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[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-126770-06]

RIN 1545-BG07

Allocation of Costs under the Simplified Methods

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations on allocating costs to certain property produced by the taxpayer or acquired by the taxpayer for resale. The proposed regulations affect taxpayers that are producers or resellers of property that are required to capitalize certain costs to the property and that allocate costs under the simplified production method or the simplified resale method. The proposed regulations provide rules for the treatment of negative additional costs.

DATES: Written (including electronic) comments and requests for a public hearing must be received by **[INSERT DATE 90 DAYS AFTER PUBLICATION OF THIS**

DOCUMENT IN THE FEDERAL REGISTER].

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-126770-06), room 5205, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044.

Submissions may be hand delivered between the hours of 8 a.m. and 4 p.m. to

CC:PA:LPD:PR (REG-126770-06), Courier's Desk, Internal Revenue Service, 1111

Constitution Avenue, N.W., Washington, DC. Taxpayers also may submit comments electronically via the Federal eRulemaking Portal at www.regulations.gov (IRS REG-126770-06).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Christopher Call, (202) 622-4970; concerning submissions of comments or to request a public hearing, Oluwafunmilayo Taylor, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations, 26 CFR part 1, relating to the allocation of costs under the simplified methods of accounting under section 263A of the Internal Revenue Code (Code).

Section 263A requires taxpayers to capitalize the direct costs and indirect costs that are properly allocable to: (1) real or tangible personal property the taxpayer produces, and (2) real property and personal property described in section 1221(a)(1) that the taxpayer acquires for resale. Section 1.263A-1(e)(2)(i) of the Income Tax Regulations provides that direct costs for producers are direct material costs and direct labor costs. Section 1.263A-1(e)(2)(ii) provides that resellers must capitalize the acquisition cost of property acquired for resale. Section 1.263A-1(e)(3)(i) defines indirect costs as 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). Indirect costs are properly allocable to property produced or acquired for resale

when the costs directly benefit or are incurred by reason of the performance of production or resale activities.

Section 263A generally requires taxpayers to allocate capitalizable section 263A costs to specific items in inventory. The legislative history of section 263A indicates that Congress intended that taxpayers would allocate additional section 263A costs (costs, other than interest, that were not capitalized under the taxpayer's method of accounting immediately prior to the effective date of section 263A, but that are required to be capitalized under section 263A) with the same degree of specificity that was required of inventoriable costs prior to the enactment of section 263A. Congress contemplated that taxpayers would continue to use the same methods of allocating costs to items in their inventory that were available under prior law. See S. Rep. No. 313, 99th Cong. 2d Sess. 142 (1986). Consistent with these principles, the regulations under §1.263A-1(f)(2) and (f)(3) provide that taxpayers may elect to use a “facts-and-circumstances” allocation method, such as the specific identification method, burden rate, standard cost method, or any other method to allocate direct and indirect costs to units of property produced or acquired for resale, if the method is reasonable within the meaning of §1.263A-1(f)(4).

Section 1.263A-1(f)(1) authorizes taxpayers to use the simplified methods provided in §1.263A-2(b) (the simplified production method) or §1.263A-3(d) (the simplified resale method) to allocate costs to eligible property produced or eligible property acquired for resale in lieu of a facts-and-circumstances allocation method. The simplified methods differ from facts-and-circumstances methods in that, as applied to

inventories, they allocate a pool of capitalizable costs (additional section 263A costs) between ending inventory and cost of goods sold using a defined ratio and are an exception to the general rule that additional section 263A costs must be allocated to specific items of inventory. Thus, the simplified methods are intended to reduce the complexity and administrative burdens of having to develop detailed cost accounting systems for the additional costs required to be capitalized under section 263A.

Under the simplified production method, a taxpayer must allocate additional section 263A costs to produced property on hand at the end of the taxable year based on the ratio of these costs incurred during the year to the taxpayer's total section 471 costs incurred during the year (the absorption ratio). The current regulations define additional section 263A costs as the costs, other than interest, that were not capitalized under the taxpayer's method of accounting immediately prior to the effective date of section 263A, but that are required to be capitalized under section 263A. See §1.263A-1(d)(3). The current regulations define section 471 costs as costs, other than interest, capitalized under the taxpayer's method of accounting immediately prior to the effective date of section 263A. If a taxpayer was not in existence before the effective date of section 263A, section 471 costs are generally those costs that would have been required to be capitalized under §1.471-11. See §1.263A-1(d)(2). The absorption ratio is multiplied by the section 471 costs incurred during the taxable year that remain in ending inventory or are otherwise on hand at year end to determine the additional

section 263A costs allocable to produced property on hand at the end of the taxable year.

