the entire storage facility is deemed to be an on-site storage facility. In contrast, if 10 percent or less of the costs of a storage facility are attributable to the on-site storage function, the entire storage facility is deemed to be an off-site storage facility.

Section 1.263A-3(c)(5)(iv) provides that to the extent costs incurred at an off-site storage facility are not properly allocable to the taxpayer's storage function, the costs are not accounted for as off-site storage costs.

Section 1.263A-3(d)(1) provides a simplified method for determining the additional § 263A costs properly allocable to property acquired for resale and other eligible property on hand at the end of the taxable year.

Section 1.263A-3(d)(2) provides that generally the simplified resale method is only available to a trade or business exclusively engaged in resale activities. However, certain resellers with property produced as a result of de minimis production activities or property produced under contract may elect the simplified resale method, as described in paragraph (a)(4) of this section.

Section 1.263A-3(d)(3)(i)(A) provides that under the simplified resale method, the additional § 263A costs allocable to eligible property remaining on hand at the close of the taxable year are computed as follows: Combined absorption ratio X section 471 costs remaining on hand at year end.

Section 1.263A-3(d)(3)(i)(C)(1) provides that the combined absorption ratio is defined as the sum of the storage and handling costs absorption ratio as defined in paragraph (d)(3)(i)(D) of this section and the purchasing costs absorption ratio as defined in paragraph (d)(3)(i)(E) of this section.

Section 1.263A-3(d)(3)(i)(C)(2) provides that section 471 costs remaining on hand at year end mean the section 471 costs, as defined in § 1.263A-1(d)(2), that the taxpayer incurs during its current taxable year, which remain in its ending inventory or are otherwise on hand at year end.

Section 1.263A-3(d)(3)(i)(D)(1) provides that under the simplified resale method, the storage and handling costs absorption ratio is determined as follows:

$$\frac{\text{Current year's storage and handling costs}}{\text{Beginning inventory plus current year's purchases}}$$

Section 1.263A-3(d)(3)(i)(D)(2) provides that current year's storage and handling costs are defined as the total storage costs plus the total handling costs incurred during the taxable year that relate to the taxpayer's property acquired for resale and other eligible property. Storage and handling costs must include the amount of allocable mixed service costs as described in paragraph (d)(3)(i)(F) of this section.

Section 1.263A-3(d)(3)(i)(E)(1) provides that under the simplified resale method, the purchasing costs absorption ratio is determined as follows:

$$\frac{\text{Current year's purchasing costs}}{\text{Current year's purchases}}$$

Section 1.263A-3(d)(3)(i)(E)(2) provides that current year's purchasing costs are defined as the total purchasing costs incurred during the taxable year that relate to the taxpayer's property acquired for resale and eligible property. Purchasing costs must include the amount of allocable mixed service costs determined in paragraph (d)(3)(i)(F) of this section.

Section 1.263A-3(d)(3)(i)(E)(2) also provides that current year's purchases generally mean the taxpayer's § 471 costs incurred with respect to purchases of property acquired for resale during the current taxable year.

Section 1.263A-3(d)(3)(i)(F) provides that if a taxpayer allocates its mixed service costs to purchasing costs, storage costs, and handling costs using a method described in § 1.263A-1(g)(4), the taxpayer is not required to determine its allocable mixed service costs under this paragraph (d)(3)(i)(F). However, if the taxpayer uses the simplified service cost method, the amount of mixed service costs allocated to and included in purchasing costs, storage costs, and handling costs in the absorption ratios in paragraphs (d)(3)(i)(D) and (E) of this section is determined as follows:

$$\frac{\text{Labor costs allocable to activity}}{\text{Total labor costs}} \times \text{Total mixed service costs}$$

Section 446(b) provides that if the method of accounting used by the taxpayer does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Commissioner, does clearly reflect income.

Section 1.446-1(a)(2) provides that it is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income.

Section 1.471-3(b) provides that in the case of merchandise purchased since the beginning of the taxable year, "cost" means the invoice price less trade or other discounts, except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer, provided a consistent course is followed. To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the goods. For taxpayers acquiring merchandise for resale that are subject to the provisions of § 263A, see §§1.263A-1 and 1.263A-3 for additional amounts that must be included in inventory costs.

ANALYSIS:

1. Under the following circumstances, whether Taxpayer's installation activities constitute production activity according to §§ 263A(g)(1) and 1.263A-2(a)(1).

- **a. Installation of parts by Taxpayer's service department**
  - i. **Customer-owned vehicles**
  - ii. **New vehicles owned by Taxpayer**
  - iii. **Used vehicles owned by Taxpayer**
- **b. Sublet Repairs/Installation of parts by subcontractors**
  - i. **Customer-owned vehicles**
  - ii. **New vehicles owned by Taxpayer**
  - iii. **Used vehicles owned by Taxpayer**

Section 263A(g) defines the term "produce" very broadly. By statute, the term includes "construct, build, install, manufacture, develop, or improve." The regulations add "create, raise, or grow" to the definition. *See* § 1.263A-2(a)(1)(i).

