

[4830-01-p]

Published August 3, 2005

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

TD 9217

RIN 1545-BE61

**SUBJECT:** Guidance Regarding the Simplified Service Cost Method and the Simplified Production Method

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Final and temporary regulations.

**SUMMARY:** This document contains final and temporary regulations relating to the capitalization of costs under the simplified service cost method and the simplified production method provided by the Income Tax Regulations. The regulations affect taxpayers that use the simplified service cost method or the simplified production method for self-constructed assets that are produced on a routine and repetitive basis in the ordinary course of their businesses. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section in this issue of the **Federal Register**. The portions of this rule that are final regulations provide necessary cross-references to the temporary regulations.

**DATES:** Effective Date: These regulations are effective August 2, 2005.

Applicability Date: These regulations apply to taxable years ending on or after August 2, 2005. See §§1.263A-1T(l) and 1.263A-2T(f).

FOR FURTHER INFORMATION CONTACT: Scott Rabinowitz, (202) 622-4970 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

### **Background**

Under section 263A of the Internal Revenue Code (Code), producers of real or tangible personal property and resellers of real or personal property must capitalize the direct costs and a proper share of the indirect costs of such property. Indirect costs include indirect labor costs, overhead, and service costs. Service costs are indirect costs that can be identified specifically with an administrative or support department. Service costs consist of 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, a production or resale activity. Deductible service costs are service costs that do not directly benefit, or are not incurred by reason of, a production or resale activity. 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.

Although section 263A requires capitalization of indirect costs, the statute generally does not set forth methods for allocating indirect costs, including mixed service costs. Instead, in accordance with the legislative history of the section, the regulations under section 263A generally provide that indirect costs are to be allocated to property using detailed or specific (facts-and-circumstances) cost allocation methods, including a specific identification method, the standard cost method, and methods using burden rates. The regulations further provide that allocations of mixed service costs are

to be made on the basis of a factor or relationship that reasonably relates such costs with the benefit provided. To alleviate the administrative burdens of using these detailed or specific methods, the Treasury Department and the Internal Revenue Service developed simplified methods. In particular, the simplified production method provided by §1.263A-2(b) determines aggregate amounts of additional section 263A costs allocable to produced “eligible property.” Additional section 263A costs are those costs, other than interest, that were not capitalized under a taxpayer’s method of accounting immediately prior to the effective date of section 263A, but that are required to be capitalized under section 263A. In addition, the final regulations provide a simplified method, the simplified service cost method provided by §1.263A-1(h), for determining capitalizable mixed service costs incurred during the taxable year with respect to “eligible property.”

On March 30, 1987, temporary regulations under section 263A were published in the **Federal Register** (TD 8131, 1987-1 C.B. 98, [52 FR 10052]). The temporary regulations limited the availability of the simplified production method and the simplified service cost method to two types of “eligible property”: stock in trade or other property properly includible in the inventory of the taxpayer and non-inventory property held by a taxpayer primarily for sale to customers in the ordinary course of the taxpayer’s trade or business. The preamble to the temporary regulations indicates that this limitation was prescribed because the simplified production method is not appropriate to account for the casual or occasional production of property (*i.e.*, property that is not mass-produced on a repetitive and routine basis and that does not have a high “turnover” rate.)

Similarly, the simplified service cost method is not appropriate to account for the casual or occasional production of property.

On August 22, 1988, the IRS published Notice 88-86 (1988-2 C.B. 401). Notice 88-86 states that forthcoming regulations will expand the categories of property eligible for the simplified production method and simplified service cost method to other types of property that share characteristics that are appropriate for application of the methods. In particular, the notice indicates that the regulations will provide that the simplified production method and the simplified service cost method are available to (1) self-constructed assets substantially identical in nature to, and produced in the same manner as, inventory property or other property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, and (2) self-constructed assets produced by the taxpayer on a routine and repetitive basis in the ordinary course of the taxpayer's production activities.

On August 9, 1993, final regulations under section 263A were published in the **Federal Register** (TD 8482, 1993-2 C.B. 77, [58 FR 42198]). The final regulations follow Notice 88-86 and expand the categories of eligible property for the simplified production method and the simplified service cost method.

Notice 2003-36 (2003-1 C.B. 992), as modified by Notice 2003-59 (2003-59 C.B. 429), indicates that the Treasury Department and the IRS are aware that uncertainty exists as to what types of property constitute "eligible property" under §§1.263A-1(h)(2)(i)(D) and 1.263A-2(b)(2)(i)(D) for purposes of the simplified service cost method and the simplified production method. These sections provide that self-constructed

assets produced by a taxpayer on a routine and repetitive basis in the ordinary course of the taxpayer's trade or business are "eligible property."