Under the simplified resale method, an eligible taxpayer computes a combined absorption ratio and multiplies it by the section 471 costs incurred during the taxable year that remain in its ending inventory or are otherwise on hand at year end to determine the additional section 263A costs allocable to eligible property on hand at year end. Section 1.263A-3(d)(3)(i)(C)(1) defines the combined absorption ratio as the sum of the storage and handling costs absorption ratio as defined by §1.263A-3(d)(3)(i)(D) and the purchasing costs absorption ratio as defined by §1.263A-3(d)(3)(i)(E).

Notice 2007-29 (2007-1 CB 881) requests comments on the treatment of negative amounts under the simplified methods. A negative amount generally occurs when a taxpayer capitalizes a cost as a section 471 cost in an amount that is greater than the amount required to be capitalized for tax purposes. For example, if a taxpayer included book depreciation in section 471 costs in accordance with §1.471-11(c)(2)(iii)(b) and the book depreciation is greater than tax depreciation for the year, the taxpayer would have capitalized more depreciation than is required to be capitalized under section 263A for that year. A negative amount may result if the taxpayer does not remove this excess depreciation amount by adjusting section 471 costs but instead makes an adjustment to its additional section 263A costs. See §601.601(d)(2)(ii)(b).

In some situations, including negative amounts in the numerator of the simplified production method formula may result in significant distortions of the amount of additional section 263A costs that is allocated to ending inventory. Distortions may also occur when the method used to capitalize a cost under section 471 is different than the method used under the simplified production method to remove the cost from ending inventory. The extent of the distortion, and whether it is favorable or unfavorable to the taxpayer, generally depends on when the cost is incurred in the production process and how the cost was allocated to raw materials, work-in-process, or finished goods inventories for purposes of section 471.

Notice 2007-29 provides that, pending the issuance of additional published guidance, the IRS will not challenge the inclusion of negative amounts in computing additional costs under section 263A or the permissibility of aggregate negative additional section 263A costs. The notice solicits public comments regarding possible changes to the simplified methods involving negative additional section 263A costs. Comments were received and considered in developing these proposed regulations.

Explanation of Provisions

1. Prohibition on Negative Amounts

To reduce the distortions that occur by including negative amounts under the simplified methods, the proposed regulations provide that, subject to certain exceptions described later in this preamble, taxpayers may not include negative amounts in additional section 263A costs. Specific comments are requested on transition rules for

taxpayers currently using the simplified production method with the historic absorption ratio election (see section 1.263A-2(b)(4)), including comments on how the regulations should apply to taxpayers that are part way through the qualifying period as described in section 1.263A-2(b)(4)(ii)(C).

To reduce the administrative burden for smaller taxpayers using the simplified production method for which the costs and burdens of excluding negative amounts from additional section 263A costs may otherwise outweigh the benefits, the proposed regulations allow producers with average annual gross receipts of \$10,000,000 or less to include negative amounts in additional section 263A costs under the simplified production method.

Additionally, because negative additional section 263A costs cause less distortion under the simplified resale method than under the simplified production method, the proposed regulations allow taxpayers using the simplified resale method to remove section 471 costs that are not required to be capitalized for tax purposes from ending inventory by treating them as negative additional section 263A costs.

The proposed regulations generally prohibit treating cash or trade discounts described in §1.471-3(b) as negative amounts under any of the simplified methods. Comments are requested on reasonable methods of allocating between ending inventory and cost of goods sold cash or trade discounts that taxpayers do not capitalize for book purposes (and therefore are not section 471 costs within the meaning of §1.263A-1(d)(2)).

2. New Modified Simplified Production Method

In response to Notice 2007-29, a commentator suggested an alternative to the simplified production method that would reduce overcapitalization and distortion, including distortions resulting from including negative amounts in additional section 263A costs. The commentator suggested that the simplified production method may allocate an excessive amount of section 263A costs to raw materials inventories because the formula does not take into account the fact that taxpayers incur fewer indirect costs for raw materials and because different inventoriable costs turn over at different rates. The commentator's alternative simplified method would allocate additional section 263A costs related to raw materials using a formula that is different from the formula used to allocate additional section 263A costs related to work-in-process and finished goods.

As suggested by this comment, the proposed regulations allow producers to use a new modified simplified production method that reduces the distortions that exist under the traditional simplified methods by more precisely allocating additional section 263A costs, including negative amounts, among raw materials, work-in-process, and finished goods inventories. Under the modified simplified production method, producers determine the allocable portion of preproduction related additional section 263A costs (such as storage and handling for raw materials) using a preproduction cost absorption ratio. The preproduction cost absorption ratio is applied to raw material section 471 costs incurred during the taxable year and remaining on hand at year end. For

purposes of computing the allocable portion of preproduction related additional section 263A costs, raw material costs on hand at year end include unprocessed raw materials and raw materials that are integrated into work-in-progress and finished goods. Under the modified simplified production method, producers determine the allocable portion of all other additional section 263A costs using a production cost absorption ratio.

