DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9843]

RIN 1545-BG07

Allocation of Costs Under the Simplified Methods

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations on allocating costs to certain property produced or acquired for resale by a taxpayer. These final regulations: provide rules for the treatment of negative adjustments related to certain costs required to be capitalized to property produced or acquired for resale; provide a new simplified method of accounting for determining the additional costs allocable to property produced or acquired for resale; and redefine how certain types of costs are categorized for purposes of the simplified methods. These final regulations affect taxpayers that are producers or resellers of property that are required to capitalize costs to the property and that elect to allocate costs using a simplified method.

DATES: Effective Date: These regulations are effective on [INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER].

Applicability Date: For date of applicability, see §§1.263A-1(l)(5) and 1.263A-2(g)(3).
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SUPPLEMENTARY INFORMATION:

Background

This document contains final regulations that amend the Income Tax Regulations (26 CFR part 1) relating to allocation of costs to certain property produced or acquired for resale 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 produced by the taxpayer, and (2) real and personal property described in section 1221(a)(1) acquired for resale by the taxpayer. The costs that a taxpayer must capitalize under section 263A are its section 471 costs, additional section 263A costs, and interest capitalizable under section 263A(f). Section 263A generally requires taxpayers to allocate capitalizable section 263A costs to specific items of property produced or acquired for resale. However, section 263A(j) instructs the Secretary to prescribe regulations that may be necessary or appropriate to carry out the purposes of section 263A, including regulations providing simplified procedures. Accordingly, §1.263A-1(f)(1) allows taxpayers to use the simplified methods provided in §1.263A-2(b) (the simplified production method (SPM)) or §1.263A-3(d) (the simplified resale method (SRM)) to allocate a lump sum of additional section 263A costs properly allocable to property produced or acquired for resale to property that is on hand at the end of the taxable year, in lieu of allocating costs to specific items of property. Some taxpayers
using the SPM or SRM include a negative adjustment in additional section 263A costs when the 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. Notice 2007–29 (2007-14 IRB 881) provides that, pending the issuance of additional published guidance, the IRS generally will not challenge the inclusion of negative adjustments in computing additional costs under section 263A or the permissibility of aggregate negative additional section 263A costs.

On September 5, 2012, the Treasury Department and the IRS published in the Federal Register (77 FR 54482) a notice of proposed rulemaking (REG-126770-06, 2012-38 IRB 347) under section 263A (the proposed regulations) relating to the inclusion of negative adjustments in additional section 263A costs under the simplified methods. The proposed regulations also provided a new simplified method of accounting, the modified simplified production method (MSPM), for determining the additional section 263A costs allocable to property produced or acquired for resale, and redefined how certain types of costs are categorized for purposes of the simplified methods. Two comments responding to the proposed regulations were received and a public hearing was held on January 7, 2013. After consideration of the comments received, these final regulations adopt the proposed regulations as revised by this Treasury decision.

**Summary of Comments and Explanation of Provisions**

1. General Prohibition on Negative Adjustments in Additional Section 263A Costs

   The proposed regulations generally provided that taxpayers could not include negative adjustments in additional section 263A costs to remove section 471 costs,
unless the taxpayers used: (1) the SPM and had average annual gross receipts of $10,000,000 or less; (2) the SRM; or (3) the MSPM.

Both commenters stated that the proposed regulations’ prohibition on including negative adjustments in additional section 263A costs for taxpayers using the SPM (and above the gross receipts threshold) was unfair to taxpayers unable or unwilling to use the MSPM. One commenter suggested that taxpayers using the SPM are at a disadvantage compared to taxpayers using the MSPM, because the SPM overcapitalizes additional section 263A costs to the raw material content of ending inventory. Another commenter stated that the proposed regulations’ prohibition on including negative adjustments in additional section 263A costs under the SPM unduly punished taxpayers that were unable to use the MSPM by requiring those taxpayers to calculate the amount of deductible section 471 costs that should be excluded from ending inventory. This commenter also suggested that only a small number of taxpayers have the resources to determine these costs.

The Treasury Department and the IRS do not adopt these comments because including negative adjustments in additional section 263A costs under the SPM may result in significant distortions of the amount of additional section 263A costs and section 471 costs allocated to ending inventory. However, these final regulations include several changes to address these comments and reduce compliance costs, burden, and administrative complexity. Generally, including negative adjustments in additional section 263A costs results in distortions because the method used to capitalize the section 471 cost is different than the method used 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 whether the cost was 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. Accordingly, the general restriction on the inclusion of negative adjustments in additional section 263A costs provided in the proposed regulations remains unchanged in these final regulations.

In order to limit potential distortion in the simplified methods, these final regulations also provide a new consistency requirement for taxpayers that are permitted to include negative adjustments in additional section 263A costs to remove section 471 costs and that include negative adjustments to remove section 471 costs. The rule provides that such taxpayer must use this method of accounting for all section 471 costs that are permitted to be removed using negative adjustments.

In addition, these final regulations clarify that certain business expenses described in section 162(c), (e), (f), and (g), including bribes, lobbying expenses, and fines and penalties, cannot be removed from a taxpayer’s section 471 costs as negative adjustments in additional section 263A costs. This clarification is consistent with §1.471-3(f), which provides that certain of these expenses are not permitted to be included in the cost of inventories.

2. Classification of Costs

One commenter stated that it was unclear how negative adjustments in additional section 263A costs are measured (for example, in the case of depreciation, at the individual asset level or using total depreciation expense). These final regulations provide that section 471 costs, additional section 263A costs, and any adjustments to section 471 costs or additional section 263A costs are classified using the narrower of
(1) the classifications of costs used by the taxpayer in its financial statement or (2) the classifications of costs in §1.263A-1(e)(2), (3), and (4). If a cost is not described within §1.263A-1(e)(2), (3), or (4), the cost is classified using the classification of costs used in the taxpayer’s financial statement.

3. **Modified Simplified Production Method**

   The proposed regulations provided a new simplified method, the MSPM, to reduce distortions that may result from the SPM. The MSPM in the proposed regulations reduced distortions by more precisely allocating additional section 263A costs, including negative adjustments, among raw materials, work-in-process, and finished goods inventories on hand at year end. Generally, taxpayers would have determined the allocable portion of pre-production additional section 263A costs using a pre-production absorption ratio of pre-production additional section 263A costs incurred during the taxable year over raw materials costs incurred during the taxable year. This ratio would have applied to raw material section 471 costs incurred during the taxable year and remaining on hand at year end (including unprocessed raw materials, and raw materials integrated into work-in-process and finished goods). Similarly, under the MSPM in the proposed regulations, taxpayers would have determined the allocable portion of all other additional section 263A costs using a production absorption ratio of production additional section 263A costs incurred during the taxable year over production section 471 costs incurred during the taxable year. This ratio would have applied to production section 471 costs incurred during the taxable year and remaining on hand at year end (excluding raw materials integrated into work-in-process and finished goods).
Both commenters stated that some taxpayers could not readily identify raw materials that are integrated into work-in-process and finished goods inventories on hand at year end. The commenters asserted that those taxpayers would have to modify their books and records or purchase a new computer system to track these raw materials. Both commenters stated that this requirement would place an unfair burden on taxpayers, especially smaller taxpayers. One commenter suggested that the final regulations clarify that a taxpayer may use any reasonable method to estimate the raw material component of work-in-process and finished goods inventories on hand at year end.

First, to reduce the number of defined terms and to be consistent with the use of that term in §1.263A-1(e)(2)(i)(A), these final regulations use the term “direct material costs” rather than “raw material costs,” as used in the proposed regulations.

Second, the Treasury Department and the IRS understand that some taxpayers may not be able to readily identify direct material costs in work-in-process and finished goods inventories on hand at year end. Accordingly, these final regulations modify the MSPM so that taxpayers using the MSPM are not required to separately track direct material costs that are integrated into work-in-process and finished goods inventories. Specifically, these final regulations modify the MSPM by: (1) applying the pre-production absorption ratio to only unprocessed direct material section 471 costs incurred during the taxable year and remaining on hand at year end; (2) applying the production absorption ratio to all production section 471 costs incurred during the taxable year and remaining on hand at year end, which includes direct material costs that have entered or completed production; (3) including the pre-production additional
section 263A costs that are not allocated by the pre-production absorption ratio in the numerator of the production absorption ratio; and (4) including the direct material costs that have entered or completed production in the denominator of the production absorption ratio. These modifications to the proposed MSPM reduce compliance costs, burden, and administrative complexity by eliminating the need to separately track direct material costs in work-in-process and finished goods inventories on hand at year end.

One commenter stated that the production absorption ratio under the MSPM in the proposed regulations was distortive because it included post-production additional section 263A costs (for example, storage and handling allocable to finished goods). This commenter suggested the MSPM include a third ratio to allocate post-production additional section 263A costs to finished goods inventories. This suggestion is not adopted in the final regulations because including a third ratio to allocate post-production additional 263A costs adds a degree of complexity to the MSPM that outweighs the benefit of the additional precision it might provide.

4. Allocation of Mixed Service Costs Under the MSPM

The proposed regulations provided that taxpayers must allocate capitalizable mixed service costs to pre-production additional section 263A costs in proportion to the raw material costs in total section 471 costs, with the remaining amount of capitalizable mixed service costs allocated to production additional section 263A costs. The proposed regulations also specifically requested comments on how mixed service costs should be allocated between raw materials, work-in-process, and finished goods under the MSPM.

Both commenters stated that generally raw materials do not attract a large
amount of mixed service costs, except for a limited amount of labor-related purchasing costs. The commenters stated that the proposed regulations’ allocation of capitalizable mixed service costs between pre-production and production additional section 263A costs resulted in a disproportionate allocation of mixed service costs to pre-production additional section 263A costs. One commenter suggested that the final regulations allow taxpayers to allocate capitalizable mixed service costs between pre-production and production additional section 263A costs using any reasonable method and provided an example of a labor-based allocation method to allocate mixed service costs.

In response to the comments, these final regulations expand the types of methods permitted under the MSPM to allocate mixed service costs between pre-production and production additional section 263A costs. These regulations provide that a taxpayer using the MSPM that capitalizes mixed service costs using the simplified service cost method under §1.263A-1(h) may allocate capitalizable mixed service costs to pre-production additional section 263A costs based on unprocessed direct material costs in section 471 costs or, alternatively, based on pre-production labor costs in total labor costs. Additionally, if a taxpayer using the MSPM determines its capitalizable mixed service costs using a method described in §1.263A-1(g)(4) (a direct reallocation method, a step-allocation method, or any other reasonable allocation method), the taxpayer must use a reasonable method to allocate the costs (for example, department or activity costs) between pre-production and production additional section 263A costs, unless the taxpayer’s departments or activities are identified as exclusively pre-production or production. For example, it may be reasonable for a taxpayer using a
method described in §1.263A-1(g)(4) to allocate a department’s mixed service costs between pre-production and production additional section 263A costs based on labor associated with the department when the department is not exclusively identified as pre-production or production. If a taxpayer that determines its capitalizable mixed service costs using a method described in §1.263A-1(g)(4) has departments or activities that are identified as exclusively pre-production or production, the department or activity costs must be allocated to pre-production or production additional section 263A costs according to the department’s or activity’s identification.

One commenter stated that the proposed regulations would unnecessarily require taxpayers that do not have any additional section 263A costs that relate to raw material costs to compute a pre-production absorption ratio. The commenter suggested allocating capitalizable mixed service costs between pre-production and production additional section 263A costs based on the relative proportion of additional section 263A costs in each category that are incurred by the taxpayer. These final regulations do not adopt this suggestion because the relative amount of pre-production and production additional section 263A costs reflect the amount of capitalizable tax costs in excess of the costs capitalized for financial statement purposes but do not accurately reflect the amount of mixed service costs allocable to pre-production and production activities. However, in response to this comment and to reduce compliance costs and burden, these final regulations include a de minimis rule that allows taxpayers using the MSPM to allocate 100 percent of capitalizable mixed service costs to pre-production or production additional section 263A costs if 90 percent or more of the mixed service costs would otherwise be allocated to that amount.
5. Property Produced for the Taxpayer Under a Contract and Property Acquired for Resale

The proposed regulations did not provide explicit rules for the treatment of costs related to property produced for the taxpayer under a contract with another party that is treated as property produced by the taxpayer, as described in §1.263A-2(a)(1)(ii)(B) (property produced under a contract), and property acquired for resale under the MSPM.

One commenter suggested that all costs related to property produced under a contract and property acquired for resale should be included in the pre-production absorption ratio under the MSPM. The Treasury Department and the IRS agree that generally costs related to property produced under a contract and property acquired for resale are best treated as pre-production costs because costs related to such property are primarily purchasing, storage, and handling costs, which are the costs frequently attributable to property that has not entered production. Accordingly, these final regulations adopt this suggestion and provide that additional section 263A costs properly allocable to property produced under a contract and property acquired for resale are generally included in pre-production additional section 263A costs under the MSPM. Similarly, section 471 costs for property produced under a contract and property acquired for resale are generally included in pre-production section 471 costs under the MSPM.

One commenter also suggested that the final regulations clarify the treatment of costs related to property produced under a contract when the property is used in an additional production activity of the taxpayer. These final regulations adopt this
suggestion and clarify that for purposes of the MSPM, direct material costs include property produced under a contract that are direct material costs for the taxpayer to be used in an additional production process of the taxpayer. These costs are included in pre-production section 471 costs.

6. **Last-In, First-Out (LIFO) Method Taxpayers Using the MSPM**

The proposed regulations provided that LIFO method taxpayers using the MSPM must multiply an inventory increment by a combined absorption ratio to determine the amount of additional section 263A costs that must be added to the taxpayers’ increment for the year. The proposed regulations defined the numerator of the combined absorption ratio as total additional section 263A costs allocable to eligible property remaining on hand at year end and the denominator as the total section 471 costs remaining on hand at year end. The proposed regulations also specifically requested comments on how the MSPM should apply to taxpayers using the LIFO method.

One commenter suggested that LIFO-method taxpayers should be allowed to use the same two absorption ratios as taxpayers using the first-in, first-out (FIFO) method of accounting for inventories, rather than a combined absorption ratio, to determine the amount of additional section 263A costs that must be added to the inventory increment for the year. This suggestion is not adopted because it would require LIFO-method taxpayers to divide their inventory increments and decrements into raw material and production components, which would add unnecessary complexity and administrability challenges to the LIFO method and the MSPM.