The examining agent argues that "install" and "improve" are within the definition of produce, and therefore, any installation or improvement, whether to Taxpayer-owned vehicles or to customer-owned vehicles, are production activities under § 1.263A-2(a)(1)(i). The examining agent argues that for Taxpayer-owned vehicles, there are two production activities and two types of § 263A property. The first production activity as defined by statute is "install" and the corresponding § 263A property is the parts being installed. The second production activity is "improve" and the corresponding § 263A property is the vehicle. The examining agent argues that for customer-owned vehicles, the production activity is "install" and the parts are the § 263A property.

Although an activity may qualify as production under the broad definition at § 263A(g)(1) and the regulations thereunder, a taxpayer is not considered to be producing property for purposes of § 263A unless it is also an owner of the property for federal income tax purposes. *See* § 1.263A-2(a)(1)(ii)(A). The examining agent argues that when all of the facts and circumstances, including the various benefits and burdens of ownership vested with Taxpayer, are examined, Taxpayer has ownership of the installed parts until it is fully compensated. The examining agent argues that Taxpayer has the benefit of ownership based on the rights conveyed to it by the execution of the mechanic's lien to the extent of the amount charged for the parts and services provided. The examining agent also argues that the cost of the parts and services to Taxpayer constitute a burden of ownership in the respect that Taxpayer has invested its resources, parts, and labor in order to repair the customer's vehicle.

In the instant case, we believe that the vehicle is the property being produced, not the parts. The parts are not otherwise produced, e.g., manufactured or developed, by Taxpayer. The parts do not retain their character as separate pieces of property for any other significant federal income tax purpose(s), e.g., depreciation, after they are installed into vehicles. These and other factors lead us to the conclusion that the § 263A analysis should be focused on the vehicles.

Although Taxpayer holds a mechanic's lien on customer-owned vehicles, the customers continue to possess the benefits and burdens of ownership. A mechanic's lien secures payment for labor or materials supplied. It encumbers the property but does not transfer an ownership interest in the vehicle to Taxpayer. Therefore, Taxpayer is not considered a producer of customer-owned vehicles under § 1.263A-2(a)(1)(ii)(A).

Taxpayer is the tax owner of the new and used vehicles. See § 1.263A-2(a)(1)(ii)(A). Therefore, to the extent Taxpayer has production activities relating to new and used vehicles, we agree with the examining agent that Taxpayer-owned vehicles are § 263A produced property. The installed parts, to the extent production activities are involved, are direct material costs, because they either become an integral part of the property produced (the vehicle) or they are consumed in the ordinary course of production and can be identified or associated with a particular vehicle. See § 1.263A-1(e)(2)(i)(A).

Production activities

Taxpayer installs certain options such as air running boards, alarm systems, plow packages, towing packages, air conditioning, stereo equipment, and entertainment systems into new vehicles. Taxpayer also repairs and installs parts into used vehicles in order to place them into a saleable condition. Taxpayer adds the costs of parts and direct labor to the inventory cost of the specific used or new vehicle, but does not add any related indirect costs to the vehicles. At the conference of right, Taxpayer's representative indicated that Taxpayer tries to capture as much cost as possible into the

basis of the vehicle. However, certain costs, such as car washes, are not charged to a specific vehicle, rather the costs are expensed as incurred.

Whether Taxpayer's activities in servicing new and used vehicles constitute production under § 1.263A-2 or handling under § 1.263A-3(c)(4) depends on the specific facts. Some of the repair/installation activities improve the vehicles and place them in a minimally saleable or more saleable condition. The installation of certain parts makes the property more readily marketable and/or adds utility to the product. For example, a dealership may install air conditioning to make a vehicle more saleable, or a dealership may replace defective parts on used vehicles to place the vehicle into a saleable condition. Costs that make property more readily marketable and/or add utility to a product, making it more suitable for use and consumption, are production costs. *See* Rev. Rul. 81-272, 1981-2 C.B. 116, and Rev. Rul. 79-339, 1979-2 C.B. 218. Thus, Taxpayer is producing tangible personal property within the meaning of § 263A when it replaces or installs some parts on some new and used vehicles and is required to capitalize all direct material costs, direct labor costs, and indirect costs properly allocable to this inventory. *See* §§ 1.263A-1(e)(2)(i) and 1.263A-1(e)(3).

Certain minor activities performed by Taxpayer may not constitute production of property. For example, at the conference of right, Taxpayer's representative indicated that some used vehicles merely need fluids replaced or cleaning. Such activities may or may not constitute production under § 263A, depending on the specific facts. To the extent the repair/installation activities are not production activities under § 1.263A-2, however, the activities are handling activities. See Issue 5 for a discussion concerning handling costs.

Finally, we note that even if certain activities performed by Taxpayer are not production activities under § 1.263A-2, items that were accounted for as inventory in the parts department and "sold" to the service department for installation into a Taxpayer-owned vehicle must be included in the cost of the vehicle. For example, if the parts department sells floor mats to the service department, the floor mats are still capitalized as an inventoriable cost when placed in a Taxpayer-owned vehicle. The cost of the floor mats can not be expensed as a handling cost under § 1.263A-3(c)(4) or otherwise.

Subcontractor activities

Taxpayer hires subcontractors to perform certain repair/installation activities to Taxpayer-owned vehicles and customer-owned vehicles.