To provide guidance as to what types of property constitute "eligible property" under the final regulations, Rev. Rul. 2005-53 (2005-35 I.R.B.) (dated August 29, 2005), holds that a taxpayer's production of property will be considered "routine and repetitive" for purposes of §§1.263A-1(h)(2)(i)(D) and 1.263A-2(b)(2)(i)(D) only if the property is mass-produced (*i.e.*, numerous identical goods are manufactured using standardized designs and assembly line techniques) or the produced property has a high degree of turnover (*i.e.*, the costs of production are recovered over a relatively short amount of time).

### **Explanation of Provisions**

Upon further consideration of the simplified service cost method and the simplified production method under §§1.263A-1(h)(2)(i)(D) and 1.263A-2(b)(2)(i)(D), the Treasury Department and the IRS believe that, to minimize the distortion of income that may arise from the use of those methods, a taxpayer's production of property is considered "routine and repetitive" for purposes of those sections only if the property is mass-produced and has a high degree of turnover. Accordingly, the temporary regulations provide that self-constructed property is considered produced on a routine and repetitive basis for purposes of the simplified service cost method and the simplified production method only if numerous substantially identical units of tangible personal property are produced within a taxable year using standardized designs and assembly line techniques and the applicable recovery period of the assets under §168(c) is not longer than 3 years.

A change in a taxpayer's treatment of mixed service costs or additional section 263A costs to comply with these temporary regulations is a change in method of accounting to which the provisions of sections 446 and 481 and the regulations thereunder apply. For the taxpayer's first taxable year ending on or after August 2, 2005, the taxpayer is granted the consent of the Commissioner to change its method of accounting to comply with these temporary regulations, provided the taxpayer follows the applicable administrative procedures for obtaining the Commissioner's automatic consent to a change in accounting method (for further guidance, for example, see Rev. Proc. 2002-9 (2002-1 C.B. 327), as modified and clarified by Announcement 2002-17 (2002-1 C.B. 561), modified and amplified by Rev. Proc. 2002-19 (2002-1 C.B. 696), and amplified, clarified, and modified by Rev. Proc. 2002-54 (2002-2 C.B. 432)). For purposes of Form 3115, "Application for Change in Accounting Method", the designated number for the automatic accounting method change authorized by this regulation is "95." If Form 3115 is revised or renumbered, any reference in this section to that form is treated as a reference to the revised or renumbered form. For the taxpayer's second and subsequent taxable years ending on or after August 2, 2005, requests to secure the consent of the Commissioner must be made under the administrative procedures for obtaining the Commissioner's advance consent to a change in accounting method (for further guidance, for example, see Rev. Proc. 97-27 (1997-1 C.B. 680), as modified and amplified by Rev. Proc. 2002-19 (2002-1 C.B. 696), as amplified and clarified by Rev. Proc. 2002-54 (2002-2 C.B. 432)). However, notwithstanding section 5.04(1) of Rev. Proc. 2002-9 and section 5.02(3)(a) of Rev. Proc. 97-27, the section 481(a) adjustment

period is two taxable years for a net positive adjustment for an accounting method change that is made to conform to these temporary regulations.

### **Special Analyses**

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. Please refer to the cross-reference notice of proposed rulemaking published elsewhere in this issue of the **Federal Register** for applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6). Pursuant to section 7805(f) of the Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

### **Drafting Information**

The principal author of these regulations is Scott Rabinowitz of the Office of Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and the Treasury Department participated in their development.

### **List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

### **Amendments to the Regulations**

Accordingly, 26 CFR part 1 is amended as follows:

#### **PART 1--INCOME TAXES**

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Par. 2. Section 1.263A-1 is amended by revising paragraph (h)(2)(i)(D) and adding paragraphs (k) and (l) to read as follows:

§1.263A-1 Uniform capitalization of costs.

\* \* \* \* \*

(h) \* \* \*

(2) \* \* \*

(i) \* \* \*

(D) [Reserved]. For further guidance, see §1.263A-1T(h)(2)(i)(D).

\* \* \* \* \*

(k) and (l) [Reserved]. For further guidance, see §1.263A-1T(k) and (l).

Par 3. Section 1.263A-1T is added to read as follows:

§1.263A-1T Uniform capitalization of costs (temporary).

(a) through (h)(2)(i)(C) [Reserved]. For further guidance, see §1.263A-1(a) through (h)(2)(i)(C).

(D) Self-constructed tangible personal property produced on a routine and repetitive basis--(1) In general. Self-constructed tangible personal property produced by the taxpayer on a routine and repetitive basis in the ordinary course of the taxpayer's trade or business. Self-constructed tangible personal property is produced by the taxpayer on a routine and repetitive basis in the ordinary course of the taxpayer's trade or business when units of tangible personal property (as defined in §1.263A-10(c)) are mass-produced, *i.e.*, numerous substantially identical assets are manufactured within a taxable year using standardized designs and assembly line techniques, and the applicable recovery period of the property determined under section 168(c) is not longer



than 3 years. For purposes of this paragraph, the applicable recovery period of the assets will be determined at the end of the taxable year in which the assets are placed in service for purposes of §1.46-3(d). Subsequent changes to the applicable recovery period after the assets are placed in service will not affect the determination of whether the assets are produced on a routine and repetitive basis for purposes of this paragraph.