One commenter suggested that LIFO-method taxpayers should be allowed to choose between annual absorption ratios and shorter-term ratios, and base the shorter-
term ratios on the taxpayer’s method of determining the current-year cost of the items in ending inventory and the value of any inventory increments. This suggestion is not adopted because it ignores the fact that indirect costs are frequently incurred outside of the period used for determining current-year cost, and use of a shorter-term ratio could cause distortions.

One commenter suggested that the final regulations provide special rules for taxpayers that have elected to apply the LIFO method only to raw materials, including raw materials that have entered or completed the production process (the raw material content LIFO method). Specifically, the commenter suggested that final regulations provide that the combined absorption ratio should be applied to any LIFO increment of a taxpayer using the raw material content LIFO method with the pre-production and production absorption ratios applied separately to non-LIFO inventory. The Treasury Department and the IRS agree that the combined, pre-production, and production absorption ratios could all apply in the case of a taxpayer using the raw material content LIFO method and believe this point is sufficiently clear in these final regulations.

One commenter stated that the definition of the combined absorption ratio was ambiguous because it did not indicate whether the combined absorption ratio was determined on a LIFO basis. The Treasury Department and the IRS intended that the combined absorption ratio be determined on a non-LIFO basis; accordingly, this point is clarified in these final regulations.

7. Definition of Section 471 Costs

The proposed regulations provided one definition of section 471 costs that applied to taxpayers using the SRM, SPM, or MSPM, regardless of whether those
taxpayers were in existence before the effective date of section 263A. The proposed regulations generally provided that a taxpayer’s section 471 costs were the costs, other than interest, that the taxpayer capitalized to its inventory or other eligible property in its financial statements. The proposed regulations also provided, consistent with the IRS’s established administrative practice, that taxpayers must include all direct costs in section 471 costs regardless of the treatment of the costs in their financial statements.

These final regulations clarify that a taxpayer’s section 471 costs are the types of costs capitalized to property produced or property acquired for resale in the taxpayer’s financial statement. These final regulations also clarify that a taxpayer determines the amounts of its section 471 costs by using the amounts of those costs that are incurred in the taxable year for federal income tax purposes. These final regulations also generally retain the proposed regulations’ requirement that section 471 costs must include all direct costs of property produced and property acquired for resale.

However, the Treasury Department and the IRS understand that maintaining separate financial statement and federal income tax cost accounting systems or adjusting the amounts of costs capitalized using the taxpayer’s financial statement methods for federal income tax purposes can be costly and burdensome. Therefore, these final regulations provide an alternative method that certain taxpayers may use to determine the amounts of their section 471 costs. This alternative method is available to a taxpayer that is permitted to include negative adjustments in additional section 263A costs to remove section 471 costs if that taxpayer’s financial statement is described in §1.263A-1(d)(6)(i), (ii), or (iii) (for example, a financial statement required to be filed with the Securities and Exchange Commission (SEC); a certified audited
financial statement used for a substantial non-tax purpose; or a financial statement (other than a tax return) required to be provided to the government). This method is not available to a taxpayer if the taxpayer’s financial statement is described only in §1.263A-1(d)(6)(iv) (for example, an unaudited financial statement used for a substantial non-tax purpose). The use of this alternative method is limited to taxpayers that have certain financial statements in order to provide adequate safeguards for the use of financial statement amounts in the simplified method formulas. A taxpayer that uses the alternative method determines the amounts of all of its section 471 costs by using the amounts of costs capitalized to property produced or property acquired for resale in the taxpayer’s financial statement using the taxpayer’s financial statement methods of accounting. A taxpayer using the alternative method may not include any financial statement write-downs, reserves, or other financial statement valuation adjustments when determining the amounts of its section 471 costs.

In order to limit potential distortions in the simplified methods’ absorption ratios, these final regulations require a taxpayer that uses the alternative method to consistently apply the method to all of its section 471 costs, including any direct costs required to be included in section 471 costs, any costs used for purposes of applying the de minimis direct costs rules, any costs included in additional section 263A costs after applying the de minimis direct costs rules and the safe harbor rule for certain variances and under or over-applied burdens, and any costs removed from section 471 costs because such costs are not required to be, or are not permitted to be, capitalized under section 263A. In addition, a taxpayer using the alternative method includes in additional section 263A costs all negative adjustments to remove section 471 costs and
all permitted positive and negative book-to-tax adjustments. A taxpayer using the alternative method, and the burden rate or standard cost methods described in §1.263A-1(f)(3), determines the book-to-tax adjustments required to be made as a result of differences in financial statement and tax amounts by comparing the actual amount of the cost incurred in the taxable year for federal income tax purposes to the actual amount of the cost incurred in the taxable year in its financial statement using the taxpayer’s financial statement methods of accounting, regardless of how the taxpayer treats its variances or under or over-applied burdens.

One commenter noted that the proposed regulations do not specify how taxpayers must account for differences between their financial statement methods and the tax methods used to determine the value of ending inventory. These differences include special tax methods, such as the lower of cost or market method and the retail inventory method, as well as special financial statement methods, such as write-downs or reserves for slow-moving goods. The final regulations do not change the current requirement that a taxpayer must value its ending inventory by applying its tax methods of accounting, and provide that a taxpayer using the alternative method to determine the amounts of its section 471 costs may not include any financial statement write-downs, reserves, or other financial statement valuation adjustments when determining the amounts of its section 471 costs.

8. Financial Statement Hierarchy and Record Keeping Requirements for Financial Statements

The proposed regulations did not provide any guidance as to which financial statement a taxpayer uses to determine its section 471 costs. For clarity and
consistency, these final regulations provide that for purposes of section 263A, a taxpayer’s financial statement is its financial statement of the highest priority, in accordance with the list of categories of financial statements, in order of priority, provided in these final regulations. For example, in order to determine its types of section 471 costs, a taxpayer uses the types of costs capitalized in its financial statement with the highest priority within the categories described in these final regulations.

These final regulations do not impose any specific record keeping requirements for a taxpayer’s identification of costs as section 471 or additional section 263A costs, or for a taxpayer’s determination of the amounts of section 471 costs. However, the regulations under section 6001 require a taxpayer to keep books and records sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown in an income tax return, which includes the identification of costs as section 471 or additional section 263A costs and the determination of the amounts of section 471 costs. This requirement also includes any books and records sufficient to establish a taxpayer’s calculation of variances and under or over-applied burdens used for financial statement purposes.

9. De Minimis Exceptions for Certain Direct Costs in Section 471 Costs

a. Direct Labor Costs

As noted previously, the proposed regulations provided, consistent with the IRS’s established administrative practice, that taxpayers must include all direct costs in section 471 costs regardless of the treatment of the costs in their financial statement. Both commenters stated that some taxpayers do not capitalize certain direct labor costs
(for example, holiday pay, sick leave pay, shift differential, and payroll taxes) to inventory for financial statement purposes, and that the proposed regulations’ requirement to include all direct costs in section 471 costs would force these taxpayers to create or purchase and maintain a second inventory costing system for tax purposes only.

These final regulations generally retain the proposed regulations’ requirement that section 471 costs must include all direct costs of property produced and property acquired for resale. However, to reduce compliance costs, burden, and administrative complexity, these final regulations provide a de minimis direct labor costs rule to allow taxpayers using the SRM, SPM, or MSPM to include in additional section 263A costs, and exclude from section 471 costs, certain direct labor costs that are not capitalized to property produced or property acquired for resale in the taxpayer’s financial statement (uncapitalized direct labor costs). However, a taxpayer cannot use this de minimis direct labor costs rule to include in additional section 263A costs basic compensation or overtime or the types of costs included in the taxpayer’s standard cost or burden rate methods used for section 471 costs.

Under this de minimis direct labor costs rule, a taxpayer includes in additional section 263A costs, and excludes from section 471 costs, the total amount of all direct labor costs that are incurred in the taxable year that are uncapitalized direct labor costs, if the total amount of those costs is less than five percent of total direct labor costs incurred in the taxable year (whether or not capitalized for financial statement purposes). The de minimis direct labor costs rule requires that any amounts that constitute a reduction to costs be treated as positive amounts for purposes of
determining whether the taxpayer’s uncapitalized direct labor costs meet the five percent test. For a taxpayer using the alternative method to determine the amounts of its section 471 costs, the five percent test and the amount included in additional section 263A costs are based on the amount of uncapitalized direct labor costs and total direct labor costs that are incurred in the taxable year in the taxpayer’s financial statement using the taxpayer’s financial statement methods of accounting. The alternative-method taxpayer includes in additional section 263A costs any negative or positive adjustment required to be made as a result of differences in financial statement and tax amounts of the taxpayer’s de minimis direct labor costs.

A taxpayer using a historic absorption ratio (HAR) that uses the de minimis direct labor costs rule during its test period or updated test period could treat a particular direct labor cost as an additional section 263A cost in one year of the test period or updated test period, and as a section 471 cost in a different year of the test period or updated test period. The de minimis direct labor costs rule provides a special rule that requires this taxpayer to use the SRM, SPM, or MSPM and HAR during the qualifying period or extended qualifying period in a manner that is most consistent with the treatment of the direct labor costs during the test period or updated test period. Under this rule, the taxpayer determines whether direct labor costs are included in any of its section 471 costs remaining on hand at year end during its qualifying period or extended qualifying period consistent with how those direct labor costs were classified in at least two of the three years of the taxpayer’s applicable test period or updated test period.

b. Direct Material Costs

The preamble to the proposed regulations stated that the proposed regulations
generally prohibited treating cash or trade discounts as negative adjustments in additional section 263A costs under any of the simplified methods. The proposed regulations expressly prohibited treating cash or trade discounts as negative adjustments in additional section 263A costs under the MSPM and the SRM, inadvertently omitting taxpayers using the SPM from the prohibition. The operative rule in the proposed regulations also specifically requested comments on reasonable methods of allocating cash or trade discounts that taxpayers do not capitalize for financial statement purposes between ending inventory and cost of goods sold. In addition, the Treasury Department and the IRS are aware that some taxpayers do not capitalize for financial statement purposes certain direct material costs (for example, transportation and other necessary charges incurred to acquire possession of goods).

One commenter stated that the proposed regulations' treatment of cash and trade discounts would impose an administrative burden on taxpayers that do not treat any or all of their cash and trade discounts as negative purchase or production costs for financial statement purposes. The commenter suggested that, if the final regulations preclude a taxpayer from treating cash and trade discounts as negative additional section 263A costs, then taxpayers should be allowed to allocate cash and trade discounts between ending inventory and costs of goods sold using some type of averaging convention.

In general, cash and trade discounts related to section 471 costs, and transportation and other necessary charges incurred to acquire possession of goods, are treated as adjustments to the underlying section 471 costs, and cannot be included as a negative adjustment in additional section 263A costs. However, to reduce
compliance costs, burden, and administrative complexity, these final regulations provide a de minimis direct material costs rule to allow taxpayers using the SRM, SPM, or MSPM to include in additional section 263A costs, and exclude from section 471 costs, certain direct material costs that are uncapitalized financial statement costs. This de minimis direct material costs rule can be used for certain direct material costs that are not capitalized to property produced or property acquired for resale in a taxpayer’s financial statement (uncapitalized direct material costs) such as cash discounts, trade discounts, and freight-in costs. However, a taxpayer cannot use this de minimis direct material costs rule to include in additional section 263A costs the types of costs that are included in the taxpayer’s standard cost method used for section 471 costs (including cash and trade discounts).

Under this de minimis direct material costs rule, a taxpayer includes in additional section 263A costs, and excludes from section 471 costs, the total amount of all direct material costs incurred in the taxable year that are uncapitalized direct material costs, if the amount of those costs in total comprise less than five percent of total direct material costs incurred in the taxable year (whether or not capitalized for financial statement purposes). The de minimis direct material costs rule requires that any amounts that constitute a reduction to costs, such as cash and trade discounts, be treated as positive amounts for purposes of determining whether the taxpayer’s uncapitalized direct material costs meet the five percent test. The de minimis direct material costs rule operates similarly to the de minimis direct labor costs rule for an alternative method taxpayer, and for a taxpayer using a HAR. Because any direct material costs included in additional section 263A costs after applying the de minimis direct material costs rule
are excluded from section 471 costs, such direct material costs are not treated as section 471 costs for any purpose, including as section 471 costs that are direct material costs in the modified simplified production method formula.

10. Variances and Under- or Over-Applied burdens

Both commenters stated that some taxpayers do not capitalize certain variances related to direct costs to inventory for financial statement purposes, and that the proposed regulations’ requirement to include all direct costs in section 471 costs would force these taxpayers to create or purchase and maintain a second inventory costing system for tax purposes only. The IRS’s established administrative practice requires taxpayers to treat positive and negative cost variances and under or over-applied burden amounts related to direct and indirect section 471 costs as adjustments to the underlying section 471 costs. However, to reduce compliance costs, burden, and administrative complexity, these final regulations provide a safe harbor rule for taxpayers using the SRM, SPM, or MSPM to include in additional section 263A costs, and exclude from section 471 costs, certain variances and under or over-applied burdens that are not capitalized to property produced or property acquired for resale in the taxpayer’s financial statement (uncapitalized variances or uncapitalized under or over-applied burdens).

Under this safe harbor rule, a taxpayer includes in additional section 263A costs, and excludes from section 471 costs, the sum of the amounts of all of those uncapitalized variances and uncapitalized under or over-applied burdens for that taxable year, if such sum is less than five percent of the taxpayer’s total section 471 costs for all items for which the taxpayer uses a standard cost or burden rate method to
allocate costs. For purposes of this rule, total section 471 costs for all items for which the taxpayer uses a standard cost or burden rate method to allocate costs are computed before application of the safe harbor method, and must reflect the actual amounts incurred by the taxpayer on these items, which therefore include variances and under or over-applied burdens. If the sum of the amounts of all of those uncapitalized variances and uncapitalized under or over-applied burdens in a taxable year are not less than five percent for the taxable year, the taxpayer must reallocate such uncapitalized amounts to or among units of property as required by §1.263A-1(f)(3)(i)(C) or (f)(3)(ii)(B), respectively.