Generally, property produced for the taxpayer under a contract with another party is treated as property produced by the taxpayer to the extent the taxpayer makes payments or otherwise incurs costs with respect to the property. *See* §§ 263A(g)(2) and 1.263A-2(a)(1)(ii)(B)(1). An exception is made for routine purchase orders. The

contracts in question are not routine purchase agreements. Having concluded previously that Taxpayer is a producer with regard to new and used vehicles, we also conclude that work performed by subcontractors on new and used vehicles is property produced by Taxpayer. Again, we note that certain minor activities performed by the subcontractor attributable to Taxpayer may not constitute production of property under § 263A, depending on the specific facts.

Marcor argument

The examining agent contends that the analysis in the Action on Decision (AOD) non-acquiescing in *Marcor, Inc. v. Commissioner*, 89 T.C. 181 (1987), nonacq 1990-2 CB 1, should be applied to the facts of this case. In *Marcor*, the Tax Court rejected the Service's argument that installation of products, including auto parts, sold by a retailer was a manufacturing activity. The Service expressed its disagreement in an AOD but concluded that the enactment of § 263A rendered the issue moot for post-1986 taxable years. Accordingly, this advice is based on the definitions of, and distinctions between, "production" and "handling" in the regulations under § 263A. We rely on neither the *Marcor* opinion nor the AOD in interpreting these regulations.

2. Whether, under § 1.263A-1(b)(11), Taxpayer has property subject to § 263A.

- **a. Whether auto repair/installation activity constitutes service activity according to § 1.263A-1(b)(11) with respect to customer-owned vehicles.**
- **b. Whether the parts provided in the auto repair/installation activity constitute property provided in the provision of services according to § 1.263A-1(b)(11) with respect to customer-owned vehicles.**

As previously noted in the facts, under tax accounting principles, the activities of an automobile dealership's service department with respect to customer-owned vehicles would qualify as providing services to customers as well as sales of goods to customers. Section 1.263A-1(b)(11) provides an exception to the requirement to capitalize costs under § 263A in the case of property provided to the client (customer) incident to providing service. To qualify for this exception, the service provider must satisfy two requirements. First, under § 1.263A-1(b)(11)(i)(A), the property provided must be de minimis in amount. Second, under § 1.263A-1(b)(11)(i)(B), the property provided must not be inventory in the hands of the service provider. Although Taxpayer does not produce the parts it installs into customer-owned vehicles, it is reselling the part in conjunction with the repair/installation activity. The vehicle parts are inventory in the hands of Taxpayer. Accordingly, we need not evaluate whether the parts satisfy the de minimis test or whether the auto repair/installation activity constitutes the provision of services under § 1.263A-1(b)(11). The exception in § 1.263A-1(b)(11) does not apply to Taxpayer. However, the mere fact that the exception does not apply does not mean that Taxpayer is engaged in a production activity subject to § 263A.

3. Whether Taxpayer is eligible for the de minimis exception under §1.263A-1(b)(12).

Section 1.263A-1(b)(12) provides a de minimis exception rule for certain producers. Under § 1.263A-2(b)(3)(iv), if a producer using the simplified production method incurs $200,000 or less of total indirect costs in a taxable year, the additional § 263A costs allocable to eligible property remaining on hand at the close of the taxable year are deemed to be zero. In applying the $200,000 rule, the indirect costs included in the calculation are all costs other than direct material costs and direct labor costs (in the case of property produced) or acquisition costs (in the case of property acquired for resale) that are properly allocable to property produced or property acquired for resale. *See* § 1.263A-1(e)(3)(i). Thus, a taxpayer's total indirect costs are broader than a taxpayer's additional § 263A costs. Taxpayer is not eligible for this de minimis exception because Taxpayer's total indirect costs exceed $200,000, and Taxpayer is not using the simplified production method.

4. Whether Taxpayer is a reseller with production activities under §1.263A-3(a)(2), and, if so, whether those activities qualify as de minimis production activities under §1.263A-3(a)(2)(iii)(A).

Section 1.263A-3(a)(2) generally provides that a reseller producing property must capitalize the additional § 263A costs associated with any inventoriable property it produces unless the taxpayer is a small reseller. Taxpayer is not a small reseller. Therefore, Taxpayer must capitalize additional § 263A costs associated with produced inventoriable property.

A reseller with de minimis production activities may use the simplified resale method. *See* § 1.263A-3(a)(4)(ii). Section 1.263A-3(a)(2)(iii) provides that the de minimis production activity test is based on all the facts and circumstances, including the volume of the production activities in its trade or business. Under §§ 1.263A-3(a)(2)(iii)(A)(1)(i) and (ii), production activities are presumed de minimis if the gross receipts from the sale of property produced by the reseller are less than 10 percent of the total gross receipts of the trade or business, and the labor costs allocable to the trade or business' production activities are less than 10 percent of the reseller's total labor costs allocable to its trade or business.

The examining agent provided information for the presumptive test. The second prong of the test compares labor costs allocable to the production activities to total labor costs. Taxpayer's labor costs attributable to the service department solely associated with the activity of repairing/installing to total labor is over 40 percent for both tax years under examination. Accordingly, the examining agent concludes that based on labor alone, Taxpayer does not meet both prongs of the two prong test in § 1.263A-3(a)(2)(iii). However, given our conclusion regarding customer-owned vehicles, the labor cost for

the second prong of the test should not include labor attributable to customer-owned vehicles.