(2) Examples. The following examples illustrate this paragraph (h)(2)(i)(D):

Example 1. Y is a manufacturer of automobiles. During the taxable year Y produces numerous substantially identical dies and molds using standardized designs and assembly line techniques. The dies and molds have a 3-year applicable recovery period for purposes of section 168(c). Y uses the dies and molds to produce or process particular automobile components and does not hold them for sale. The dies and molds are produced on a routine and repetitive basis in the ordinary course of Y's business for purposes of this paragraph because the dies and molds are both mass-produced and have a recovery period of not longer than 3 years.

Example 2. Z is an electric utility that regularly manufactures and installs identical poles that are used in transmitting and distributing electricity. The poles have a 20-year applicable recovery period for purposes of section 168(c). The poles are not produced on a routine and repetitive basis in the ordinary course of Z's business for purposes of this paragraph because the poles have an applicable recovery period that is longer than 3 years.

(h)(2)(ii) through (j) [Reserved]. For further guidance, see §1.263A-1(h)(2)(ii) through (j).

(k) Change in method of accounting--(1) In general. A change in a taxpayer's treatment of mixed service costs to comply with these temporary regulations is a change in method of accounting to which the provisions of sections 446 and 481 and the regulations thereunder apply. See §1.263A-7. For a taxpayer's first taxable year ending on or after August 2, 2005, the taxpayer is granted the consent of the Commissioner to change its method of accounting to comply with these temporary

regulations, provided the taxpayer follows the administrative procedures, as modified by paragraphs (k)(2) through (4) of this section, issued under §1.446-1(e)(3)(ii) for obtaining the Commissioner's automatic consent to a change in accounting method (for further guidance, for example, see Rev. Proc. 2002-9 (2002-1 C.B. 327), as modified and clarified by Announcement 2002-17 (2002-1 C.B. 561), modified and amplified by Rev. Proc. 2002-19 (2002-1 C.B. 696), and amplified, clarified, and modified by Rev. Proc. 2002-54 (2002-2 C.B. 432), and §601.601(d)(2)(ii)(b) of this chapter). For purposes of Form 3115, "Application for Change in Accounting Method," the designated number for the automatic accounting method change authorized by this paragraph (k) is "95." If Form 3115 is revised or renumbered, any reference in this section to that form is treated as a reference to the revised or renumbered form. For the taxpayer's second and subsequent taxable years ending on or after August 2, 2005, requests to secure the consent of the Commissioner must be made under the administrative procedures, as modified by paragraphs (k)(2) through (4) of this section, for obtaining the Commissioner's advance consent to a change in accounting method (for further guidance, for example, see Rev. Proc. 97-27 (1997-1 C.B. 680), as modified and amplified by Rev. Proc. 2002-19 (2002-1 C.B. 696), as amplified and clarified by Rev. Proc. 2002-54 (2002-2 C.B. 432), and §601.601(d)(2)(ii)(b) of this chapter).

(2) Scope limitations. Any limitations on obtaining the automatic consent of the Commissioner do not apply to a taxpayer seeking to change its method of accounting to comply with this section for its first taxable year ending on or after August 2, 2005.

(3) Audit protection. A taxpayer that changes its method of accounting in accordance with this paragraph (k) to comply with these temporary regulations does not receive

audit protection if its method of accounting for mixed service costs is an issue under consideration at the time the application is filed with the national office.

(4) Section 481(a) adjustment. A change in method of accounting to conform to these temporary regulations requires a section 481(a) adjustment. The section 481(a) adjustment period is two taxable years for a net positive adjustment for an accounting method change that is made to conform to these temporary regulations.

(l) Effective date. This section applies for taxable years ending on or after August 2, 2005.

Par. 4. Section 1.263A-2 is amended by revising paragraph (b)(2)(i)(D) and adding paragraphs (e) and (f) to read as follows:

§1.263A-2 Rules relating to property produced by the taxpayer.

\* \* \* \* \*

(b) \* \* \*

(2) \* \* \*

(i) \* \* \*

(D) [Reserved]. For further guidance, see §1.263A-2T(b)(2)(i)(D).

\* \* \* \* \*

(e) and (f) [Reserved]. For further guidance, see §1.263A-2T(e) and (f).

Par. 5. Section 1.263A-2T is added to read as follows:

§263A-2T Rules relating to property produced by the taxpayer (temporary).

