

# **Exhibit A**

[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 a n 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) though (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.



## Part I

### Section 263A.—Capitalization and Inclusion in Inventory Costs of Certain Expenses

26 CFR 1.263A-1: Uniform capitalization of costs  
(Also: § 1.263A-2)

Rev. Rul. 2005-53

#### BACKGROUND

In Notice 2003-36, 2003-1 C.B. 992, modified by Notice 2003-59, 2003-2 C.B. 429, the Treasury Department and the Internal Revenue Service indicate that they 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) of the Income Tax Regulations for which qualifying taxpayers may use the simplified service cost and simplified production methods. In particular, there is uncertainty about the proper interpretation and application of the term “routine and repetitive.” The notice indicates that the Treasury Department and the Service plan to publish guidance that will clarify the types of property that qualify as eligible property under those sections and address the interpretation and application of the term “routine and repetitive.” This revenue ruling

clarifies the types of property that qualify as eligible property for purposes of §§ 1.263A-1(h)(2)(i)(D) and 1.263A-2(b)(2)(i)(D) and how the term “routine and repetitive” is interpreted for this purpose.

#### ISSUE

Under what circumstances are a taxpayer’s self-constructed assets produced on a routine and repetitive basis in the ordinary course of its trade or business for purposes of the simplified service cost method and the simplified production method (the “simplified methods”) under §§ 1.263A-1(h)(2)(i)(D) and 1.263A-2(b)(2)(i)(D) of the Income Tax Regulations?

#### FACTS

Situation 1. U, a manufacturer of office equipment, produces numerous identical copiers during the year using assembly line techniques. U leases the copiers and does not hold them for sale.

Situation 2. V, a manufacturer of automobiles, regularly produces molds that are specifically designed for the production of particular automobile parts. The molds cannot be adapted for a further or different use after changes or improvements are made to the particular part that is produced by the mold. The molds generally are used for one to three years. Accordingly, the molds have a high degree of turnover.

Situation 3. W, a telephone company, manufactures numerous identical poles using standardized designs and assembly line techniques for use in its business.

Situation 4. X, an electric utility, regularly purchases identical meters and installs them on its customers’ properties. The meters measure the amount of electric current

used by X's customers. X does not manufacture meters. Meters are included in asset class 49.14 under Rev. Proc. 87-56, 1987-2 C.B. 674, as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785, and have a class life of 30 years.

Situation 5. Y, an electric utility, constructs from various components substations that it uses in transmitting and distributing electricity. Substations and their components are facilities built on land that house an assembly of equipment designed for switching, changing, or regulating the voltage of electricity. Each substation is intended to operate for an extended length of time, is specifically custom designed for a specific geographic site, and serves a particular function within Y's electrical grid.

Situation 6. Z, a company that owns and operates a national chain of restaurants, continually constructs new restaurants each year. Z generally uses a standardized design when constructing new restaurants. However, local zoning laws and the physical characteristics of the specific construction site require Z to modify the design for each new restaurant.

#### LAW AND ANALYSIS

Section 263A of the Internal Revenue Code provides that producers of real or tangible personal property must capitalize the direct costs and a proper share of the indirect costs of such property.

Section 1.263A-1(e)(3) provides that indirect costs include service costs. For this purpose, § 1.263A-1(e)(4) states that service costs are a type of indirect costs that can be identified specifically with an administrative or support department or function. Service costs include capitalizable service costs, deductible service costs, and mixed

service costs. Under § 1.263A-1(e)(4)(ii)(C), mixed service costs include service costs that are partially allocable to production activities and partially allocable to non-production activities.

Section 1.263A-1(g)(3) provides that indirect costs are generally allocated to intermediate cost objectives such as departments or activities prior to the allocation of such costs to property produced. This section further provides that taxpayers are required to allocate indirect costs using either a specific identification method, a standard cost method, a burden rate method, or any other reasonable allocation method (as defined under the principles of § 1.263A-1(f)(4)).