The first prong of the presumptive test compares gross receipts from the sale of property produced to total gross receipts of the trade or business. As explained above, the vehicle is the property produced. Thus, the test takes into account the gross receipts from the sale of the entire vehicle, not just the value of the production added by Taxpayer. Taxpayer agrees that it does not meet the first prong of the presumptive test.

While Taxpayer fails the presumptive test as described in the regulations, its production activities may still be considered de minimis based on a consideration of all of the facts and circumstances of the case. *See* § 1.263A-3(a)(2)(iii)(A)(1).

The examining agent provided information for a test using the gross receipts from the service department. The gross receipts from selling parts and labor from the service department are 10.39 percent and 8.51 percent of total gross receipts for the two years under examination. The gross receipts include parts and labor used in servicing both Taxpayer-owned and customer-owned vehicles. If only parts and labor used to service Taxpayer-owned vehicles is included, the percentages will be reduced. We were not provided with data showing which costs and gross receipts are attributable to Taxpayer-owned vehicles and which are attributable to customer-owned vehicles. At the conference of right, the examining agent indicated that Taxpayer did not provide the data during the examination. Taxpayer's representative indicated at the conference of right that the data is available.

Also, at the conference of right, Taxpayer's representative indicated that Taxpayer uses internal work orders to track parts and labor costs for each vehicle serviced, whether new, used, or customer-owned. Taxpayer's representative indicated work performed on used and new vehicles is insignificant when compared to the acquisition cost of the vehicle. For example, in 2004, Taxpayer had 21 used vehicles in ending inventory and only $2,800 total costs were attributable to those vehicles. Taxpayer's representative stated that in most cases, the costs incurred in getting the vehicles ready for resale are minor and incidental compared to the acquisition costs of the vehicles. Taxpayer's representative indicated that these costs are usually around three to five percent of the acquisition cost of the vehicle.

Taxpayer's statement and information submitted with this request for technical advice takes the position that it does not produce any inventory. Taxpayer did not provide any written arguments concerning the de minimis test for production activities. Although alternative de minimis tests were discussed at the conference of right, Taxpayer did not provide a post-conference submission. Consequently, we cannot determine whether Taxpayer's production activities are de minimis.

The examining agent should look at all the facts and circumstances to determine whether the production activities are de minimis. Factors to consider are the relative material and labor costs added to the particular vehicle compared to the cost of the particular vehicle and the relative material and labor costs added to all the vehicles compared to the cost of all vehicles. Another significant factor is the value added to the vehicle by the production activity. We believe these factors may demonstrate that Taxpayer's production activities are de minimis.

5. Whether Taxpayer's repair/installation activities are handling costs.

In Issue 1, we concluded that the installation of parts to Taxpayer-owned vehicles could be production activities under § 263A depending on the specific facts. We also concluded that the parts installed in a customer's vehicle are not § 263A property produced by Taxpayer. However, the parts installed in the customer's vehicles are property acquired for resale and are subject to the capitalization rules under § 1.263A-3.

Section 1.263A-3(c)(4)(i) provides that handling costs include costs attributable to processing, assembling, repackaging, transporting, and other similar activities with respect to property acquired for resale, provided the activities do not come within the meaning of the term produce as defined in § 1.263A-2(a)(1). Handling costs must be capitalized unless they are incurred at a retail sales facility with respect to property sold to retail customers at the facility. *See* § 1.263A-3(c)(4)(i).

When a customer brings a vehicle to Taxpayer's service department, service technicians disassemble a component or components of the vehicle in order to remove defective parts. Subsequently, they install new parts and re-assemble the component(s). This activity is similar to the bicycle assembly example described at § 1.263A-3(c)(4)(iii). The bicycle is sold to customers. The customers can buy the bicycle in a box and assemble it themselves. Alternatively, the customers can pay a fee and have the bicycle assembled. Taxpayer's customers have the same choice; they can buy and install the parts themselves, or they can pay a fee and have Taxpayer install the parts. Therefore, costs attributable to installing parts in customer-owned vehicles are handling costs.

Certain minor activities with respect to Taxpayer-owned vehicles do not come within the meaning of the term produce as defined in § 1.263A-2(a)(1). Activities such as washing vehicles and adding fluids to Taxpayer-owned vehicles are handling costs. Furthermore, if a subcontractor does handling-type activities to customer-owned or Taxpayer-owned vehicles, those costs are also capitalizable as handling costs under § 1.263A-3(c)(4).

6. If Taxpayer is permitted to use the simplified resale method because it has de minimis production under § 1.263A-3(a)(2)(iii), how are the production costs accounted for in the formula?

A taxpayer that uses the simplified resale method and has de minimis production activities incident to its resale activities or property produced under contract must capitalize all costs allocable to eligible property produced using the simplified resale method. *See* § 1.263A-3(a)(4)(iv). Costs allocable to eligible property produced include direct material costs, direct labor costs, and indirect costs properly allocable to property produced. *See* § 1.263A-1(a)(3)(i).

At Taxpayer's conference of right, Taxpayer's representative asked where the de minimis production costs should go in the simplified resale method formula. Taxpayer's representative indicated that there is no "place" for production costs in the formula.