In addition to reducing distortions that exist under the simplified production method by more precisely allocating additional section 263A costs to raw materials, the modified simplified production method provides producers with a method to remove section 471 costs that are not required to be capitalized for tax purposes from ending inventory by treating them as negative additional section 263A costs. Both resellers and producers, thereby, are allowed to use methods that more precisely allocate additional section 263A costs while alleviating administrative burden, consistent with the purpose of the simplified methods.

As with other simplified methods, a taxpayer must maintain adequate records substantiating proper use of the modified simplified production method (see section 6001).

Comments are requested on the modified simplified production method, including: (1) whether distortions will occur if preproduction related additional section 263A costs are not directly traced from raw materials through work-in-process and finished goods inventories from year to year; (2) how mixed service costs should be allocated between raw materials, work-in-process, and finished goods inventories under

the new formula; and (3) how the new formula should apply to a taxpayer using the last-in, first-out method of accounting.

3. Simplified Definition of Section 471 Costs and Elimination of Separate Provisions for New Taxpayers

For most taxpayers, section 471 costs generally are the acquisition or production costs, other than interest, that the taxpayer capitalized under its method of accounting immediately before the effective date of section 263A. See §1.263A-1(d)(2)(i). If a taxpayer was not in existence at that time, section 471 costs generally are the acquisition or production costs, other than interest, that the taxpayer would have been required to capitalize if the taxpayer had been in existence immediately before the effective date of section 263A. See §1.263A-1(d)(2)(ii).

To provide greater simplicity and consistency among taxpayers, the proposed regulations adopt a single definition of section 471 costs that applies to taxpayers that were in existence before the effective date of section 263A and to newer taxpayers, whether using the simplified production method, the modified simplified production method, or the simplified resale method. The proposed regulations provide that, for purposes of the simplified methods, a taxpayer's section 471 costs, in general, are the costs, other than interest, that a taxpayer capitalizes to its inventory in its financial statements. However, a taxpayer must include all direct costs in its section 471 costs regardless of the taxpayer's treatment of the costs in its financial statements. The proposed regulations require a taxpayer that is not permitted to remove section 471

costs as negative additional section 263A costs to reduce its section 471 costs. The proposed regulations provide that a taxpayer that reduces its section 471 costs must use a reasonable method that approximates the manner in which the taxpayer originally capitalized the costs.

Effective/Applicability Date

The regulations are proposed to apply to taxable years ending on or after the date the regulations are published as final regulations in the **Federal Register**.

Effect on Other Documents

Notice 2007-29 would be superseded as of the date these regulations are published as final regulations in the **Federal Register**.

Special Analyses

This notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. Section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. Because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the “Addresses” heading. The IRS and the Treasury Department request comments on all aspects of the proposed rules. All comments will be available at www.regulations.gov or upon request.

A public hearing will be scheduled if requested in writing by any person who timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these proposed regulations is W. Thomas McElroy, Jr. 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.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART I -- INCOME TAXES

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

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

Section 1.263A-1 also issued under 26 U.S.C. 263A. * * *

Section 1.263A-2 also issued under 26 U.S.C. 263A. * * *

Par. 2. Section 1.263A-0 is amended as follows:

1. Revising the entries in §1.263A-1 for paragraphs (d)(2) and (d)(3).
2. Revising the entries in §1.263A-2 for paragraphs (c) and (d).
3. Adding new entries to §1.263A-2 for paragraphs (e), (f) and (g).

The revisions and addition read as follows:

§1.263A-0 Outline of regulations under section 263A.

* * * * *

§1.263A-1 Uniform capitalization of costs.

* * * * *

(d) * * *

(2) Section 471 costs.

(i) In general.

(ii) Removal of costs from inventory.

(iii) Method changes.

(3) Additional section 263A costs

(i) In general.

(ii) Negative amounts.

(A) In general.

(B) Exception for small taxpayers using the simplified production method.

(C) Exception for modified simplified production method and simplified resale method.

* * * * *

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

* * * * *

(c) Modified simplified production method.

(1) In general.

(2) Eligible property.

(3) Modified simplified production method without historic absorption ratio election.

(i) General allocation formula.

(A) In general.

(B) Allocable preproduction additional section 263A costs.

- (C) Allocable production additional section 263A costs.
- (D) Effect of allocation.
- (E) Treatment of mixed service costs.
- (ii) Definitions
 - (A) Preproduction absorption ratio.
 - (1) In general.
 - (2) Preproduction additional section 263A costs.
 - (3) Raw material costs.
 - (B) Production absorption ratio.
 - (1) In general.
 - (2) Production additional section 263A costs.
 - (3) Production section 471 costs.
 - (iii) LIFO taxpayers electing the modified simplified production method.
 - (A) In general.
 - (B) LIFO increment.
 - (1) In general.
 - (2) Combined absorption ratio defined.
 - (C) LIFO decrement.
 - (iv) De minimis rule for producers with total indirect costs of \$200,000 or less.
 - (v) Examples.
 - (4) Modified simplified production method with historic absorption ratio election.
 - (i) In general.
 - (ii) General allocation formula.
 - (A) In general.
 - (B) Preproduction historic absorption ratio.
 - (C) Production historic absorption ratio.
 - (iii) LIFO taxpayers making the historic absorption ratio election.
 - (A) In general.
 - (B) Combined historic absorption ratio.
 - (C) Total allocable additional section 263A costs incurred during the test period.
 - (D) Total section 471 costs remaining on hand at year end during the test period.
 - (iv) Extension of qualifying period.
 - (v) Transition rule.
 - (vi) Examples.
 - (d) Additional simplified methods for producers.
 - (e) Cross reference.
 - (f) Change in method of accounting.
 - (1) In general.
 - (2) Scope limitations.
 - (3) Audit protection.
 - (4) Section 481(a) adjustment.
 - (5) Time for requesting change.