Under this safe harbor rule, all variances and under or over-applied burdens are treated as positive amounts for purposes of determining whether the taxpayer’s uncapitalized variances and uncapitalized under or over-applied burdens meet this five percent test. Additionally, this safe harbor rule applies to any variances on cash or trade discounts that are included in the taxpayer’s standard cost, if those discounts are capitalized as part of the taxpayer’s standard cost method used for section 471 costs. An eligible taxpayer must consistently apply the safe harbor method to all items for which the taxpayer uses a standard cost or burden rate method to allocate costs. However, the safe harbor rule only applies to a taxpayer’s uncapitalized variances and uncapitalized under or over-applied burdens. In addition, a taxpayer using this safe harbor rule is not permitted to treat uncapitalized variances and uncapitalized under or over-applied burdens that are not significant as not allocable to property produced or property acquired for resale under §1.263A-1(f)(3)(i)(C) and (f)(3)(ii)(B), respectively.

Finally, for taxpayers using either the SRM or MSPM, allocation rules are
provided to help taxpayers allocate these uncapitalized costs between storage and handling costs and current year purchasing costs, in the case of the SRM, and pre-production and production costs, in the case of the MSPM.

11. Smaller Taxpayers Using the SPM

The proposed regulations allowed taxpayers with average annual gross receipts of $10,000,000 or less for the three previous taxable years to include negative adjustments in additional section 263A costs under the SPM.

One commenter stated that average annual gross receipts of $10,000,000 or less does not accurately represent a “small taxpayer.” The commenter suggested using the average aggregate value of ending inventory, rather than gross receipts, to identify this group of taxpayers. Both commenters also stated that small taxpayers would have difficulty complying with the MSPM.

The Treasury Department and the IRS do not believe that an average aggregated ending inventory value accurately identifies smaller taxpayers because inventory value can fluctuate greatly within the taxable year, or from year to year. Accordingly, this suggestion is not adopted. However, to reduce compliance costs and burden for smaller taxpayers using the SPM and minimize the difficulty that smaller taxpayers may face complying with the MSPM, these final regulations allow taxpayers with average annual gross receipts of $50,000,000 or less for the three previous taxable years to include negative adjustments in additional section 263A costs under the SPM.

12. Comments Regarding the HAR and the MSPM

The proposed regulations provided that a taxpayer using the MSPM could make the HAR election. Under the proposed regulations, a non-LIFO-method taxpayer using
the MSPM with the HAR election calculates both a pre-production HAR and a production HAR, to be used for each taxable year within a qualifying period (in place of the actual pre-production absorption ratio and actual production absorption ratio). In the first taxable year following the close of a qualifying period—the recomputation year—if the taxpayer's actual pre-production absorption ratio or actual production absorption ratio is not within one-half of one percentage point (plus or minus) of the corresponding HAR, the taxpayer must use actual absorption ratios during an updated test period, and the qualifying period is not extended. A LIFO-method taxpayer using the MSPM with the HAR election, however, calculates a combined HAR to be used for each taxable year within a qualifying period (in place of the actual combined absorption ratio). In the recomputation year, if the LIFO-method taxpayer's actual combined absorption ratio is not within one-half of one percentage point (plus or minus) of the combined HAR, the taxpayer must use an actual combined absorption ratio during an updated test period, and the qualifying period is not extended.

One commenter suggested that the rules for determining whether a qualifying period is extended for LIFO taxpayers should also apply to non-LIFO-method taxpayers, and therefore, in the recomputation year, all taxpayers should use a combined HAR to compare to an actual combined absorption ratio. This suggestion is not adopted because calculating combined absorption ratios does not match the ratios required to be calculated by a non-LIFO-method taxpayer using the MSPM. A non-LIFO-method taxpayer using the MSPM is required to calculate separate absorption ratios, even when using the HAR.

The proposed regulations also specifically requested comments on transition
rules for taxpayers currently using the SPM with the HAR election that change to the
MSM, including comments on how the regulations should apply to taxpayers within a
qualifying period as described in §1.263A-2(b)(4)(ii)(C). One commenter suggested
allowing taxpayers currently using the HAR that are changing to the MSM with the
HAR election to open a new test period. Additionally, one commenter suggested that
taxpayers be permitted to make the change using a section 481(a) adjustment instead
of a cut-off method.

Except as otherwise expressly provided by the Code or the regulations
thereunder, section 446(e) and §1.446-1(e)(2) require a taxpayer to secure the consent
of the Commissioner before changing a method of accounting for federal income tax
purposes. Section 1.446-1(e)(3)(ii) authorizes the Commissioner to prescribe
administrative procedures setting forth the terms and conditions necessary for a
taxpayer to obtain consent to a change in method of accounting. Revenue Procedure
1067, as modified by Rev. Proc. 2016-1, 2016-1 IRB 1, and as modified by Rev. Proc.
2017-59, 2017-48 IRB 543, provides the general procedures by which a taxpayer may
obtain automatic consent of the Commissioner to a change in method of accounting
reduce filing requirements, waive user fees, and extend filing deadlines normally
associated with a request for change in method of accounting.

Simultaneously with the publication of these final regulations, the Treasury
Department and the IRS are issuing Revenue Procedure 2018-56 (2018-50 IRB) to
modify Rev. Proc. 2018-31 and provide the procedures by which a taxpayer may obtain
automatic consent to make certain method changes to conform to these final regulations, such as a change to the MSPM by a taxpayer using the HAR.

13. **Procedural Requirements for Changing Section 471 Costs or Changing to the MSPM**

   The proposed regulations did not provide procedural rules for taxpayers changing to comply with the final regulations. One commenter suggested that the automatic change procedures apply or that procedures be implemented allowing the change to be made on an expedited basis.

   Simultaneously with the publication of these final regulations, the Treasury Department and the IRS are issuing Revenue Procedure 2018-56 to modify Rev. Proc. 2018-31 and provide the procedures by which a taxpayer may obtain automatic consent to make certain method changes to conform to these final regulations, such as a change to comply with the new definition of section 471 costs or a change to the MSPM.

**Effective Date**

These final regulations are generally effective as of **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]** and apply for taxable years beginning on or after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. For any taxable year that both begins before **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]** and ends after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**, the IRS will not challenge return positions consistent with all of these final regulations.

**Special Analyses**

Regulatory Planning and Review – Economic Analysis
Executive Orders 13563 and 12866 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, reducing costs, of harmonizing rules, and of promoting flexibility.

These final regulations have been designated by the Office of Information and Regulatory Affairs (OIRA) as Significant under Executive Order 12866 and section 1(b) of the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget (OMB) regarding review of tax regulations and thereby subject to review under Executive Order 12866. Accordingly, these final regulations have been reviewed by OIRA.

A. Overview

These final regulations provide taxpayers with computational and definitional guidance regarding the application of section 263A under the simplified methods. Specifically, they provide guidance for taxpayers to determine the amount of additional section 263A costs to capitalize and make several changes regarding the application of section 263A under the simplified methods to reduce compliance costs, burden, and administrative complexity. This economic analysis describes the economic benefits and costs of these final regulations.

B. Economic Analysis of the Final Regulations

1. Background

For a discussion of the background of these final regulations, see the
2. Anticipated Benefits and Costs of the Final Regulations

a. Baseline

The Treasury Department and the IRS have assessed the benefits and costs of these final regulations against a status quo baseline that reflects projected tax-related and other behavior in the absence of these final regulations and includes the effect of Notice 2007-29. Notice 2007-29 allows taxpayers to include negative adjustments in computing additional costs under section 263A and allows aggregate negative additional section 263 costs.

b. Anticipated Benefits

The Treasury Department and the IRS expect that the certainty and clarity provided by these final regulations as well as the substantive contribution of the regulations will enhance economic efficiency relative to the baseline.

In developing these final regulations, the Treasury Department and the IRS have generally aimed to apply the principle that an economically efficient tax system would treat income derived from similar economic decisions similarly, to the extent consistent with the Code and considerations of administrability of the tax system.

An economically efficient tax system would generally allow businesses to deduct from income taxes an amount meant to capture the economic cost of their capital investments. Under this principle, rules for capitalization and deductions are most efficient when they most closely mimic true economic depreciation. This conclusion is complicated by a large number of real world factors, including that economic depreciation is endogenous and difficult to measure and that the tax system itself will
affect true depreciation. Furthermore, the principles from which the true-economic-depreciation prescription is derived are themselves based on a “pure” tax system rather than the complex real world tax code. The Treasury Department and the IRS do not anticipate substantial changes to the aggregate cost of goods sold, the aggregate tax bases of other produced assets, or the depreciation deductions that will be generated under the new simplified method, the MSPM, relative to the baseline. Therefore these final regulations should not materially affect aggregate tax revenues or aggregate inventory investment relative to the baseline. There may be some modest increase in investment in inventory. For example, investment in raw materials inventory may increase under these final regulations because the relative tax cost of buying and carrying raw materials under the MSPM is generally less than under the SPM. Treatment of inventory under the simplified methods generally remains the same. Because the tax system requires a periodic determination of inventory, there was and still is, an incentive to minimize inventory as of that date, usually the end of the taxable year. The increased investment in raw materials inventory under the MSPM is due to the fact that inventory as of the determination date may be divided into pre-production and production inventory and a specific rate is applied to estimate overhead for each category. While under the SPM the inventory as of the determination date is not divided and one rate is used to estimate overhead for all inventory. There may also be a modest shifting of investment between different types of inventory because the MSPM should improve the measurement of certain types of final inventory and improved precision would generally lead to small adjustments in inventory amounts. Though no specific types of inventory are treated favorably, the modest shifting of investment is
expected because the reduced carrying cost associated with maintaining raw materials inventory may encourage or allow some taxpayers to carry a larger quantity of raw materials for business purposes.

c. Anticipated Impacts on Administrative and Compliance Costs

The Treasury Department and the IRS expect that the certainty, clarity, and simplifying changes regarding the application of section 263A provided by these final regulations, relative to the baseline, will reduce annual compliance costs, burden, and administrative complexity. Absent these final regulations, different parties would continue to take different positions regarding the inclusion of negative adjustments in computing additional costs under section 263A and the permissibility of aggregate negative additional section 263A costs. More uniform positions by taxpayers will in general reduce the costs of tax administration.

For taxpayers, the major cost savings of these final regulations derive from the reduction in the computational and record-keeping burdens involved with the use of the simplified methods for calculating end-of-year inventory. These burdens are reduced because taxpayers will now generally be able to use their own current financial accounting methods to determine their section 471 costs, albeit using cost amounts determined under tax law. Taxpayers with audited financial statements, or those who file regulatory financial statements, will also be able to use cost amounts determined according to financial accounting rules. In addition, taxpayers using a simplified method will be able to make positive and negative adjustments to their additional section 263A costs in cases where their section 471 costs, determined using financial accounting methods, either do not capitalize all actual costs or over-capitalize those costs. Finally,
taxpayers using the SRM or the MSPM, and smaller taxpayers (those with average gross receipts of $50 million or less) using the SPM will be able to make negative adjustments to their additional section 263A costs in cases where the capitalization of certain costs is either optional or not permitted under the tax law. It is anticipated that larger taxpayers using the SPM who desire such treatment will switch from using the SPM to the MSPM in order to continue to make these negative adjustments.

In addition, absent these final regulations, taxpayers and the IRS would:
(1) continue to be required to use definitions based on a taxpayer’s accounting practices used in 1986; (2) continue to be required to use tax accounting rules, rather than their own financial accounting rules, to determine the allocation of certain capitalized amounts; (3) not be able to use the MSPM to more precisely determine the lump-sum of costs to capitalize; (4) not be able to use the new safe-harbors for direct labor and direct material costs not capitalized on a taxpayer’s financial statements; and (5) not be able to use the de minimis rules for variances and under- or over-applied burden not capitalized on a taxpayer’s financial statements. The changes in each of these directions under the final regulations will generally reduce taxpayer compliance costs.

For example, under these final regulations, one definition of section 471 costs applies to all taxpayers, regardless of when the taxpayer came into existence. Previously, taxpayers in existence when section 263A was enacted were required to use definitions based on their actual tax cost accounting practices as of enactment. However, taxpayers that were not in existence when section 263A was enacted were required to use definitions based on what their tax cost accounting practices would have been as of enactment under the law at that time. Under these final regulations, all taxpayers use
their present financial statement cost accounting practices. Moreover, taxpayers using the simplified resale method or simplified production method will benefit from no longer being required to adjust their section 471 costs incurred during the taxable year to reflect tax adjustments in their respective simplified method formula. Rather, these simplified method taxpayers may use an alternative method that permits them to use their financial statement amounts for their section 471 costs incurred during the taxable year and make tax adjustments to these costs by using negative adjustments to their section 263A costs.