The combined absorption ratio under the simplified resale method is:

$$\frac{\text{Current year's storage and handling costs}}{\text{Beginning inventory plus current year's purchases}} + \frac{\text{Current year's purchasing costs}}{\text{Current year's purchases}}$$

The combined absorption ratio is multiplied by "section 471 costs remaining on hand at year end" to determine the additional § 263A costs allocable to eligible property remaining on hand at the close of the taxable year. *See* § 1.263A-3(d)(3).

Taxpayer accumulates the cost of parts and labor on internal repair orders, which are generated for each new and used vehicle serviced. The total amount from the repair order is added to the inventory cost of the new or used vehicle. Since Taxpayer already capitalizes these costs under its present method of accounting, the costs would be § 471 costs for purposes of the regulations under § 263A. See §§1.263A-1(d)(2)(i) and (ii).

Under the simplified resale method, current year's purchases used in the denominator of the combined absorption ratio generally mean the taxpayer's § 471 costs incurred with respect to purchases of property acquired for resale during the current taxable year. *See* § 1.263A-3(d)(3)(i)(E)(2). Taxpayer's costs of parts and labor are incurred with respect to the purchases of property acquired for resale, so those costs are § 471 costs and belong in the denominator of the formula. The costs of parts and labor also are included in the § 471 costs remaining on hand at year end. *See* § 1.263A-3(d)(3)(i)(C)(2).

Besides direct material costs and direct labor costs, Taxpayer must also allocate indirect costs to property produced. Since the indirect costs properly allocable to property produced were not previously capitalized, they are additional § 263A costs. *See* § 1.263A-1(d)(3).

Under the simplified resale method, additional § 263A costs are in the numerator of the storage and handling costs absorption ratio and the purchasing costs absorption ratio.

Taxpayer's indirect costs properly allocable to property produced are similar to handling costs. Therefore, the indirect costs allocable to property produced could be added to the other additional § 263A costs included in numerator of the storage and handling costs absorption ratio. However, it is not unreasonable to include the indirect costs allocable to property produced in the purchasing costs absorption ratio since that ratio is similar to the simplified production method described at § 1.263A-2(b)(3).

7. Do the following sales constitute on-site sales to retail customers?

- **a. Vehicles taken in trade or purchased at auction and subsequently resold at wholesale,**
- **b. Vehicles sold to another dealership at cost,**
- **c. Vehicles leased,**
- **d. Vehicles sold as part of a fleet sale, and**
- **e. Wholesale sales of parts to purchasers who are, or are not, end users where the parts are picked up at Taxpayer's parts department by the purchaser or delivered to the purchaser by a driver from Taxpayer's parts department**.

Section 1.263A-3(c)(5)(ii)(D) defines on-site sales as sales made to retail customers physically present at a facility.

Section 1.263A-3(c)(5)(ii)(E) defines a retail customer as the final purchaser of the merchandise and excludes from the definition of a retail customer a person who resells the merchandise to others.

Accordingly, under this definition it appears that few of the sales under consideration constitute on-site sales to retail customers. Most vehicles sold at wholesale are not sold to the final purchaser of the merchandise. Likewise, vehicles sold to other dealerships are not sold to the final purchaser of the merchandise. Leased vehicles are sold to Credit and accordingly are not on-site sales since Credit does not purchase the vehicles at one of Taxpayer's sales locations. Fleet sales do appear to qualify as on-site retail sales since presumably the customer purchases the vehicles at one of Taxpayer's sales facilities. Some part sales under consideration are wholesale sales and therefore are not made to a retail customer. Parts sales (including parts sold to Taxpayer's service department) made to end users do appear to qualify as retail sales where they are on-site sales made to final purchasers.

8. Is Taxpayer's storage facility at Location 1 an on-site, off-site, or a dual-function storage facility?

Taxpayer's storage facility at Location 1 is a dual-function storage facility because Taxpayer engages in on-site and off-site sales at Location 1.

On-site sales are defined in § 1.263A-3(c)(5)(ii)(D) as sales made to retail customers physically present at a facility. From the discussion of Issue 7, it is clear that Taxpayer engages in both on-site and off-site sales at Location 1.

Therefore, because Taxpayer's storage facility at Location 1 is a dual-function storage facility, it must determine storage and handling costs capitalizable under § 263A by applying the ratio in § 1.263A-3(c)(5)(iii)(B). *See* §§ 1.263A-3(c)(4)(i) and 1.263A-3(c)(5)(iii).

9. Is Taxpayer's storage facility at Location 2 an on-site, off-site, or a dual-function storage facility?

An off-site storage facility is defined in § 1.263A-3(c)(5)(ii)(F) as a storage facility that is not an on-site storage facility. An on-site storage facility is defined as a storage or warehousing facility that is physically attached to, and an integral part of, a retail sales facility. See § 1.263A-3(c)(5)(ii)(A). Taxpayer engages in no sales to retail customers at Location 2. At the conference of right held in this case, Taxpayer asserted that Location 2 was commonly known as Taxpayer's overflow lot and that retail customers would go to Location 2 to look at vehicles. Nevertheless, no retail sales were alleged to have taken place at Location 2, and Location 2 is too far from Location 1 (one-half mile) to be considered part of one retail sales facility under § 1.263A-3(c)(5)(ii)(B)(2) (two lots physically separated by an alley or an access road). Thus, Taxpayer's storage facility at Location 2 is an off-site storage facility.