(g) Effective/applicability date.

Par. 3. Section 1.263A-1 is amended by:

1. Revising paragraphs (d)(2) and (d)(3).
2. Adding a sentence to the end of paragraph (m).

The addition and revisions read as follows:

§1.263A-1 Uniform capitalization of costs.

* * * * *

(d) * * *

(2) Section 471 costs--(i) In general. Except as otherwise provided in paragraph (d)(2)(ii) of this section, for purposes of section 263A, a taxpayer's section 471 costs are the costs, other than interest, that a taxpayer capitalizes to its inventory (or other eligible property) in its financial statements. Thus, although section 471 applies only to inventories, section 471 costs include any non-inventory costs, other than interest, that a taxpayer capitalizes or includes in acquisition or production costs in its financial statements. However, notwithstanding the last sentence of paragraph (g)(2) of this section, section 471 costs must include all direct costs of producing property and of acquiring property held for resale, whether or not a taxpayer capitalizes these costs to inventory or to other eligible property in its financial statements. See paragraph (e)(2) of this section for a description of direct production costs and direct costs of acquiring property held for resale.

(ii) Removal of costs from inventory. A taxpayer must reduce its section 471 costs by those costs that the taxpayer capitalizes to its inventory (or other eligible property) in its financial statements that may not be capitalized under either §1.263A-1(c)(2) or §1.263A-1(j)(2)(ii), and those period costs that the taxpayer capitalizes to its inventory (or other eligible property) in its financial statements that, under §1.263A-1(j)(2), the taxpayer chooses not to capitalize under section 263A (for example, section 179 costs). A taxpayer described in paragraph (d)(3)(ii)(B) or (d)(3)(ii)(C) of this section that may remove these costs from inventory by including them as negative amounts in additional section 263A costs instead may reduce its section 471 costs for these costs. A taxpayer that reduces its section 471 costs must use a reasonable method that approximates the manner in which the taxpayer originally capitalized the costs to its inventory (or other eligible property) in its financial statements.

(iii) Method changes. A taxpayer may change its method of accounting for determining section 471 costs only with the consent of the Commissioner as required under section 446(e) and the corresponding regulations. If a taxpayer is using the simplified production method described in §1.263A-2(b), the modified simplified production method described in §1.263A-2(c), or the simplified resale method described in §1.263A-3(d), and changes its financial reporting practices regarding the costs capitalized to its inventory (or other eligible property) in a manner that would change its section 471 costs under the general provisions of paragraph (d)(2)(i) of this section,

then the taxpayer must secure the Commissioner's consent prior to computing its taxable income under the new method of accounting for section 471 costs.

(3) Additional section 263A costs--(i) In general. Additional section 263A costs are defined as the costs, other than interest, that are not included in a taxpayer's section 471 costs, but that are required to be capitalized under section 263A. Additional section 263A costs do not include the direct costs that are required to be included in a taxpayer's section 471 costs under paragraph (d)(2)(i) of this section.

(ii) Negative amounts--(A) In general. Except as otherwise provided by regulations or other published guidance, see §601.601(d)(2), a taxpayer may not include negative amounts in additional section 263A costs.

(B) Exception for small taxpayers using the simplified production method. Paragraph (d)(3)(ii)(A) of this section does not apply to a taxpayer using the simplified production method under §1.263A-2(b) if the taxpayer's (or its predecessors') average annual gross receipts for the three previous taxable years (test period) do not exceed \$10,000,000. The rules of §1.263A-3(b) apply for purposes of determining the amount of a taxpayer's gross receipts and the test period.

(C) Exception for modified simplified production method and simplified resale method. In general, a taxpayer using the modified simplified production method under §1.263A-2(c) or the simplified resale method under §1.263A-3(d) may (but is not required to) remove as negative amounts under section 263A indirect costs that are included in the taxpayer's section 471 costs but that are not required to be, or may not

be, capitalized into inventory (or other eligible property) for federal income tax purposes. However, a taxpayer using the modified simplified production method or the simplified resale method may not use negative amounts to adjust additional section 263A costs for cash or trade discounts described in §1.471-3(b).