Section 1.263A-2(b) allows producers 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. Section 1.263A-2(b)(3)(i)(A) generally provides that the amount of additional § 263A costs that is allocable to eligible property remaining on hand at the close of the taxable year under the simplified production method is computed by multiplying the § 471 costs on hand at the end of the year by an absorption ratio. Section 1.263A-2(b)(3)(ii)(A) provides that the absorption ratio generally is equal to the additional § 263A costs incurred during the year divided by the § 471 costs incurred during the year.

Additional § 263A costs are the costs, other than interest, that were not capitalized under the taxpayer's method of accounting immediately prior to the effective date of § 263A, but that are required to be capitalized under § 263A. See § 1.263A-1(d)(3). Section 471 costs generally are the costs, other than interest, that the taxpayer

capitalized under its method of accounting immediately prior to the effective date of § 263A. See § 1.263A-1(d)(2).

Section 1.263A-2(b)(2)(i) provides that a taxpayer electing to use the simplified production method generally must use the method for all production activities associated with the following categories of eligible property:

1. Inventory property. Stock in trade or other property properly includible in the inventory of the taxpayer. See § 1.263A-2(b)(2)(i)(A).
2. Non-inventory property held for sale. Non-inventory property held by a taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business. See § 1.263A-2(b)(2)(i)(B).
3. Certain self-constructed assets. Self-constructed assets substantially identical in nature to, and produced in the same manner as, inventory property produced by the taxpayer or other property produced by the taxpayer and held primarily for sale to customers in the ordinary course of the taxpayer's trade or business. See § 1.263A-2(b)(2)(i)(C).
4. Self-constructed assets produced on a repetitive basis. Self-constructed assets produced by the taxpayer on a routine and repetitive basis in the ordinary course of the taxpayer's trade or business. See § 1.263A-2(b)(2)(i)(D).

Section 1.263A-1(g)(4) generally requires taxpayers to allocate mixed service costs to property produced using reasonable factors or relationships under a direct reallocation method (as defined in § 1.263A-1(g)(4)(iii)(A)), a step-allocation method (as defined in § 1.263A-1(g)(4)(iii)(B)), or any other reasonable allocation method (as defined under the principles of § 1.263A-1(f)(4)).

Section 1.263A-1(h) permits taxpayers to use the simplified service cost method to determine the aggregate portion of mixed service costs incurred during the taxable year that are properly allocable to "eligible property." The categories of eligible property

provided by the simplified service cost method are identical to the four categories of eligible property provided by the simplified production method. Compare § 1.263A-1(h)(2)(i) with § 1.263A-2(b)(2)(i).

Section 1.263A-1(h)(3)(i) provides that under the simplified service cost method, a taxpayer computes its capitalizable mixed service costs by multiplying its total mixed service costs by an allocation ratio. The allocation ratio can be either the labor-based or production-based ratio. See §§ 1.263A-1(h)(4) and (5).

The four categories of eligible property in §§ 1.263A-1(h)(2)(i) and 1.263A-2(b)(2)(i) all share common characteristics that make application of the simplified methods appropriate. Prior to the issuance of the final § 263A regulations, the temporary § 263A regulations, issued under T.D. 8131, 1987-1 C.B. 98, and published in the Federal Register on March 30, 1987, limited the availability of the simplified methods to two categories of property: inventory 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 § 263A regulations indicates that this limitation was prescribed because the simplified methods are not appropriate to account for the casual or occasional production of property. Instead, the simplified methods were "designed to alleviate the administrative burdens of complying with the new capitalization rules in situations where mass production of assets occurs on a repetitive and routine basis, with a typically high 'turnover' rate for the produced assets." See T.D. 8131, 1987-1 C.B. 98, 102. The final regulations retain these two categories of

eligible property in §§ 1.263A-1(h)(2)(i)(A) and (B) and 1.263A-2(b)(2)(i)(A) and (B).

See T.D. 8482, 1993-2 C.B. 77, published in the Federal Register on August 9, 1993.