10. Whether purchasing, storage, and handling costs as described in § 1.263A-3(c) are mixed service costs:

- **a. Under the simplified production method.**
- **b. Under the simplified resale method.**

The examining agent asserts that if Taxpayer is a producer and required to use the simplified production method, purchasing, storage, and handling costs are mixed service costs according to § 1.263A-1(e)(4)(ii)(C) and the applicable examples in §§ 1.263A-1(e)(4)(iii) and 1.263A-1(e)(4)(iv). Alternatively, if Taxpayer is a reseller and required to use the simplified resale method, the examining agent asserts that the purchasing, storage, and handling costs are not mixed service costs according to § 1.263A-1(e)(4).

The classification of purchasing, storage, and handling costs as mixed service costs does not depend on whether Taxpayer uses the simplified production method or the simplified resale method. Nor does the classification of a cost depend on whether Taxpayer is a producer or a reseller. For the reasons discussed below, we conclude that Taxpayer's purchasing, storage, and handling costs are not mixed service costs.

General rules classifying indirect costs

Generally, § 1.263A-1(e) describes the types of costs that must be capitalized by taxpayers. Resellers must capitalize the acquisition cost of property as well as indirect costs described in § 1.263A-1(e)(3). The indirect costs most often incurred by resellers are purchasing, handling, and storage costs. *See* § 1.263A-3(c)(1). The rules provided in § 1.263A-3(c) also apply to producers incurring purchasing, handling, and storage costs. Id.

Section 1.263A-1(e)(3)(i) provides, in part, that taxpayers subject to § 263A must capitalize all indirect costs properly allocable to property produced or property acquired for resale. Indirect costs are properly allocable to property produced or property acquired for resale when the costs directly benefit or are incurred by reason of the performance of production or resale activities.

The regulations define service costs as indirect costs (e.g., general and administrative costs) that can be identified specifically with a service department or function or that directly benefit or are incurred by reason of a service department or function. *See* § 1.263A-1(e)(4)(i)(A). For this purpose, service departments are defined as administrative, service, or support departments that incur service costs. *See* § 1.263A-1(e)(4)(i)(B). The mere title or activity of a department or function does not determine whether the department or function constitutes a service department. Instead, the facts and circumstances of the taxpayer's activities and business organization control whether a department is a service department. Id.

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

Examining agent’s position

The examining agent’s position is based on cost accounting principles regarding producers. Traditionally, cost accounting has distinguished between operating departments and service departments. An operating department (also called a production department for a manufacturer) adds value to a product or service. *See* Charles T. Horngren, George Foster, & Srikant M. Datar, Cost Accounting, A Managerial Approach, 510 (10th ed. 1998). On the other hand, a service department is a department that assists or supports other internal departments so that its costs are allocable to such departments. Service departments are those activities that are

necessary to facilitate a company's core activities, but in which the core activities themselves are not performed. *See* John J. W. Neuner & Samuel Frumer, Cost Accounting, Principles and Practice, 223 (Irwin 1967).

In the context of a manufacturer, the purchasing, storage, and handling departments are often service departments because such departments do not directly engage in the production of the manufacturer's products, but only assist or support the production departments. *See* Horngren, supra; Neuner, supra. In contrast, with regard to resellers, the purchasing, storage, and handling departments are generally akin to the manufacturer's production departments. These departments directly act on the products and goods that will be sold to the retailer's customers. Accordingly, resellers' purchasing, storage, and handling departments generally are not service departments, and therefore cannot be treated as mixed service departments.

The examining agent points to examples at §§ 1.263A-1(e)(4)(iii)(C) and (D) to show that purchasing operations and materials handling and warehousing costs can be incurred in service departments. Although these examples provide that purchasing and warehousing costs can be service costs, they do not conclude that they are always service costs. Further, the examples do not conclude that if they are service costs, they are mixed service costs. The costs could be fully capitalizable service costs or fully deductible service costs.

Analysis based on Taxpayer's functions

Taxpayer is a reseller with production activities. The activities performed in Taxpayer's purchasing, storage, and handling functions are the same regardless of whether Taxpayer uses the simplified production method or the simplified resale method. Therefore, we must look at the facts and circumstances of Taxpayer's activities and business organization to determine whether the functions are incurred in a service department.

Taxpayer's purchasing costs related to the retail activity include sales managers' wages and associated payroll taxes benefits and demo expense (an employee benefit) attributable to the purchasing activity of purchasing new vehicles and used vehicles obtained from trade-in, auction, and other dealers. Taxpayer has an off-site storage facility dedicated to storing overflow vehicles. Taxpayer incurs handling costs at its sales facility.

The purchasing, storage, and handling costs incurred by Taxpayer are the traditional types of costs incurred by resellers in connection with their core activity of acquiring merchandise for resale. These costs directly benefit or are incurred by reason of the performance of production or resale activities. They can not be identified specifically with a service department or function and do not directly benefit or are incurred by

reason of a service department or function. Therefore, Taxpayer's purchasing, storage, and handling costs are indirect costs of its resale activity, not service costs.

To the extent, Taxpayer's purchasing, storage, and handling costs are not fully allocable to resale or production activities, Taxpayer can make a reasonable allocation between capitalizable activities and deductible activities. *See* § 1.263A-1(e)(3)(i). For example, if a person performs both purchasing and non-purchasing activities, Taxpayer must reasonably allocate the person's labor costs between these activities. *See* § 1.263A-3(c)(3)(ii). Storage costs are capitalized to the extent they are attributable to an off-site storage facility. *See* § 1.263A-3(c)(5)(i). Likewise, handling costs generally are required to be capitalized to the extent they are not incurred at a retail sales facility. *See* § 1.263A-3(c)(4).