* * * * *

(m) * * * Paragraphs (d)(2) and (d)(3) of this section apply for taxable years ending on or after the date these regulations are published as final regulations in the **Federal Register**.

Par. 4. Section 1.263A-2 is amended by:

1. Redesignating paragraphs (c), (d), (e), and (f) as paragraphs (d), (e), (f), and (g).
2. Adding a new paragraph (c).
3. Revising newly designated paragraph (g).

The addition and revisions read as follows:

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

* * * * *

(c) Modified simplified production method--(1) In general. This paragraph (c) provides a modified simplified method for determining the additional section 263A costs properly allocable to ending inventories of property produced and other eligible property on hand at the end of the taxable year.

(2) Eligible property. For purposes of this paragraph (c), eligible property has the

same meaning as in paragraph (b)(2) of this section.

(3) Modified simplified production method without historic absorption ratio election--(i) General allocation formula--(A) In general. Except as otherwise provided in paragraph (c)(3)(iv) of this section, a taxpayer may compute the total additional section 263A costs allocable to eligible property remaining on hand at the close of the taxable year under the modified simplified production method as follows:

Allocable preproduction additional section 263A costs + Allocable production additional section 263A costs.

(B) Allocable preproduction additional section 263A costs. The amount of preproduction additional section 263A costs allocable to ending inventory or to other eligible property on hand at the end of the taxable year is computed as follows:

Preproduction absorption ratio x raw material section 471 costs incurred during the taxable year and remaining on hand at year end.

(C) Allocable production additional section 263A costs. The amount of production additional section 263A costs allocable to ending inventory or to other eligible property on hand at the end of the taxable year is computed as follows:

Production absorption ratio x production section 471 costs incurred during the taxable year and remaining on hand at year end.

(D) Effect of allocation. The allocable preproduction additional section 263A costs and the allocable production additional section 263A costs are totaled to compute the additional section 263A costs, which are added to the taxpayer's ending section 471

costs to determine the total section 263A costs that are capitalized. See, however, paragraph (c)(3)(iii) of this section for special rules for LIFO taxpayers. Except as otherwise provided in this section or in §1.263A-1 or §1.263A-3, additional section 263A costs that are allocated to inventories on hand at the close of the taxable year under the modified simplified production method are treated as inventory costs for all purposes of the Internal Revenue Code.

(E) Treatment of mixed service costs. A taxpayer must apportion capitalizable mixed service costs (the aggregate portion of mixed service costs that are properly allocable to the taxpayer's production or resale activities as additional section 263A costs) between preproduction additional section 263A costs described in paragraph (c)(3)(ii)(A)(2) of this section and production additional section 263A costs described in paragraph (c)(3)(ii)(B)(2) of this section. Under the modified simplified production method, a taxpayer must allocate capitalizable mixed service costs to preproduction additional section 263A costs in proportion to the raw material costs in total section 471 costs. The taxpayer must include the capitalizable mixed service costs that are not allocated to preproduction additional section 263A costs in production additional section 263A costs.

(ii) Definitions--(A) Preproduction absorption ratio--(1) In general. Under the modified simplified production method, the preproduction absorption ratio is determined as follows:

Preproduction additional section 263A costs
Raw material costs

(2) Preproduction additional section 263A costs. Preproduction additional section 263A costs are the sum of the additional section 263A costs (as defined in §1.263A-1(d)(3)) incurred during the current taxable year that are described in paragraph (a)(3)(ii) of this section to the extent the costs are not treated as section 471 costs and the allocable portion of capitalizable mixed service costs as described in paragraph (c)(3)(i)(E) of this section.

(3) Raw material costs. Raw material costs are defined as the direct costs of acquiring raw materials that a taxpayer purchases during its current taxable year. Raw material section 471 costs incurred during the taxable year and remaining on hand at year end include the raw material costs in work-in-process and finished goods as well as unprocessed raw materials.

(B) Production absorption ratio--(1) In general. Under the modified simplified production method, the production absorption ratio is determined as follows:

Production additional section 263A costs
Production section 471 costs

(2) Production additional section 263A costs. Production additional section 263A costs are the sum of all additional section 263A costs (as defined in §1.263A-1(d)(3)) incurred during the current taxable year that are not preproduction additional section 263A costs as described in this section and the allocable portion of capitalizable mixed service costs as described in paragraph (c)(3)(i)(E) of this section. For example, production additional section 263A costs include the additional section 263A costs that

constitute post-production costs as defined in paragraph (a)(3)(iii) of this section.

(3) Production section 471 costs. Production section 471 costs are defined as the total section 471 costs that a taxpayer incurs during its current taxable year less the taxpayer's raw material costs.

(iii) LIFO taxpayers electing the modified simplified production method--(A) In general. Under the modified simplified production method, a taxpayer using a LIFO method must calculate a particular year's index (for example, under §1.472-8(e)) without regard to its additional section 263A costs. Similarly, a taxpayer that adjusts current-year costs by applicable indexes to determine whether there has been an inventory increment or decrement in the current year for a particular LIFO pool must disregard the additional section 263A costs in making that determination.