The most recently available Statistics of Income (SOI) indicates that approximately 30,000 taxpayers were subject to section 263A in 2015 and would be impacted by these final regulations. While the number of affected taxpayers will increase with growth in the economy, the Treasury Department and the IRS do not expect that these final regulations will change the portion of affected taxpayers that use a simplified method because those taxpayers not using a simplified method will likely continue to allocate capitalizable costs to specific items of property under their present method, and taxpayers using a simplified method are not likely to begin capitalizing costs to specific items of property due to these final regulations. The IRS's Office of Research, Applied Analytics, and Statistics (RAAS) estimate that these 30,000 taxpayers spent approximately 315,000 hours and $26 million ($2015) annually to comply with the simplified methods, as implemented under Notice 2007-29. The dollar burden is derived from RAAS’s Business Taxpayer Burden model that relates time and out-of-pocket costs of business tax preparation, derived from survey data, to assets and receipts of affected taxpayers along with other relevant variables, and converted by the
Treasury Department to $2015. See Tax Compliance Burden (John Guyton et al, July 2018) at https://www.irs.gov/pub/irs-soi/d13315.pdf. The Treasury Department and IRS then used this framework to estimate the taxpayer burden associated with section 263A compliance under the final regulations. These estimates reflect the Treasury Department’s and IRS’s estimate that because these final regulations implement an approach substantially consistent with current practice, but also offer taxpayers additional compliance simplifications, these final regulations will result in a reduction in the aggregate annual taxpayer compliance burden of approximately ten percent. The estimated reduction in annual compliance burden for impacted taxpayers is summarized below.

| Estimated Reduction in Annual Compliance Burden (2015 levels) |
|-----------------------------------|---------------|----------------|---------------|
|                                   | Baseline      | Final Regulations | Burden Reduction |
| Taxpayers                         | 30,000        | 30,000           | -             |
| Hours                             | 315,000       | 283,500          | 31,500        |
| Cost ($2015)                      | $26,000,000   | $23,400,000      | $2,600,000    |

C. Paperwork Reduction Act

The collection of information in these final regulations is in §1.263A-2(c)(4)(i). The collection of information in §1.263A-2(c)(4)(i) only applies to taxpayers using the MPSM with HAR. The burden for the collection of information contained in these final regulations is reflected in the burden for §§1.263A-2(b)(4)(iii)(A) and (B) and 1.263A-3(d)(4)(iii)(A) and (B) and is not expected to change the previously determined estimated annual burden per respondent, the estimated annual burden per recordkeeper, or the estimated number of respondents because (i) taxpayers could previously use a simplified method with HAR, (ii) these final regulations do not make a
simplified method with HAR more or less desirable, and (iii) only those taxpayers previously using a simplified method with HAR are likely to do so under these final regulations. For purposes of the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)), the reporting burden associated with §1.263A-2(c)(4)(i) will be reflected in the IRS Form 14029, Paperwork Reduction Act Submission, associated with Form 1120 (OMB control number 1545-0123) at www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201706-1545-005.

D. Executive Order 13771

These final regulations are expected to be an Executive Order 13771 deregulatory action. Details on the estimated effects of this rule can be found in the rule’s economic analysis.

E. Regulatory Flexibility Analysis

It is hereby certified that these final regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that: (1) many small business taxpayers are no longer required to capitalize costs under section 263A if their average annual gross receipts are less than $25,000,000; (2) a taxpayer with average annual gross receipts of less than $50,000,000 may continue to use the simplified production method and the simplified production method with a historical absorption rate (HAR) with negative amounts in additional section 263A costs; and (3) a relatively small number of taxpayers use a simplified method with HAR compared to a simplified method without HAR and, therefore, it is expected that few small business taxpayers will use the modified simplified production method with HAR. Thus, a Regulatory Flexibility Analysis under
the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required.

F. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. In 2018, that threshold is approximately $150 million. This rule does not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

G. Executive Order 13132: Federalism

Executive Order 13132 (entitled “Federalism”) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This rule does not have federalism implications and does not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

Drafting Information

The principal author of these final regulations is Natasha M. Mulleneaux 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.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART I -- INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by revising the sectional authority entries for §§1.263A-1, 1.263A-2, 1.263A-3 and 1.263A-7, and adding a sectional authority for §1.471-3 in numerical order to read in part as follows:


* * * * *

Section 1.263A-1 also issued under 26 U.S.C. 263A(j).

Section 1.263A-2 also issued under 26 U.S.C. 263A(j).

Section 1.263A-3 also issued under 26 U.S.C. 263A(j).

* * * * *

Section 1.263A-7 also issued under 26 U.S.C. 263A(j).

* * * * *

Section 1.471-3 issued under 26 U.S.C. 471(a).

* * * * *

Par. 2. Section 1.263A-0 is amended by:

1. Revising the entry for §1.263A-1(d)(2)(ii).

2. Adding entries for §1.263A-1(d)(2)(ii)(A) and (B).


4. Adding entries for §1.263A-1(d)(2)(iii)(A) through (E), (d)(2)(iv), (d)(2)(iv)(A) through (E), (d)(2)(v), (d)(2)(v)(A) through (E), and (d)(2)(vi) and (vii).

6. Adding entries for §1.263A-1(d)(5) and (6).

7. Adding entries for §1.263A-2(b)(4)(v)(A) and (B).

8. Revising the entry for §1.263A-2(c).

9. Adding entries for §1.263A-2(c)(1), (c)(2), (c)(2)(i) and (ii), (c)(3), (c)(3)(i), (c)(3)(i)(A) and (B), (c)(3)(ii), (c)(3)(ii)(A) and (B), (c)(3)(ii)(B)(1) and (2), (c)(3)(ii)(C) and (D), (c)(3)(ii)(D)(1) through (4), (c)(3)(ii)(E) and (F), (c)(3)(iii), (c)(3)(iii)(A) through (C), (c)(3)(iv), (c)(3)(iv)(A) and (B), (c)(3)(iv)(B)(1) and (2), (c)(3)(iv)(C), (c)(3)(v) and (vi), (c)(4), (c)(4)(i) and (ii), (c)(4)(ii)(A) and (B), (c)(4)(iii), (c)(4)(iii)(A) and (B), (c)(4)(iii)(B)(1) and (2), and (c)(4)(iv) and (v).

10. Revising the entry for §1.263A-2(d).

11. Revising the entry for §1.263A-2(e).

12. Removing the entries for §1.263A-2(e)(1) through (5).

13. Revising the entry for §1.263A-2(f).


15. Adding an entry for §1.263A-2(g).

16. Adding entries for §1.263A-3(d)(4)(v)(A) and (B).

The revisions and additions read as follows:

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

§1.263A-1 Uniform Capitalization of Costs.

(d) * * *
(2) * * *
(ii) Inclusion of direct costs.
(A) In general.
(B) Allocation of direct costs.
(iii) Alternative method to determine amounts of section 471 costs by using taxpayer's financial statement.
(A) In general.
(B) Book-to-tax adjustments.
(C) Exclusion of certain financial statement items.
(D) Changes in method of accounting.
(E) Examples.
(iv) De minimis rule exceptions for certain direct costs.
(A) In general.
(B) De minimis rule for certain direct labor costs.
(C) De minimis rule for certain direct material costs.
(D) Taxpayers using a historic absorption ratio.
(E) Examples.
(v) Safe harbor method for certain variances and under or over-applied burdens.
(A) In general.
(B) Consistency requirement.
(C) Allocation of variances and under or over-applied burdens between production and preproduction costs under the modified simplified production method.
(D) Allocation of variances and under or over-applied burdens between storage and handling costs absorption ratio and purchasing costs absorption ratio under the simplified resale method.
(E) Method of accounting.
(vi) Removal of section 471 costs.
(vii) Method changes.
(3) * * *
(i) In general.
(ii) Negative adjustments.
(A) In general.
(B) Exception for certain taxpayers removing costs from section 471 costs.
(C) No negative adjustments for cash or trade discounts.
(D) No negative adjustments for certain expenses.
(E) Consistency requirement for negative adjustments.
(4) Section 263A costs.
(5) Classification of costs.
(6) Financial statement.
* * * * *
§1.263A-2 Rules Relating to Property Produced by the Taxpayer.
* * * * *
(b) * * *
(4) * * *
(v) * * *
(A) Transition to elect historic absorption ratio.
(B) Transition to revoke historic absorption ratio.
* * * * *
(c) Modified simplified production method.
(1) Introduction.
(2) Eligible property.
(i) In general.
(ii) Election to exclude self-constructed assets.
(3) Modified simplified production method without historic absorption ratio election.
(i) General allocation formula.
(A) In general.
(B) Effect of allocation.
   (ii) Definitions.
   (A) Direct material costs.
   (B) Pre-production absorption ratio.
      (1) Pre-production additional section 263A costs.
      (2) Pre-production section 471 costs.
      (C) Pre-production section 471 costs remaining on hand at year end.
   (D) Production absorption ratio.
      (1) Production additional section 263A costs.
      (2) Residual pre-production additional section 263A costs.
      (3) Production section 471 costs.
      (4) Direct materials adjustment.
   (E) Production section 471 costs remaining on hand at year end.
   (F) Costs allocated to property sold.
   (iii) Allocable mixed service costs.
      (A) In general.
      (B) Taxpayer using the simplified service cost method.
      (C) De minimis rule.
   (iv) 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.
      (v) De minimis rule for producers with total indirect costs of $200,000 or less.
      (vi) Examples.
      (4) Modified simplified production method with historic absorption ratio election.
         (i) In general.
         (ii) Operating rules and definitions.
            (A) Pre-production historic absorption ratio.
            (B) Production historic absorption ratio.
         (iii) LIFO taxpayers making the historic absorption ratio election.
            (A) In general.
            (B) Combined historic absorption ratio.
            (1) Total allocable additional section 263A costs incurred during the test period.
            (2) Total section 471 costs remaining on hand at each year end of the test period.
            (iv) Extension of qualifying period.
            (v) 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.

§1.263A-3 Rules Relating to Property Acquired for Resale
* * * * *
(d) * * *
(4) * * *
(v) * * *
(A) Transition to elect historic absorption ratio.
(B) Transition to revoke historic absorption ratio.
* * * * *

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

1. Revising the last sentence of paragraph (c)(1).
2. Revising paragraphs (d)(2) and (3).
3. Adding paragraphs (d)(5) and (6).
4. Revising the third sentence of paragraph (f)(1).
6. Revising paragraph (h)(9).
7. Adding paragraph (l)(5).

The revisions and additions read as follows:

§1.263A-1 Uniform capitalization of costs.
* * * * *

(c) * * *

(1) * * * See however, the simplified production method, the modified simplified production method, and the simplified resale method in §§1.263A-2(b) and (c) and 1.263A-3(d).
* * * * *
Section 471 costs -- (i) In general. Except as otherwise provided in paragraphs (d)(2)(ii), (iv), (v), and (vi) of this section, for purposes of section 263A, a taxpayer’s section 471 costs are the types of costs, other than interest, that a taxpayer capitalizes to property produced or property acquired for resale in its financial statement. Thus, although section 471 applies only to inventories, section 471 costs include any non-inventory costs, other than interest, that a taxpayer capitalizes to, or includes in acquisition or production costs of, property produced or property acquired for resale in its financial statement. Except as otherwise provided in paragraph (d)(2)(iii) of this section, a taxpayer determines the amounts of section 471 costs by using the amounts of such costs that are incurred in the taxable year for federal income tax purposes.

(ii) Inclusion of direct costs -- (A) In general. Notwithstanding the last sentence of paragraph (g)(2) of this section, a taxpayer’s section 471 costs must include all direct costs of property produced and property acquired for resale, whether or not a taxpayer capitalizes these costs to property produced or property acquired for resale in its financial statement. See paragraph (e)(2) of this section for a description of direct costs of property produced and property acquired for resale.

(B) Allocation of direct costs. Except for any direct costs that are treated as additional section 263A costs under paragraphs (d)(2)(iv) and (v) of this section, a taxpayer’s direct costs of property produced and property acquired for resale must be allocated using a method provided in paragraph (f) of this section.

(iii) Alternative method to determine amounts of section 471 costs by using taxpayer’s financial statement -- (A) In general. In lieu of determining the amounts of
section 471 costs under paragraph (d)(2)(i) of this section, a taxpayer described in paragraph (d)(3)(ii)(B) of this section may determine the amounts of section 471 costs by using the amounts of such costs that are incurred in the taxable year in its financial statement using the taxpayer’s financial statement methods of accounting if the taxpayer’s financial statement is described in paragraph (d)(6)(i), (ii), or (iii) of this section. If the taxpayer’s financial statement is described only in paragraph (d)(6)(iv) of this section, the taxpayer may not use the alternative method described in this paragraph (d)(2)(iii) and must use the method described in paragraph (d)(2)(i) of this section to determine its amounts of section 471 costs. A taxpayer using the alternative method described in this paragraph (d)(2)(iii) must remove all section 471 costs described in paragraph (d)(2)(vi) of this section, if any, by including negative adjustments in additional section 263A costs. A taxpayer using the alternative method described in this paragraph (d)(2)(iii) applies the method to all of its section 471 costs, including costs described under paragraphs (d)(2)(ii), (iv), (v), and (vi) of this section.

(B) Book-to-tax adjustments. A taxpayer using the alternative method described in this paragraph (d)(2)(iii) must include as additional section 263A costs all negative and positive adjustments required to be made as a result of differences in the book and tax amounts of the taxpayer’s section 471 costs, including adjustments for direct costs required to be added to section 471 costs under paragraph (d)(2)(ii) of this section, and costs removed from section 471 costs under paragraphs (d)(2)(vi) and (d)(3)(ii)(B) of this section. In addition, the taxpayer must include as additional section 263A costs all negative and positive adjustments required to be made as a result of differences in the book and tax amounts of section 471 costs that are treated as additional section 263A
costs (for example, de minimis direct costs described in paragraph (d)(2)(iv) of this
section and certain variances and under or over-applied burdens described in
paragraph (d)(2)(v) of this section). For purposes of determining the negative and
positive adjustments required to be made as a result of differences in book and tax
amounts for a taxpayer using the burden rate or standard cost methods described in
paragraph (f)(3) of this section, the taxpayer compares the actual amount of the cost
incurred in the taxable year for federal income tax purposes to the actual amount of the
cost incurred in the taxable year in its financial statement using the taxpayer's financial
statement methods of accounting, regardless of how the taxpayer treats its variances or
under or over-applied burdens.

(C) Exclusion of certain financial statement items. A taxpayer that determines
the amounts of section 471 costs under this paragraph (d)(2)(iii) may not include any
financial statement write-downs, reserves, or other financial statement valuation
adjustments when determining the amounts of its section 471 costs.

(D) Changes in method of accounting. The use of this method to determine the
amounts of section 471 costs under this paragraph (d)(2)(iii) is the adoption of, or a
change in, a method of accounting under section 446 of the Internal Revenue Code.