(a) through (b)(2)(i)(C) [Reserved]. For further guidance, see §1.263A-2(a) through (b)(2)(i)(C).

(D) Self-constructed tangible personal property produced on a routine and repetitive basis--(1) In general. Self-constructed tangible personal property produced by the taxpayer on a routine and repetitive basis in the ordinary course of the taxpayer's trade or business. Self-constructed tangible personal property is produced by the taxpayer on a routine and repetitive basis in the ordinary course of the taxpayer's trade or business when units of tangible personal property (as defined in §1.263A-10(c)) are mass-produced, *i.e.*, numerous substantially identical assets are manufactured within a taxable year using standardized designs and assembly line techniques, and the applicable recovery period of the property determined under section 168(c) is not longer than 3 years. For purposes of this paragraph, the applicable recovery period of the assets will be determined at the end of the taxable year in which the assets are placed in service for purposes of §1.46-3(d). Subsequent changes to the applicable recovery period after the assets are placed in service will not affect the determination of whether the assets are produced on a routine and repetitive basis for purposes of this paragraph.

(2) Examples. The following examples illustrate this paragraph (D):

Example 1. Y is a manufacturer of automobiles. During the taxable year Y produces numerous substantially identical dies and molds using standardized designs and assembly line techniques. The dies and molds have a 3-year applicable recovery period for purposes of section 168(c). Y uses the dies and molds to produce or process particular automobile components and does not hold them for sale. The dies and molds are produced on a routine and repetitive basis in the ordinary course of Y's business for purposes of this paragraph because the dies and molds are both mass-produced and have an applicable recovery period of not longer than 3 years.

Example 2. Z is an electric utility that regularly manufactures and installs identical poles that are used in transmitting and distributing electricity. The poles have a 20-year applicable recovery period for purposes of section 168(a). The poles are not produced on a routine and repetitive basis in the ordinary course of Z's business for purposes of

this paragraph because the poles have an applicable recovery period that is longer than 3 years.

(b)(2)(ii) through (d) [Reserved]. For further guidance, see §1.263A-2(b)(2)(ii) through (d).

(e) Change in method of accounting- (1) In general. A change in a taxpayer's treatment of additional section 263A costs to comply with these temporary regulations is a change in method of accounting to which the provisions of sections 446 and 481 and the regulations thereunder apply. See §1.263A-7. For a taxpayer's first taxable year ending on or after August 2, 2005, the taxpayer is granted the consent of the Commissioner to change its method of accounting to comply with these temporary regulations, provided the taxpayer follows the administrative procedures, as modified by paragraphs (e)(2) through (4) of this section, issued under §1.446-1(e)(3)(ii) for obtaining the Commissioner's automatic consent to a change in accounting method (for further guidance, for example, see Rev. Proc. 2002-9 (2002-1 C.B. 327), as modified and clarified by Announcement 2002-17 (2002-1 C.B. 561), modified and amplified by Rev. Proc. 2002-19 (2002-1 C.B. 696), and amplified, clarified, and modified by Rev. Proc. 2002-54 (2002-2 C.B. 432), and §601.601(d)(2)(ii)(b) of this chapter). For purposes of Form 3115, "Application for Change in Accounting Method," the designated number for the automatic accounting method change authorized by this paragraph (e) is "95." If Form 3115 is revised or renumbered, any reference in this section to that form is treated as a reference to the revised or renumbered form. For the taxpayer's second and subsequent taxable years ending on or after August 2, 2005, requests to secure the consent of the Commissioner must be made under the administrative procedures, as modified by paragraphs (e)(2) through (4) of this section, for obtaining the

Commissioner's advance consent to a change in accounting method (for further guidance, for example, see Rev. Proc. 97-27 (1997-1 C.B. 680), as modified and amplified by Rev. Proc. 2002-19 (2002-1 C.B. 696), as amplified and clarified by Rev. Proc. 2002-54 (2002-2 C.B. 432), and §601.601(d)92)(ii)(b) of this chapter).

(2) Scope limitations. Any limitations on obtaining the automatic consent of the Commissioner do not apply to a taxpayer seeking to change its method of accounting to comply with this section for its first taxable year ending on or after August 2, 2005.

(3) Audit protection. A taxpayer that changes its method of accounting in accordance with this paragraph (e) to comply with these temporary regulations does not receive audit protection if its method of accounting for additional section 263A costs is an issue under consideration at the time the application is filed with the national office.

(4) Section 481(a) adjustment. A change in method of accounting to conform to these temporary regulations requires a section 481(a) adjustment. The section 481(a) adjustment period is two taxable years for a net positive adjustment for an accounting method change that is made to conform to these temporary regulations.

(f) Effective date. This section applies for taxable years ending on or after August 2, 2005.

Deputy Commissioner for Services and Enforcement.

Approved: July 14, 2005

Acting Deputy Assistant Secretary of the Treasury.