(B) LIFO increment--(1) In general. If a taxpayer determines there has been an inventory increment, the taxpayer must state the amount of the increment in current-year dollars (stated in terms of section 471 costs). The taxpayer then multiplies this amount by the combined absorption ratio, as defined in paragraph (c)(3)(iii)(B)(2) of this section. The resulting product is the additional section 263A costs that must be added to the taxpayer's increment for the year stated in terms of section 471 costs.

(2) Combined absorption ratio defined. For purposes of this paragraph (c)(3)(iii), the numerator of the combined absorption ratio is the total additional section 263A costs allocable to eligible property remaining on hand at the close of the taxable year, as described in paragraph (c)(3)(i)(A) of this section. The denominator of the combined

absorption ratio is the total section 471 costs remaining on hand at year end, as described in paragraph (b)(3)(ii)(B) of this section.

(C) LIFO decrement. If a taxpayer determines there has been an inventory decrement, the taxpayer must state the amount of the decrement in dollars for the particular year for which the LIFO decrement has occurred. The additional section 263A costs incurred in prior years that apply to the decrement are included in cost of goods sold. The taxpayer determines the additional section 263A costs that apply to the decrement by multiplying the additional section 263A costs allocated to the layer of the pool in which the decrement occurred by the ratio of the decrement (excluding additional section 263A costs) to the section 471 costs in the layer of that pool.

(iv) De minimis rule for producers with total indirect costs of \$200,000 or less. Paragraph (b)(3)(iv) of this section, which provides that the additional section 263A costs allocable to eligible property remaining on hand at the close of the taxable year are deemed to be zero for producers with total indirect costs of \$200,000 or less, applies to the modified simplified production method.

(v) Examples. The rules of this paragraph (c)(3) are illustrated by the following examples:

Example 1. FIFO inventory method. (i) Taxpayer P uses the first-in, first-out (FIFO) method of accounting for inventories and a calendar taxable year. P's beginning inventory for 2010 is \$2,500,000, including \$2,000,000 of section 471 costs and \$500,000 of additional section 263A costs.

(ii) During 2010, P incurs \$10,000,000 of section 471 costs, including \$4,000,000 of raw material costs (as defined in paragraph (c)(3)(ii)(A)(3) of this section) and \$6,000,000 of production section 471 costs (as defined in paragraph (c)(3)(ii)(B)(3) of

this section). P also incurs \$1,060,000 of additional section 263A costs, including \$340,000 of preproduction additional section 263A costs (as defined in paragraph (c)(3)(ii)(A)(2) of this section) and \$720,000 of production additional section 263A costs (as defined in paragraph (c)(3)(ii)(B)(2) of this section).

(iii) At the end of 2010, P's section 471 costs incurred during the taxable year remaining in ending inventory are \$3,500,000, including \$2,000,000 of raw materials section 471 costs and \$1,500,000 of production section 471 costs.

(iv) P computes its preproduction absorption ratio for 2010 under paragraph (c)(3)(ii)(A) of this section as follows:

$$\frac{\text{Preproduction additional section 263A costs}}{\text{Raw material costs}} = \frac{\$ 340,000}{\$4,000,000} = 8.5 \text{ percent}$$

(v) P computes its production absorption ratio for 2010 under paragraph (c)(3)(ii)(B)(1) of this section as follows:

$$\frac{\text{Production additional section 263A costs}}{\text{Production section 471 costs}} = \frac{\$ 720,000}{\$6,000,000} = 12 \text{ percent}$$

(vi) Under paragraph (c)(3)(i)(B) of this section, P computes its allocable preproduction additional section 263A costs by multiplying the preproduction absorption ratio by raw materials section 471 costs incurred during the taxable year and remaining in ending inventory (8.5 percent * \$2,000,000 = \$170,000).

(vii) Under paragraph (c)(3)(i)(C) of this section, P computes its allocable production additional section 263A costs by multiplying the production absorption ratio by production section 471 costs incurred during the taxable year and remaining in ending inventory at year end (12 percent * \$1,500,000 = \$180,000).

(viii) Under paragraph (c)(3)(i)(A) of this section, P computes its total additional section 263A costs allocable to ending inventory by adding its allocable preproduction additional section 263A costs to its allocable production additional section 263A costs (\$170,000 + \$180,000 = \$350,000).

(ix) P adds the \$350,000 additional section 263A costs to the \$3,500,000 of section 471 costs remaining in its ending inventory to calculate its total ending inventory of \$3,850,000. P includes the balance of P's additional section 263A costs incurred during 2010, \$710,000 (\$1,060,000 less \$350,000), in P's cost of goods sold.

Example 2. LIFO inventory method. (i) The facts are the same as in Example 1,

except that P uses the LIFO inventory method rather than the FIFO method. P's 2010 LIFO increment is \$1,500,000.