Commentators to the temporary regulations suggested that the categories of property eligible for the simplified methods be expanded to other types of property that share the characteristics that are appropriate for application of the methods. In response, Notice 88-86, 1988-2 C.B. 401, published on August 5, 1988, expanded the availability of the simplified methods to:

(1) property constructed by a taxpayer for use in its trade or business if the taxpayer is also producing, in the ordinary course of its business, inventory property (or any other property with respect to which the use of the simplified production method is permitted under the present regulations), and the property constructed by the taxpayer for use in its trade or business is substantially identical in nature to, and is produced in the same manner as, the inventory property (or such other property) produced by the taxpayer, and

(2) property constructed by a taxpayer for use in its trade or business if, in the ordinary course of its production activities, the taxpayer produces such property on a routine and repetitive basis (i.e., the taxpayer produces numerous items of such property within a taxable year.)

The final regulations follow Notice 88-86 and expand the categories of produced property eligible for the simplified methods by adding §§ 1.263A-1(h)(2)(i)(C) and (D) and 1.263A-2(b)(2)(i)(C) and (D).

The simplified methods are predicated on the assumption that it is appropriate to allocate production costs on a ratable basis when assets are either mass-produced (*i.e.*, numerous identical goods are manufactured using standardized designs and assembly line techniques) or have a high degree of turnover. In contrast, it is not appropriate to

allocate production costs on a ratable basis when assets are neither mass-produced nor have a high degree of turnover.

The first three categories of eligible property provided in §§ 1.263A-1(h)(2)(i)(A)-(C) and 1.263A-2(b)(2)(i)(A)-(C) are either mass-produced and/or have a high degree of turnover or are identical to assets that are mass-produced and/or have a high degree of turnover. The fourth category of eligible property, self-constructed assets produced on a routine and repetitive basis, is similar to these first three categories. It was intended that the fourth category of eligible property provided by the simplified methods, §§ 1.263A-1(h)(2)(i)(D) and 1.263A-2(b)(2)(i)(D), possess the same characteristics shared by all of the preceding categories of eligible property. Therefore, to be eligible under the fourth category, the property also must be either mass-produced (numerous identical goods are manufactured using standardized designs and assembly line techniques) or have a high degree of turnover (in this case have a relatively short useful life). Mass production does not include all the terms provided by § 263A(g) and § 1.263A-2(a)(1) (for example, install, develop, and improve). Instead property is mass-produced only if it is *manufactured* numerous times during the year using standardized designs and assembly line techniques.

For example, the fourth category of eligible property provided by the simplified methods, §§ 1.263A-1(h)(2)(i)(D) and 1.263A-2(b)(2)(i)(D), includes property mass-produced by a vertically integrated business for use in its own business that would have been properly included in inventory of a third party if mass-produced for sale by the third party. Thus, if a telephone company mass-produces its own poles for use in its



business, the poles would be eligible property for purposes of §§ 1.263A-1(h)(2)(i)(D) and 1.263A-2(b)(2)(i)(D).

In Situation 1, U is producing copiers on a routine and repetitive basis for purposes of the simplified methods because the copiers are mass-produced.

In Situation 2, V is producing molds on a routine and repetitive basis for purposes of the simplified methods because the molds have a high degree of turnover.

In Situation 3, W is producing poles on a routine and repetitive basis for purposes of the simplified methods because the poles are mass-produced.

In Situation 4, X is not producing meters on a routine and repetitive basis for purposes of the simplified methods because the meters are neither mass-produced by X nor have a high degree of turnover. Mass production does not include installation of meters and meters do not have a short useful life.

In Situation 5, Y is not producing substations on a routine and repetitive basis for purposes of the simplified methods because the substations are neither mass-produced nor have a high degree of turnover.

In Situation 6, Z is not producing restaurants on a routine and repetitive basis for purposes of the simplified methods because the restaurants are neither mass-produced nor have a high degree of turnover.

#### HOLDING

For purposes of the simplified methods under §§ 1.263A-1(h)(2)(i)(D) and 1.263A-2(b)(2)(i)(D), a taxpayer's self-constructed assets are produced on a routine and repetitive basis in the ordinary course of its trade or business if the assets are either

mass-produced (numerous identical goods are manufactured using standardized designs and assembly line techniques) or have a high degree of turnover.

**DRAFTING INFORMATION**

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