If Taxpayer is required to use the simplified production method, the allocable purchasing, storage, and handling costs are additional § 263A costs and included in the numerator of the absorption ratio. See § 1.263A-2(b)(3)(ii)(A). If Taxpayer is required to use the simplified resale method, the allocable purchasing costs are included in the numerator of the purchasing costs absorption ratio and the allocable storage and handling costs are included in the numerator of the storage and handling costs absorption ratio. *See* § 1.263A-3(d)(3)(i).

11. Which costs are mixed service costs for purposes of the simplified service cost method?

The examining agent provided a list of indirect costs and concluded that they are mixed service costs. Based on the reasons discussed below, we agree that the following costs are mixed service costs for purposes of determining the capitalizable portion of mixed service costs under §§ 1.263A-1(h) and 1.263A-3(d)(3)(i)(F):

1. Salaries - executive costs including payroll tax and employee benefits
2. Salaries - administrative costs including payroll taxes and employee benefits
3. Rent, real estate taxes, utilities, repairs and office supplies allocable to administrative departments
4. Data processing costs
5. Legal and audit costs

Taxpayer has executive and administrative departments that perform various duties. At issue is whether the above-named costs incurred in the executive and administrative departments are mixed service costs.

As discussed in Issue 10, service costs are indirect costs (e.g., general and administrative costs) that can be identified specifically with a service department or function or that directly benefit or are incurred by reason of a service department or function. *See* § 1.263A-1(e)(4)(i)(A). For this purpose, service departments are defined

as administrative, service, or support departments that incur service costs. *See* § 1.263A-1(e)(4)(i)(B). Service costs can be capitalizable service costs, deductible service costs, and mixed service costs. Capitalizable service costs are service costs that directly benefit or are incurred by reason of the performance of a production or resale activity of the taxpayer. *See* § 1.263A-1(e)(4)(ii)(A). Deductible service costs are service costs that do not directly benefit or are not incurred by reason of the performance of a production or resale activity of the taxpayer. *See* § 1.263A-1(e)(4)(ii)(B). Mixed service costs are service costs that are partially allocable to production or resale activities and partially allocable to non-production or non-resale activities. *See* § 1.263A-1(e)(4)(ii)(C).

The executive and administrative departments are administrative, service, or support departments incurring both capitalizable service costs and deductible service costs. Accordingly, the departments are mixed service departments, and the above listed costs incurred in those departments are mixed service costs. Under § 1.263A-1(h), Taxpayer may use the simplified service cost method for determining capitalizable mixed service costs incurred during the taxable year.

12. Provided that Taxpayer's self-developed method for capitalizing additional § 263A costs is not a proper method, what method of accounting can the examining agent use in order to compute Taxpayer's taxable income?

Taxpayer's present method

Taxpayer uses a self-developed method for allocating additional § 263A costs to new vehicles and parts. Taxpayer includes some, but not all, mixed service costs in the calculation. Taxpayer does not allocate any additional § 263A costs to used vehicle inventory.

Taxpayer's self-developed method allocates its additional § 263A costs using two absorption ratios. The first absorption ratio is the ratio of Taxpayer's additional § 263A costs incurred during the taxable year related to new vehicles to current year purchases of new vehicles. Taxpayer applies this ratio to the LIFO increment, if any. On the other hand, Taxpayer liquidates additional § 263A when it invades a LIFO layer. The second absorption ratio is the ratio of Taxpayer's additional § 263A costs incurred during the taxable year related to parts to current year purchases of parts incurred during the taxable year. Taxpayer applies this ratio to the section 471 costs in ending inventory. Taxpayer's section 471 costs in ending inventory are the acquisition costs of the parts remaining on hand at the end of the taxable year. Taxpayer did not provide documentation showing how it determined the percentage of costs attributable to new vehicles or to parts.

The examining agent calculated the amount of additional § 263A costs required to be capitalized using both the simplified production method as described at § 1.263A-2(b)

and the simplified resale method as described at § 1.263A-3(d). Under both methods of accounting, Taxpayer's self-developed method capitalized less additional § 263A costs than either the simplified production or simplified resale methods. The examining agent concludes that Taxpayer's method of accounting does not provide for a clear reflection of income.

We agree with the examining agent that the present method of allocating additional § 263A costs is not proper. Aside from the fact that this is a modification of the simplified methods, Taxpayer is required to allocate all costs required to be capitalized under § 263A and the regulations thereunder to all inventory, including used vehicles. Taxpayer's method is similar to the simplified production method. The simplified production method is applied on a trade or business basis. Unless new vehicles and parts are separate trades or businesses, Taxpayer is incorrectly applying the simplified production method to those inventories. Moreover, Taxpayer has not allocated any indirect costs to used vehicles. Also, Taxpayer has not included all required costs.

Commissioner's discretion

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." *See 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 a method which, in his opinion, does clearly reflect income. *See* § 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, Inc. v. Commissioner*, 97 T.C. 120, 129 (1991) (citing *Photo-Sonics, Inc. v. Commissioner*, 42 T.C. 926, 933 (1964), affd. 357 F.2d 656 (9th Cir. 1966)).