(ii) Under paragraph (c)(3)(iii)(B)(1) of this section, P determines the additional section 263A costs allocable to its 2010 LIFO increment by multiplying the increment by a combined absorption ratio. Under paragraph (c)(3)(iii)(B)(2) of this section, P computes the combined absorption ratio as follows:

Additional section 263A costs allocable to eligible property remaining in ending inventory at the close of 2010	=	$\frac{\$ 350,000}{\$3,500,000}$	=	10 percent
Section 471 costs remaining in ending inventory at the end of 2010				

(iii) P's additional section 263A costs allocable to its 2010 increment are \$150,000 (10 percent * \$1,500,000). Under paragraph (c)(3)(iii)(B)(1) of this section, P adds the \$150,000 additional section 263A costs to its \$1,500,000 LIFO increment to determine a total 2010 LIFO increment of \$1,650,000. P's ending inventory is \$4,150,000 (its beginning inventory of \$2,500,000 plus the \$1,650,000 increment). P includes the remaining \$910,000 (\$1,060,000 less \$150,000) of additional section 263A costs incurred during 2010 in P's cost of goods sold.

Example 3. Mixed service costs. (i) During 2010, Taxpayer R incurs \$200,000 of capitalizable mixed service costs (within the meaning of paragraph (c)(3)(i)(E) of this section). R incurs \$8,000,000 of section 471 costs, including \$2,000,000 of raw material costs (as defined in paragraph (c)(3)(ii)(A)(3) of this section).

(ii) Under paragraph (c)(3)(i)(E) of this section, R allocates its mixed service costs to preproduction additional section 263A costs by computing the proportion of raw material costs in its section 471 costs and multiplying its mixed service costs by this percentage. The proportion of raw material costs in R's section 471 costs is 25 percent (\$2,000,000/\$8,000,000). R allocates \$50,000 (25 percent * \$200,000) of mixed service costs to preproduction additional section 263A costs. R includes the remaining \$150,000 (\$200,000 less \$50,000) of capitalizable mixed service costs as production additional section 263A costs.

(4) Modified simplified production method with historic absorption ratio election--

(i) In general. Except as otherwise provided in this paragraph (c)(4), paragraph (b)(4) of this section applies to the historic absorption ratio election under the modified simplified

production method.

(ii) General allocation formula--(A) In general. Except as provided in paragraph (c)(4)(iii) of this section (relating to LIFO taxpayers), a taxpayer making the historic absorption ratio election under the modified simplified production method uses a preproduction historic absorption ratio and a production historic absorption ratio in place of the actual preproduction absorption ratio and production absorption ratio under paragraph (c)(3)(ii) of this section. The preproduction and production historic absorption ratios are based on costs a taxpayer capitalizes during its test period.

(B) Preproduction historic absorption ratio. The preproduction historic absorption ratio is computed as follows:

Preproduction additional section 263A costs incurred during the test period
Raw material costs incurred during the test period

(C) Production historic absorption ratio. The production historic absorption ratio is computed as follows:

Production additional section 263A costs incurred during the test period
Production section 471 costs incurred during the test period

(iii) LIFO taxpayers making the historic absorption ratio election--(A) In general. Instead of the combined absorption ratio under paragraph (c)(3)(iii)(B)(2) of this section, a LIFO taxpayer making the historic absorption ratio election under the modified simplified production method calculates a combined historic absorption ratio based on costs a taxpayer capitalizes during its test period.

(B) Combined historic absorption ratio. The combined historic absorption ratio is

computed as follows:

Total allocable additional section 263A costs incurred during the test period
 Total section 471 costs remaining on hand at each year end of the test period

(C) Total allocable additional section 263A costs incurred during the test period.

Total allocable additional section 263A costs incurred during the test period are the sum of the total additional section 263A costs allocable to eligible property on hand at year end as described in paragraph (c)(3)(i)(A) of this section, for all years in the test period.

(D) Total section 471 costs remaining on hand at each year end of the test period. Total section 471 costs remaining on hand at each year end of the test period are the sum of the total section 471 costs remaining on hand at year end described in paragraph (b)(3)(ii)(B) of this section, for all taxable years in the test period.

(iv) Extension of qualifying period. In the first taxable year following the close of each qualifying period (for example, the sixth taxable year following the test period), a taxpayer must compute the actual absorption ratios under paragraph (c)(3) of this section (preproduction and production absorption ratios or, for LIFO taxpayers, the combined absorption ratio). If the actual combined absorption ratio or both the actual preproduction and production absorption ratios, as applicable, computed for this taxable year (the recomputation year) is within one-half of one percentage point (plus or minus) of the corresponding historic absorption ratio or ratios used in determining capitalizable costs for the qualifying period (the previous five taxable years), the qualifying period is extended to include the recomputation year and the following five taxable years, and the taxpayer must continue to use the historic absorption ratio or ratios throughout the

extended qualifying period. If, however, the actual combined historic absorption ratio or either the actual preproduction absorption ratio or production absorption ratio, as applicable, is not within one-half of one percentage point (plus or minus) of the corresponding historic absorption ratio, the taxpayer must use the actual absorption ratio or ratios beginning with the recomputation year and throughout the updated test period. The taxpayer must resume using the historic absorption ratio or ratios based on the updated test period in the third taxable year following the recomputation year.