(E) Examples. The following examples illustrate this paragraph (d)(2)(iii):

(1) Example 1--Alternative-method taxpayer using de minimis direct labor costs
rule. Taxpayer P uses the modified simplified production method described in §1.263A-
2(c) and determines its amounts of section 471 costs by using the alternative method
under paragraph (d)(2)(iii) of this section. Additionally, P uses the de minimis direct
labor costs rule under paragraph (d)(2)(iv)(B) of this section. P does not capitalize
vacation pay or holiday pay to property produced or property acquired for resale in its
financial statement but does capitalize all other direct labor costs to such property in its
financial statement. On its 2018 financial statement, P incurs $3,500,000 of total direct
labor costs, including $110,000 of vacation pay costs and $10,000 of holiday pay costs.
For federal income tax purposes, P incurs $150,000 of vacation pay costs and $18,000
of holiday pay costs in the taxable year. P's uncapitalized direct labor costs are $120,000 ($110,000 of vacation pay plus $10,000 of holiday pay). For purposes of the five percent test in paragraph (d)(2)(iv)(B) of this section, P's uncapitalized direct labor costs are 3.43% of total direct labor costs ($120,000 divided by $3,500,000). Accordingly, under paragraph (d)(2)(iv)(B) of this section, P includes $120,000 in its additional section 263A costs and excludes that amount from its section 471 costs in the taxable year. Additionally, pursuant to paragraph (d)(2)(iii)(B) of this section, P includes in additional section 263A costs a positive book-to-tax adjustment of $40,000 for vacation pay costs ($150,000 tax amount - $110,000 book amount) and a positive book-to-tax adjustment of $8,000 for holiday pay costs ($18,000 tax amount - $10,000 book amount).

(2) Example 2--Alternative-method taxpayer with under and over-applied burdens that uses safe harbor rule for certain variances and under or over-applied burdens. Taxpayer X uses the modified simplified production method described in §1.263A-2(c) and determines its amounts of section 471 costs by using the alternative method under paragraph (d)(2)(iii) of this section. In 2018, X uses a burden rate method for book purposes to allocate costs to Products A and B, and does not capitalize any under or over-applied burdens to property produced or property acquired for resale in its financial statement. X does not allocate costs to any other products using a burden rate method, and X does not allocate costs to any products using a standard cost method. On its 2018 financial statement, using X's burden rate, the total amount of predetermined indirect costs for Product A is $545,000 and the total amount of actual indirect costs incurred for Product A is $550,000; accordingly, X has an under-applied burden of $5,000 for Product A. For federal income tax purposes, the actual indirect costs incurred in 2018 for Product A is $560,000. Additionally, on its 2018 financial statement, using X's burden rate, the total amount of predetermined indirect costs for Product B is $250,000 and the total amount of actual indirect costs incurred for Product B is $225,000; accordingly, X has an over-applied burden of $25,000 for Product B. For federal income tax purposes, the actual indirect costs incurred in 2018 for Product B is $240,000. X uses the safe harbor rule for certain variances and under or over-applied burdens. Prior to the application of this safe harbor rule, X's total section 471 costs for 2018 for Products A and B (the only items to which X allocates costs using a standard cost method or burden rate method) are $2,000,000, which includes $550,000 actual indirect costs for Product A, $225,000 actual indirect costs for Product B, and $1,225,000 of other section 471 costs for Products A and B that are not allocated under X’s burden rate method. For purposes of determining the amount of uncapitalized variances and uncapitalized under or over-applied burdens for the five percent test in paragraph (d)(2)(v)(A) of this section, X’s under and over-applied burdens for Products A and B are treated as positive amounts. Consequently, the sum of X’s uncapitalized variances and uncapitalized under or over-applied burdens is $30,000 ($5,000 under-applied burden for Product A plus $25,000 over-applied burden for Product B). Accordingly, under paragraph (d)(2)(v)(A) of this section, the sum of X’s uncapitalized variances and uncapitalized under or over-applied burdens is 1.5% of X’s total section 471 costs for all items to which it allocates costs using a standard cost method or burden rate method ($30,000 divided by $2,000,000), and X includes a positive $5,000
under-applied burden for Product A and a negative $25,000 over-applied burden for Product B in its additional section 263A costs, and excludes those amounts from its section 471 costs. Additionally, pursuant to paragraph (d)(2)(iii)(B) of this section, X includes in its additional section 263A costs a positive book-to-tax adjustment of $10,000 for Product A ($560,000 actual cost tax amount - $550,000 actual cost book amount) and a positive book-to-tax adjustment of $15,000 for Product B ($240,000 actual tax amount cost - $225,000 actual book amount cost) in the taxable year.

(iv) **De minimis rule exceptions for certain direct costs**--(A) *In general.* Notwithstanding paragraph (d)(2)(ii) of this section, a taxpayer that uses the simplified resale method, the simplified production method, or the modified simplified production method, and that does not capitalize certain direct costs to property produced or property acquired for resale in its financial statement (uncapitalized direct labor costs or uncapitalized direct material costs), may use either or both the de minimis direct labor costs rule or the de minimis direct material costs rule to include in additional section 263A costs, and exclude from section 471 costs, certain uncapitalized direct labor costs or uncapitalized direct material costs that are incurred in the taxable year as provided in paragraphs (d)(2)(iv)(B) and (C) of this section, respectively. The use of the de minimis rules described in paragraphs (d)(2)(iv)(B) and (C) of this section is the adoption of, or a change in, a method of accounting under section 446 of the Internal Revenue Code.

(B) **De minimis rule for certain direct labor costs.** A taxpayer described in paragraph (d)(2)(iv)(A) of this section that uses the de minimis rule described in this paragraph (d)(2)(iv)(B) includes in additional section 263A costs, and excludes from section 471 costs, the sum of the amounts of all of those uncapitalized direct labor costs that are incurred in the taxable year, if that sum is less than five percent of total direct labor costs incurred in the taxable year (whether or not capitalized in the taxpayer’s financial statement), or another amount specified in other published guidance (see
§601.601(d)(2) of this chapter. For purposes of determining the amount of uncapitalized direct labor costs for this five percent test, any amounts that constitute a reduction to costs are treated as a positive amount. The amounts of uncapitalized direct labor costs used for the five percent test, and the amounts of uncapitalized direct labor costs included in additional section 263A costs under this paragraph (d)(2)(iv)(B), must not include amounts relating to basic compensation or overtime, or the types of costs included in the taxpayer’s standard cost or burden rate methods used for section 471 costs (but see paragraphs (d)(2)(v) and (f)(3)(i)(C) of this section for special rules for certain variances and under or over-applied burdens).

(C) De minimis rule for certain direct material costs. A taxpayer described in paragraph (d)(2)(iv)(A) of this section that uses the de minimis rule described in this paragraph (d)(2)(iv)(C) includes in additional section 263A costs, and excludes from section 471 costs, the sum of the amounts of all of those uncapitalized direct material costs that are incurred in the taxable year, if that sum is less than five percent of total direct material costs incurred in the taxable year (whether or not capitalized in the taxpayer’s financial statement), or another amount specified in other published guidance (see §601.601(d)(2) of this chapter). For purposes of determining the amount of uncapitalized direct material costs for this five percent test, any amounts that constitute a reduction to costs, such as cash and trade discounts, are treated as a positive amount. The amounts of uncapitalized direct material costs used for the five percent test, and the amounts of uncapitalized direct material costs included in additional section 263A costs under this paragraph (d)(2)(iv)(C), must not include the types of costs included in the taxpayer’s standard cost method used for section 471 costs (but
see paragraphs (d)(2)(v) and (f)(3)(ii)(B) of this section for special rules for certain variances).

(D) Taxpayers using a historic absorption ratio. A taxpayer that uses the historic absorption ratio provided in §1.263A-2(b)(4) or (c)(4) or §1.263A-3(d)(4), and that uses a de minimis rule described in paragraph (d)(2)(iv) of this section during its test period or updated test period, determines whether direct labor costs or direct material costs, as applicable, are included in any of its section 471 costs remaining on hand at year end during its qualifying period or extended qualifying period according to how those direct labor costs or direct material costs, respectively, are identified in at least two of the three years of the taxpayer’s applicable test period or updated test period. If a taxpayer described in this paragraph (d)(2)(iv)(D) is required to revise any of its actual absorption ratios for its test period or updated test period as a result of a change in a method of accounting, the taxpayer determines whether direct labor costs or direct material costs, as applicable, are included in any of its section 471 costs on hand at year end during a qualifying period or extended qualifying period according to how those direct labor costs or direct material costs, respectively, are identified in the taxpayer’s revised actual absorption ratios during its applicable test period or updated test period.

(E) Examples. The following examples illustrate this paragraph (d)(2)(iv):

(1) Example 1--Taxpayer using de minimis direct material costs rule. Taxpayer R uses the modified simplified production method described in §1.263A-2(c) and the de minimis method of accounting under paragraph (d)(2)(iv)(C) of this section. In 2018, R does not capitalize freight-in costs or trade discounts to property produced or property acquired for resale in its financial statement but does capitalize all other direct material costs to such property in its financial statement. R incurs total direct material costs of $3,105,000, which represents invoice price of $3,000,000 on goods purchased, plus $120,000 of freight-in costs, less $15,000 for trade discounts. For purposes of determining the amount of uncapitalized direct material costs for the five percent test in paragraph (d)(2)(iv)(C) of this section, R’s trade discounts are treated as a positive
amount. Consequently, R’s uncapitalized direct material costs for purposes of the five percent test are $135,000 ($120,000 of freight-in plus $15,000 of trade discounts). Accordingly, under paragraph (d)(2)(iv)(C) of this section, R’s uncapitalized direct material costs are 4.35% of total direct material costs ($135,000 divided by $3,105,000), and R includes a positive $120,000 of freight-in and a negative $15,000 of trade discounts in its additional section 263A costs and excludes those amounts from its section 471 costs in the taxable year.

(2) Example 2--Taxpayer using de minimis direct labor costs rule and historic absorption ratio. Taxpayer S uses the historic absorption ratio provided in §1.263A-2(c)(4). S uses the de minimis method of accounting under paragraph (d)(2)(iv)(B). S excludes certain uncapitalized direct labor costs from its section 471 costs (and includes them in additional section 263A costs) under paragraph (d)(2)(iv)(B) of this section in Years 1 and 3 of its applicable test period. Because S excluded direct labor costs from its section 471 costs in at least two of the three years of its applicable test period, S must exclude those same costs from its pre-production and production section 471 costs remaining on hand at year end during its qualifying period or extended qualifying period.

(v) Safe harbor method for certain variances and under or over-applied burdens--

(A) In general. Notwithstanding paragraphs (d)(2)(i) and (ii), (f)(3)(i)(C), and (f)(3)(ii)(B) of this section, a taxpayer that uses the simplified resale method, the simplified production method, or the modified simplified production method, may use the safe harbor method described in this paragraph (d)(2)(v)(A) for all of its variances and under or over-applied burdens that are not capitalized to property produced or property acquired for resale in its financial statement (uncapitalized variances and uncapitalized under or over-applied burdens). A taxpayer using this safe harbor method must include in additional section 263A costs, and exclude from section 471 costs, the sum of the amounts of all of those uncapitalized variances and uncapitalized under or over-applied burdens for the taxable year, if that sum is less than five percent of the taxpayer’s total section 471 costs for all items to which it allocates costs using a standard cost method or burden rate method, or another percentage specified in other published guidance (see §601.601(d)(2) of this chapter). If the sum of uncapitalized variances and
uncapitalized under or over-applied burdens is not less than this five percent threshold, the taxpayer may not exclude such uncapitalized variances and uncapitalized under or over-applied burdens from section 471 costs, and must reallocate such uncapitalized variances and uncapitalized under or over-applied burdens to or among the units of property to which the costs are allocable in accordance with paragraphs (f)(3)(i)(C) and (f)(3)(ii)(B) of this section (but see paragraph (d)(2)(v)(B) of this section for a rule that a taxpayer using the safe harbor method described in this paragraph (d)(2)(v)(A) may not use the methods of accounting described in paragraphs (f)(3)(i)(C) and (f)(3)(ii)(B) of this section to treat certain uncapitalized variances and certain uncapitalized under or over-applied burdens as not allocable to property). For purposes of determining the amounts of uncapitalized variances and uncapitalized under or over-applied burdens for this five percent test, all variances and under or over-applied burdens are treated as positive amounts. Additionally, for purposes of this five percent test, a taxpayer’s total section 471 costs for all items to which it allocates costs using a standard cost method or burden rate method are determined before application of the safe harbor method described in this paragraph (d)(2)(v)(A), and therefore this amount must reflect the actual amounts incurred by the taxpayer for those items during the taxable year, which includes variances and under or over-applied burdens. The variances described in this paragraph (d)(2)(v)(A) include any variances on cash or trade discounts, if those discounts are capitalized as part of the taxpayer’s standard cost method used for section 471 costs.

(B) Consistency requirement. A taxpayer using the safe harbor method described in paragraph (d)(2)(v)(A) of this section must use the method consistently for
all items to which it allocates costs using a standard cost method or burden rate method and may not use the methods of accounting described in paragraphs (f)(3)(i)(C) and (f)(3)(ii)(B) of this section to treat its uncapitalized variances and uncapitalized under or over-applied burdens that are not significant in amount relative to the taxpayer’s total indirect costs incurred with respect to production and resale activities for the year as not allocable to property produced or property acquired for resale.

(C) Allocation of variances and under or over-applied burdens between production and preproduction costs under the modified simplified production method. In the case of a taxpayer using the modified simplified production method and the safe harbor method described in paragraph (d)(2)(v)(A) of this section, uncapitalized variances and uncapitalized under or over-applied burdens treated as additional section 263A costs under the safe harbor method must be allocated between production additional section 263A costs, as described in §1.263A-2(c)(3)(ii)(D)(1), and pre-production additional section 263A costs, as described in §1.263A-2(c)(3)(ii)(B)(1), using any reasonable method. In the case of a taxpayer using the modified simplified production method and the safe harbor method described in paragraph (d)(2)(v)(A) of this section, uncapitalized variances and uncapitalized under or over-applied burdens that are not excluded from section 471 costs must be allocated between production section 471 costs, as described in §1.263A-2(c)(3)(ii)(D)(3), and pre-production section 471 costs, as described in §1.263A-2(c)(3)(ii)(B)(2) based on the taxpayer’s reallocation of such uncapitalized variances and uncapitalized under or over-applied burdens to or among the units of property to which the costs are allocable in accordance with paragraphs (f)(3)(i)(C) and (f)(3)(ii)(B) of this section, as described in paragraph
(d)(2)(v)(A) of this section.

(D) Allocation of variances and under or over-applied burdens between storage and handling costs absorption ratio and purchasing costs absorption ratio under the simplified resale method. In the case of a taxpayer using the simplified resale method, any uncapitalized variances and uncapitalized under or over-applied burdens treated as additional section 263A costs under the safe harbor method described in paragraph (d)(2)(v)(A) of this section must be allocated between storage and handling costs, as described in §1.263A-3(d)(3)(i)(D)(2), and current year's purchasing costs, as described in §1.263A-3(d)(3)(i)(E)(2), using any reasonable method.