The courts have consistently held that the Commissioner's authority under § 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 Tool Co. v. Commissioner*, 439 U.S. 522 (1979), 1979-1 C.B. 167; *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).

Accordingly, we conclude that the examining agent may compute Taxpayer's taxable income using any method that clearly reflects Taxpayer's taxable income.

Permissible methods – general rules

The regulations provide two simplified methods for allocating additional § 263A costs to ending inventory and other eligible property. Section 1.263A-2(b)(1) provides that producers may elect to use the simplified production method to determine the additional § 263A costs properly allocable to ending inventories of property produced and other eligible property on hand at the end of the taxable year. Similarly, § 1.263A-3(d)(1) provides that resellers may elect to use the simplified resale method to determine the additional § 263A costs properly allocable to property acquired for resale and other eligible property on hand at the end of the taxable year. The simplified methods are permissible methods for taxpayers eligible to use them.

In general, a taxpayer may elect the simplified production method if engaged in both production and resale activities with respect to items of eligible property. *See* § 1.263A-3(a)(4). However, generally, the simplified resale method is only available to a trade or business exclusively engaged in resale activities. *See* § 1.263A-3(d)(2). Therefore, as a general rule, if a reseller is engaged in both production and resale activities with respect to the items of eligible property, then the reseller may only elect the simplified production method and is not allowed to elect the simplified resale method. *See* § 1.263A-3(a)(4).

Despite the general rule prohibiting resellers engaged in production activities from using the simplified resale method, § 1.263A-3(a)(4) provides two exceptions which allow resellers engaged in both production and resale activities to elect the simplified resale method. First, a reseller otherwise permitted to use the simplified resale method may use the simplified resale method if its production activities with respect to the items of eligible property are de minimis and incident to its resale of personal property described in § 1221(a)(1). *See* § 1.263A-3(a)(4)(ii). Second, a reseller otherwise permitted to use the simplified resale method may use the simplified resale method even though it has personal property produced for it (e.g., private label goods) under a contract with an unrelated person if the contract is entered into incident to its resale activities and the property is sold to its customers. *See* § 1.263A-3(a)(4)(iii).

In addition to the simplified methods, a taxpayer may use the methods described in §§ 1.263A-1(f)(2) or (3) if they are reasonable allocation methods within the meaning of § 1.263A-1(f)(4). In addition, a taxpayer may use any other reasonable allocation method to properly allocate direct and indirect costs among units of property produced or property acquired for resale during the taxable year. *See* 1.263A-1(f)(4).

Allocation methods available to the examining agent

The examining agent concludes that if Taxpayer is a reseller with more than de minimis production activities, then Taxpayer must allocate additional § 263A using the simplified production method. If Taxpayer is a reseller with de minimis production, the examining agent concludes that Taxpayer may use the simplified resale method.

If Taxpayer has more than de minimis production activities, the examining agent can require Taxpayer to use the simplified production method in order to capitalize all additional § 263A costs to both production and resale property that remain on hand at year end.

If Taxpayer's production activities are determined to be de minimis, §§ 1.263A-3(a)(4)(ii) and 1.263A-3(a)(4)(iv) in combination provide that Taxpayer can be required to use the simplified resale method to capitalize additional § 263A costs. However, because Taxpayer has de minimis production costs incident to its resale activities and property produced under contract, it is required to capitalize all costs allocable to eligible property produced using the simplified resale method. Taxpayer must include any de minimis production costs, subcontractor's costs, as well as handling costs incurred in servicing Taxpayer-owned vehicles, in the storage and handling costs absorption ratio or the purchasing costs absorption ratio of the simplified resale method to the extent these costs are not capitalized to the basis of the vehicles.

Even if Taxpayer's production activities are de minimis, the examining agent can require Taxpayer to use the simplified production method. See § 1.263A-3(a)(4) which provides that resellers may elect the simplified production method if engaged in both production and resale activities with respect to items of eligible property.

In addition, the examining agent can require Taxpayer to use any other method that is a reasonable method within the meaning of § 1.263A-1(f)(4).

Taxpayer's arguments

Taxpayer argues that even if it were a producer, the simplified production method does not clearly reflect income, because due to the nature of its activities, it has little inventory on hand at year end that is produced. Taxpayer further argues that if little or no produced inventory is on hand at the end of the year, income is distorted if production costs are allocated to inventory that was not produced. Rather, Taxpayer argues that it should be entitled to use a method that capitalizes only necessary pre-production costs as provided in § 1.263A-2(a)(3)(ii) and whatever small amount would apply to the vehicles in process at the body shop.

Although they may produce results that differ from a facts-and-circumstances method, the simplified production method and simplified resale method clearly reflect income when properly applied by an eligible taxpayer. See T.D. 8482, 1993-2 C.B. 77, 83-4. As explained above, the examining agent may require Taxpayer to use any permissible method, including a reasonable method under § 1.263A-1(f)(4), the simplified production method, or the simplified resale method if Taxpayer's production activities are de minimis. If the examining agent requires Taxpayer to use one of the simplified methods and Taxpayer is not satisfied with the results of that method, it may request to change its method of accounting to a facts-and-circumstances allocation method. Id.

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.