(v) Transition rule. [Reserved].

(vi) Examples. The provisions of this paragraph (c)(4) are illustrated by the following examples:

Example 1. FIFO inventory method. (i) Taxpayer S uses the FIFO method of accounting for inventories and a calendar taxable year, and in 2010 elects to use the modified simplified production method. In 2013, S makes the historic absorption ratio election. S identifies the following costs incurred during the test period:

	2010	2011	2012
Preproduction additional section 263A costs	\$ 100	\$ 200	\$ 300
Production additional section 263A costs	200	350	450
Raw material costs	2,000	2,500	3,000
Production section 471 costs	2,500	3,500	4,000

In 2013, S incurs \$10,000 of section 471 costs of which \$1,000 raw material costs and \$2,000 production 471 costs remain in ending inventory.

(ii) Under paragraph (c)(4)(ii)(B) of this section, in 2013 S computes the preproduction historic absorption ratio as follows:

$$\frac{\text{Preproduction additional section 263A costs}}{\text{Raw material costs}} = \frac{\$ 100 + 200 + 300}{\$2,000 + 2,500 + 3,000} = \frac{600}{7,500} = 8 \text{ percent}$$

(iii) Under paragraph (c)(4)(ii)(C) of this section, S computes the production

historic absorption ratio as follows:

$$\frac{\text{Production additional section 263A costs}}{\text{Production 471 costs}} = \frac{\$ 200 + 350 + 450}{\$2,500 + 3,500 + 4,000} = \frac{1,000}{10,000} = 10 \text{ percent}$$

(iv) Under paragraph (c)(4)(ii)(A) of this section, S determines the preproduction additional section 263A costs allocable to its ending inventory for 2013 by multiplying its raw materials section 471 costs incurred during the 2013 taxable year and remaining in its ending inventory by its preproduction historic absorption ratio. S allocates \$80 preproduction additional section 263A costs to its ending inventory (\$1,000 * 8 percent).

(v) S determines the production additional section 263A costs allocable to its ending inventory for 2013 by multiplying its production section 471 costs incurred during the 2013 taxable year and remaining in its ending inventory by its production historic absorption ratio. S allocates \$200 production additional section 263A costs to its ending inventory (\$2,000 * 10 percent).

(vi) Under paragraph (c)(4)(ii) of this section, S's total additional section 263A costs allocable to ending inventory in 2013 are \$280, which is the sum of the allocable preproduction additional section 263A costs (\$80) and the allocable production additional section 263A costs (\$200). S's ending inventory in 2013 is \$3,280, which is the sum of S's additional section 263A costs allocable to ending inventory and S's section 471 costs remaining in ending inventory (\$280 + \$3,000). S includes the balance of S's additional section 263A costs incurred during 2013 in S's cost of goods sold.

Example 2. LIFO inventory method. (i) The facts are the same as in Example 1, except that S uses the LIFO inventory method rather than the FIFO method. S calculates additional section 263A costs incurred during the taxable year and allocable to ending inventory under paragraph (c)(3)(iii) of this section and identifies the following costs incurred during the test period:

	2010	2011	2012
Additional section 263A costs incurred during the taxable year allocable to ending inventory	\$ 100	\$ 150	\$ 200
Section 471 costs incurred during the taxable year that remain in ending inventory	1,000	1,400	2,100

In 2013, the LIFO value of S's increment is \$1,500.

(ii) Under paragraph (c)(4)(iii) of this section, S computes a combined historic

absorption ratio as follows:

Additional section 263A costs incurred during each taxable year in the test period allocable <u>to ending inventory</u>	=	$\frac{\$ 100 + 150 + 200}{\$1,000 + 1,400 + 2,100} = \frac{\$ 450}{\$4,500}$	= 10 percent
Section 471 costs incurred during each taxable year in the test period that remain in ending inventory			

(iii) S's additional section 263A costs allocable to its 2013 LIFO increment is \$150 (\$1,500 beginning LIFO increment * 10 percent combined historic absorption ratio). S adds the \$150 to the \$1,500 LIFO increment to determine a total 2013 LIFO increment of \$1,650.

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(g) Effective/applicability date. Paragraphs (b)(2)(i)(D), and (f) of this section apply for taxable years ending on or after August 2, 2005. Paragraph (c) of this section applies for taxable years ending on or after the date these regulations are published as final regulations in the **Federal Register**.

Steven T. Miller

Deputy Commissioner for Services and Enforcement.

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