(E) Method of accounting. The use of the safe harbor method described in this paragraph (d)(2)(v) is the adoption of, or a change in, a method of accounting under section 446 of the Internal Revenue Code.

(vi) Removal of section 471 costs. A taxpayer must remove those costs included in its section 471 costs that are not permitted to be capitalized under either paragraph (c)(2) or (j)(2)(ii) of this section and those costs included in its section 471 costs that are eligible for capitalization under paragraph (j)(2) of this section that the taxpayer does not elect to capitalize under section 263A. Except as otherwise provided in paragraph (d)(3)(ii)(B) of this section, a taxpayer must remove costs pursuant to this paragraph (d)(2)(vi) by adjusting its section 471 costs and may not remove the costs by including a negative adjustment in its additional section 263A costs. A taxpayer that removes costs pursuant to this paragraph (d)(2)(vi) by adjusting its section 471 costs must use a reasonable method that approximates the manner in which the taxpayer originally capitalized the costs to its property produced or property acquired for resale in its
financial statement.

(vii) **Method changes.** A taxpayer using the simplified production method, simplified resale method, or the modified simplified production method and that changes its financial statement practices for a cost in a manner that would change its section 471 costs is required to change its method of accounting for federal income tax purposes. 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.

(3) **Additional section 263A costs**--(i) **In general.** Additional section 263A costs are 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 generally do not include the direct costs that are required to be included in a taxpayer’s section 471 costs under paragraph (d)(2)(ii) of this section; however, additional section 263A costs must include any direct costs excluded from section 471 costs under paragraphs (d)(2)(iv) and (v) of this section. For a taxpayer using the alternative method described in paragraph (d)(2)(iii) of this section, additional section 263A costs must also include any negative or positive adjustments required to be made as a result of differences in the book and tax amounts of the taxpayer’s section 471 costs.

(ii) **Negative adjustments**--(A) **In general.** Except as otherwise provided by regulations or other published guidance (see §601.601(d)(2) of this chapter), a taxpayer may not include negative adjustments in additional section 263A costs. However, for a taxpayer using the alternative method described in paragraph (d)(2)(iii) of this section,
see paragraph (d)(2)(iii)(B) of this section for negative or positive adjustments required to be made as a result of differences in the book and tax amounts of the taxpayer's section 471 costs.

(B) Exception for certain taxpayers removing costs from section 471 costs. Notwithstanding paragraphs (d)(2)(vi) and (d)(3)(ii)(A) of this section, and except as otherwise provided in paragraphs (d)(3)(ii)(C) and (D) of this section, the following taxpayers may, but are not required to, include negative adjustments in additional section 263A costs to remove the taxpayer's section 471 costs that are described in paragraph (d)(2)(vi) of this section (costs that are not required to be, or are not permitted to be, capitalized under section 263A):

1. A taxpayer using the simplified production method under §1.263A-2(b) if the taxpayer's (or its predecessor's) average annual gross receipts for the three previous taxable years (test period) do not exceed $50,000,000, or another amount specified in other published guidance (see §601.601(d)(2) of this chapter). The rules of §1.263A-3(b) apply for purposes of determining the amount of a taxpayer's gross receipts and the test period;

2. A taxpayer using the modified simplified production method under §1.263A-2(c);

3. A taxpayer using the simplified resale method under §1.263A-3(d).

(C) No negative adjustments for cash or trade discounts. A taxpayer may not include negative adjustments in additional section 263A costs for cash or trade discounts described in §1.471-3(b). However, see paragraph (d)(2)(iv)(C) of this section for a de minimis rule for certain direct material costs that may be included in
additional section 263A costs and paragraph (d)(2)(v) of this section for certain variance amounts that may be included in additional section 263A costs.

(D) No negative adjustments for certain expenses. A taxpayer may not include negative adjustments in additional section 263A costs for an amount which is of a type for which a deduction would be disallowed under section 162(c), (e), (f), or (g) and the regulations thereunder in the case of a business expense.

(E) Consistency requirement for negative adjustments. A taxpayer that is permitted to include negative adjustments in additional section 263A costs to remove section 471 costs under paragraph (d)(3)(ii)(B) of this section and that includes negative adjustments to remove section 471 costs must use that method of accounting to remove all section 471 costs required to be removed under paragraph (d)(2)(vi) of this section.

(5) Classification of costs. A taxpayer must classify section 471 costs, additional section 263A costs, and any permitted adjustments to section 471 or additional section 263A costs, using the narrower of the classifications of costs described in paragraphs (e)(2), (3), and (4) of this section, whether or not the taxpayer is required to maintain inventories, or the classifications of costs used by a taxpayer in its financial statement. If a cost is not described in paragraph (e)(2), (3), or (4) of this section, the cost is to be classified using the classification of costs used in the taxpayer's financial statement.

(6) Financial statement. For purposes of section 263A, financial statement means the taxpayer's financial statement listed in paragraphs (d)(6)(i) through (iv) of this section that has the highest priority, including within paragraphs (d)(6)(ii) and (iv) of this section. The financial statements are, in descending priority:
(i) A financial statement required to be filed with the Securities and Exchange Commission (SEC) (the 10-K or the Annual Statement to Shareholders);

(ii) A certified audited financial statement that is accompanied by the report of an independent certified public accountant (or in the case of a foreign entity, by the report of a similarly qualified independent professional) that is used for:

   (A) Credit purposes;
   (B) Reporting to shareholders, partners, or similar persons; or
   (C) Any other substantial non-tax purpose;

(iii) A financial statement (other than a tax return) required to be provided to the federal or a state government or any federal or state agency (other than the SEC or the Internal Revenue Service); or

(iv) A financial statement that is used for:

   (A) Credit purposes;
   (B) Reporting to shareholders, partners, or similar persons; or
   (C) Any other substantial non-tax purpose.

* * * *

(f) * * *

(1) * * * In addition, in lieu of a facts-and-circumstances allocation method, taxpayers may use the simplified methods provided in §§1.263A-2(b) and (c) and 1.263A-3(d) to allocate direct and indirect costs to eligible property produced or eligible property acquired for resale; see those sections for definitions of eligible property.* * * * * * * * * * * * * * * *
(9) **Separate election.** A taxpayer may elect the simplified service cost method in conjunction with any other allocation method used at the trade or business level, including the simplified methods described in §§1.263A-2(b) and (c) and 1.263A-3(d). However, the election of the simplified service cost method must be made independently of the election to use those other simplified methods.

* * * * *

(l) * * *

(5) **Definitions of section 471 costs and additional section 263A costs.** Paragraphs (d)(2) and (3) of this section apply for taxable years beginning on or after [INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]. For any taxable year that both begins before [INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER] and ends after [INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER], the IRS will not challenge return positions consistent with all of paragraphs (d)(2) and (3) of this section.

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

1. Revising paragraph (a)(5).

2. Designating the text of paragraph (b)(4)(v) as paragraph (b)(4)(v)(A) and adding a paragraph heading.


4. Redesignating paragraphs (c), (d), (e), and (f) as paragraphs (d), (e), (f), and (g).

5. Adding a new paragraph (c).

6. Adding paragraph (g)(3).
The revision and additions read as follows:

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

(a) * * *

(5) ** Taxpayers required to capitalize costs under this section. This section generally applies to taxpayers that produce property. If a taxpayer is engaged in both production activities and resale activities, the taxpayer applies the principles of this section as if it read production or resale activities, and by applying appropriate principles from §1.263A-3. If a taxpayer is engaged in both production and resale activities, the taxpayer may elect the simplified production method or the modified simplified production method provided in this section, but generally may not elect the simplified resale method discussed in §1.263A-3(d). If elected, the simplified production method or the modified simplified production method must be applied to all eligible property produced and all eligible property acquired for resale by the taxpayer.

(b) * * *

(4) * * *

(v) * * *

(A) Transition to elect historic absorption ratio. * * *

(B) Transition to revoke historic absorption ratio. Notwithstanding the requirements provided in paragraph (b)(4)(iii)(B) of this section regarding revocations of the historic absorption ratio during a qualifying period, a taxpayer will be permitted to revoke the historic absorption ratio in their first, second, or third taxable year ending on or after [INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER], under such administrative procedures and with terms and conditions prescribed by the
(c) Modified simplified production method--(1) Introduction. This paragraph (c) provides a 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--(i) In general. Except as otherwise provided in paragraph (c)(2)(ii) of this section, the modified simplified production method, if elected for any trade or business of a producer, must be used for all production and resale activities associated with any of the categories of property to which section 263A applies as described in paragraph (b)(2)(i) of this section.

(ii) Election to exclude-self-constructed assets. A taxpayer using the modified simplified production method may elect to exclude self-constructed assets from application of the modified simplified production method by following the same rules applicable to a taxpayer using the simplified production method provided in paragraph (b)(2)(ii) 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)(v) of this section, the additional section 263A costs allocable to eligible property remaining on hand at the close of the taxable year under the modified simplified production method are computed as follows:

\[
\left( \text{Pre-production absorption ratio} \times \text{Pre-production section 471 costs remaining on hand at year end} \right) + \left( \text{Production absorption ratio} \times \text{Production section 471 costs remaining on hand at year end} \right)
\]
(B) **Effect of allocation.** The pre-production and production absorption ratios generally are multiplied by the pre-production and production section 471 costs, respectively, remaining in ending inventory or otherwise on hand at the end of each taxable year in which the modified simplified production method is applied. The sum of the resulting products is the additional section 263A costs that are added to the taxpayer’s ending section 471 costs to determine the section 263A costs that are capitalized. See, however, paragraph (c)(3)(iv) of this section for special rules applicable to 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 of this paragraph (c) are treated as inventory costs for all purposes of the Internal Revenue Code.

(ii) **Definitions--(A) Direct material costs.** For purposes of paragraph (c) of this section, direct material costs has the same meaning as described in §1.263A-1(e)(2)(i)(A). For purposes of paragraph (c) of this section, direct material costs include property produced for the taxpayer under a contract with another party that are direct material costs for the taxpayer to be used in an additional production process of the taxpayer.

(B) **Pre-production absorption ratio.** Under the modified simplified production method, the pre-production absorption ratio is determined as follows:

\[
\text{Pre-production } \frac{\text{additional section 263A costs}}{\text{production section 471 costs}}
\]

(1) **Pre-production additional section 263A costs.** Pre-production additional section 263A costs are defined as the additional section 263A costs described in
§1.263A-1(d)(3) that are pre-production costs, as described in paragraph (a)(3)(ii) of this section, that a taxpayer incurs during its current taxable year, including capitalizable mixed service costs allocable to pre-production additional section 263A costs, as described in paragraph (c)(3)(iii) of this section, that a taxpayer incurs during its current taxable year:

(i) Plus additional section 263A costs properly allocable to property acquired for resale that a taxpayer incurs during its current taxable year; and

(ii) Plus additional section 263A costs properly allocable to property produced for the taxpayer under a contract with another party that is treated as property produced by the taxpayer, as described in paragraph (a)(1)(ii)(B) of this section, that a taxpayer incurs during its current taxable year.

(2) Pre-production section 471 costs. Pre-production section 471 costs are defined as the section 471 costs described in §1.263A-1(d)(2) that are direct material costs that a taxpayer incurs during its current taxable year plus the section 471 costs for property acquired for resale (see §1.263A-1(e)(2)(ii)) that a taxpayer incurs during its current taxable year, including property produced for the taxpayer under a contract with another party that is acquired for resale.

(C) Pre-production section 471 costs remaining on hand at year end. Pre-production section 471 costs remaining on hand at year end means the pre-production section 471 costs, as defined in paragraph (c)(3)(ii)(B)(2) of this section, that a taxpayer incurs during its current taxable year which remain in its ending inventory or are otherwise on hand at year end, excluding the section 471 costs that are direct material costs that have entered or completed production at year end (for example, direct
material costs in ending work-in-process inventory and ending finished goods
inventory). For LIFO inventories of a taxpayer, see paragraph (c)(3)(iv) of this section.

(D) **Production absorption ratio.** Under the modified simplified production
method, the production absorption ratio is determined as follows:

\[
\frac{\text{Production additional section 263A costs} + \text{Residual pre-production additional section 263A costs}}{\text{Production section 471 costs} + \text{Direct materials adjustment}}
\]

(1) **Production additional section 263A costs.** Production additional section 263A
costs are defined as the additional section 263A costs described in §1.263A-1(d)(3) that
are not pre-production additional section 263A costs, as defined in paragraph
(c)(3)(ii)(B)(1) of this section, that a taxpayer incurs during its current taxable year,
including capitalizable mixed service costs not allocable to pre-production additional
section 263A costs, as described in paragraph (c)(3)(iii) of this section, that a taxpayer
incurs during its current taxable year. For example, production additional section 263A
costs include post-production costs, other than post-production costs included in section
471 costs, as described in paragraph (a)(3)(iii) of this section.

(2) **Residual pre-production additional section 263A costs.** Residual pre-
production additional section 263A costs are defined as the pre-production additional
section 263A costs, as defined in paragraph (c)(3)(ii)(B)(1) of this section, that a
taxpayer incurs during its current taxable year less the product of the pre-production
absorption ratio, as determined in paragraph (c)(3)(ii)(B) of this section, and the pre-
production section 471 costs remaining on hand at year end, as defined in paragraph
(c)(3)(ii)(C) of this section.

(3) **Production section 471 costs.** Production section 471 costs are defined as
the section 471 costs described in §1.263A-1(d)(2) that a taxpayer incurs during its
current taxable year less pre-production section 471 costs, as defined in paragraph (c)(3)(ii)(B)(2) of this section, that a taxpayer incurs during its current taxable year.

(4) **Direct materials adjustment.** The direct materials adjustment is defined as the section 471 costs that are direct material costs, including property produced for a taxpayer under a contract with another party that are direct material costs for the taxpayer to be used in an additional production process of the taxpayer, that had not entered production at the beginning of the current taxable year:

(i) Plus the section 471 costs that are direct material costs incurred during the current taxable year (that is, direct material purchases); and

(ii) Less the section 471 costs that are direct material costs that have not entered production at the end of the current taxable year.

(E) **Production section 471 costs remaining on hand at year end.** Production section 471 costs remaining on hand at year end means the section 471 costs, as defined in §1.263A-1(d)(2), that a taxpayer incurs during its current taxable year which remain in its ending inventory or are otherwise on hand at year end, less the pre-production section 471 costs remaining on hand at year end, as described in paragraph (c)(3)(ii)(C) of this section. For LIFO inventories of a taxpayer, see paragraph (c)(3)(iv) of this section.

(F) **Costs allocated to property sold.** The terms defined in paragraph (c)(3)(ii) of this section do not include costs described in §1.263A–1(e)(3)(ii) or cost reductions described in §1.471–3(e) that a taxpayer properly allocates entirely to property that has been sold.

(iii) **Allocable mixed service costs.** *(A) In general.* If a taxpayer using the
modified simplified production method determines its capitalizable mixed service costs using a method described in §1.263A–1(g)(4), the taxpayer must use a reasonable method to allocate the costs (for example, department or activity costs) between production and pre-production additional section 263A costs. If the taxpayer’s §1.263A–1(g)(4) method allocates costs to a department or activity that is exclusively identified as production or pre-production, those costs must be allocated to production or pre-production additional section 263A costs, respectively.

(B) Taxpayer using the simplified service cost method. If a taxpayer using the modified simplified production method determines its capitalizable mixed service costs using the simplified service cost method described in §1.263A–1(h), the amount of capitalizable mixed service costs, as computed using the general allocation formula in §1.263A–1(h)(3)(i), allocated to and included in pre-production additional section 263A costs in the absorption ratio described in paragraph (c)(3)(ii)(B) of this section is determined based on either of the following: the proportion of direct material costs to total section 471 costs that a taxpayer incurs during its current taxable year or the proportion of pre-production labor costs to total labor costs that a taxpayer incurs during its current taxable year. The taxpayer must include the capitalizable mixed service costs that are not allocated to pre-production additional section 263A costs in production additional section 263A costs in the absorption ratio described in paragraph (c)(3)(ii)(D) of this section. A taxpayer that allocates capitalizable mixed service costs based on labor under this paragraph (c)(3)(iii)(B) must exclude mixed service labor costs from both pre-production labor costs and total labor costs.

(C) De minimis rule. Notwithstanding paragraphs (c)(3)(iii)(A) and (B) of this
section, if 90 percent or more of a taxpayer's capitalizable mixed service costs determined under paragraph (c)(3)(iii)(A) or (B) of this section are allocated to pre-production additional section 263A costs or production additional section 263A costs, the taxpayer may elect to allocate 100 percent of its capitalizable mixed service costs to that amount. For example, if 90 percent of capitalizable mixed service costs are allocated to production additional section 263A costs based on the labor costs that are pre-production costs in total labor costs incurred in the taxpayer's trade or business during the taxable year, then 100 percent of capitalizable mixed service costs may be allocated to production additional section 263A costs. An election to allocate capitalizable mixed service costs under this paragraph (c)(3)(iii)(C) is the adoption of, or a change in, a method of accounting under section 446 of the Internal Revenue Code.

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

(2) Combined absorption ratio defined. For purposes of paragraph (c)(3)(iv)(B)(1) of this section, the combined absorption ratio is the 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, determined on a non-LIFO basis, divided by the pre-production and production section 471 costs remaining on hand at year end, determined on a non-LIFO basis.

(C) LIFO decrement. If the taxpayer determines there has been an inventory decrement, the taxpayer must state the amount of the decrement in dollars applicable to the particular year for which the LIFO layer has been invaded. The additional section 263A costs incurred in prior years that are applicable to the decrement are charged to cost of goods sold. The additional section 263A costs that are applicable to the decrement are determined 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.

(v) 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.

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

(A) Example 1--FIFO inventory method. (1) Taxpayer P uses the FIFO method of accounting for inventories valued at cost. P's beginning inventory for 2018 (all of which is sold during 2018) is $2,500,000, consisting of $500,000 of pre-production section 471 costs (including $400,000 of direct material costs and $100,000 of property acquired for resale), $1,500,000 of production section 471 costs, and $500,000 of additional section 263A costs. During 2018, P incurs $2,500,000 of pre-production section 471 costs (including $1,900,000 of direct material costs and $600,000 of property acquired for resale), $7,500,000 of production section 471 costs, $200,000 of pre-production additional section 263A costs, and $800,000 of production additional section 263A costs. P's additional section 263A costs include capitalizable mixed service costs under the simplified service cost method. P's pre-production and production section 471 costs remaining in ending inventory at the end of 2018 are $1,000,000 (including $800,000 of direct material costs and $200,000 of property acquired for resale) and $2,000,000, respectively. P computes its pre-production absorption ratio for 2018 under paragraph (c)(3)(ii)(B) of this section, as follows:

\[
\frac{\text{Pre-production additional section 263A costs}}{\text{Pre-production section 471 costs}} = \frac{200,000}{2,500,000} = 8.00\%
\]

(2) Under paragraph (c)(3)(ii)(D)(2) of this section, P's residual pre-production additional section 263A costs for 2018 are $120,000 ($200,000 of pre-production additional section 263A costs less $80,000 (the product of the 8% pre-production absorption ratio and the $1,000,000 of pre-production section 471 costs remaining on hand at year end)).

(3) Under paragraph (c)(3)(ii)(D)(4) of this section, P's direct materials adjustment for 2018 is $1,500,000 ($400,000 of direct material costs in beginning raw materials inventory, plus $1,900,000 of direct material costs incurred to acquire raw materials during the taxable year, less $800,000 direct material costs in ending raw materials inventory).

(4) P computes its production absorption ratio for 2018 under paragraph (c)(3)(ii)(D) of this section, as follows:

\[
\frac{\text{(Production additional section 263A costs + Residual pre-production additional section 263A costs)}}{\text{(Production section 471 costs + Direct materials adjustment)}} = \frac{800,000 + 120,000}{7,500,000 + 1,500,000} = 10.22\%
\]

(5) Under the modified simplified production method, P determines the additional section 263A costs allocable to its ending inventory under paragraph (c)(3)(i)(A) of this section by multiplying the pre-production absorption ratio by the pre-production section 471 costs remaining on hand at year end and the production absorption ratio by the
production section 471 costs remaining on hand at year end, as follows:

Additional section 263A costs = (8% x $1,000,000)+(10.22% x $2,000,000) = $284,400

(6) P adds this $284,400 to the $3,000,000 of section 471 costs remaining on hand at year end to calculate its total ending inventory of $3,284,400. The balance of P’s additional section 263A costs incurred during 2018, $715,600 ($1,000,000 less $284,400), is taken into account in 2018 as part of P’s cost of goods sold.

(7) P’s computation is summarized in the following table:

<table>
<thead>
<tr>
<th>Beginning Inventory</th>
<th>Reference</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct material costs</td>
<td>a</td>
<td>$400,000</td>
</tr>
<tr>
<td>Property acquired for resale</td>
<td>b</td>
<td>$100,000</td>
</tr>
<tr>
<td>Pre-production section 471 costs</td>
<td>c=a+b</td>
<td>$500,000</td>
</tr>
<tr>
<td>Production section 471 costs</td>
<td>d</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>Additional section 263A costs</td>
<td>e</td>
<td>$500,000</td>
</tr>
<tr>
<td>Total</td>
<td>f=c+d+e</td>
<td>$2,500,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Incurred During 2018</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct material costs</td>
<td>g</td>
<td>$1,900,000</td>
</tr>
<tr>
<td>Property acquired for resale</td>
<td>h</td>
<td>$600,000</td>
</tr>
<tr>
<td>Pre-production section 471 costs</td>
<td>i=g+h</td>
<td>$2,500,000</td>
</tr>
<tr>
<td>Production section 471 costs</td>
<td>j</td>
<td>$7,500,000</td>
</tr>
<tr>
<td>Pre-production additional section 263A costs</td>
<td>k</td>
<td>$200,000</td>
</tr>
<tr>
<td>Production additional section 263A costs</td>
<td>l</td>
<td>$800,000</td>
</tr>
<tr>
<td>Total</td>
<td>m=i+j+k+l</td>
<td>$11,000,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Ending inventory</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct material costs</td>
<td>n</td>
<td>$800,000</td>
</tr>
<tr>
<td>Property acquired for resale</td>
<td>o</td>
<td>$200,000</td>
</tr>
<tr>
<td>Pre-production section 471 costs</td>
<td>p=n+o</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Production section 471 costs</td>
<td>q</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Section 471 costs</td>
<td>r=p+q</td>
<td>$3,000,000</td>
</tr>
<tr>
<td>Additional section 263A costs allocable to ending inventory</td>
<td>s=v+z</td>
<td>$284,400</td>
</tr>
<tr>
<td>Total</td>
<td>t=r+s</td>
<td>$3,284,400</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Modified Simplified Production Method</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-production additional section 263A costs</td>
<td>k</td>
<td>$200,000</td>
</tr>
<tr>
<td>Pre-production section 471 costs</td>
<td>i</td>
<td>$2,500,000</td>
</tr>
<tr>
<td>Pre-production absorption ratio</td>
<td>u=k/i</td>
<td>8.00%</td>
</tr>
<tr>
<td>Pre-production section 471 costs remaining on hand at year end</td>
<td>p</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Pre-production additional section 263A costs allocable to ending inventory</td>
<td>v=u*p</td>
<td>$80,000</td>
</tr>
<tr>
<td>Production additional section 263A costs</td>
<td>l</td>
<td>$800,000</td>
</tr>
</tbody>
</table>


<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Residual pre-production additional section 263A costs</td>
<td>w = k - (u*p)</td>
<td>$ 120,000</td>
</tr>
<tr>
<td>Production section 471 costs</td>
<td>j</td>
<td>$ 7,500,000</td>
</tr>
<tr>
<td>Direct materials adjustment</td>
<td>x = a + g - n</td>
<td>$ 1,500,000</td>
</tr>
<tr>
<td>Production absorption ratio</td>
<td>y = (l+w)/(j+x)</td>
<td>10.22%</td>
</tr>
<tr>
<td>Production section 471 costs remaining on hand at year end</td>
<td>q</td>
<td>$ 2,000,000</td>
</tr>
<tr>
<td>Production additional section 263A costs allocable to ending inventory</td>
<td>z = y*q</td>
<td>$ 204,400</td>
</tr>
</tbody>
</table>

**Summary**

- Pre-production additional section 263A costs allocable to ending inventory: $80,000
- Production additional section 263A costs allocable to ending inventory: $204,400
- Additional section 263A costs allocable to ending inventory: $284,400
- Section 471 costs: $3,000,000
- Total Ending Inventory: $3,284,400

(B) Example 2--FIFO inventory method with alternative method to determine amounts of section 471 costs. (1) The facts are the same as in Example 1 of paragraph (c)(3)(vi)(A) of this section, except that P uses the alternative method to determine amounts of section 471 costs by using its financial statement under §1.263A-1(d)(2)(iii) rather than tax amounts under §1.263A-1(d)(2)(i). In 2018, P’s production section 471 costs exclude $40,000 of tax depreciation in excess of financial statement depreciation and include $50,000 of financial statement direct labor in excess of tax direct labor. These are P’s only differences in its book and tax amounts.

(2) Under §1.263A-1(d)(2)(iii)(B), the positive $40,000 depreciation adjustment and the negative $50,000 direct labor adjustment must be included in additional section 263A costs. Accordingly, P’s production additional section 263A costs are $790,000 ($800,000 plus $40,000 less $50,000).

(3) P computes its production absorption ratio for 2018 under paragraph (c)(3)(ii)(D) of this section, as follows:

\[
\frac{(\text{Production additional section 263A costs} + \text{Residual pre-production additional section 263A costs})}{(\text{Production section 471 costs} + \text{Direct materials adjustment})} = \frac{($790,000 + 120,000)}{($7,500,000 + 1,500,000)} = 10.11\%
\]

(4) Under the modified simplified production method, P determines the additional section 263A costs allocable to its ending inventory under paragraph (c)(3)(i)(A) of this section by multiplying the pre-production absorption ratio by the pre-production section 471 costs remaining on hand at year end and the production absorption ratio by the production section 471 costs remaining on hand at year end, as follows:

Additional section 263A costs = (8.00% x $1,000,000) + (10.11% x $2,000,000) = $282,200
(5) P adds this $282,200 to the $3,000,000 of section 471 costs remaining on hand at year end to calculate its total ending inventory of $3,282,200. The balance of P's additional section 263A costs incurred during 2018, $717,800 ($1,000,000 less $282,200), is taken into account in 2018 as part of P's cost of goods sold.

(C) Example 3--LIFO inventory method. (1) The facts are the same as in Example 1 of paragraph (c)(3)(vi)(A) of this section, except that P uses a dollar-value LIFO inventory method rather than the FIFO method. P's 2018 LIFO increment is $1,500,000.

(2) Under paragraph (c)(3)(iv)(B)(1) of this section, to determine the additional section 263A costs allocable to its ending inventory, P multiplies the combined absorption ratio by the $1,500,000 of LIFO increment. Under paragraph (c)(3)(iv)(B)(2) of this section, the combined absorption ratio is 9.48% ($284,400 additional section 263A costs allocable to ending inventory, determined on a non-LIFO basis, divided by $3,000,000 of section 471 costs on hand at year end, determined on a non-LIFO basis). Thus, P's additional section 263A costs allocable to its ending inventory are $142,200 ($1,500,000 multiplied by 9.48%). This $142,200 is added to the $1,500,000 to determine a total 2018 LIFO increment of $1,642,200. The balance of P's additional section 263A costs incurred during 2018, $857,800 ($1,000,000 less $142,200), is taken into account in 2018 as part of P's cost of goods sold.

(3) In 2019, P sells one-half of the inventory in its 2018 increment. P must include in its cost of goods sold for 2019 the amount of additional section 263A costs relating to this inventory, $71,100 (one-half of the $142,200 additional section 263A costs capitalized in 2018 ending inventory).

(D) Example 4--Direct materials-based allocation of mixed service costs. (1) Taxpayer R computes its capitalizable mixed service costs using the simplified service cost method described in §1.263A-1(h). During 2018, R incurs $200,000 of capitalizable mixed service costs, computed using the general allocation formula in §1.263A-1(h). During 2018, R also incurs $8,000,000 of total section 471 costs, including $2,000,000 of direct material costs.

(2) Under paragraph (c)(3)(iii)(B) of this section, R determines its capitalizable mixed service costs allocable to pre-production additional section 263A costs based on the proportion of direct material costs in total section 471 costs. R's direct material costs are 25% of total section 471 costs ($2,000,000 of direct material costs incurred during the year divided by $8,000,000 of total section 471 costs incurred during the year). Thus, R allocates $50,000 (25% x $200,000) of mixed service costs to pre-production 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.

(E) Example 5--Labor-based allocation of mixed service costs. (1) Taxpayer S computes its capitalizable mixed service costs using the simplified service cost method
described in §1.263A-1(h). During 2018, S incurs $200,000 of capitalizable mixed service costs, computed using the general allocation formula in §1.263A-1(h). During 2018, S also incurs $10,000,000 of total labor costs (excluding any labor costs included in mixed service costs), including $1,000,000 of labor costs that are pre-production costs as described in paragraph (a)(3)(ii) of this section (excluding any labor costs included in mixed service costs).

(2) Under paragraph (c)(3)(iii)(B) of this section, S determines its capitalizable mixed service costs allocable to pre-production additional section 263A costs based on the proportion of labor costs that are pre-production costs in labor costs. S’s pre-production labor costs are 10% of labor costs ($1,000,000 of labor costs incurred during the year that are pre-production costs (excluding any labor costs included in mixed service costs), divided by $10,000,000 of total labor costs incurred during the year (excluding any labor costs included in mixed service costs). Thus, S allocates $20,000 (10% x $200,000) of mixed service costs to pre-production additional section 263A costs. S includes the remaining $180,000 ($200,000 less $20,000) of capitalizable mixed service costs as production additional section 263A costs.

(F) Example 6--De minimis rule for allocation of mixed service costs. The facts are the same as in Example 5 in paragraph (c)(3)(vi)(E) of this section, except that S uses the de minimis rule for mixed service costs in paragraph (c)(3)(iii)(C) of this section. Because 90% or more of S’s capitalizable mixed service costs are allocated to production additional section 263A costs, under the de minimis rule, S allocates all $200,000 of capitalizable mixed service costs to production additional section 263A costs. None of the capitalizable mixed service costs are allocated to pre-production additional section 263A costs.

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

(i) In general. This paragraph (c)(4) generally permits taxpayers using the modified simplified production method to elect a historic absorption ratio in determining additional section 263A costs allocable to eligible property remaining on hand at the close of their taxable years. A taxpayer may only make a historic absorption ratio election under this paragraph (c)(4) if it has used the modified simplified production method for three or more consecutive taxable years immediately prior to the year of election and has capitalized additional section 263A costs using an actual pre-production absorption ratio, as defined in paragraph (c)(3)(ii)(B) of this section, and an actual production absorption ratio, as defined in paragraph (c)(3)(ii)(D) of this section, or an actual
combined absorption ratio, as defined in paragraph (c)(3)(iv)(B)(2) of this section, for its three most recent consecutive taxable years. This method is not available to a taxpayer that is deemed to have zero additional section 263A costs under paragraph (c)(3)(v) of this section. The historic absorption ratio is used in lieu of the actual absorption ratios computed under paragraph (c)(3)(ii) of this section or the actual combined absorption ratio computed under paragraph (c)(3)(iv) and is based on costs capitalized by a taxpayer during its test period. If elected, the historic absorption ratio must be used for each taxable year within the qualifying period described in paragraph (b)(4)(ii)(C) of this section. 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) **Operating rules and definitions**

(A) **Pre-production historic absorption ratio.**

The pre-production historic absorption ratio is computed as follows:

\[
\text{Pre-production historic absorption ratio} = \frac{\text{Pre-production additional section 263A costs incurred during the test period}}{\text{Pre-production section 471 costs incurred during the test period}}
\]

(1) Pre-production additional section 263A costs incurred during the test period are defined as the pre-production additional section 263A costs described in paragraph (c)(3)(ii)(B)(1) of this section that the taxpayer incurs during the test period described in paragraph (b)(4)(ii)(B) of this section.

(2) Pre-production section 471 costs incurred during the test period are defined as the pre-production section 471 costs described in paragraph (c)(3)(ii)(B)(2) of this section that the taxpayer incurs during the test period described in paragraph (b)(4)(ii)(B) of this section.

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

\[
\frac{(\text{Production additional section 263A costs incurred during the test period} + \text{Residual pre-production additional section 263A costs incurred during the test period})}{(\text{Production section 471 costs incurred during the test period} + \text{Direct materials adjustments made during the test period})}
\]

(1) Production additional section 263A costs incurred during the test period are defined as the production additional section 263A costs described in paragraph (c)(3)(ii)(D)(1) of this section that the taxpayer incurs during the test period described in paragraph (b)(4)(ii)(B) of this section.

(2) Residual pre-production additional section 263A costs incurred during the test period are defined as the residual pre-production additional section 263A costs described in paragraph (c)(3)(ii)(D)(2) of this section that the taxpayer incurs during the test period described in paragraph (b)(4)(ii)(B) of this section.

(3) Production section 471 costs incurred during the test period are defined as the production section 471 costs described in paragraph (c)(3)(ii)(D)(3) of this section that the taxpayer incurs during the test period described in paragraph (b)(4)(ii)(B) of this section.

(4) Direct materials adjustments made during the test period are defined as the direct materials adjustments described in paragraph (c)(3)(ii)(D)(4) of this section that the taxpayer incurs during the test period described in paragraph (b)(4)(ii)(B) of this section.

(iii) LIFO taxpayers making the historic absorption ratio election--(A) In general.

Instead of the pre-production and production historic absorption ratios defined in paragraph (c)(4)(ii) 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 the taxpayer capitalizes during its test period.

(B) Combined historic absorption ratio. The combined historic absorption ratio is computed as follows:

$$\frac{\text{Total allocable additional section 263A costs incurred during the test period}}{\text{Total section 471 costs remaining on hand at each year end of the test period}}$$

(1) 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, determined on a non-LIFO basis, for all taxable years in the test period.

(2) 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 pre-production section 471 costs remaining on hand at year end as described in paragraph (c)(3)(ii)(C) of this section and the total production section 471 costs remaining on hand at year end as described in paragraph (c)(3)(ii)(E) of this section, determined on a non-LIFO basis, 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 (pre-production and production absorption ratios or, for LIFO taxpayers, the combined absorption ratio). If the actual combined absorption ratio or both the actual pre-production 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 pre-production 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 combined 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) Examples. The provisions of this paragraph (c)(4) are illustrated by the following examples:

(A) Example 1--HAR and FIFO inventory method. (1) Taxpayer S uses the FIFO method of accounting for inventories valued at cost and for 2021 elects to use the historic absorption ratio with the modified simplified production method. S identifies the following costs incurred during the test period:

<table>
<thead>
<tr>
<th></th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-production additional section 263A costs</td>
<td>$100</td>
<td>$200</td>
<td>$300</td>
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<tr>
<td>Production additional section 263A costs</td>
<td>200</td>
<td>350</td>
<td>450</td>
</tr>
<tr>
<td>Pre-production section 471 costs</td>
<td>2,000</td>
<td>2,500</td>
<td>3,000</td>
</tr>
<tr>
<td>Production section 471 costs</td>
<td>2,500</td>
<td>3,500</td>
<td>4,000</td>
</tr>
<tr>
<td>Residual pre-production additional section 263A costs</td>
<td>60</td>
<td>136</td>
<td>220</td>
</tr>
<tr>
<td>Direct materials adjustments</td>
<td>$2,700</td>
<td>$3,200</td>
<td>$3,700</td>
</tr>
</tbody>
</table>
(2) Under paragraph (c)(4)(ii)(A) of this section, S computes the pre-production historic absorption ratio as follows:

$$\text{Pre-production additional section 263A costs incurred during the test period} = \frac{\$100 + 200 + 300}{\$2,000 + 2,500 + 3,000} = \frac{\$600}{\$7,500} = 8.00\%$$

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

$$\left(\frac{\text{Production additional section 263A costs incurred during the test period}}{\text{Production section 471 costs incurred during the test period}}\right) + \left(\frac{\text{Residual pre-production additional section 263A costs incurred during the test period}}{\text{Direct materials adjustments made during the test period}}\right) = \frac{\frac{\$200 + 350 + 450}{\$2,500 + 3,500 + 4,000} + \frac{60 + 136 + 220}{2,700 + 3,200 + 3,700}}{\frac{1,416}{19,600}} = \frac{\$1,416}{\$19,600} = 7.22\%$$

(4) In 2021, S incurs $10,000 of section 471 costs of which $1,000 pre-production section 471 costs and $2,000 production 471 costs remain in ending inventory. Under the modified simplified production method using a historic absorption ratio, S determines the pre-production additional section 263A costs allocable to its ending inventory by multiplying its pre-production historic absorption ratio (8.00%) by the pre-production section 471 costs remaining on hand at year end ($1,000). Thus, S allocates $80 of pre-production additional section 263A costs to its ending inventory (8.00% x $1,000). S determines the production additional section 263A costs allocable to its ending inventory by multiplying its production historic absorption ratio (7.22%) by the production section 471 costs remaining on hand at year end ($2,000). Thus, S allocates $144 of production additional section 263A costs to its ending inventory (7.22% x $2,000).

(5) Under paragraph (c)(4)(i) of this section, S's total additional section 263A costs allocable to ending inventory in 2021 are $224, which is the sum of the allocable pre-production additional section 263A costs ($80) and the allocable production additional section 263A costs ($144). S's ending inventory in 2021 is $3,224, 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 ($224 + $3,000). The balance of S's additional section 263A costs incurred during 2021 is taken into account in 2021 as part of S's cost of goods sold.

(B) Example 2--HAR and LIFO inventory method. (1)(i) The facts are the same as in Example 1 in paragraph (c)(4)(v)(A) of this section, except that S uses a dollar-value 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)(4)(iii) of this section and identifies the following costs incurred during the test period:

<table>
<thead>
<tr>
<th></th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Additional section 263A costs incurred during the taxable year allocable to ending inventory</td>
<td>$90</td>
<td>$137</td>
<td>$167</td>
</tr>
<tr>
<td>Section 471 costs incurred during the taxable year that remain in ending inventory</td>
<td>$1,000</td>
<td>$1,400</td>
<td>$2,100</td>
</tr>
</tbody>
</table>

(ii) In 2021, the LIFO value of S’s increment is $1,500.

(2) Under paragraph (c)(4)(iii) of this section, S computes a combined historic absorption ratio as follows:

\[
\frac{\text{Total allocable additional section 263A costs incurred during the test period}}{\text{Total section 471 costs remaining on hand at each year end of the test period}} = \frac{$90 + 137 + 167}{1,000 + 1,400 + 2,100} = \frac{$394}{4,500} = 8.76\%
\]

(3) S’s additional section 263A costs allocable to its 2021 LIFO increment are $131 ( $1,500 beginning LIFO increment x 8.76% combined historic absorption ratio). S adds the $131 to the $1,500 LIFO increment to determine a total 2021 LIFO increment of $1,631.

* * * * *

(g) * * *

(3) Paragraph (c) of this section applies for taxable years beginning on or after [INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]. For any taxable year that both begins before [INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER] and ends after [INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER], the IRS will not challenge return positions consistent with all of paragraphs (c) of this section.

Par. 5. Section 1.263A-3 is amended by:

1. Revising paragraph (a)(4)(i).
2. Designating the text of paragraph (d)(4)(v) as paragraph (d)(4)(v)(A) and adding a paragraph heading.


The revision and additions read as follows:

§1.263A-3 Rules relating to property acquired for resale.

(a) * * *

(4) * * *

(i) In general. Except as provided in paragraphs (a)(4)(ii) and (iii) of this section, a taxpayer may elect the simplified production method, as described in §1.263A–2(b), or the modified simplified production method, as described in §1.263A–2(c), but may not elect the simplified resale method, as described in paragraph (d) of this section, if the taxpayer is engaged in both production and resale activities with respect to the items of eligible property listed in §1.263A–2(b)(2).

* * * * *

(d) * * *

(4) * * *

(v) * * *

(A) Transition to elect historic absorption ratio. * * *

(B) Transition to revoke historic absorption ratio. Notwithstanding the requirements provided in paragraph (d)(4)(iii)(B) of this section regarding revocations of the historic absorption ratio during a qualifying period, a taxpayer will be permitted to revoke the historic absorption ratio in their first, second, or third taxable year ending on or after [INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER], under
such administrative procedures and with terms and conditions prescribed by the Commissioner.

Par. 6. In §1.263A-7, paragraph (b)(2)(iii)(A)(2)(ii) is revised to read as follows:

§1.263A-7 Changing a method of accounting under section 263A.

(b) * * *

(2) * * *

(iii) * * *

(A) * * *

(ii) Simplified method used. A dollar-value LIFO taxpayer using the 3-year average method and the simplified production method, the modified simplified production method, or the simplified resale method to revalue its inventory is permitted, but not required, to establish a new base year.

Par. 7. In §1.471-3, paragraph (b) is revised to read as follows:

§1.471-3 Inventories at cost.

(b) In the case of merchandise purchased since the beginning of the taxable year, the invoice price less trade or other discounts, except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer, provided a consistent course is followed. To this net invoice price should be
added transportation or other necessary charges incurred in acquiring possession of the
goods. But see §1.263A-1(d)(2)(iv)(C) for special rules for certain direct material costs
that in certain cases are permitted to be capitalized as additional section 263A costs by
taxpayers using a simplified method under §1.263A-2(b) or (c) or §1.263A-3(d). For
taxpayers acquiring merchandise for resale that are subject to the provisions of section
263A, see §§1.263A-1 and 1.263A-3 for additional amounts that must be included in
inventory costs.

* * * * *

Kirsten Wielobob,

Deputy Commissioner for Services and Enforcement.

Approved: July 23, 2018.

David J. Kautter,

Assistant Secretary of the Treasury (Tax Policy).

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on November 6, 2018.

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